



Department  
of the  
Treasury

Internal  
Revenue  
Service

# Your Federal Income Tax For Individuals

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For use in  
preparing  
**1999**  
Returns

*Tax  
Guide  
for*



**1999**

*Individuals*

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# Your Federal Income Tax For Individuals

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All material in this publication may be reprinted freely. A citation to Your Federal Income Tax (1999) would be appropriate.

The explanations and examples in this publication reflect the interpretation by the Internal Revenue Service (IRS) of:

- Tax laws enacted by Congress,
- Treasury regulations, and
- Court decisions.

However, the information given does not cover every situation and is not intended to replace the law or change its meaning.

This publication covers some subjects on which a court may have made a decision more favorable to taxpayers than the interpretation by the IRS. Until these differing interpretations are resolved by higher court decisions or in some other way, this publication will continue to present the interpretation by the IRS.

All taxpayers have important rights when working with the IRS. These rights are described in *Your Rights as a Taxpayer* in the back of this publication.

**The IRS Mission.** Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.

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## Introduction

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This publication can help you prepare your tax return by taking you through each part of the return. It supplements the information in your tax form instruction booklet. It explains the tax law and will help you understand your taxes so that you pay only the tax you owe and no more.

The publication begins with the rules for filing a tax return. It explains who must file a return, which tax form to use, when the return is due, and other general information. It will help you identify which filing status you qualify for, whether you can claim any dependents, and whether the income you are receiving is taxable. The publication goes on to explain the standard deduction, the kinds of expenses you may be able to deduct, and the vari-

ous kinds of credits you may be able to take to reduce your tax.

Throughout the publication are examples showing how the tax law applies in typical situations. Sample forms and schedules show you how to report certain items on your return. Also throughout the publication are flowcharts and tables that present tax information in an easy-to-understand manner.

The index in the back of the publication will help you find the information you need.

Some material that you may find helpful is not included in this publication but can be found in your tax form instruction booklet. It includes the following information.

- List of mailing addresses for where to file returns.
- List of recorded tax information topics (TeleTax).
- List of where to report certain items listed on information documents.
- List of mailing addresses for where to file returns.
- List of recorded tax information topics (TeleTax).

If you operate your own business or have other self-employment income, such as babysitting or selling crafts, see the following publications for more information.

- Publication 334, *Tax Guide for Small Business*.
- Publication 533, *Self-Employment Tax*.
- Publication 535, *Business Expenses*.
- Publication 587, *Business Use of Your Home (Including Use by Day-Care Providers)*.

For information on how you can get free IRS publications and forms, see *How To Get More Information* in the back of this publication.

We welcome your suggestions for future editions of this publication. Please send your ideas to the following address.

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We respond to many letters by telephone. Therefore, it would be helpful if you would include your area code and daytime phone number along with your return address.

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## Important Changes for 1999

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This section summarizes important tax changes that took effect in 1999. These changes are discussed in more detail throughout this publication.

Changes are also discussed in Publication 553, *Highlights of 1999 Tax Changes*.

**Child tax credit.** You may be able to claim a tax credit for each of your qualifying children under the age of 17. For 1999, this credit can be as much as \$500 for each qualifying child. See chapter 35.

**Interest on student loans.** You may be able to claim a deduction for interest paid on a qualified student loan. The maximum deduction for interest paid on a qualified student loan is increased to \$1,500. You claim the deduction on line 24 of Form 1040 or line 16 of Form 1040A. See your form instructions.

**Tax from recapture of education credits.** You may owe this tax if you claimed an education credit on your 1998 return and, in 1999, you, your spouse if filing jointly, or your dependent received:

- A refund of qualified tuition and related expenses, or

- Tax-free educational assistance.

See chapter 36.

**Individual retirement arrangements (IRA).** Generally, if you have a traditional IRA and are covered by an employer retirement plan, the amount of income you can have and not be affected by the deduction phaseout is increased. The amounts vary depending on filing status. See chapter 18 for details.

**Capital gain distributions.** For 1999, if the only amount you would have to report on Schedule D (Form 1040) is a capital gain distribution, you may be able to report that amount directly on Form 1040, line 13. See chapter 17.

**Foreign earned income exclusion.** The amount of foreign earned income that you can exclude increases to \$74,000. See Publication 54, *Tax Guide for U.S. Citizens and Resident Aliens Abroad*.

**Standard mileage rate.** The standard mileage rate for the cost of operating your car is 32½ cents a mile for all business

miles driven before April 1, 1999. The rate is 31 cents a mile for all business miles driven after March 31, 1999. See chapter 28.

**Self-employed health insurance.** The part of your self-employed health insurance premiums that you can deduct as an adjustment to income increased to 60%. See chapter 23.

**Stop smoking program.** You can now include in medical expenses the amount you pay for a program to stop smoking and for prescribed drugs to treat nicotine withdrawal. See chapter 23.

**Certain amounts increased.** Some tax items that are indexed for inflation increased for 1999.

**Earned income credit.** The maximum amount of income you can earn and still get the earned income credit has increased. You may be able to take the credit if you earned less than \$30,580 (\$10,200 if you do not have any qualifying children). The maximum amount of investment income you can have and still be eligible for the credit has increased to \$2,350. See chapter 37.

**Exemption amount.** You are allowed a \$2,750 deduction for each exemption to which you are entitled. However, your exemption amount could be phased out if you have high income. See chapter 3.

**Limit on itemized deductions.** Some of your itemized deductions may be limited if your adjusted gross income is more than \$126,600 (\$63,300 if you are married filing separately). See chapter 22.

**Social security and Medicare taxes.** The maximum wages subject to social security tax (6.2%) is increased to \$72,600. All wages are subject to Medicare tax (1.45%).

**Photographs of missing children.** The Internal Revenue Service is a proud partner with the National Center for Missing and Exploited Children. Photographs of missing children selected by the Center may appear in this publication on pages that would otherwise be blank. You can help bring these children home by looking at the photographs and calling **1-800-THE-LOST (1-800-843-5678)** if you recognize a child.

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## Important Reminders

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Listed below are important reminders and other items that may help you file your 1999 tax return. Many of these items are explained in more detail later in this publication.

**Write in your social security number.** To protect your privacy, social security numbers (SSNs) are not printed on the peel-off label that comes in the mail with your tax instruction booklet. This means you must enter your SSN in the space provided on your tax form. If you filed a joint return for 1998 and are filing a joint return for 1999 with the same spouse, enter your names and SSNs in the same order as on your 1998 return. See chapter 1.

**Taxpayer identification numbers.** You must provide the taxpayer identification number for each person for whom you claim certain tax benefits. This applies even if the person was born in 1999. Generally, this number is the person's social security number (SSN). See chapter 1.

**Advance earned income credit.** If a qualifying child lives with you and you expect to qualify for the earned income credit in 2000, you may be able to get part of the credit paid to you in advance throughout the year (by your employer) instead of waiting until you file your tax return. See chapter 37.

**Sale of your home.** Generally, you will only need to report the sale of your home if your gain is

more than \$250,000 (\$500,000 if married filing a joint return). See chapter 16.

**Individual retirement arrangements (IRAs).** The following paragraphs highlight important reminders that relate to IRAs. See chapter 18 for details.

**Individual retirement arrangement (IRA) for spouse.** A married couple filing a joint return can contribute up to \$2,000 each to their IRAs, even if one spouse had little or no income.

**Spouse covered by plan.** Even if your spouse is covered by an employer-sponsored retirement plan, you may be able to deduct contributions to your traditional IRA if you are not covered by an employer plan.

**Roth IRA.** You may be able to establish a Roth IRA. In this type of IRA, contributions are not deductible but earnings grow tax free and qualified withdrawals are not taxable. You may also be able to convert a traditional IRA to a Roth IRA, but you must include all or part of the taxable converted amount in income.

**Foreign source income.** If you are a U.S. citizen with income from sources outside the United States (foreign income), you must report all such income on your tax return unless it is exempt by U.S. law. This is true whether you reside inside or outside the United States and whether or not you receive a Form W-2 or 1099 from the foreign payer. This applies to earned income (such as wages and tips) as well as unearned

income (such as interest, dividends, capital gains, pensions, rents and royalties).

If you reside outside the United States, you may be able to exclude part or all of your foreign source earned income. For details, see Publication 54, *Tax Guide for U.S. Citizens and Resident Aliens Abroad*.

**Claiming the foreign tax credit.** If your foreign taxes are \$300 or less (\$600 or less in the case of a joint return) and all your foreign income is passive income, you may be able to claim the foreign tax credit without filing Form 1116. See chapter 38.

**Joint return responsibility.** Generally, both spouses are responsible for the tax and any interest or penalties on a joint tax return. In some cases, one spouse may be relieved of that responsibility for items of the other spouse that were incorrectly reported on the joint return. For details, see *Joint responsibility* in chapter 2.

**Include your phone number on your return.** To promptly resolve any questions we have in processing your tax return, we would like to be able to call you. Please enter your daytime telephone number on your tax form in the space provided next to your signature.

**Payment of taxes.** Make your check or money order payable to "United States Treasury." You may be able to pay your taxes by credit card. See chapter 1.

**Faster ways to file your return.** The IRS offers fast, accurate ways to file your tax return information. These include the following methods:

- IRS e-file (electronic filing),
- TeleFile, and
- Computerized returns.

For details on these fast filing methods, see chapter 1.

**Private delivery services.** You may be able to use a designated private delivery service to mail your tax returns and payments. See chapter 1 for more information.

**Privacy Act and paperwork reduction information.** The Privacy Act of 1974 and the Paperwork Reduction Act of 1980 say that when we ask you for information we must first tell you what our legal right is to ask for the information, why we are asking for it, how it will be used, what could happen if we do not receive it, and whether your response is voluntary, required to obtain a benefit, or mandatory under the law. A complete statement on this subject can be found in your tax form instruction booklet.

**Treasury Inspector General for Tax Administration.** If you want to confidentially report misconduct, waste, fraud, or abuse by an IRS employee, you can call **1-800-336-4484** (1-800-877-8339 for TTY/TDD users). You can remain anonymous.

# Part One.

## The Income Tax Return

The five chapters in this part provide basic information on the tax system. They take you through the first steps of filling out a tax return—such as deciding what your filing status is, how many exemptions you can take, and what form to file. They also discuss recordkeeping requirements, IRS e-file (electronic filing), certain penalties, and the two methods used to pay tax during the year: withholding and estimated tax.

### 1.

## Filing Information

### Important Change

**Who must file.** Generally, the amount of income you can receive before you must file a return has been increased.

### Important Reminders

**Alternative filing methods.** Rather than filing a return on paper, you may be able to use one of the following methods.

- IRS e-file.
- TeleFile.
- Computerized return.

For information on these methods, see *Does My Return Have To Be On Paper*, later.

**Change of address.** If you change your address, you should notify the IRS. See *Change of Address*, later, under *What Happens After I File*.

**Write in your social security number.** You must write your social security number (SSN) in the spaces provided on your tax return. If you file a joint return, please write the SSNs in the same order as the names.

**Direct deposit of refund.** Instead of getting a paper check, you may be able to have your refund deposited directly into your account at a bank or other financial institution. See *Direct deposit* under *Refunds*, later.

**Installment agreement.** If you cannot pay the full amount due with your return, you may ask to make monthly installment payments. See *Installment Agreement*, later, under *Amount You Owe*.

**Service in combat zone.** You are allowed extra time to take care of tax matters if you are a member of the Armed Forces who served in a combat zone, or if you served in the combat zone in support of the Armed Forces. See *Individuals Serving in Combat Zone*, later, under *When Do I Have To File*.

**Adoption taxpayer identification number.** If a child has been placed in your home for purposes of legal adoption and you will not be able to get a social security number (SSN) for the child in time to file your return, you may be able to get an adoption taxpayer identification number (ATIN). See *Adoptive child with no SSN*, later, under *Social Security Number*.

**Taxpayer identification number for aliens.** If you or your dependent is a nonresident or resident alien who does not have and is not eligible to get a social security number, file **Form W-7** with the IRS to apply for an Individual Taxpayer Identification Number (ITIN). For more information on ITINs, see *Social Security Number* under *How Do I Prepare My Return*.

## Introduction

This chapter discusses:

- Whether you have to file a return,
- Which form to use,
- When, how, and where to file your return,
- What happens if you pay too little or too much tax,
- What records you should keep and how long you should keep them, and
- How you can change a return you have already filed.


## Do I Have To File a Return?

You must file a federal income tax return if you are a citizen or resident of the United States or a resident of Puerto Rico and you meet the filing requirements for any of the following categories that apply to you.

- 1) Individuals in general. (There are special rules for surviving spouses, executors, administrators, legal representatives, U.S. citizens living outside the United States, residents of Puerto Rico, and individuals with income from U.S. possessions.)
- 2) Dependents.
- 3) Self-employed persons.
- 4) Aliens.

The filing requirements for each category are explained in this chapter.

The filing requirements apply even if you do not owe tax.

 **TIP** Even if you do not have to file a return, it may be to your advantage to do so. See *Who Should File*, later.

**One return.** File only **one** federal income tax return for the year regardless of how many jobs you had, how many Forms W-2 you received, or how many states you lived in during the year.

### Individuals—In General

If you are a U.S. citizen or resident, whether you must file a return depends on three factors:


- 1) Your gross income,
- 2) Your filing status, and
- 3) Your age.

To find out whether you must file, see *Table 1-1*, *Table 1-2*, and *Table 1-3*. Even if no table shows that you must file, you may need to file to get money back (see *Who Should File*, later).

**Gross income.** This includes all income you receive in the form of money, goods, property, and services that is not exempt from tax. Common types of income are discussed in the chapters in *Part Two* of this publication.

**Community property.** If you are married and your permanent home is in a community property state, half of any income described by state law as community income may be considered yours. This affects your federal taxes, including whether you must file, if you do not file a joint return with your spouse. See *Publication 555, Community Property*, for more information.

**Self-employed individuals.** If you are self-employed, your gross income includes the amount on line 7 of Schedule C (Form 1040), *Profit or Loss From Business*, or line 1 of Schedule C-EZ (Form 1040), *Net Profit From Business*. See *Self-Employed Persons*, later, for more information about your filing requirements.

 **CAUTION** By not reporting all of your self-employment income, you could cause your social security benefits to be lower when you retire.

**Filing status.** Your filing status depends on whether you are single or married and on your family situation. Your filing status is determined on the last day of your tax year, which is December 31 for most taxpayers. See chapter 2 for an explanation of each filing status.

**Age.** If you are 65 or older at the end of the year, you generally can have a higher amount of gross income than other taxpayers before you must file. See *Table 1-1*. You are considered 65 on the day before your 65th birthday. For example, if your 65th birthday was on January 1, 2000, you are considered 65 for 1999.

### Surviving Spouses, Executors, Administrators, or Legal Representatives

You must file a final return for a decedent (a person who died) if both of the following are true.

- You are the surviving spouse, executor, administrator, or legal representative.
- The decedent met the filing requirements at the date of death.

For more information on rules for filing a decedent's final return, see chapter 4.

### U.S. Citizens Living Outside the United States

If you are a U.S. citizen living outside the United States, you must file a return if you meet the filing requirements. For information on special tax rules that may apply to you, get Publication 54, *Tax Guide for U.S. Citizens and Resident Aliens Abroad*. It is available at most U.S. embassies and consulates. Also see *How To Get More Information* in the back of this publication.

### Residents of Puerto Rico

Generally, if you are a U.S. citizen and a resident of Puerto Rico, you must file a U.S. income tax return if you meet the filing requirements. This is in addition to any legal requirement you may have to file an income tax return for Puerto Rico.

If you are a resident of Puerto Rico for the entire year, gross income does not include income from sources within Puerto Rico, except for amounts received as an employee of the United States or a United States agency. If you receive income from Puerto Rican sources that is not subject to U.S. tax, you must reduce your standard deduction. As a result, the amount of income you must have before you are required to file a U.S. income tax return is lower than the applicable amount in *Table 1-1* or *Table 1-2*. See *U.S. taxation* and its discussion, *Standard deduction*, under *The Commonwealth of Puerto Rico* in Publication 570, *Tax Guide for Individuals With Income From U.S. Possessions*, for further information.

### Individuals With Income From U.S. Possessions

If you had income from Guam, the Commonwealth of the Northern Mariana Islands, American Samoa, or the Virgin Islands, special rules may apply when determining whether you must file a U.S. federal income tax return. In addition, you may have to file a return with the individual island government. See Publication 570 for more information.

**Table 1-1. 1999 Filing Requirements for Most Taxpayers**

To use this table, first find your marital status at the end of 1999. Then, read across the line that shows your filing status and age at the end of 1999. You must file a return if your gross income was at least the amount shown in the last column.			
Gross income means all income you received in the form of money, goods, property, and services that is not exempt from tax, including any income from sources outside the United States (even if you may exclude part or all of it).			
When using this table, do not include social security benefits as gross income unless you are married filing a separate return and lived with your spouse at any time in 1999. (If you must include the benefits, see chapter 12 for the amount to include.)			
Also, see <i>Table 1-2</i> and <i>Table 1-3</i> for other situations when you must file a return.			
Marital Status	Filing Status	Age*	Gross Income
Single (including divorced and legally separated)	Single	under 65 65 or older	\$7,050 \$8,100
	Head of household	under 65 65 or older	\$9,100 \$10,150
Married, with a child, living apart from your spouse during the last 6 months of 1999	Head of household	under 65 65 or older	\$9,100 \$10,150
		Married, joint return	under 65 (both spouses) 65 or older (one spouse) 65 or older (both spouses)
Married, living with your spouse at end of 1999 (or on the date your spouse died)	Married, separate return	any age	\$2,750
	Married, joint or separate return	any age	\$2,750
Married, not living with your spouse at end of 1999 (or on the date your spouse died)	Single	under 65 65 or older	\$7,050 \$8,100
		Head of household	under 65 65 or older
Widowed before 1999 and not remarried in 1999	Qualifying widow(er) with dependent child	under 65 65 or older	\$9,950 \$10,800

\*If you turned age 65 on January 1, 2000, you are considered to be age 65 at the end of 1999.

### Dependents

If you are a dependent (one who meets the dependency tests in chapter 3), see *Table 1-2* to find whether you must file a return. You also must file if your situation is described in *Table 1-3*.

**Responsibility of parent.** Generally, a child is responsible for filing his or her own tax return and for paying any tax on the return. But if a dependent child who must file an income tax return cannot file it for any reason, such as age, a parent, guardian, or other legally responsible person must file it for the child. If the child cannot sign the return, the parent or guardian must sign the child's name followed by the words "By (signature), parent (or guardian) for minor child."

**Child's earnings.** Amounts a child earns by performing services are his or her gross income. This is true even if under local law the child's parents have the right to the earnings and may actually have received them. If the child does not pay the

tax due on this income, the parent is liable for the tax.

### Child Under Age 14

If a child's only income is interest and dividends (including Alaska Permanent Fund dividends) and certain other conditions are met, a parent can elect to include the child's income on the parent's return. If this election is made, the child does not have to file a return. See *Parent's Election To Report Child's Interest and Dividends* in chapter 32.

### Self-Employed Persons

You are self-employed if you:

- Carry on a trade or business as a sole proprietor,
- Are an independent contractor,
- Are a member of a partnership, or
- Are in business for yourself in any other way.

Table 1–2. **1999 Filing Requirements for Dependents**

See chapter 3 to find out if someone can claim you as a dependent.

<p>If your parents (or someone else) can claim you as a dependent, and any of the situations below apply to you, you must file a return. (See Table 1–3 for other situations when you must file.)</p> <p>In this table, <b>earned income</b> includes salaries, wages, tips, and professional fees. It also includes taxable scholarship and fellowship grants (see <i>Scholarship and Fellowship Grants</i> in chapter 13). <b>Unearned income</b> includes investment-type income such as interest, dividends, and capital gains. It also includes unemployment compensation, taxable social security benefits, pensions, annuities, and distributions of unearned income from a trust.</p> <p><b>Caution:</b> If your gross income was \$2,750 or more, you generally cannot be claimed as a dependent unless you were under age 19 or a full-time student under age 24. For details, see <i>Gross Income Test</i> in chapter 3.</p>
<p><b>Single dependents</b>—Were you either age 65 or older or blind?</p> <p><input type="checkbox"/> <b>No.</b> You must file a return if any of the following apply.</p> <ul style="list-style-type: none"> <li>● Your unearned income was more than \$700.</li> <li>● Your earned income was more than \$4,300.</li> <li>● Your gross income was more than the larger of:             <ol style="list-style-type: none"> <li>1) \$700, or</li> <li>2) Your earned income (up to \$4,050) plus \$250.</li> </ol> </li> </ul> <p><input type="checkbox"/> <b>Yes.</b> You must file a return if any of the following apply.</p> <ul style="list-style-type: none"> <li>● Your earned income was more than \$5,350 (\$6,400 if 65 or older <b>and</b> blind).</li> <li>● Your unearned income was more than \$1,750 (\$2,800 if 65 or older <b>and</b> blind).</li> <li>● Your gross income was more than:             <ol style="list-style-type: none"> <li>1) The larger of \$700, or your earned income (up to \$4,050) plus \$250, plus</li> <li>2) \$1,050 (\$2,100 if 65 or older <b>and</b> blind).</li> </ol> </li> </ul>
<p><b>Married dependents</b>—Were you either age 65 or older or blind?</p> <p><input type="checkbox"/> <b>No.</b> You must file a return if any of the following apply.</p> <ul style="list-style-type: none"> <li>● Your gross income was at least \$5 and your spouse files a separate return and itemizes deductions.</li> <li>● Your earned income was more than \$3,600.</li> <li>● Your unearned income was more than \$700.</li> <li>● Your gross income was more than the larger of:             <ol style="list-style-type: none"> <li>1) \$700, or</li> <li>2) Your earned income (up to \$3,350) plus \$250.</li> </ol> </li> </ul> <p><input type="checkbox"/> <b>Yes.</b> You must file a return if any of the following apply.</p> <ul style="list-style-type: none"> <li>● Your gross income was at least \$5 and your spouse files a separate return and itemizes deductions.</li> <li>● Your earned income was more than \$4,450 (\$5,300 if 65 or older <b>and</b> blind).</li> <li>● Your unearned income was more than \$1,550 (\$2,400 if 65 or older <b>and</b> blind).</li> <li>● Your gross income was more than:             <ol style="list-style-type: none"> <li>1) The larger of \$700 or your earned income (up to \$3,350) plus \$250, plus</li> <li>2) \$850 (\$1,700 if 65 or older <b>and</b> blind).</li> </ol> </li> </ul>

Self-employment can include work in addition to your regular full-time business activities. It also includes certain part-time work that you do at home or in addition to your regular job.

You must file a return if your gross income is at least as much as the filing requirement amount for your filing status and age (shown in Table 1–1). Also, you must file Form 1040 and **Schedule SE** (Form 1040), *Self-Employment Tax*, if:

- 1) Your net earnings from self-employment (excluding church employee income) were \$400 or more, or
- 2) You had church employee income of \$108.28 or more (see Table 1–3).

Use Schedule SE (Form 1040) to figure your self-employment tax. Self-employment tax is comparable to the social security and Medicare tax withheld from an employee's wages. For more information about this tax, get Publication 533, *Self-Employment Tax*.

**Foreign governments or international organizations.** If you are a U.S. citizen who works in the United States for an international organization, a foreign government,

or a wholly owned instrumentality of a foreign government, and your employer does not deduct social security and Medicare taxes from your income, you must include your earnings from services performed in the United States when figuring your net earnings from self-employment.

**Ministers.** You must include income from services you performed as a minister when figuring your net earnings from self-employment, unless you have requested and received an exemption from self-employment tax. This also applies to Christian Science practitioners and members of a religious order who have not taken a vow of poverty. For more information, get Publication 517, *Social Security and Other Information for Members of the Clergy and Religious Workers*.

## Aliens

Your status as an alien—resident, nonresident, or dual-status—determines whether and how you must file an income tax return.

The rules used to determine your alien status are discussed in Publication 519, *U.S. Tax Guide for Aliens*.

**Resident alien.** If you are a resident alien for the entire year, you must file a tax return following the same rules that apply to U.S. citizens. Use the forms discussed in this publication.

**Nonresident alien.** If you are a nonresident alien, the rules and tax forms that apply to you are different from those that apply to U.S. citizens and resident aliens. See Publication 519 to find out if U.S. income tax laws apply to you and which forms you should file.

**Dual-status taxpayer.** If you were a resident alien for part of the tax year and a nonresident alien for the rest of the year, you are a dual-status taxpayer. Different rules apply for each part of the year. For information on dual-status taxpayers, see Publication 519.

## Who Should File

**TIP** Even if you do not have to file, you should file a federal income tax return to get money back if any of the following conditions apply.

- 1) You had income tax withheld from your pay.
- 2) You qualify for the earned income credit. See chapter 37 for more information.
- 3) You qualify for the additional child tax credit. See chapter 35 for more information.

## Which Form Should I Use?

You must use one of three forms to file your return: Form 1040EZ, Form 1040A, or Form 1040. (But also see *Does My Return Have To Be On Paper*, later.)

## Form 1040EZ

Form 1040EZ is the simplest form to use.

**You can use Form 1040EZ if all of the following apply.**

- 1) Your filing status is single or married filing jointly.
- 2) You (and your spouse if married filing a joint return) were under age 65 on January 1, 2000, and not blind at the end of 1999.
- 3) You do not claim any dependents.
- 4) Your taxable income is less than \$5,000.
- 5) Your income is only from wages, salaries, tips, unemployment compensation, Alaska Permanent Fund dividends, taxable scholarship and fellowship grants, qualified state tuition program earnings, and taxable interest of \$400 or less.
- 6) You did not receive any advance earned income credit (EIC) payments.
- 7) If you were a nonresident alien at any time in 1999, your filing status is married filing jointly.

- 8) You do not claim any adjustments to income, such as a deduction for IRA contributions or student loan interest.
- 9) You do not claim any credits other than the earned income credit.

You must meet all of these requirements to use Form 1040EZ. If you do not, you must use Form 1040A or Form 1040.

## Form 1040A

If you do not qualify to use Form 1040EZ, you may be able to use Form 1040A.

**You can use Form 1040A if all of the following apply.**

- 1) Your income is **only** from wages, salaries, tips, IRA distributions, pensions and annuities, taxable social security and railroad retirement benefits, taxable scholarship and fellowship grants, interest, ordinary dividends (including Alaska Permanent Fund dividends), qualified state tuition program earnings, and unemployment compensation.
- 2) Your taxable income is less than \$50,000.
- 3) Your adjustments to income are for only the following items.
  - a) The deduction for contributions to an IRA.
  - b) The student loan interest deduction.
- 4) You do not itemize your deductions.
- 5) Your taxes are from only the following items.
  - a) Tax Table.
  - b) Alternative minimum tax (see chapter 31).
  - c) Advance earned income credit (EIC) payments, if you received any (see chapter 37).
- 6) You claim only the following credits.
  - a) The credit for child and dependent care expenses (see chapter 33).
  - b) The credit for the elderly or the disabled (see chapter 34).
  - c) The child tax credit (see chapter 35).
  - d) The education credits (see chapter 36).
  - e) The earned income credit (see chapter 37).
  - f) The adoption credit (see chapter 38).

You must meet all of the above requirements to use Form 1040A. If you do not, you must use Form 1040.

## Form 1040

If you cannot use Form 1040EZ or Form 1040A, you must use Form 1040. You can use Form 1040 to report all types of income, deductions, and credits, including those you cannot put on either Form 1040EZ or Form 1040A.

You may have received Form 1040A or Form 1040EZ in the mail because of the

## Table 1–3. Other Situations When You Must File a 1999 Return

If any of the four conditions listed below apply, you must file a return, even if your income is less than the amount shown in *Table 1–1* or *Table 1–2*.

1. You owe any special taxes, such as:

- Social security or Medicare tax on tips you did not report to your employer. (See chapter 7.)
- Uncollected social security, Medicare, or railroad retirement tax on tips you reported to your employer. (See chapter 7.)
- Uncollected social security, Medicare, or railroad retirement tax on your group-term life insurance.
- Alternative minimum tax. (See chapter 31.)
- Tax on a qualified retirement plan, including an individual retirement arrangement (IRA). (See chapter 18.)
- Tax on a medical savings account (MSA). (See Publication 969, *Medical Savings Accounts (MSAs)*.)
- Tax from recapture of investment credit or a low-income housing credit you claimed in a previous year. (See the instructions for Form 4255, *Recapture of Investment Credit*, or Form 8611, *Recapture of Low-Income Housing Credit*.)
- Recapture tax on the disposition of a home purchased with a federally-subsidized mortgage. (See chapter 16.)
- Recapture of the qualified electric vehicle credit. (See chapter 38.)
- Recapture of the Indian employment credit.

2. You received any advance earned income credit (EIC) payments from your employer. This amount should be shown in box 9 of your Form W–2. (See chapter 37.)

3. You had net earnings from self-employment of at least \$400. (See *Self-Employed Persons* in this chapter.)

4. You had wages of \$108.28 or more from a church or qualified church-controlled organization that is exempt from employer social security and Medicare taxes. (See Publication 533.)

return you filed last year. If your situation has changed this year, it may be to your advantage to file Form 1040 instead. You may pay less tax by filing Form 1040 because you can take itemized deductions, and some adjustments to income, and credits that you cannot take on Form 1040A or Form 1040EZ.

**You must use Form 1040 if any of the following apply.**

- 1) Your taxable income is \$50,000 or more.
- 2) You itemize your deductions.
- 3) You received or paid accrued interest on securities transferred between interest payment dates.
- 4) You received nontaxable dividends or capital gain distributions.
- 5) You have to complete Part III of Schedule B (Form 1040) because:
  - a) You received a distribution from a foreign trust, or
  - b) You had a bank, securities, or other financial account in a foreign country at any time during the year.

**Note:** If the combined value of the foreign account(s) was \$10,000 or less during all of 1999,

or if the account(s) was with a U.S. military banking facility operated by a U.S. financial institution, you may be able to use Form 1040A or Form 1040EZ.

6) You had income that cannot be reported on Form 1040EZ or Form 1040A. This includes gain from the sale of property, barter income, alimony income, taxable refunds of state and local income taxes, and self-employment income (including farm income).

7) You sold or exchanged capital assets or business property.

8) You claim adjustments to gross income for payments to a medical savings account; moving expenses; one-half of your self-employment tax; payments for self-employed health insurance; payments to a Keogh, SEP, or SIMPLE plan; the penalty on early withdrawal of savings; alimony paid; certain required repayments of supplemental unemployment benefits; jury pay turned over to your employer; qualified performing artists' expenses; or other allowable adjustments to income.

9) Your Form W–2 shows uncollected employee tax (social security and Medicare tax) on tips or group-term life insurance in box 13. See chapter 7.



- 10) You received \$20 or more in tips in any one month and did not report all of them to your employer. See chapter 7.
- 11) You must pay tax on self-employment income. See Schedule SE (Form 1040), *Self-Employment Tax*.
- 12) You must pay household employment taxes. See Schedule H (Form 1040).
- 13) You have to recapture an investment credit, a low-income housing credit, a qualified electric vehicle credit, or an Indian employment credit you claimed in a previous year.
- 14) You have to recapture tax on the disposition of a home purchased with a federally-subsidized mortgage. See chapter 16.
- 15) You have to pay tax on an excess golden parachute payment.
- 16) You claim any of the following credits.
  - a) Mortgage interest credit.
  - b) Foreign tax credit.
  - c) Any general business credit.
  - d) Credit for prior year minimum tax.
  - e) Credit for fuel from a nonconventional source.
  - f) Credit for federal tax on fuels.
  - g) Qualified electric vehicle credit.
  - h) Regulated investment company credit.
- 17) You file any of the following forms.
  - a) Form 2555, *Foreign Earned Income*.
  - b) Form 2555-EZ, *Foreign Earned Income Exclusion*.
  - c) Form 4563, *Exclusion of Income for Bona Fide Residents of American Samoa*.
  - d) Form 4970, *Tax on Accumulation Distribution of Trusts*.
  - e) Form 4972, *Tax on Lump-Sum Distributions*. (See chapter 11.)
  - f) Form 5329, *Additional Taxes Attributable to IRAs, Other Qualified Retirement Plans, Annuities, Modified Endowment Contracts, and MSAs*.
 

**Note:** Do not file Form 1040 only because you have to file Form 5329. File Form 5329 by itself. (See chapters 11 and 18.)
  - g) Form 8271, *Investor Reporting of Tax Shelter Registration Number*.
  - h) Form 8814, *Parents' Election To Report Child's Interest and Dividends*.
  - i) Form 8853, *Medical Savings Accounts and Long-Term Care Insurance Contracts*.

## Does My Return Have To Be On Paper?

You may be able to file a paperless return, or a return with less paper. This section explains:

- 1) IRS *e-file* (electronic filing):
  - a) Using a tax professional,
  - b) Using your personal computer, or
  - c) Using a telephone (TeleFile), and
- 2) Computerized returns.

### IRS *e-file*

Table 1–4 lists the benefits of IRS *e-file*. IRS *e-file* uses automation to replace most of the manual steps needed to process paper returns. As a result, processing of *e-file* returns is faster and more accurate than the processing of paper returns. However, errors on the return or problems with its transmission can delay processing.

As with a paper return, you are responsible for making sure your return contains accurate information and is filed on time.

Using *e-file* does not affect your chances of an IRS examination of your return.

**State returns.** In most states, you can file an electronic state return simultaneously with your federal return. For more information, check with your local IRS office, state tax agency, tax professional, or the IRS Web site at [www.irs.gov](http://www.irs.gov).

**Refunds.** You can have a refund check mailed to you, or you can have your refund deposited directly to your checking or savings account.

With *e-file*, your refund will be issued in half the time as when filing on paper (even faster if you choose direct deposit). Most refunds are issued within 3 weeks. In many cases, you can receive your refund in about 14 days, particularly if you choose direct deposit.

**Offset against debts.** As with a paper return, you may not get all of your refund if you owe certain past-due amounts, such as federal tax, state tax, a student loan, or child support. See *Offset Against Debts* under *Refunds*, later.

**Refund inquiries.** If you do not receive your refund within 4 weeks after your return was accepted by IRS, you can call TeleTax Table 1–4. **Benefits of IRS *e-file***

<b>Accuracy</b>	• Computer program quickly checks for errors or missing information
<b>Acknowledgment</b>	• IRS provides an acknowledgment within 48 hours that your return has been accepted for processing
<b>File Now, Pay Later</b>	• File early and pay the balance due by April 17, 2000
<b>Fast Refunds</b>	• Expect to receive it in half the time as when filing on paper—even faster with direct deposit
<b>Simultaneous Federal/State Filing</b>	• File both federal and state tax returns with the IRS at the same time

Refund Information. See *What is TeleTax?* in your tax forms package for information on how to use this service.

If TeleTax has no information about your return, contact your tax professional or electronic return transmitter for the date IRS accepted your return. If your return was accepted more than 6 weeks ago, contact the IRS. Explain that you filed your return electronically and that TeleTax has no information on it. Also, provide the first social security number shown on your return and the date the IRS accepted your return.

**Balance due.** If you have a balance due with your return, you must pay it by April 17, 2000, to avoid late-payment penalties and interest. You can make your payment electronically, by credit card, or a direct debit to your checking or savings account. See your tax form instructions for how to make your payments electronically.

See *How To Pay*, later for other information on how to pay the balance due.

**VITA or TCE.** The IRS Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE) programs may be able to help you file your return electronically. For information on these programs, call the IRS.

### Using a Tax Professional

Many tax professionals file returns electronically for their clients. You can prepare your own return and have a professional electronically transmit it, or you can have your return prepared and transmitted by a tax professional. Depending on the tax professional, and the specific services requested, a fee may be charged. Look for the "Authorized IRS *e-file* Provider" sign.

**Form 8453.** Your tax professional will ask you to sign Form 8453, *U.S. Individual Income Tax Declaration for Electronic Filing*. Both spouses must sign if a joint return is being filed. Your tax professional will file the Form 8453, along with your Forms W–2 and other required documents, with the IRS. Your tax professional is required to give you the preparer-signed copy of your return, including a copy of the completed Form 8453. This material is for your records. Do not mail this copy to the IRS.

### Using a Personal Computer

If you have a computer and tax preparation software, you can *e-file* your return electronically from your home. Tax preparation software offering the *e-file* option is avail-

able at your local computer retailer or through various web sites over the Internet. You will need Internet access and, depending on the software program, a modem to file your return. Using your personal computer, you can file 24 hours a day, 7 days a week. You may be charged a fee for having your return transmitted to the IRS. Your electronic return transmitter will inform you when the IRS accepts your return.

**Form 8453-OL.** After the IRS has accepted your return, you will have to send the IRS Form 8453-OL, *U.S. Individual Income Tax Declaration for On-line Filing*, along with your Forms W-2 and other required documents. Form 8453-OL is available through your electronic return transmitter.

**Note.** If you filed electronically last year, you may receive a post card in the mail with an e-file customer number (ECN) instead of a tax return package. If you meet the requirements, you can use your ECN to file your return and not have to file any paper forms.

## Using a Telephone (TeleFile)

If you receive a TeleFile tax package, you may be able to file your Form 1040EZ information over the phone. If you are eligible to use TeleFile, IRS will send you the TeleFile tax package automatically. You can use TeleFile only if you receive the package. You cannot order it.

To file using TeleFile, follow the instructions in the TeleFile tax package. The call takes about 10 minutes and is free. You must use a touch-tone phone.

**TeleFile is a paperless system.** You will not have to mail a paper tax return or Forms W-2 to the IRS.

## Computerized Returns

Almost anyone who files a tax return (Form 1040, 1040A, or 1040EZ) can now file a 1040PC return instead. You prepare a 1040PC return on a personal computer. It generally has fewer pages than a conventional return.

The computer prints the return in a three-column "answer sheet" format. It prints line numbers and dollar amounts (and/or supporting explanations if necessary) only for lines on which you made an entry. Supporting tax forms and schedules are also printed in this format. As a result, an 11-page conventional return requiring forms and schedules can be printed as a two-page 1040PC return. For your records, the computer will also print out a legend paper with line item descriptions.

Tax preparation software that includes the 1040PC print option is checked and accepted by the IRS and has the 1040PC logo. It can be processed faster and more accurately than the regular tax return. Software packages are available at many computer software stores. Visit the IRS Website at [www.irs.gov](http://www.irs.gov) for a listing of software companies that provide the 1040PC option. For more information, call the TeleTax number for your area listed in your tax forms package.

## When Do I Have To File?

April 17, 2000, is the due date for filing your 1999 income tax return if you use the calendar year. For a quick view of due dates for filing a return with or without an extension of time to file (discussed later), see *Table 1-5*.

If you use a fiscal year (a year ending on the last day of any month except December, or a 52-53 week year), your income tax return is due by the 15th day of the 4th month after the close of your fiscal year.

When the due date for doing **any** act for tax purposes—filing a return, paying taxes, etc.—falls on a Saturday, Sunday, or legal holiday, the due date is delayed until the next business day.

**Filing on time.** Your return is filed on time if it is properly addressed and is postmarked by the due date. The return must have enough postage. If you send your return by registered mail, the date of the registration is the postmark date. The registration is evidence that the return was delivered. If you send a return by certified mail and have your receipt postmarked by a postal employee, the date on the receipt is the postmark date. The postmarked certified mail receipt is evidence that the return was delivered.

**Private delivery services.** If you use a private delivery service designated by the IRS (rather than the U.S. Postal Service) to send your return, the postmark date generally is the date the private delivery service records in its database or marks on the mailing label. The private delivery service can tell you how to get written proof of this date.

The following are designated private delivery services.

- Airborne Express (Airborne): Overnight Air Express Service, Next Afternoon Service, and Second Day Service.
- DHL Worldwide Express (DHL): DHL "Same Day" Service and DHL USA Overnight.
- Federal Express (FedEx): FedEx Priority Overnight, FedEx Standard Overnight, and FedEx 2Day.
- United Parcel Service (UPS): UPS Next Day Air, UPS Next Day Air Saver, UPS 2nd Day Air, and UPS 2nd Day Air A.M.



**Private delivery services cannot deliver items to P.O. boxes. You must use the U.S. Postal Service to mail any item to an IRS P.O. box address.**

**Filing late.** If you do not file your return by the due date, you may have to pay a failure-to-file penalty and interest. For more information, see *Penalties*, later. Also see *Interest under Amount You Owe*.

If your return is filed late, the postmark date does not determine the date of filing. Your return is considered filed when it is received by the Internal Revenue Service.

**Nonresident alien.** If you are a nonresident alien and earn wages subject to U.S. income tax withholding, your 1999 U.S. in-

come tax return (Form 1040NR or Form 1040NR-EZ) is due by:

- April 17, 2000, if you use a calendar year, or
- The 15th day of the 4th month after the end of your fiscal year if you use a fiscal year.

If you do not earn wages subject to U.S. income tax withholding, your return is due by:

- June 15, 2000, if you use a calendar year, or
- The 15th day of the 6th month after the end of your fiscal year, if you use a fiscal year.

Get Publication 519, *U.S. Tax Guide for Aliens*, for more filing information.

**Filing for a decedent.** If you must file a final return as an executor, administrator, legal representative, or surviving spouse of a taxpayer who died during the year (a decedent), the income tax return is due by the 15th day of the 4th month after the end of the decedent's normal tax year. In most cases, for a 1999 return, this will be April 17, 2000. See *Final Return for the Decedent* in chapter 4.

## Extensions of Time To File

You may be able to get an extension of time to file your return. Special rules apply if you were:

- Outside the United States, or
- Serving in a combat zone.

These rules are discussed separately.

**Form 4868.** If you cannot file your 1999 return by the due date, you may be able to get an automatic 4-month extension of time to file. To get the automatic extension, you must file Form 4868, *Application for Automatic Extension of Time To File U.S. Individual Income Tax Return*, unless you are using a credit card to make the required tax payment.

**Example.** If your return is due on April 17, 2000, you will have until August 15, 2000, to file.



**If you want the IRS to figure your tax, you cannot use the automatic extension of time to file. Nor can you use it if you are under a court order to file by the regular due date.**

**When to file.** You must file Form 4868 or make the required payment by credit card by the regular due date for your return. You can file your return any time before the 4-month extension period ends.

**Required payment.** An extension of time to file is not an extension of time to pay. You must make an accurate estimate of your tax for 1999 and send any necessary payment with your Form 4868. If you find you cannot pay the full amount due with Form 4868, you can still get the extension. You will owe interest on the unpaid amount.

Table 1–5. **When To File Your 1999 Return** (For U.S. citizens and residents who file returns on a calendar year)

	For Most Taxpayers	For Certain Taxpayers Outside the U.S.
No extension requested	April 17, 2000	June 15, 2000
Form 4868 filed (1st extension)	August 15, 2000	August 15, 2000
Form 2688 filed after filing Form 4868 (2nd extension)	October 16, 2000	October 16, 2000

You also may be charged a penalty for paying the tax late unless you have reasonable cause for not paying your tax when due. See *Penalties*, later.

Interest and penalties are assessed (charged) from the original due date of the return, which, for most taxpayers, is April 17, 2000.

**Credit card.** You do not have to submit Form 4868 if you pay by credit card. See *Payment by credit card*, under *How To Pay*, later.

**When you file your return.** Enter any payment you made on line 61, Form 1040. If you file Form 1040EZ or Form 1040A, include any payment you made in your total payments on line 9 of Form 1040EZ or line 39 of Form 1040A. Also print "Form 4868" and the amount paid in the space to the left of line 9 or line 39.

**Extension beyond 4 months.** If you qualify for the 4-month extension and you later find that you are not able to file within the 4-month extension period, you may be able to get 2 more months to file, for a total of 6 months.

You can apply for an extension beyond the 4-month extension either by writing a letter to the IRS or by filing **Form 2688**, *Application for Additional Extension of Time To File U.S. Individual Income Tax Return*. You should ask for the extension early so that, if it is not approved, you still will be able to file on time. Except in cases of undue hardship, a request for additional time will not be approved unless you have first used the automatic 4-month extension. Form 2688 or your letter will not be considered if you file it after the extended due date.

To get an extension beyond the automatic 4-month extension, you must give all the following information.

- The reason for requesting the extension.
- The tax year to which the extension applies.
- The length of time needed for the extension.
- Whether another extension of time to file has already been requested for this tax year.

You must sign the request for this extension, or it may be signed by your attorney, CPA, enrolled agent, or a person with a power of attorney. If you are unable to sign

the request because of illness or for another good reason, a person with a close personal or business relationship to you can sign for you, stating why you could not sign the request.

**Extension approved.** If your application for this extension is approved, you will be notified by the IRS. Attach the notice to your return when you file it.

If the IRS later determines that the statements made on your request for this extension are false or misleading and an extension would not have been approved at the time based on the true facts, the extension is null and void. You will have to pay the failure-to-file penalty (discussed later).

**Extension not approved.** If your application for this extension is not approved, you must file your return by the extended due date of the automatic extension. You may be allowed to file within 10 days of the date of the notice you get from the IRS if the end of the 10-day period is later than the due date. The notice will tell you if the 10-day grace period is granted.

**No further extensions.** An extension of more than 6 months will not be approved if you are in the United States.

### Individuals Outside the United States

You are allowed an automatic 2-month extension (until June 15, 2000, if you use the calendar year) to file your 1999 return and pay any federal income tax due if:

- 1) You are a U.S. citizen or resident, and
- 2) On the regular due date of your return (April 17, 2000, if you use the calendar year):
  - a) You are living outside of the United States and Puerto Rico, and your main place of business or post of duty is outside the United States and Puerto Rico, **or**
  - b) You are in military or naval service on duty outside the United States and Puerto Rico.

However, if you pay the tax due after the regular due date, interest will be charged from the regular due date until the date the tax is paid.

See *When To File and Pay* in Publication 54 for more information.

If you served in a combat zone, see *Individuals Serving in Combat Zone*, later, for special rules that apply to you.

**Married taxpayers.** If you file a joint return, only one spouse has to qualify for this automatic extension. If you and your spouse file separate returns, this automatic extension applies only to the spouse who qualifies.

**How to get the extension.** To use this special automatic extension, you must attach a statement to your return explaining what situation (see the situations listed under 2, earlier) qualified you for the extension.

**Extensions beyond 2 months.** If you cannot file your return within the automatic 2-month extension period, you may be able to get an additional 2-month extension, for a total of 4 months. Generally, you must file Form 4868 by the end of the automatic extension period (usually June 15, 2000) to get this additional 2-month extension.

This additional 2-month extension of time to file is **not** an extension of time to pay. See *Required payment*, earlier.

**Extension beyond 4 months.** If you are still unable to file your return within the 4-month extension, you may be able to get an extension for 2 more months, for a total of 6 months. See *Extension beyond 4 months*, earlier.

**No further extension.** An extension of more than 6 months will generally not be granted. However, if you are outside the United States and meet certain tests, you may be granted a longer extension. See *When To File and Pay* in Publication 54 for more information.

### Individuals Serving in Combat Zone

The deadline for filing your tax return, paying any tax you may owe, and filing a claim for refund is automatically extended if you serve in a combat zone. This applies to members of the Armed Forces, as well as Red Cross personnel, accredited correspondents, and civilians under the direction of the Armed Forces in support of the Armed Forces.

**Combat zone.** For purposes of the automatic extension, the term "combat zone" includes the following areas.

- 1) The Persian Gulf Area, effective August 2, 1990.
- 2) The qualified hazardous duty area of Bosnia and Herzegovina, Croatia, and Macedonia, effective November 21, 1995.
- 3) The qualified hazardous duty area of the Federal Republic of Yugoslavia (Serbia/Montenegro), Albania, the Adriatic Sea, and the Ionian Sea north of the 39th parallel, effective March 24, 1999.

See Publication 3, *Armed Forces' Tax Guide*, for information about other tax benefits available to military personnel serving in a combat zone.

**Extension period.** The deadline for filing your return, paying any tax due, and filing a claim for refund is extended for at least 180 days after the later of:

- 1) The last day you are in a combat zone (or the last day the area qualifies as a combat zone), or
- 2) The last day of any continuous qualified hospitalization for injury from service in the combat zone.

In addition to the 180 days, your deadline is also extended by the number of days you had left to take action with the IRS when you entered the combat zone. For example, you have 3½ months (January 1 – April 17, 2000) to file your 1999 tax return. Any days left in this period when you entered the combat zone (or the entire 3½ months if you entered it before January 1, 2000) are added to the 180 days. See *Extension of Deadline*, in Publication 3, for more information.

## How Do I Prepare My Return?

This section explains how to get ready to fill in your tax return and when to report your income and expenses. It also explains how to complete certain sections of the form. You may find *Table 1–6* helpful when you prepare your return.

In most cases, the IRS will mail you Form 1040, Form 1040A, or Form 1040EZ with related instructions, based on what you filed last year. Before you fill in the form, look it over to see if you need additional forms or schedules. You may also want to read *Does My Return Have To Be On Paper*, earlier.

If you do not receive a tax return package in the mail, or if you need other forms, you can order them. See *How To Get More Information* in the back of this publication.

### Table 1–6. 6 Steps for Preparing Your Return

- 1—Get your records together for income and expenses.
- 2—Get the forms, schedules, and publications you need.
- 3—Fill in your return.
- 4—Check your return to make sure it is correct.
- 5—Sign and date your return.
- 6—Attach all required forms and schedules.

**Substitute tax forms.** You cannot use your own version of a tax form unless it meets the requirements explained in Publication 1167, *Substitute Printed, Computer-Prepared, and Computer-Generated Tax Forms and Schedules*.

**Form W–2.** If you are an employee, you should receive Form W–2 from your employer. You will need the information from this form before you prepare your return.

If you do not receive Form W–2 by January 31, 2000, contact your employer. If you still do not get the form by February 15, the IRS can help you by requesting the form from your employer. For more information, see *Form W–2* under *Credit for Withholding and Estimated Tax* in chapter 5.

**Form 1099.** If you received certain types of income, you may receive a Form 1099. For example, if you received taxable interest of \$10 or more, the payer generally must give you a Form 1099–INT. If you have not received it by January 31, 2000, contact the payer. If you still do not get the form by February 15, call the IRS for help.

## When Do I Report My Income and Expenses?

You must figure your taxable income on the basis of a tax year. A “tax year” is an annual accounting period used for keeping records and reporting income and expenses. You must account for your income and expenses in a way that clearly shows your taxable income. The way you do this is called an accounting method. This section explains which accounting periods and methods you can use.

### Accounting Periods

Most individual tax returns cover a **calendar year** — the 12 months from January 1 through December 31. If you do not use a calendar year, your accounting period is a **fiscal year**. A regular fiscal year is a 12-month period that ends on the last day of any month except December. A 52–53 week fiscal year varies from 52 to 53 weeks and always ends on the same day of the week.

You must choose your accounting period when you file your first income tax return. It cannot be longer than 12 months.

**More information.** For more information on accounting periods, including how to change your accounting period, see Publication 538, *Accounting Periods and Methods*.

### Accounting Methods

Your accounting method is the way you account for your income and expenses. Most taxpayers use either the cash method or an accrual method. You choose a method when you file your first income tax return. If you want to change your accounting method after that, you generally must get IRS approval.

**Cash method.** If you use this method, report all items of income in the year in which you actually or constructively receive them. Deduct all expenses in the year you actually pay them. This is the method most individual taxpayers use.

**Constructive receipt.** You constructively receive income when it is credited to your account or set apart in any way that makes it available to you. You do not need to have physical possession of it. For example, interest credited to your bank account on December 31, 1999, is taxable income to you in 1999 if you could have withdrawn it in 1999 (even if the amount is

not entered in your passbook or withdrawn until 2000).

**Garnisheed wages.** If your employer uses your wages to pay your debts, or if your wages are attached or garnisheed, the full amount is constructively received by you. You must include these wages in income for the year you would have received them.

**Brokerage and other accounts.** Profits from a brokerage account, or similar account, are fully taxable in the year you earn them. This is true even if:

- 1) You do not withdraw the earnings,
- 2) The credit balance in the account may be reduced or eliminated by losses in later years, or
- 3) Current profits are used to reduce or eliminate a debit balance from previous years.

**Debts paid for you.** If another person cancels or pays your debts (but not as a gift or loan), you have constructively received the amount and generally must include it in your gross income for the year. See *Canceled Debts* in chapter 13 for more information.

**Payment to third party.** If a third party is paid income from property you own, you have constructively received the income. It is the same as if you had actually received the income and paid it to the third party.

**Payment to an agent.** Income an agent receives for you is income you constructively received in the year the agent receives it. If you indicate in a contract that your income is to be paid to another person, you must include the amount in your gross income when the other person receives it.

**Check received or available.** A valid check you received or that was made available to you before the end of the tax year is constructively received by you in that year, even if you do not cash the check or deposit it in your account until the next year.

**No constructive receipt.** There may be facts to show that you did not constructively receive income.

**Example.** Alice Johnson, a teacher, agreed to her school board's condition that, in her absence, she would receive only the difference between her regular salary and the salary of a substitute teacher hired by the school board. Therefore, Alice did not constructively receive the amount by which her salary was reduced to pay the substitute teacher.

**Accrual method.** If you use an accrual method, you generally report income when you earn it, rather than when you receive it. You generally deduct your expenses when you incur them, rather than when you pay them.

**Income paid in advance.** Prepaid income is generally included in gross income in the year you receive it. Your method of accounting does not matter as long as the income is available to you. Prepaid income includes rents or interest you receive in advance and pay for services you will perform later.

**Additional information.** For more information on accounting methods, including how to change your accounting method, get Publication 538.

## Social Security Number

You must enter your social security number (SSN) in the space provided on your return. Be sure the SSN on your return is the same as the SSN on your social security card. If you are married, enter the SSNs for both you and your spouse, whether you file jointly or separately.

If you are filing a joint return, write the SSNs in the same order as the names. Please use this same order in submitting other forms and documents to the IRS.

**Name change.** If you changed your name because of marriage, divorce, etc., immediately notify your Social Security Administration (SSA) office so the name on your tax return is the same as the one the SSA has on its records. This may prevent delays in issuing your refund and safeguard your future social security benefits.

**Dependent's social security number.** You must provide the SSN of each dependent you claim, regardless of the dependent's age. This requirement applies to **all dependents** (not just your children) claimed on your tax return.

**Exception.** If your child was born and died in 1999 and you do not have an SSN for the child, you may attach a copy of the child's birth certificate instead. If you do, enter "DIED" in column 2 of line 6c.

**No social security number.** File **Form SS-5** with your local SSA office to get an SSN for yourself or your dependent. It usually takes about 2 weeks to get an SSN. If you or your dependent is not eligible for an SSN, see *Individual taxpayer identification number for aliens*, later.

If you are a U.S. citizen, you must show proof of age, identity, and citizenship with your Form SS-5. If you are 18 or older, you must appear in person with this proof at an SSA office.

Form SS-5 is available at any SSA office. If you have any questions about which documents you can use as proof of age, identity, or citizenship, contact your SSA office.

If your dependent does not have an SSN by the time your return is due, you may want to ask for an extension of time to file, as explained earlier under *When Do I Have To File*.

If you do not provide a required SSN or if you provide an incorrect SSN, your tax may be increased and any refund may be reduced.

**Adoptive child with no SSN.** If you are in the process of adopting a child who is a U.S. citizen or resident and cannot get an SSN for the child until the adoption is final, you can apply for an adoption taxpayer identification number (an **ATIN**) to use instead of an SSN.

File **Form W-7A** with the IRS to get an ATIN if all of the following are true.

- You have a child living with you who was placed in your home for legal adoption by an authorized placement agency.
- You cannot get the child's existing SSN even though you have made a reason-

able attempt to get it from the birth parents, the placement agency, and other persons.

- You cannot get an SSN for the child from the SSA because, for example, the adoption is not final.
- You cannot get an ITIN for the child.
- You are eligible to claim the child as a dependent on your tax return.

After the adoption is final, you must apply for a social security number for the child. You cannot continue using the ATIN.

See **Form W-7A** for more information.

**Nonresident alien spouse.** If your spouse is a nonresident alien and you file a joint or separate return, your spouse must have either an SSN or an individual taxpayer identification number (ITIN). If your spouse is not eligible for an SSN, see the next discussion.

**Individual taxpayer identification number (ITIN) for aliens.** The IRS will issue you an ITIN if you are a nonresident or resident alien and you do not have and are not eligible to get an SSN. To apply for an ITIN, file **Form W-7** with the IRS. It usually takes about 30 days to get an ITIN. Enter this number on your tax return wherever your SSN is requested. An incorrect or missing taxpayer identification number may increase your tax or reduce your refund.

**Alien dependent.** If your dependent is a nonresident or resident alien who does not have and is not eligible to get a social security number (SSN), file **Form W-7** with the IRS to apply for an ITIN. Enter this number on your return wherever the dependent's SSN is requested.



*An ITIN is for tax use only. It does not entitle you or your dependent to social security benefits or change the employment or immigration status of either of you under U.S. law.*

**Penalty for not providing social security number.** If you do not include your SSN or the SSN of your spouse or dependent as required, you may have to pay a penalty. See the discussion on *Penalties*, later, for more information.

**SSN on correspondence.** If you write to the IRS about your tax account, be sure to include your SSN in your correspondence. Because your SSN is used to identify your account, this helps the IRS respond to your correspondence promptly.

## Presidential Election Campaign Fund

This fund was set up to help pay for presidential election campaigns. You may have \$3 of your tax liability go to this fund by checking the Yes box on **Form 1040**, **Form 1040A**, or **Form 1040EZ**. If you are filing a joint return, your spouse may also have \$3 go to the fund. If you check Yes, it will not change the tax you pay or the refund you will receive.

## Rounding Off Dollars

You may round off cents to whole dollars on your return and schedules. If you do round to whole dollars, you must round all amounts. To round, drop amounts under 50 cents and increase amounts from 50 to 99 cents to the next dollar. For example, \$1.39 becomes \$1 and \$2.50 becomes \$3.

If you have to add two or more amounts to figure the amount to enter on a line, include cents when adding the amounts and round off only the total.

**Example.** You receive two W-2 forms: one showing wages of \$5,000.55 and one showing wages of \$18,500.73. On **Form 1040**, line 7, you would enter \$23,501 (\$5,000.55 + \$18,500.73 = \$23,501.28), not \$23,502 (\$5,001 + \$18,501).

## Attachments

Depending on the form you file and the items reported on your return, you may have to complete additional schedules and forms and attach them to your return.

**Form W-2.** **Form W-2, Wage and Tax Statement**, is a statement from your employer of wages and other compensation paid to you and taxes withheld from your pay. You should have a **Form W-2** from each employer. Be sure to attach the first copy or copy B of **Form W-2** in the place indicated on the front page of your return. Attach it only to the front page of your return, not to any attachments. For more information, see *Form W-2* in chapter 5.

If you received a **Form 1099-R**, *Distributions from Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.*, showing federal income tax withheld, attach the first copy or Copy B of that form in the place indicated on the front page of your return.

**Form 1040EZ.** There are no additional schedules to file with **Form 1040EZ**.

**Form 1040A.** Attach the additional schedules and forms that you had to complete behind the **Form 1040A** in order by number. If you are filing **Schedule EIC**, put it last. Do not attach items unless required to do so.

**Form 1040.** Attach any forms and schedules behind **Form 1040** in order of the "Attachment Sequence Number" shown in the upper right corner of the form or schedule. Put forms without an attachment sequence number next. Then arrange all other statements or attachments in the same order as the forms and schedules they relate to and attach them last. Do not attach items unless required to do so.

## Signatures

You must sign and date your return. If you file a joint return, both you and your spouse must sign the return, even if only one of you had income.



*If you file a joint return, both spouses are generally liable for the tax, and the entire tax liability may be assessed against either spouse. See chapter 2.*

If you are due a refund, it cannot be issued unless you have signed your return.

Enter your occupation in the space provided in the signature section. If you file a joint return, enter both your occupation and your spouse's occupation. Entering your daytime telephone number is optional.

If you prepare your own return, leave the space under your signature blank. If another person prepares your return and does not charge you, that person should not sign your return.

**Paid preparer.** Generally, anyone you pay to prepare, assist in preparing, or review your tax return must sign it and fill in the other blanks in the paid preparer's area of your return. Signature stamps and labels are not acceptable. Paid preparers of Form 1040EZ must also put an "X" in box 10 in the lower right corner of page 1 of the return.

If the preparer is self-employed (that is, not employed by any person or business to prepare the return), he or she should check the self-employed box in the *Paid Preparer's Use Only* space on the return.

The preparer must give you a copy of your return in addition to the copy filed with the IRS.

If you have questions about whether a preparer must sign your return, please contact any IRS office.

**When someone can sign for you.** You can appoint an agent to sign your return if you are:

- 1) Unable to sign the return because of disease or injury,
- 2) Absent from the United States for a continuous period of at least 60 days before the due date for filing your return, or
- 3) Given permission to do so by the IRS district director in your district.

**Power of attorney.** A return signed by an agent in any of these cases must have a power of attorney (POA) attached that authorizes the agent to sign for you. You can use a POA that states that the agent is granted authority to sign the return, or you can use Form 2848, *Power of Attorney and Declaration of Representative*. Part I of Form 2848 must state that the agent is granted authority to sign the return.

**Unable to sign.** If the taxpayer is mentally incompetent and cannot sign the return, it must be signed by a court-appointed representative who can act for the taxpayer.

If the taxpayer is mentally competent but physically unable to sign the return or POA, a valid "signature" is defined under state law. It can be anything that clearly indicates the taxpayer's intent to sign. For example, the taxpayer's "X" with the signatures of two witnesses might be considered a valid signature under a state's law.

**Spouse unable to sign.** If your spouse is unable to sign for any reason, see *Signing a joint return*, in chapter 2.

**Child's return.** If a child has to file a tax return but cannot sign the return, the child's parent, guardian, or another legally responsible person must sign the child's name,

followed by the words "By (signature), parent (or guardian) for minor child."

## Refunds

When you complete your return, you will determine if you paid more income tax than you owed. If so, you can get a refund of the amount you overpaid or, if you file Form 1040 or Form 1040A, you can choose to apply all or part of the overpayment to your next year's (2000) estimated tax.



*If you choose to have a 1999 overpayment applied to your 2000 estimated tax, you cannot change your mind and have any of it refunded to you after the due date of your 1999 return.*

You cannot have your overpayment applied to your 2000 estimated tax if you file Form 1040EZ.

Follow the instructions in your tax forms package to complete the entries to claim your refund and/or to apply your overpayment to your 2000 estimated tax.

**Direct deposit.** Instead of getting a paper check, you may be able to have your refund deposited directly into your account at a bank or other financial institution. To request direct deposit, follow the instructions for the refund line on your return.

If the direct deposit cannot be done, the IRS will send a check instead.

**Overpayment less than one dollar.** If your overpayment is less than one dollar, you will not get a refund unless you ask for it in writing.

**Cashing your refund check.** Cash your tax refund check soon after you receive it. Checks not cashed within 12 months of the date they are issued will be canceled and the proceeds returned to the IRS.

If your check has been canceled, you can apply to the IRS to have it reissued.

**Refund more or less than expected.** If you receive a check for a refund you are not entitled to, or for an overpayment that should have been credited to estimated tax, do not cash the check. Call the IRS.

If you receive a check for more than the refund you claimed, do not cash the check until you receive a notice explaining the difference.

If your refund check is for less than you claimed, it should be accompanied by a notice explaining the difference. Cashing the check does not stop you from claiming an additional amount of refund.

If you did not receive a notice and you have any questions about the amount of your refund, you should wait two weeks. If you still have not received a notice, call the IRS.

**Offset against debts.** If you are due a refund but have not paid certain amounts you owe, all or part of your refund may be used to pay all or part of the past-due amount. This includes past-due federal income tax, other federal debts (such as student loans), state income tax, and child and spousal support payments. You will be notified if the refund you claimed has been offset against your debts.

### **Joint return and injured spouse.**

When a joint return is filed and only one spouse owes a past-due amount, the other spouse can be considered an **injured spouse**. An injured spouse can get a refund for his or her share of the overpayment that would otherwise be used to pay the past-due amount.

To be considered an injured spouse, you must:

- 1) File a joint return,
- 2) Have reported income (such as wages, interest, etc.),
- 3) Have made and reported tax payments (such as federal income tax withheld from wages or estimated tax payments), or claimed the earned income credit or other refundable credit, and
- 4) Have an overpayment, all or part of which may be applied against the past-due amount.

If you are an injured spouse, you can obtain your portion of the joint refund by completing **Form 8379, Injured Spouse Claim and Allocation**. Follow the instructions on the form.

## Amount You Owe

When you complete your return, you will determine if you have paid the full amount of tax that you owe. If you owe additional tax, you should pay it with your return. If you owe less than one dollar, you need not pay it.

If the IRS figures your tax for you, you will receive a bill for any tax that is due. You should pay this bill within 30 days (or by the due date of your return, if later). See *Tax Figured by IRS* in chapter 31.



*If you do not pay your tax when due, you may have to pay a failure-to-pay penalty. See Penalties, later. For more information about your balance due, see Publication 594, The IRS Collection Process.*

## Interest

Interest is charged on tax you do not pay by the due date of your return. Interest is charged even if you get an extension of time for filing.



*If the IRS figures your tax for you, interest cannot start earlier than the 31st day after the IRS sends you a bill. For information, see Tax Figured by IRS in chapter 31.*

**Interest on penalties.** Interest is charged on the failure-to-file penalty, the accuracy-related penalty, and the fraud penalty from the due date of the return (including extensions) to the date of payment. Interest on other penalties starts on the date of notice and demand, but is not charged on penalties paid within 21 calendar days from the date of the notice (or within 10 business days if the notice is for \$100,000 or more).

**Interest due to IRS error or delay.** All or part of any interest you were charged can be forgiven if the interest is due to an unreasonable error or delay by an officer or

employee of the IRS in performing a ministerial or managerial act.

A ministerial act is a procedural or mechanical act that occurs during the processing of a taxpayer's case. A managerial act includes personnel transfers and extended personnel training. A decision concerning the proper application of federal tax law is not a ministerial or managerial act.

The interest can be forgiven only if you are not responsible in any important way for the error or delay and the IRS has notified you in writing of the deficiency or payment. For more information, get Publication 556, *Examination of Returns, Appeal Rights, and Claims for Refund*.

Interest and certain penalties may also be suspended for a limited period if you filed your return by the due date (including extensions) and the IRS does not provide you with a notice specifically stating your liability and the basis for it before the close of the 18-month period beginning on the later of:

- The date the return is filed, or
- The due date of the return without regard to extensions.

For more information, get Publication 556.

## How To Pay

If you pay by check or money order, make it out to the "United States Treasury." Please show your correct name, address, social security number, daytime telephone number, and the tax year and form number on the front of your check or money order.

For example, if you file Form 1040 for 1999 and you owe additional tax, show your name, address, social security number, daytime telephone number, and "1999 Form 1040" on the front of your check or money order. If you file an amended return (Form 1040X) for 1998 and you owe tax, show your name, address, social security number, daytime telephone number, and "1998 Form 1040X" on the front of your check or money order.

Enclose your payment with your return, but do not attach it to the form.

Do not mail cash with your return. If you pay cash at an IRS office, keep the receipt as part of your records.

**Payment voucher.** If you have a balance due on your 1999 Form 1040 and you receive **Form 1040-V, Payment Voucher**, use it to send your payment to the IRS. This will help us process your payment more accurately and efficiently. Follow the instructions that come with the form.

**Payment by credit card.** To pay by credit card (American Express® Card, MasterCard®, or Discover® Card), call **1-888-2PAY-TAX** (1-888-272-9829) and follow the instructions. A convenience fee will be charged by the credit card processor based on the amount you are paying. You will be told what the fee is when you call and you will have the option to continue or cancel the call. Do not include the convenience fee as part of your tax payment. You can also find out what the fee will be on the Internet at **www.8882paytax.com**. If you paid by credit card, enter the confirmation

number you were given at the end of the call on page 1 of Form 1040 in the upper left corner.

**Estimated tax payments.** Do not include any 2000 estimated tax payment in the payment for your 1999 income tax return. See chapter 5 for information on how to pay estimated tax.

**Payment not honored.** If your check or money order is not honored by your bank (or other financial institution) and the IRS does not receive the funds, you still owe the tax. In addition, you may be subject to a dishonored check penalty.

## Installment Agreement

If you cannot pay the full amount due with your return, you can ask to make monthly installment payments. However, you will be charged interest and may be charged a late payment penalty on the tax not paid by April 17, 2000, even if your request to pay in installments is granted. If your request is granted, you must also pay a fee. To limit the interest and penalty charges, pay as much of the tax as possible with your return. But before requesting an installment agreement, you should consider other less costly alternatives, such as a bank loan.

To ask for an installment agreement, use **Form 9465, Installment Agreement Request**. You should receive a response to your request within 30 days. But if you file your return after March 31, it may take longer for a reply.

**Guaranteed availability of installment agreement.** The IRS must agree to accept the payment of your tax liability in installments if, as of the date you offer to enter into the agreement:

- 1) Your total taxes (not counting interest, penalties, additions to the tax, or additional amounts) do not exceed \$10,000,
- 2) In the last 5 years, you (and your spouse if the liability relates to a joint return) have not:
  - a) Failed to file any required income tax return,
  - b) Failed to pay any tax shown on any such return, or
  - c) Entered into an installment agreement for the payment of any income tax,
- 3) You show you cannot pay your income tax in full when due,
- 4) The tax will be paid in full in 3 years or less, and
- 5) You agree to comply with the tax laws while your agreement is in effect.

## Gift To Reduce the Public Debt



You can make a contribution (gift) to reduce the public debt. If you wish to do so, make a **separate** check payable to "Bureau of the Public Debt." You can send it to:

Bureau of the Public Debt  
Department G  
P.O. Box 2188  
Parkersburg, WV 26106-2188.

Or, you can enclose the check in the envelope with your income tax return. Please do not add this gift to any tax you owe.

You can deduct this gift as a charitable contribution on next year's tax return if you itemize your deductions on Schedule A (Form 1040).

## Peel-Off Address Label

After you have completed your return, peel off the label with your name and address from the inside of your tax return package and place it in the appropriate area of the Form 1040, Form 1040A, or Form 1040EZ you send to the IRS. If you have someone prepare your return, give that person your label to use on your tax return.

If you file a 1040PC return, place the label over the name and address area. If you file electronically, use your label on Form 8453. (More information on electronic filing and the 1040PC return is found earlier in this chapter.)

The label helps the IRS to correctly identify your account. It also saves processing costs and speeds up processing so that refunds can be issued sooner.



You must write your SSN in the spaces provided on your tax return.

**Correcting the label.** Make necessary name and address changes on the label. If you have an apartment number that is not shown on the label, please write it in. If you changed your name, see the discussion under *Social Security Number*, earlier.

**No label.** If you did not receive a tax return package with a label, print or type your name and address in the spaces provided at the top of Form 1040 or Form 1040A. If you are married filing a separate return, do not enter your spouse's name in the space at the top. Instead, enter his or her name in the space provided on line 3.

If you file Form 1040EZ and you do not have a label, print (do not type) this information in the spaces provided.

**P.O. box.** If your post office does not deliver mail to your street address and you have a P.O. box, print your P.O. box number on the line for your present home address instead of your street address.

**Foreign address.** If your address is outside the United States or its possessions or territories, enter the information on the line for "City, town or post office, state, and ZIP code" in the following order:

- 1) City,
- 2) Province or state, and
- 3) Name of foreign country (**do not** abbreviate the name of the country).

Follow the country's practice for entering the postal code.

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## Where Do I File?

After you complete your return, you must send it to the IRS. You can mail it or you may be able to file it electronically. See *Does My Return Have To Be On Paper*, earlier.

**Mailing your return.** If an addressed envelope came with your tax forms package, you should mail your return in that envelope.

If you do not have an addressed envelope or if you moved during the year, mail your return to the Internal Revenue Service Center for the area where you now live. The street address of the Service Center is not needed. A list of Service Center addresses is shown in your tax forms package.

If you are making a payment, follow any additional instructions in your tax forms package.

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## What Happens After I File?

After you send your return to IRS, you may have some questions. This section discusses concerns you may have about recordkeeping, your refund, and what to do if you move.

## What Records Should I Keep?



You must keep records so that you can prepare a complete and accurate income tax return. The law does not require any special form of records. However, you should keep all receipts, canceled checks or other proof of payment, and any other records to support any deductions or credits you claim.

If you file a claim for refund, you must be able to prove by your records that you have overpaid your tax.

**How long to keep records.** You must keep your records for as long as they are important for the federal tax law.

Keep records that support an item of income or a deduction appearing on a return until the period of limitations for the return runs out. (A period of limitations is the period of time after which no legal action can be brought.) For assessment or collection of tax you owe, this is 3 years from the date you filed the return. For filing a claim for credit or refund, this generally is 3 years from the date you filed the original return, or 2 years from the date you paid the tax, whichever is later. Returns filed before the due date are treated as filed on the due date.

If you did not report income that you should have reported on your return, and it is more than 25% of the income shown on the return, the period of limitations does not run out until 6 years after you filed the return. If a return is false or fraudulent with

intent to evade tax, or if no return is filed, an action can generally be brought at any time.

You may need to keep records relating to the basis of property longer than the period of limitations. Keep those records as long as they are important in figuring the basis of the original or replacement property. Generally, this means for as long as you own the property and, after you dispose of it, for the period of limitations that applies to you. See chapter 14 for information on basis.

**Note.** If you receive a Form W-2, keep Copy C until you begin receiving social security benefits. This will help protect those benefits, just in case there is a question about your work record or earnings in a particular year. The Social Security Administration suggests that you confirm your work record with them from time to time.

**Copies of returns.** You should keep copies of tax returns you have filed and the tax forms package as part of your records. They may be helpful in amending filed returns or preparing future ones.

If you need a copy of a prior year tax return, you can get it from the IRS. Use **Form 4506**. There is a charge for a copy of a return, which you must pay with Form 4506.

**Transcript.** You can also use Form 4506 to ask for a transcript of your return filed this year or during the 3 preceding years. It will show most lines from your original return, including accompanying forms and schedules.

**Tax account information.** If you need a statement of your tax account showing any later changes that you or the IRS made to the original return, you will need to ask for tax account information.

**Do not** use Form 4506 for tax account information. Instead, contact the IRS. You should have your name, social security number or employer identification number (if applicable), tax period, and form number available. You will get the following information:

- Type of return filed,
- Filing status,
- Federal income tax withheld,
- Tax shown on return,
- Adjusted gross income,
- Taxable income,
- Self-employment tax,
- Number of exemptions,
- Amount of refund,
- Amount of earned income credit, and
- Whether you claimed a mortgage interest deduction or real estate tax deduction.

**More information.** For more information on recordkeeping, get Publication 552, *Recordkeeping for Individuals*.

## Interest on Refunds

If you are due a refund, you may get interest on it. The interest rates are adjusted quarterly.

If the refund is made within 45 days after the due date of your return, no interest will be paid. If you file your return after the due date (including extensions), no interest will be paid if the refund is made within 45 days after the date you filed. If the refund is not made within this 45-day period, interest will be paid from the due date of the return or from the date you filed, whichever is later.

Accepting a refund check does not change your right to claim an additional refund and interest. File your claim within the period of time that applies. See *Amended Returns and Claims for Refund*, later. If you do not accept a refund check, no more interest will be paid on the overpayment included in the check.

**Interest on erroneous refund.** All or part of any interest you were charged on an erroneous refund generally will be forgiven. Any interest charged for the period before demand for repayment was made will be forgiven unless:

- 1) You, or a person related to you, caused the erroneous refund in any way, or
- 2) The refund is more than \$50,000.

For example, if you claimed a refund of \$100 on your return, but the IRS made an error and sent you \$1,000, you would not be charged interest for the time you held the \$900 difference. You must, however, repay the \$900 when the IRS asks.

## Past-Due Refund

If you do not get your refund within 4 weeks after filing your return, you can call TeleTax. For details on how to use this telephone service, see *What Is TeleTax?* in your tax forms package. Please wait at least 4 weeks after filing your 1999 tax return before using this service. In some cases, TeleTax may not have refund information until 6 weeks after you file.

See *IRS e-file*, earlier, for information about refund inquiries when you file an electronic return.

## Change of Address

If you have moved, file your return using your new address.

If you move after you filed your return, always notify in writing the Internal Revenue Service Center where you filed your last return, or the Chief, Customer Service Division, in your local IRS district office. You can use **Form 8822, Change of Address**, to notify us of your new address. If you are expecting a refund, also notify the post office serving your old address. This will help in forwarding your check to your new address (unless you chose direct deposit of your refund).

Be sure to include your social security number (and the name and social security number of your spouse, if you filed a joint return) in any correspondence with the IRS.



## What If I Made a Mistake?

Errors may delay your refund or result in notices being sent to you. If you discover an error, you can file an amended return or claim for refund.

### Amended Returns and Claims for Refund

You should correct your return if, after you have filed it, you find that:

- 1) You did not report some income,
- 2) You claimed deductions or credits you should not have claimed,
- 3) You did not claim deductions or credits you could have claimed, or
- 4) You should have claimed a different filing status. (You cannot change your filing status from married filing jointly to married filing separately after the due date of the original return. However, an executor may be able to make this change for a deceased spouse.)

If you need a copy of your return, see *Copies of returns under What Records Should I Keep*, earlier in this chapter.

**Form 1040X.** Use Form 1040X, *Amended U.S. Individual Income Tax Return*, to correct the return you have already filed. An amended tax return cannot be filed electronically under the e-file system.

**Completing Form 1040X.** On Form 1040X, write your income, deductions, and credits as you originally reported them on your return, the changes you are making, and the corrected amounts. Then figure the tax on the corrected amount of taxable income and the amount you owe or your refund.

If you owe tax, pay the full amount with Form 1040X. The tax owed will not be subtracted from any amount you had credited to your estimated tax.

If you cannot pay the full amount due with your return, you can ask to make monthly installment payments. See *Installment Agreement*, earlier.

If you overpaid tax, you can have all or part of the overpayment refunded to you, or you can apply all or part of it to your estimated tax. If you choose to get a refund, it will be sent separately from any refund shown on your original return.

**Filing Form 1040X.** After you finish your Form 1040X, check it to be sure that it is complete. Do not forget to show the year of your original return and explain all changes you made. Be sure to attach any forms or schedules needed to explain your changes. Mail your Form 1040X to the Internal Revenue Service Center serving the area where you now live (as shown in the instructions to the form).

File a separate form for each tax year involved.

**Time for filing a claim for refund.** Generally, you must file your claim for a credit or refund within 3 years after the date you filed your original return or within 2 years after the date you paid the tax, whichever is later.

Returns filed before the due date (without regard to extensions) are considered filed on the due date (even if the due date was a Saturday, Sunday, or legal holiday). These time periods are suspended while you are financially disabled, discussed later.

If the last day for claiming a credit or refund is a Saturday, Sunday, or legal holiday, you can file the claim on the next business day.

If you do not file a claim within this period, you may not be entitled to a credit or a refund.

**Late-filed return.** If you did not file an original return when it was due, you generally can claim a refund by filing your return within 3 years from the time the tax was paid. The return must be received by the Internal Revenue Service within the 3-year period. See *Tax paid* in the discussion that follows.



*If your return is filed late, the postmark date does not determine the date of filing.*

**Limit on amount of refund.** If you file your claim within 3 years after the date you filed your return, the credit or refund cannot be more than the part of the tax paid within the 3-year period (plus any extension of time for filing your return) immediately before you filed the claim. This time period is suspended while you are financially disabled, discussed later.

**Tax paid.** Payments made before the due date (without regard to extensions) of the original return are considered paid on the due date. Examples include federal income tax withheld from wages and estimated income tax.

**Example 1.** You made estimated tax payments of \$500 and got an automatic extension of time to August 15, 1997, to file your 1996 income tax return. When you filed your return on that date, you paid an additional \$200 tax. On August 15, 2000, you filed an amended return and claimed a refund of \$700. Because you filed your claim within 3 years after you filed your return, you can get a refund of up to \$700, the tax paid within the 3 years plus the 4-month extension period immediately before you filed the claim.

**Example 2.** The situation is the same as in Example 1, except you filed your return on October 31, 1997, 2½ months after the extension period ended. You paid an additional \$200 on that date. On October 27, 2000, you filed an amended return and claimed a refund of \$700. Although you filed your claim within 3 years from the date you filed your original return, the refund was limited to \$200, the tax paid within the 3 years plus the 4-month extension period immediately before you filed the claim. The estimated tax of \$500 paid before that period cannot be refunded or credited.

**If you file a claim more than 3 years after you file your return,** the credit or refund cannot be more than the tax you paid within the 2 years immediately before you file the claim.

**Example.** You filed your 1996 tax return on April 15, 1997. You paid taxes of \$500. On November 1, 1998, after an examination of your 1996 return, you had to pay an ad-

ditional tax of \$200. On May 11, 2000, you file a claim for a refund of \$300. However, because you filed your claim more than 3 years after you filed your return, your refund will be limited to the \$200 you paid during the 2 years immediately before you filed your claim.

**Financially disabled.** The time periods are suspended for the period in which you are financially disabled. You are financially disabled if you are unable to manage your financial affairs because of a medically determinable physical or mental impairment which has lasted or can be expected to last for a continuous period of not less than 12 months. However, you are not treated as financially disabled during any period your spouse or any other person is authorized to act on your behalf in financial matters.

If you are financially disabled, you must send in the following written statements with your claim for refund. If you were financially disabled, the following:

- 1) A statement from your qualified physician that includes:
  - a) The name and a description of your physical or mental impairment,
  - b) The physician's medical opinion that the impairment prevented you from managing your financial affairs,
  - c) The physician's medical opinion that the impairment was or can be expected to result in death, or that its duration has lasted, or can be expected to last, at least 12 months,
  - d) The specific time period (to the best of the physician's knowledge), and
- 2) The following certification signed by the physician: "I hereby certify that, to the best of my knowledge and belief, the above representations are true, correct, and complete."
- 3) A statement made by the person signing the claim for credit or refund that no person, including your spouse, was authorized to act on your behalf in financial matters during the period of disability (or the exact dates that a person was authorized to act for you).

#### Exceptions for special types of refunds.

If you file a claim for one of the items listed below, the dates and limits discussed earlier may not apply. These items, and where to get more information, are:

- A bad debt (see *Nonbusiness Bad Debts* in chapter 15),
- A worthless security (see *Worthless securities* in chapter 15),
- Foreign tax paid or accrued (see Publication 514, *Foreign Tax Credit for Individuals*),
- Net operating loss carryback (see Publication 536, *Net Operating Losses*),
- Carryback of certain business tax credits (see Form 3800, *General Business Credit*),

- A claim based on an agreement with the Service extending the period for assessment of tax, and
- An injured spouse claim (see *Offset against debts*, earlier).

**Processing claims for refund.** Claims are usually processed shortly after they are filed. Your claim may be accepted as filed, disallowed, or subject to examination. If a claim is examined, the procedures are the same as in the examination of a tax return.

If your claim is disallowed, you will receive an explanation of why it was disallowed.

**Taking your claim to court.** You can sue for a refund in court, but you must first file a timely claim with the IRS. If the IRS rejects your claim or does not act on your claim within 6 months after you file it, you can then take your claim to court. For information on the burden of proof in a court proceeding, see Publication 556, *Examination of Returns, Appeal Rights, and Claims for Refund*.

The IRS provides a fast method to move your claim to court if:

- You are filing a claim for a credit or refund based solely on contested income tax or on estate tax or gift tax issues considered in your previously examined returns, and
- You want to take your case to court instead of appealing it within the IRS.

When you file your claim with the IRS, you get the fast method by requesting in writing that your claim be immediately rejected. A notice of claim disallowance will then be promptly sent to you.

You have 2 years from the date of mailing of the notice of disallowance to file a refund suit in the United States District Court having jurisdiction or in the United States Court of Federal Claims.

**Interest on refund.** If you receive a refund because of your amended return, interest will be paid on it from the due date of your original return or the date you filed your original return, whichever is later, to the date you filed the amended return. However, if the refund is not made within 45 days after you file the amended return, interest will be paid up to the date the refund is paid.

**Reduced refund.** Your refund may be reduced by an additional tax liability that has been assessed against you.

Also, your refund may be reduced by amounts you owe for past-due child support, debts to another federal agency, or for state tax. The refund procedures discussed in this chapter will not be available to you to get back the reduction. See *Offset against debts*, earlier.

**Effect on state tax liability.** If your return is changed for any reason, it may affect your state income tax liability. This includes changes made as a result of an examination of your return by the IRS. Contact your state tax agency for more information.

## Penalties

The law provides penalties for failure to file returns or pay taxes as required.

### Civil Penalties

If you do not file your return and pay your tax by the due date, you may have to pay a penalty. You may also have to pay a penalty if you substantially understate your tax, file a frivolous return, or fail to supply your social security number. If you provide fraudulent information on your return, you may have to pay a civil fraud penalty.

**Filing late.** If you do not file your return by the due date (including extensions), you may have to pay a **failure-to-file** penalty. The penalty is based on the tax not paid by the due date (without regard to extensions). The penalty is usually 5% for each month or part of a month that a return is late, but not more than 25%.

**Fraud.** If your failure to file is due to fraud, the penalty is 15% for each month or part of a month that your return is late, up to a maximum of 75%.

**Return over 60 days late.** If you file your return more than 60 days after the due date or extended due date, the minimum penalty is the smaller of \$100 or 100% of the unpaid tax.

**Exception.** You will not have to pay the penalty if you show that you failed to file on time because of reasonable cause and not because of willful neglect.

**Paying tax late.** You will have to pay a **failure-to-pay** penalty of 1/2 of 1% of your unpaid taxes for each month, or part of a month, after the due date that the tax is not paid. This penalty does not apply during the automatic 4-month extension of time to file period, if you paid at least 90% of your actual tax liability before the original due date of your return.

After 1999, the monthly rate of the failure to pay penalty will be half the usual rate (.25% instead of .50%) if an installment agreement is in effect for that month. You must have filed your return by the due date (including extensions) to qualify for this reduced penalty.

If a notice of intent to levy is issued, the rate will increase to 1% at the start of the first month beginning at least 10 days after the day that the notice is issued. If a notice and demand for immediate payment is issued, the rate will increase to 1% at the start of the first month beginning after the day that the notice and demand is issued.

This penalty cannot be more than 25% of your unpaid tax. You will not have to pay the penalty if you can show that you had a good reason for not paying your tax on time.

**Combined penalties.** If both the failure-to-file penalty and the failure-to-pay penalty (discussed earlier) apply in any month, the 5% (or 15%) failure-to-file penalty is reduced by the failure-to-pay penalty. However, if you file your return more than 60 days after the due date or extended due date, the minimum penalty is the smaller of \$100 or 100% of the unpaid tax.

**Accuracy-related penalty.** You may have to pay an accuracy-related penalty if:

- 1) You underpay your tax because of ei-

ther "negligence" or "disregard" of rules or regulations, or

- 2) You substantially understate your income tax.

The penalty is equal to 20% of the underpayment. The penalty will not be figured on any part of an underpayment on which a fraud penalty (discussed later) is charged.

**Negligence or disregard.** The term "negligence" includes a failure to make a reasonable attempt to comply with the tax law or to exercise ordinary and reasonable care in preparing a return. Negligence also includes failure to keep adequate books and records. You will not have to pay a negligence penalty if you have a reasonable basis for a position you took.

The term "disregard" includes any careless, reckless, or intentional disregard.

**Adequate disclosure.** You can avoid the penalty for disregard of rules or regulations if you adequately disclose on your return a position that has at least a reasonable basis. See *Disclosure statement*, later.

**Substantial understatement of income tax.** You understate your tax if the tax shown on your return is less than the correct tax. The understatement is substantial if it is more than the larger of 10% of the correct tax or \$5,000. However, the amount of the understatement is reduced to the extent the understatement is due to:

- 1) Substantial authority, or
- 2) Adequate disclosure and a reasonable basis.

**Substantial authority.** Whether there is or was substantial authority for the tax treatment of an item depends on the facts and circumstances. Consideration will be given to court opinions, Treasury regulations, revenue rulings, revenue procedures, and notices and announcements issued by the IRS and published in the *Internal Revenue Bulletin* that involve the same or similar circumstances as yours.

**Disclosure statement.** The understatement may also be reduced if you have adequately disclosed the relevant facts about your tax treatment of an item. To make this disclosure, use **Form 8275, Disclosure Statement**. You must also have a reasonable basis for treating the item the way you did.

In cases of substantial understatement only, items that meet the requirements of Revenue Procedure 98-62 (or later update) are considered adequately disclosed on your return without filing Form 8275.

Use **Form 8275-R, Regulation Disclosure Statement**, to disclose items or positions contrary to regulations.

**Reasonable cause.** You will not have to pay a penalty if you show a good reason (reasonable cause) for the way you treated an item. You must also show that you acted in good faith.

**Frivolous return.** You may have to pay a penalty of \$500 if you file a frivolous return. A frivolous return is one that does not include enough information to figure the correct tax or that contains information clearly showing that the tax you reported is substantially incorrect.

You will have to pay the penalty if you filed this kind of return because of a frivo-

lous position on your part or a desire to delay or interfere with the administration of federal income tax laws. This includes altering or striking out the preprinted language above the space provided for your signature.

This penalty is added to any other penalty provided by law.

The penalty must be paid in full upon notice and demand from IRS even if you protest the penalty.

**Fraud.** If there is any underpayment of tax on your return due to fraud, a penalty of 75% of the underpayment due to fraud will be added to your tax.

**Joint return.** The fraud penalty on a joint return does not apply to a spouse unless some part of the underpayment is due to the fraud of that spouse.

**Failure to supply social security number.** If you do not include your social security number (SSN) or the SSN of another person

where required on a return, statement, or other document, you will be subject to a penalty of \$50 for **each** failure. You will also be subject to the penalty of \$50 if you do not give your SSN to another person when it is required on a return, statement, or other document.

For example, if you have a bank account that earns interest, you must give your SSN to the bank. The number must be shown on the Form 1099-INT or other statement the bank sends you. If you do not give the bank your SSN, you will be subject to the \$50 penalty. (You also may be subject to "backup" withholding of income tax. See chapter 5.)

You will not have to pay the penalty if you are able to show that the failure was due to reasonable cause and not willful neglect.

**Failure to furnish tax shelter registration number.** A person who sells (or otherwise transfers) to you an interest in a tax shelter

must give you the tax shelter registration number or be subject to a \$100 penalty. If you claim any deduction, credit, or other tax benefit because of the tax shelter, you must attach **Form 8271, Investor Reporting of Tax Shelter Registration Number**, to your return to report this number. You will have to pay a penalty of \$250 for each failure to report a tax shelter registration number on your return. The penalty can be excused if you have a reasonable cause for not reporting the number.

## Criminal Penalties

You may be subject to criminal prosecution (brought to trial) for actions such as:

- 1) Tax evasion,
- 2) Willful failure to file a return, supply information, or pay any tax due,
- 3) Fraud and false statements, or
- 4) Preparing and filing a fraudulent return.

## 2.

# Filing Status

## Introduction

This chapter discusses which filing status you should use. There are five filing statuses. They are:

- Single,
- Married Filing Jointly,
- Married Filing Separately,
- Head of Household, and
- Qualifying Widow(er) With Dependent Child.

**TIP** *If more than one filing status applies to you, choose the one that will give you the lowest tax.*

You use your filing status in determining whether you must file a return (see chapter 1), your standard deduction (see chapter 21), and your correct tax (see chapter 31). Your filing status is also important in determining whether you can take certain deductions and credits.

## Useful Items

You may want to see:

### Publication

- 501** Exemptions, Standard Deduction, and Filing Information
- 519** U.S. Tax Guide for Aliens
- 555** Community Property

## Marital Status

In general, your filing status depends on whether you are considered unmarried or married. A marriage means only a legal union between a man and a woman as husband and wife.

**Unmarried persons.** You are considered unmarried for the whole year if, on the last day of your tax year, you are unmarried or legally separated from your spouse under a divorce or a separate maintenance decree. State law governs whether you are married, or legally separated under a divorce or separate maintenance decree.

**Divorced persons.** If you are divorced under a final decree by the last day of the year, you are considered unmarried for the whole year.

**Divorce and remarriage.** If you obtain a divorce in one year for the sole purpose of filing tax returns as unmarried individuals, and at the time of divorce you intended to and did remarry each other in the next tax

year, you and your spouse must file as married individuals.

**Annulled marriages.** If you obtain a court decree of annulment, which holds that no valid marriage ever existed, you are considered unmarried even if you filed joint returns for earlier years. You must file amended returns (Form 1040X, *Amended U.S. Individual Income Tax Return*) claiming single or head of household status for all tax years affected by the annulment that are not closed by the statute of limitations for filing a tax return. The statute of limitations generally does not expire until 3 years after your original return was filed.

**Head of household or qualifying widow(er) with dependent child.** If you are considered unmarried, you may be able to file as a head of household or as a qualifying widow(er) with a dependent child. See *Head of Household and Qualifying Widow(er) With Dependent Child* to see if you qualify.

**Married persons.** If you are considered married for the whole year, you and your spouse can file a joint return, or you can file separate returns.

**Considered married.** You are considered married for the whole year if on the last day of your tax year you and your spouse meet any one of the following tests.

- 1) You are married and living together as husband and wife.
- 2) You are living together in a **common law marriage** that is recognized in the state where you now live or in the state where the common law marriage began.
- 3) You are married and living apart, but not legally separated under a decree of divorce or separate maintenance.
- 4) You are separated under an interlocutory (not final) decree of divorce. For purposes of filing a joint return, you are not considered divorced.

**Spouse died during the year.** If your spouse died during the year, you are considered married for the whole year for filing status purposes.

If you did not remarry before the end of the tax year, you can file a joint return for yourself and your deceased spouse. For the next 2 years, you may be entitled to the special benefits described later under *Qualifying Widow(er) With Dependent Child*.

If you remarried before the end of the tax year, you can file a joint return with your new spouse. Your deceased spouse's filing status is married filing separately for that year.

**Married persons living apart.** If you live apart from your spouse and meet certain tests, you may be **considered unmarried**. If this applies to you, you can file as head of household even though you are not divorced or legally separated. If you qualify to file as head of household instead of as married filing separately, your standard deduction will be higher. Also, your tax may be lower, and you may be able to claim the earned income credit. See *Head of Household*, later.

## Single

Your filing status is **single** if, on the last day of the year, you are unmarried or legally separated from your spouse under a divorce or separate maintenance decree, and you do not qualify for another filing status. To determine your marital status on the last day of the year, see *Marital Status* earlier.

Your filing status may be single if you were widowed before January 1, 1999, and did not remarry in 1999. However, you may be able to use another filing status that will give you a lower tax. See *Head of Household and Qualifying Widow(er) With Dependent Child* to see if you qualify.

**How to file.** You can file Form 1040EZ (if you have no dependents, are under 65 and not blind and meet other requirements), Form 1040A, or Form 1040. If you file Form 1040A or Form 1040, show your filing status as single by checking the box on line 1. Use the *Single* column of the Tax Table, or *Schedule X* of the Tax Rate Schedules, to figure your tax.

## Married Filing Jointly

You can choose **married filing jointly** as your filing status if you are married and both you and your spouse agree to file a joint return. On a joint return, you report your combined income and deduct your combined allowable expenses.

If you and your spouse decide to file a joint return, your tax may be lower than your combined tax for the other filing statuses. Also, your standard deduction (if you do not itemize deductions) may be higher, and you may qualify for tax benefits that do not apply to other filing statuses. You can file a joint return even if one of you had no income or deductions.

**TIP** *If you and your spouse each have income, you may want to figure your tax both on a joint return and on separate returns (using the filing status of married filing separately). Choose the method that gives the two of you the lower combined tax.*

**How to file.** If you file as married filing jointly, you can use Form 1040EZ (if you have no dependents, are under 65 and not blind, and meet other requirements), Form 1040A, or Form 1040. If you file Form 1040A or Form 1040, show this filing status by checking the box on line 2. Use the *Married filing jointly* column of the Tax Table, or *Schedule Y-1* of the Tax Rate Schedules, to figure your tax.

**Spouse died during the year.** If your spouse died during the year, you are considered married for the whole year and can choose married filing jointly as your filing status. See *Spouse died during the year*, earlier.

**Divorced persons.** If you are divorced under a final decree by the last day of the year, you are considered unmarried for the whole year and you cannot choose married filing jointly as your filing status.

## Filing a Joint Return

Both you and your spouse must include all of your income, exemptions, and deductions on your joint return.

**Accounting period.** Both of you must use the same accounting period, but you can use different accounting methods. See *Accounting Periods and Accounting Methods* in chapter 1.

**Joint responsibility.** Both of you may be held responsible, jointly and individually, for the tax and any interest or penalty due on your joint return. One spouse may be held responsible for all the tax due even if all the income was earned by the other spouse.

**Divorced taxpayer.** You may be held jointly and individually responsible for any tax, interest, and penalties due on a joint return filed before your divorce. This responsibility may apply even if your divorce decree states that your former spouse will be responsible for any amounts due on previously filed joint returns.

**Relief from joint liability.** In some cases, one spouse may be relieved of joint liability for tax, interest, and penalties on a joint return for items of the other spouse that were incorrectly reported on the joint return. You can ask for relief no matter how small the liability.

There are three types of relief available.

- 1) Innocent spouse relief, which applies to all joint filers.
- 2) Separation of liability, which applies to joint filers who are divorced, widowed, legally separated, or have not lived together for the past 12 months.
- 3) Equitable relief, which applies to all joint filers who do not qualify for innocent spouse relief or separation of liability and to married couples filing separate returns in community property states.

You must file Form 8857, *Request for Innocent Spouse Relief* to request any of these kinds of relief. Publication 971, *Innocent Spouse Relief*, explains these kinds of relief and who may qualify for them.

**Signing a joint return.** For a return to be considered a joint return, both husband and wife must generally sign the return. If your spouse died before signing the return, see *Signing the return* in chapter 4.

**Spouse away from home.** If your spouse is away from home, you should prepare the return, sign it, and send it to your spouse to sign so that it can be filed on time.

**Injury or disease prevents signing.** If your spouse cannot sign because of disease or injury and tells you to sign, you can sign your spouse's name in the proper space on the return followed by the words "By (your name), Husband (or Wife)." Be sure to also sign in the space provided for your signature. Attach a dated statement, signed by you, to the return. The statement should include the form number of the return you are filing, the tax year, the reason your spouse cannot sign, and that your spouse has agreed to your signing for him or her.

**Signing as guardian of spouse.** If you are the guardian of your spouse who is mentally incompetent, you can sign the return for your spouse as guardian.

**Spouse in combat zone.** If your spouse is unable to sign the return because he or she is serving in a combat zone, such as the Persian Gulf Area, the qualified hazardous duty area of Yugoslavia, or the qualified hazardous duty area of Bosnia and Herzegovina, Croatia, and Macedonia, and you do not have a power of attorney or other statement, you can sign for your spouse. Attach a signed statement to your return that explains that your spouse is serving in a combat zone. For more information on special tax rules for persons who are serving in a combat zone, get Publication 3, *Armed Forces' Tax Guide*.

**Other reasons spouse cannot sign.** If your spouse cannot sign the joint return for any other reason, you can sign for your spouse only if you are given a valid power of attorney (a legal document giving you permission to act for your spouse). Attach the power of attorney (or a copy of it) to your tax return. You can use Form 2848, *Power of Attorney and Declaration of Representative*.

### Nonresident alien or dual-status alien.

A joint return generally cannot be made if either spouse is a nonresident alien at any time during the tax year. However, if one spouse was a nonresident alien or dual-status alien who was married to a U.S. citizen or resident at the end of the year, the spouses can choose to file a joint return. If you do file a joint return, you and your spouse are both treated as U.S. citizens or residents for the entire tax year. For information on this choice, see chapter 1 of Publication 519.

## Married Filing Separately

You can choose **married filing separately** as your filing status if you are married. This method may benefit you if you want to be responsible only for your own tax or if this method results in less tax than a joint return. If you and your spouse do not agree to file a joint return, you may have to use this filing status.

If you live apart from your spouse and meet certain tests, you may be **considered unmarried** and may be able to file as head of household. This can apply to you even if you are not divorced or legally separated. If you qualify to file as head of household, instead of as married filing separately, your tax may be lower, you may be able to claim the earned income credit and certain other credits, and your standard deduction will be higher. The head of household filing status allows you to choose the standard deduction even if your spouse chooses to itemize deductions. See *Head of Household*, later, for more information.

Unless you are required to file separately, you should figure your tax both ways (on a joint return and on separate returns). This way you can make sure you are using the method that results in the lowest combined tax. However, you will generally pay more combined tax on separate returns than you would on a joint return because the tax rate is higher for married persons filing separately.

**How to file.** If you file a separate return, you generally report only your own income, exemptions, credits, and deductions on your individual return. You can claim an exemption for your spouse if your spouse had no gross income and was not a dependent of another person. However, if your spouse had any gross income, or was the dependent of someone else, you cannot claim an exemption for him or her on your separate return.

If you file as married filing separately, you can use Form 1040A or Form 1040. Select this filing status by checking the box on line 3 of either form. You must also write your spouse's social security number and full name in the spaces provided. Use the *Married filing separately* column of the Tax Table or *Schedule Y-2* of the Tax Rate Schedules, to figure your tax.

## Separate Returns

Special rules apply if you file a separate return.

**Community property states.** If you live in Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, or Wisconsin and file separately, your income may be considered separate income or community income for income tax purposes. See Publication 555.

**Deductions, credits, and certain income.** If you file a separate return:

- 1) You should itemize deductions if your spouse itemizes deductions, because you cannot claim the standard deduction.
- 2) You cannot deduct interest paid on a qualified student loan.
- 3) You cannot take the credit for child and dependent care expenses in most instances, and the amount that you can exclude from income under an employer's dependent care assistance program is limited to \$2,500 (instead of \$5,000 if you filed a joint return).
- 4) You cannot take the earned income credit.
- 5) You cannot exclude any interest income from qualified U.S. savings bonds that you used for higher education expenses.
- 6) You cannot take the credit for the elderly or the disabled unless you lived apart from your spouse for the entire year.
- 7) You cannot take the education credits (the Hope and lifetime learning credits).
- 8) You cannot take the exclusion or credit for adoption expenses in most instances.
- 9) You will become subject to the limit on the child tax credit, the limit on itemized deductions, and the phaseout of the deduction for personal exemptions at income levels that are half of those for a joint return.
- 10) You may have to include in income more of your social security benefits (or equivalent railroad retirement benefits) than you would on a joint return. For information on social security and railroad retirement benefits, see Publica-

Table 2-1. Who Is a Qualifying Person For Filing as Head of Household?<sup>1</sup>

IF the person is your ...	AND ...	THEN that person is ...
Parent, Grandparent, Brother, Sister, Stepbrother, Stepsister, Stepmother, Stepfather, Mother-in-law, Father-in-law, Half brother, Half sister, Brother-in-law, Sister-in-law, Son-in-law, or Daughter-in-law	You can claim an exemption for him or her <sup>2</sup>	A qualifying person
	You cannot claim an exemption for him or her	NOT a qualifying person
Uncle, Aunt, Nephew, or Niece	He or she is related to you by blood and you can claim an exemption for him or her <sup>2,3</sup>	A qualifying person
	He or she is not related to you by blood <sup>3</sup>	NOT a qualifying person
	You cannot claim an exemption for him or her	
Child, Grandchild, Stepchild, or Adopted child	He or she is single	A qualifying person
	He or she is married, <u>and</u> you can claim an exemption for him or her <sup>2</sup>	A qualifying person
	He or she is married, <u>and</u> you cannot claim an exemption for him or her	NOT a qualifying person <sup>4</sup>
Foster child <sup>5</sup>	You can claim an exemption for him or her <sup>2</sup>	A qualifying person
	You cannot claim an exemption for him or her	NOT a qualifying person

<sup>1</sup>A person cannot qualify more than one taxpayer to use the head of household filing status for the year.

<sup>2</sup>If you can claim an exemption for a person only because of a multiple support agreement, that person cannot be a qualifying person. See *Multiple Support Agreement*.

<sup>3</sup>You are related by blood to an uncle or aunt if he or she is the brother or sister of your mother or father. You are related by blood to a nephew or niece if he or she is the child of your brother or sister.

<sup>4</sup>This child is a qualifying person if you could claim an exemption for the child except that the child's other parent claims the exemption under the special rules for a noncustodial parent discussed under *Support Test for Divorced or Separated Parents* in chapter 3.

<sup>5</sup>The term "foster child" is defined under *Exemptions for Dependents* in chapter 3.

tion 915, *Social Security and Equivalent Railroad Retirement Benefits*.

- 11) You cannot roll over amounts from a traditional IRA into a Roth IRA during a year you file a separate return.
- 12) Your capital loss deduction limit is \$1,500 (instead of \$3,000 if you filed a joint return).

**Individual retirement arrangements (IRAs).** You may not be able to deduct all or part of your contributions to an individual retirement arrangement (IRA) that is a traditional IRA if you or your spouse were covered by an employee retirement plan at work during the year. Your deduction is reduced or eliminated if your income is more than a certain amount. This amount is lower for married individuals who file separately and lived together at any time during the year. For more information, see *How Much Can I Deduct?* in Publication 590, *Individual Retirement Arrangements (IRAs)*.

**Rental activity losses.** If your rental of real estate is a passive activity, you can generally offset a loss of up to \$25,000 against your nonpassive income if you actively participate in the activity. However, married persons filing separate returns who lived together at any time during the year cannot claim this offset. Married persons filing separate returns who lived apart at all times during the year are each allowed a \$12,500

maximum offset for passive real estate activities. See *Limits on Rental Losses* in chapter 10.

### Joint Return After Separate Returns

You can change your filing status by filing an amended return using Form 1040X, *Amended U.S. Individual Income Tax Return*.

If you or your spouse (or each of you) file a separate return, you generally can change to a joint return any time within 3 years from the due date of the separate return or returns. This does not include any extensions. A separate return includes a return filed by you or your spouse claiming married filing separately, single, or head of household filing status.

### Separate Returns After Joint Return

Once you file a joint return, you cannot choose to file separate returns for that year after the due date of the return.

**Exception.** A personal representative for a decedent can change from a joint return elected by the surviving spouse to a separate return for the decedent. The personal representative has one year from the due date of the return to make the change. See chapter 4 for more information on filing a return for a decedent.

## Head of Household

You may be able to file as head of household if you meet all of the following requirements.

- 1) You are unmarried or considered unmarried on the last day of the year.
- 2) You paid more than half the cost of keeping up a home for the year.
- 3) A qualifying person must live with you in the home for more than half the year (except for temporary absences, such as school). However, your dependent parent does not have to live with you. See *Special rule for parent*, later.

**TIP** If you qualify to file as head of household, your tax rate usually will be lower than the rates for single or married filing separately. You will also receive a higher standard deduction than if you file as single or married filing separately.

**How to file.** If you file as head of household, you can use either Form 1040A or Form 1040. Indicate your choice of this filing status by checking the box on line 4 of either form. Use the *Head of a household* column of the Tax Table, or *Schedule Z* of the Tax Rate Schedules, to figure your tax.

## Considered Unmarried

You are considered unmarried on the last day of the year if you are legally separated from your spouse, according to your state law, under a divorce or separate maintenance decree.

You are also considered unmarried on the last day of the tax year if you meet **all** of the following tests.

- 1) You file a separate return.
- 2) You paid more than half the cost of keeping up your home for the tax year.
- 3) Your spouse did not live in your home during the last 6 months of the tax year. Your spouse is considered to live in your home even if he or she is temporarily absent due to special circumstances. See *Temporary absences*, later.
- 4) Your home was the main home of your child, stepchild or adopted child for more than half the year or was the main home of your foster child for the entire year. (See *Home of qualifying person*, later, for rules applying to a child's birth, death, or temporary absence during the year.)
- 5) You must be able to claim an exemption for the child. However, you can still meet this test if you cannot claim the exemption only because the noncustodial parent is allowed to claim the exemption for the child. See *Noncustodial parent* in chapter 3 for situations where the noncustodial parent is allowed to claim the exemption for the child.

The general rules to claim an exemption for a dependent are explained in chapter 3.



*If you were considered married for part of the year and lived in a community property state (listed earlier under Separate Returns), special rules may apply in determining your income and expenses. See Publication 555 for more information.*

**Nonresident alien spouse.** You are considered unmarried for head of household purposes if your spouse was a nonresident alien at any time during the year and you do not choose to treat your nonresident spouse as a resident alien. However, your spouse is not a qualifying person for head of household purposes. You must have another qualifying person and meet the other tests to be eligible to file as a head of household.

**Earned income credit.** Even if you are considered unmarried for head of household purposes because you are married to a nonresident alien, you may still be considered married for purposes of the earned income credit (unless you meet the five tests listed earlier). In that case, you will not be entitled to the credit unless you file a joint return with your spouse and meet other qualifications. See Publication 596, *Earned Income Credit*, for more information.

**Choice to treat spouse as resident.** You are considered married if you choose to treat your spouse as a resident alien.

## Keeping Up a Home

To qualify for head of household status, you must pay more than half of the cost of keeping up a home for the year. You can determine whether you paid more than half of the cost of keeping up a home by using the *Cost of Keeping Up a Home* worksheet, shown later.

**Costs you include.** Include in the cost of upkeep expenses such as rent, mortgage interest, real estate taxes, insurance on the home, repairs, utilities, and food eaten in the home.

**Costs you do not include.** Do not include in the cost of upkeep expenses such as clothing, education, medical treatment, vacations, life insurance, or transportation. Also, do not include the rental value of a home you own or the value of your services or those of a member of your household.



### Cost of Keeping Up a Home

	Amount You Paid	Total Cost
Property taxes	\$ _____	\$ _____
Mortgage interest expense	_____	_____
Rent	_____	_____
Utility charges	_____	_____
Upkeep and repairs	_____	_____
Property insurance	_____	_____
Food consumed on the premises	_____	_____
Other household expenses	_____	_____
Totals	\$ _____	\$ _____
Minus total amount you paid		( _____ )
Amount others paid		\$ _____

If the total amount you paid is more than the amount others paid, you meet the requirement of paying more than half the cost of keeping up the home.

## Qualifying Person

See Table 2-1 to see who is a qualifying person.

**Home of qualifying person.** Generally, the qualifying person must live with you for more than half the year.

**Special rule for parent.** You may be eligible to file as head of household even if the parent for whom you can claim an exemption does not live with you. You must pay more than half the cost of keeping up a home that was the main home for the **entire year** for your father or mother. You are keeping up a main home for your father or mother if you pay more than half the cost of keeping your parent in a rest home or home for the elderly.

**Temporary absences.** You and your qualifying person are considered to live together even if one or both of you are temporarily absent from your home due to special circumstances such as illness, education, business, vacation, and military service. It must be reasonable to assume that the absent person will return to the household after the temporary absence. You must continue to keep up the home during the absence.

**Death or birth.** You may be eligible to file as head of household if the individual who qualifies you for this filing status is born or dies during the year. You must have provided more than half of the cost of keeping up a home that was the individual's main home for more than half the year, or, if less, the period during which the individual lived.

**Example.** You are unmarried. Your mother, for whom you can claim an exemption, lived in an apartment by herself. She died on September 2. The cost of the upkeep of her apartment for the year until her death was \$6,000. You paid \$4,000 and your brother paid \$2,000. Your brother made no other payments toward your mother's support. Your mother had no income. Because you paid more than half the cost of keeping up your mother's apartment from January 1 until her death, and you can claim an exemption for her, you can file as a head of household.

## Qualifying Widow(er) With Dependent Child

If your spouse died in 1999, you can use married filing jointly as your filing status for 1999 if you would otherwise qualify to use that status. The year of death is the last year for which you can file jointly with your deceased spouse. See *Married Filing Jointly*, earlier.

You may be eligible to use **qualifying widow(er) with dependent child** as your filing status for 2 years following the year of death of your spouse. For example, if your spouse died in 1998, and you have not remarried, you may be able to use this filing status for 1999 and 2000.

This filing status entitles you to use joint return tax rates and the highest standard deduction amount (if you do not itemize deductions). This status does not entitle you to file a joint return.

**How to file.** If you file as qualifying widow(er) with dependent child, you can use either Form 1040A or Form 1040. Indicate your filing status by checking the box on line 5 of either form. Write the year your spouse died in the space provided on line 5. Use the *Married filing jointly* column of the Tax Table or *Schedule Y-1* of the Tax Rate Schedules, to figure your tax.

**Eligibility rules.** You are eligible to file as a qualifying widow(er) with dependent child if you meet all of the following tests.

- 1) You were entitled to file a joint return with your spouse for the year your spouse died. (It does not matter whether you actually filed a joint return.)
- 2) You did not remarry before the end of the tax year for which you are filing the return.
- 3) You have a child, stepchild, adopted child, or foster child for whom you can claim an exemption.
- 4) You paid more than half the cost of keeping up a home that is the main home for you and that child for the entire year, except for temporary ab-

sences. See *Temporary absences* and *Keeping Up a Home*, discussed earlier under *Head of Household*.



*As mentioned earlier, this filing status is only available for 2 years following the year of death of your spouse.*

**Example.** John Reed's wife died in 1997. John has not remarried. During 1998 and 1999, he continued to keep up a home for himself and his child (for whom he can claim an exemption). For 1997 he was entitled to file a joint return for himself and his deceased wife. For 1998 and 1999 he can file as qualifying widower with a dependent child. After 1999 he can file as head of household if he qualifies.

**Death or birth.** You may be eligible to file as a qualifying widow(er) with dependent child if the child who qualifies you for this filing status is born or dies during the year. You must have provided more than half of the cost of keeping up a home that was the child's main home during the entire part of the year he or she was alive.



### 3.

## Personal Exemptions and Dependents

### Important Changes

**Exemption amount.** The amount you can deduct for each exemption has increased from \$2,700 in 1998 to \$2,750 in 1999.

**Exemption phaseout.** You will lose all or part of the benefit of your exemptions if your adjusted gross income is above a certain amount. The amount at which this phaseout begins depends on your filing status. For 1999, the phaseout begins at \$94,975 for married persons filing separately; \$126,600 for unmarried individuals; \$158,300 for heads of household; and at \$189,950 for married persons filing jointly. See *Phaseout of Exemptions*, later.

### Introduction

This chapter discusses exemptions. The following topics will be explained.

- Personal exemptions — You generally can take one for yourself and, if you are married, one for your spouse.
- Exemptions for dependents — You must meet five exemption tests for each exemption you claim. If you are entitled to claim an exemption for a dependent, that dependent cannot claim a personal exemption on his or her own tax return.
- Phaseout of exemptions — You get less of a deduction when your taxable income goes above a certain amount.
- Social security number (SSN) requirement for dependents.

Exemptions reduce your taxable income. Generally, you can deduct \$2,750 for each exemption you claim in 1999. How you claim an exemption on your tax return depends on which form you file.

If you file Form 1040EZ, the exemption amount is combined with the standard deduction amount and entered on line 5.

If you file Form 1040A or Form 1040, follow the instructions for the form. The total number of exemptions you can claim is the total in the box on line 6d. Also complete line 23 (Form 1040A) or line 38 (Form 1040) by multiplying the total number of exemptions shown in the box on line 6d by \$2,750



If your adjusted gross income is \$94,975 or more, see *Phaseout of Exemptions*, later.

### Useful Items

You may want to see:

#### Form (and Instructions)

- 2120** Multiple Support Declaration
- 8332** Release of Claim to Exemption for Child of Divorced or Separated Parents

### Exemptions

There are two types of exemptions: personal exemptions and exemptions for dependents. While these are both worth the same amount, different rules apply to each type.

#### Personal Exemptions

You are generally allowed one exemption for yourself and, if you are married, one exemption for your spouse. These are called personal exemptions.

#### Your Own Exemption

You can take one exemption for yourself unless you can be claimed as a dependent by another taxpayer.

**Single persons.** If another taxpayer is entitled to claim you as a dependent, you cannot take an exemption for yourself. This is true even if the other taxpayer does not actually claim your exemption.

**Married persons.** If you file a joint return, you can take your own exemption. If you file a separate return, you can take your own exemption only if another taxpayer is not entitled to claim you as a dependent.

#### Your Spouse's Exemption

Your spouse is never considered your dependent. You may be able to take one exemption for your spouse only because you are married.

**Joint return.** On a joint return you can claim one exemption for yourself and one for your spouse.

**Separate return.** If you file a separate return, you can claim the exemption for your spouse only if your spouse had **no gross income** and was not the dependent of another taxpayer. This is true even if the other taxpayer does not actually claim your spouse's exemption. This is also true if your spouse is a nonresident alien.

**Death of spouse.** If your spouse died during the year, you can generally claim your spouse's exemption under the rules just explained under *Joint return* and *Separate return*.

If you remarried during the year, you cannot take an exemption for your deceased spouse.

If you are a surviving spouse without gross income and you remarry in the year your spouse died, you can be claimed as an exemption on both the final separate return of your deceased spouse and the separate return for that year of your new

spouse. If you file a joint return with your new spouse, you can be claimed as an exemption only on that return.

**Divorced or separated spouse.** If you obtained a final decree of divorce or separate maintenance by the end of the year, you cannot take your former spouse's exemption. This rule applies even if you provided all of your former spouse's support.

### Exemptions for Dependents

You are allowed one exemption for each person you can claim as a dependent.

You can claim an exemption for a person if **all five** of the exemption tests, discussed later, are met. You can take an exemption for your dependent even if your dependent files a return. But that dependent cannot claim his or her own personal exemption if you are entitled to do so. However, see *Joint Return Test*, later in this chapter.

**Child tax credit.** You may be entitled to a child tax credit for each of your qualifying children for whom you can claim an exemption. For more information see chapter 35.

**Child born alive.** If your child was born alive during the year, and the exemption tests are met, you can take the full exemption. This is true even if the child lived only for a moment. Whether your child was born alive depends on state or local law. There must be proof of a live birth shown by an official document, such as a birth certificate.

**Stillborn child.** You cannot claim an exemption for a stillborn child.

**Death of dependent.** If your dependent died during the year and otherwise met the exemption tests, you can take an exemption for your dependent.

**Example.** Your dependent mother died on January 15. The five exemption tests are met. You can take a full exemption for her on your return.

**Housekeepers, maids, or servants.** If these people work for you, you cannot claim exemptions for them.

**Exemption tests.** The following five tests must be met for you to claim an exemption for a dependent.

- 1) Member of Household or Relationship Test.
- 2) Citizenship Test.
- 3) Joint Return Test.
- 4) Gross Income Test.
- 5) Support Test.

#### Member of Household or Relationship Test

To meet this test, a person must live with you for the entire year as a member of your household or be related to you in one of the ways listed later under *Relatives not living with you*. If at any time during the year the person was your spouse, that person can-

not be your dependent. However, see *Personal Exemptions*, earlier.

**Temporary absences.** A person lives with you as a member of your household even if either (or both) of you are temporarily absent due to special circumstances. Temporary absences due to special circumstances include absences because of illness, education, business, vacation, and military service.

If the person is placed in a nursing home for an indefinite period of time to receive constant medical care, the absence is considered temporary.

**Death or birth.** A person who died during the year, but was a member of your household until death, will meet the member of household test. The same is true for a child who was born during the year and was a member of your household for the rest of the year. The test is also met if a child would have been a member except for any required hospital stay following birth.

**Test not met.** A person does not meet the member of household test if at any time during your tax year the relationship between you and that person violates local law.

**Relatives not living with you.** A person related to you in any of the following ways does not have to live with you for the entire year as a member of your household to meet this test.

- Your child, grandchild, great grandchild, etc. (a legally adopted child is considered your child).
- Your stepchild.
- Your brother, sister, half brother, half sister, stepbrother, or stepsister.
- Your parent, grandparent, or other direct ancestor, but not foster parent.
- Your stepfather or stepmother.
- A brother or sister of your father or mother.
- A son or daughter of your brother or sister.
- Your father-in-law, mother-in-law, son-in-law, daughter-in-law, brother-in-law, or sister-in-law.

Any of these relationships that were established by marriage are not ended by death or divorce.

**Adoption.** Before legal adoption, a child is considered to be your child if he or she was placed with you for adoption by an authorized agency. Also, the child must have been a member of your household. If the child was not placed with you by an authorized agency, the child will meet this test only if he or she was a member of your household for your entire tax year.

**Foster child.** A foster child must live with you as a member of your household for the entire year to qualify as your dependent.

**Cousin.** You can claim an exemption for your cousin only if he or she lives with you as a member of your household for the entire year. A cousin is a descendant of a

brother or sister of your father or mother and does not qualify under the relationship test.

**Joint return.** If you file a joint return, you do not need to show that a person is related to both you and your spouse. You also do not need to show that a person is related to the spouse who provides support.

For example, your spouse's uncle who receives more than half his support from you may be your dependent, even though he does not live with you. However, if you and your spouse file **separate returns**, your spouse's uncle can be your dependent only if he is a member of your household and lives with you for your entire tax year.

## Citizenship Test

To meet the citizenship test, a person must be a U.S. citizen or resident, or a resident of Canada or Mexico, for some part of the calendar year in which your tax year begins.

**Children's place of residence.** Children usually are citizens or residents of the country of their parents.

If you were a U.S. citizen when your child was born, the child may be a U.S. citizen although the other parent was a non-resident alien and the child was born in a foreign country. If so, and the other exemption tests are met, you can take the exemption. It does not matter if the child lives abroad with the nonresident alien parent.

If you are a U.S. citizen who has legally adopted a child who is not a U.S. citizen or resident, and the other exemption tests are met, you can take the exemption if your home is the child's main home and the child is a member of your household for your entire tax year.

**Foreign students' place of residence.** Foreign students brought to this country under a qualified international education exchange program and placed in American homes for a temporary period generally are not U.S. residents and do not meet the citizenship test. You cannot claim exemptions for them. However, if you provided a home for a foreign student, you may be able to take a charitable contribution deduction. See *Expenses Paid for Student Living With You* in chapter 26.

## Joint Return Test

Even if the other exemption tests are met, you are generally not allowed an exemption for your dependent if he or she files a joint return.

**Example.** You supported your daughter for the entire year while her husband was in the Armed Forces. The couple files a joint return. Even though all the other tests are met, you cannot take an exemption for your daughter.

**Exception.** The joint return test does not apply if a joint return is filed by the dependent and his or her spouse merely as a claim for refund and no tax liability would exist for either spouse on separate returns.

**Example.** Your son and his wife each had less than \$2,000 of wages and no unearned income. Neither is required to file a tax return. Taxes were taken out of their

pay, so they file a joint return to get a refund. You are allowed to take exemptions for your son and daughter-in-law if the other exemption tests are met.

## Gross Income Test

Generally, you cannot take an exemption for a dependent if that person had gross income of \$2,750 or more for the year. This test does not apply if the person is your child and is either under age 19, or a student under age 24, as discussed later.

If you file on a fiscal year basis, the gross income test applies to the calendar year in which your fiscal year begins.

**Gross income defined.** All income in the form of money, property, and services that is not exempt from tax is gross income.

In a manufacturing, merchandising, or mining business, gross income is the total net sales minus the cost of goods sold, plus any miscellaneous income from the business.

Gross receipts from rental property are gross income. Do not deduct taxes, repairs, etc., to determine the gross income from rental property.

Gross income includes a partner's share of the gross, not a share of the net, partnership income.

Gross income also includes all unemployment compensation and certain scholarship and fellowship grants. Scholarships received by degree candidates that are used for tuition, fees, supplies, books, and equipment required for particular courses are not included in gross income. For more information, see chapter 13.

Tax-exempt income, such as certain social security payments, is not included in gross income.

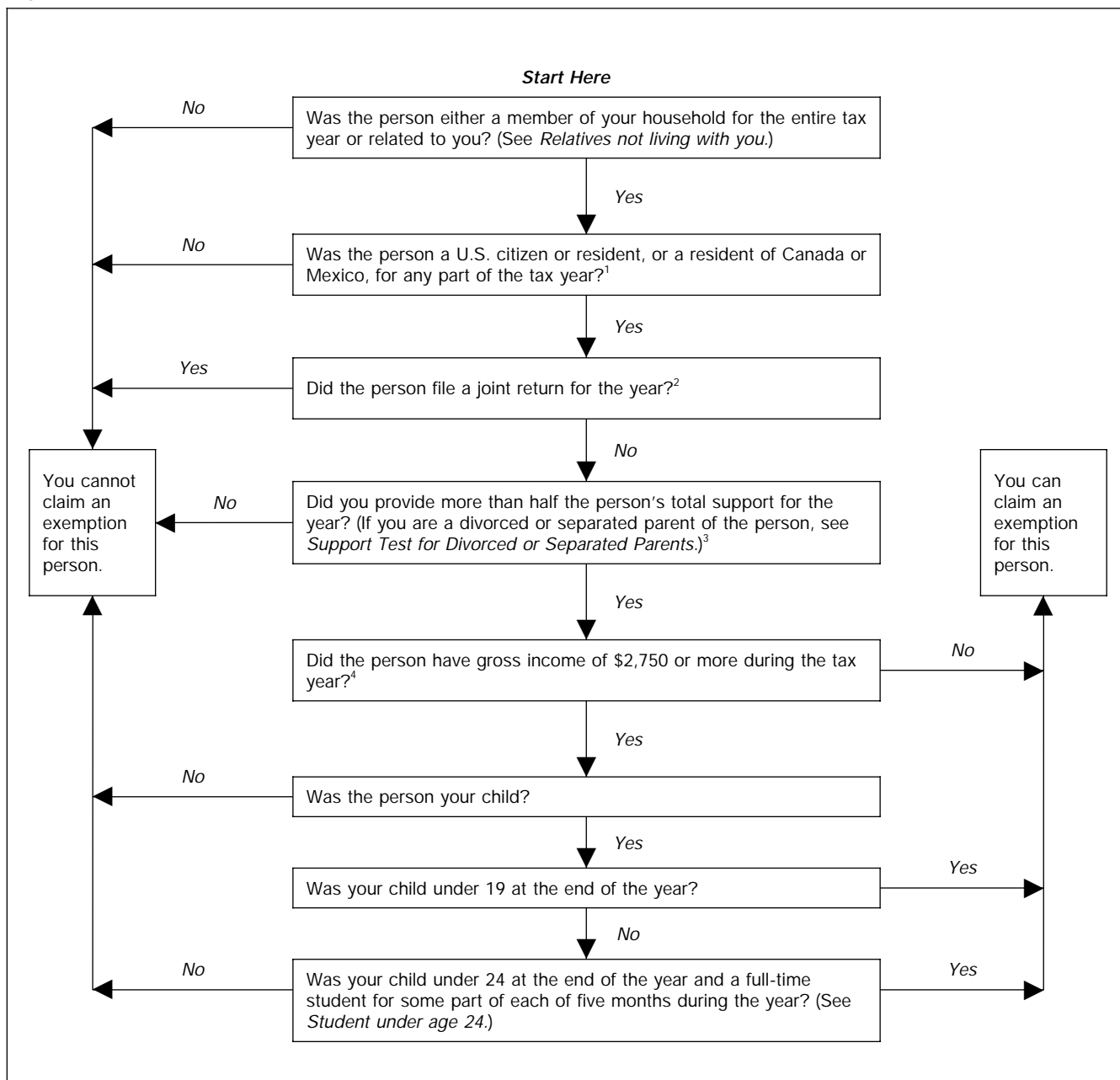
**Disabled dependents.** For this gross income test, gross income does not include income received by a permanently and totally disabled individual for services performed at a sheltered workshop. The availability of medical care must be the main reason the individual is at the workshop. Also, the income must come solely from activities at the workshop that are incident to this medical care. A sheltered workshop is a school operated by certain tax-exempt organizations, or by a state, a U.S. possession, a political subdivision of a state or possession, the United States, or the District of Columbia, that provides special instruction or training designed to alleviate the disability of the individual.

**Child defined.** For purposes of the gross income test, your child is your son, stepson, daughter, stepdaughter, a legally adopted child, or a child who was placed with you by an authorized placement agency for your legal adoption. A foster child who was a member of your household for your entire tax year is also considered your child.

**Child under 19.** If your child is under 19 at the end of the year, the gross income test does not apply. Your child can have any amount of income and you can still claim an exemption if the other exemption tests, including the support test, are met.

**Example.** Marie, 18, earned \$3,000. Her father provided more than half her support. Because Marie is under 19, the gross income test does not apply. If the

Figure 3–A. Can You Claim an Exemption for a Dependent?



<sup>1</sup>If the person was your legally adopted child and lived in your home as a member of your household for the entire tax year, answer "yes" to this question.  
<sup>2</sup>If neither the person nor the person's spouse is required to file a return, but they file a joint return only to claim a refund of tax withheld, answer "no" to this question.  
<sup>3</sup>Answer "yes" to this question if you meet the multiple support requirements under *Multiple Support Agreement*.  
<sup>4</sup>Gross income for this purpose does not include income received by a permanently disabled individual at a sheltered workshop. See *Disabled dependent*.

other exemption tests were met, Marie's father can claim an exemption for her.

**Student under age 24.** The gross income test does not apply if your child is a student who is under age 24 at the end of the calendar year. The other exemption tests must still be met.

**Student defined.** To qualify as a student, your child must be, during some part of each of 5 calendar months during the calendar year (not necessarily consecutive):

- 1) A full-time student at a school that has a regular teaching staff, course of study, and regularly enrolled body of students in attendance, 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.

**Full-time student defined.** A full-time student is a person who is enrolled for the number of hours or courses the school considers to be full-time attendance.

**School defined.** The term "school" includes elementary schools, junior and senior high schools, colleges, universities, and technical, trade, and mechanical schools. It does **not** include on-the-job training courses, correspondence schools, and night schools.

**Example.** James, 22, attends college as a full-time student. During the summer, James earned \$3,000. If the other exemption tests are met, his parents can take the exemption for James.

**Vocational high school students.** People who work on "co-op" jobs in private industry as a part of the school's prescribed course of classroom and practical training are considered full-time students.

**Night school.** Your child is not a full-time student while attending school only at night. However, full-time attendance at a school can include some attendance at night as part of a full-time course of study.

## Support Test

You must provide more than half of a person's total support during the calendar year to meet the support test. You figure whether you have provided more than half by comparing the amount you contributed to the person's support with the entire amount of support the person received from all sources. This includes support the person provided from his or her own funds.

You may find *Table 3-1* helpful in figuring whether you provided more than half of a person's support.

**Person's own funds not used for support.** A person's own funds are not support unless they are actually spent for support.

**Example.** Your mother received \$2,400 in social security benefits and \$300 in interest. She paid \$2,000 for lodging and \$400 for recreation.

Even though your mother received a total of \$2,700, she spent only \$2,400 for her own support. If you spent more than \$2,400 for her support and no other support was received, you have provided more than half of her support.

**Child's wages used for own support.** You cannot include in your contribution to your child's support any support that is paid for by the child with the child's own wages, even if you paid the wages.

**Year support is provided.** The year you provide the support is the year you pay for it, even if you do so with borrowed money that you repay in a later year.

If you use a fiscal year to report your income, you must provide more than half of the dependent's support for the calendar year in which your fiscal year begins.

**Armed Forces dependency allotments.** The part of the allotment contributed by the government and the part taken out of your military pay are both considered provided by you in figuring whether you provide more than half of the support. If your allotment is used to support persons other than those you name, you can take the exemptions for them if they otherwise qualify.

**Example.** You are in the Armed Forces. You authorize an allotment for your widowed mother that she uses to support herself and your sister. If the allotment provides more than half of their support, you can take an exemption for each of them, if they otherwise qualify, even though you authorize the allotment only for your mother.

**Tax-exempt military quarters allowances.** These allowances are treated the same way as dependency allotments in figuring support. The allotment of pay and the tax-exempt basic allowance for quarters are both considered as provided by you for support.

**Tax-exempt income.** In figuring a person's total support, include tax-exempt income, savings, and borrowed amounts used to support that person. Tax-exempt income includes certain social security benefits, welfare benefits, nontaxable life insurance proceeds, Armed Forces family allotments, nontaxable pensions, and tax-exempt interest.

**Example 1.** You provide \$4,000 toward your mother's support during the year. She has earned income of \$600, nontaxable social security benefit payments of \$4,800, and tax-exempt interest of \$200. She uses all these for her support. You cannot claim an exemption for your mother because the \$4,000 you provide is not more than half of her total support of \$9,600.

**Example 2.** Your daughter takes out a student loan of \$2,500 and uses it to pay her college tuition. She is personally responsible for the loan. You provide \$2,000 toward her total support. You cannot claim an exemption for your daughter because you provide less than half of her support.

**Social security benefit payments.** If a husband and wife each receive payments that are paid by one check made out to both of them, half of the total paid is considered to be for the support of each spouse, unless they can show otherwise.

If a child receives social security benefits and uses them toward his or her own support, the payments are considered as provided by the child.

**Support provided by the state (food stamps, housing, etc.).** Benefits provided by the state to a needy person generally are considered to be used for support. However, payments based on the needs of the recipient will not be considered as used entirely for that person's support if it is shown that part of the payments were not used for that purpose.

**Foster care payments.** Payments you receive for the support of a foster child from a child placement agency are considered support provided by the agency. Similarly, payments you receive for the support of a foster child from a state or county are considered support provided by the state or county.

If you are not in the trade or business of providing foster care to a child, your unreimbursed out-of-pocket expenses for the support of the foster child are considered support provided by you if you do not deduct those expenses as a charitable contribution. For information about the deduction for charitable contributions, see Publication 526, *Charitable Contributions*.

If you are in the trade or business of providing foster care, your unreimbursed expenses for the support of the foster child are not considered support provided by you.

**Home for the aged.** If you make a lump-sum advance payment to a home for the aged to take care of your relative for life and the payment is based on that person's life expectancy, the amount of support you provide each year is the lump-sum payment divided by the relative's life expectancy. The amount of support you provide also includes any other amounts that you provided during the year.

## Total Support

To figure if you provided more than half of the support of a person, you must first determine the total support provided for that person. Total support includes amounts spent to provide food, lodging, clothing, education, medical and dental care, recreation, transportation, and similar necessities.

Generally, the amount of an item of support is the amount of the expense incurred in providing that item. Expenses that are not directly related to any one member of a household, such as the cost of food for the household, must be divided among the members of the household. For lodging, the amount of support is the fair rental value of the lodging.

**Example.** Your parents live with you, your spouse, and your two children in a house you own. The fair rental value of your parents' share of lodging is \$2,000 a year, which includes furnishings and utilities. Your father receives a nontaxable pension of \$4,200, which he spends equally between your mother and himself for items of support such as clothing, transportation, and recreation. Your total food expense for the household is \$6,000. Your heat and utility bills amount to \$1,200. Your mother has hospital and medical expenses of \$600, which you pay during the year. Figure your parents' total support as follows:

Support Provided	Father	Mother
Fair rental value of lodging .....	\$1,000	\$1,000
Pension spent for their support ....	2,100	2,100
Share of food (1/6 of \$6,000) .....	1,000	1,000
Medical expenses for mother .....		600
<b>Parents' total support</b>	<b>\$4,100</b>	<b>\$4,700</b>

You must apply the support test separately to each parent. You provide \$2,000 (\$1,000 lodging, \$1,000 food) of your father's total support of \$4,100 — less than half. You provide \$2,600 to your mother (\$1,000 lodging, \$1,000 food, \$600 medical) — more than half of her total support of \$4,700. You meet the support test for your mother, but not your father. Heat and utility costs are included in the fair rental value of the lodging, so these are not considered separately.

**Lodging defined.** Lodging is the fair rental value of the room, apartment, or house in which the person lives. It includes a reasonable allowance for the use of furniture and appliances, and for heat and other utilities.

**Fair rental value defined.** This is the amount you could reasonably expect to receive from a stranger for the same kind of lodging. It is used in place of rent or taxes, interest, depreciation, paint, insurance, utilities, cost of furniture and appliances, etc. In some cases, fair rental value may be equal to the rent paid.

If you provide the total lodging, the amount of support you provide is the fair rental value of the room the person uses, or a share of the fair rental value of the entire dwelling if the person has use of your entire home. If you do not provide the total lodging, the total fair rental value must be divided depending on how much of the total lodging you provide. If you provide only a part and the person supplies the rest, the fair rental value must be divided between both of you according to the amount each provides.

**Example.** Your parents live rent free in a house you own. It has a fair rental value of \$5,400 a year furnished, which includes a fair rental value of \$3,600 for the house and \$1,800 for the furniture. This does not include heat and utilities. The house is completely furnished with furniture belonging to your parents. You pay \$600 for their utility bills. Utilities are not usually included

Table 3–1. **Worksheet for Determining Support**

<b>Funds Belonging to the Person You Supported</b>	
1) Total funds belonging to the person you supported, including income received (taxable and nontaxable) and amounts borrowed during the year, plus the amount in savings and other accounts at the beginning of the year	\$ _____
2) Amount used for support	\$ _____
3) Amount used for other purposes	\$ _____
4) Amount in savings and other accounts at end of the year	\$ _____
(The total of lines 2, 3, and 4 should equal line 1)	\$ _____
<b>Expenses for Entire Household</b> (where the person you supported lived)	
5) Lodging (Complete item a or b)	
a) Rent paid	\$ _____
b) If not rented, show fair rental value of home. If the person you supported owned the home, include this amount in line 19.	\$ _____
6) Food	\$ _____
7) Utilities (heat, light, water, etc. not included in line 5a or 5b)	\$ _____
8) Repairs (not included in line 5a or 5b)	\$ _____
9) Other. Do not include expenses of maintaining home, such as mortgage interest, real estate taxes, and insurance.	\$ _____
10) Total household expenses (Add lines 5 through 9)	\$ _____
11) Total number of persons who lived in household	_____
<b>Expenses for the Person You Supported</b>	
12) Each person's part of household expenses (line 10 divided by line 11)	\$ _____
13) Clothing	\$ _____
14) Education	\$ _____
15) Medical, dental	\$ _____
16) Travel, recreation	\$ _____
17) Other (specify)	\$ _____
18) Total cost of support for the year (Add lines 12 through 17)	\$ _____
<b>Did You Provide More Than Half?</b>	
19) Amount the person provided for own support (line 2, plus line 5b if the person you supported owned the home)	\$ _____
20) Amount others provided for the person's support. Include amounts provided by state, local, and other welfare societies or agencies. Do not include any amounts included on line 1.	\$ _____
21) Amount you provided for the person's support (line 18 minus lines 19 and 20)	\$ _____
22) 50% of line 18	\$ _____
Is line 21 is more than line 22? <b>Yes.</b> You meet the support test for the person. If the other exemption tests are met, you may claim an exemption for the person. <b>No.</b> You do not meet the support test for the person. You cannot claim an exemption for the person unless you can do so under a multiple support agreement. See <i>Multiple Support Agreement</i> in this chapter.	

in rent for houses in the area where your parents live. Therefore, you consider the total fair rental value of the lodging to be \$6,000 (\$3,600 fair rental value of the unfurnished house, \$1,800 allowance for furnishings provided by your parents, and \$600 cost of utilities) of which you are considered to provide \$4,200 (\$3,600 + \$600).

#### **Person living in his or her own home.**

The total fair rental value of a person's home that he or she owns is considered support contributed by that person.

**Living with someone rent free.** If you live with a person rent free in his or her home, you must reduce the amount you provide for support by the fair rental value of lodging he or she provides you.

**Property.** Property provided as support is measured by its fair market value. Fair market value is the price that property would sell for on the open market. It is the price that would be agreed upon between a willing buyer and a willing seller, with neither being required to act, and both having reasonable knowledge of the relevant facts.

**Capital expenses.** Capital items, such as furniture, appliances, and cars, that are bought for a person during the year can be included in total support under certain circumstances.

The following examples show when a capital item is or is not support.

**Example 1.** You buy a \$200 power lawn mower for your 13-year-old child. The child is given the duty of keeping the lawn trimmed. Because a lawn mower is ordinarily an item you buy for personal and family reasons that benefits all members of the household, you cannot include the cost of the lawn mower in the support of your child.

**Example 2.** You buy a \$150 television set as a birthday present for your 12-year-old child. The television set is placed in your child's bedroom. You can include the cost of the television set in the support of your child.

**Example 3.** You pay \$5,000 for a car and register it in your name. You and your 17-year-old daughter use the car equally. Because you own the car and do not give it to your daughter but merely let her use it, you cannot include the cost of the car in your daughter's total support. However, you can include in your daughter's support your out-of-pocket expenses of operating the car for her benefit.

**Example 4.** Your 17-year-old son, using personal funds, buys a car for \$4,500. You provide all the rest of your son's support — \$4,000. Since the car is bought and owned by your son, the car's fair market value (\$4,500) must be included in his support. The \$4,000 support you provide is less than half of his total support of \$8,500. You cannot claim an exemption for your son.

**Medical insurance premiums.** Medical insurance premiums you pay, including premiums for supplementary Medicare coverage, are included in the support you provide.

**Medical insurance benefits.** Medical insurance benefits, including basic and supplementary Medicare benefits, are not part of support.

**Tuition payments and allowances under the GI Bill.** Amounts veterans receive under the GI Bill for tuition payments and allowances while they attend school are included in total support.

**Example.** During the year, your son receives \$2,200 from the government under the GI Bill. He uses this amount for his education. You provide the rest of his support — \$2,000. Because GI benefits are included in total support, your son is not your dependent.

**Other support items.** Other items may be considered as support depending on the facts in each case. For example, if you pay someone to provide child care or disabled dependent care, you can include these payments as support, even if you claim a credit for them. For information on the credit, see chapter 33.

### **Do Not Include in Total Support**

The following items are not included in total support.

- 1) Federal, state, and local income taxes paid by persons from their own income.
- 2) Social security and Medicare taxes paid by persons from their own income.
- 3) Life insurance premiums.
- 4) Funeral expenses.
- 5) Scholarships received by your child if your child is a full-time student.
- 6) Survivors' and Dependents' Educational Assistance payments used for support of the child who receives them.

### **Multiple Support Agreement**

Sometimes no one provides more than half of the support of a person. Instead, two or more persons, each of whom would be able to take the exemption but for the support test, together provide more than half of the person's support.

When this happens, you can agree that any one of you who individually provides more than 10% of the person's support, but **only one**, can claim an exemption for that person. Each of the others must sign a written statement agreeing not to claim the exemption for that year. The statements must be filed with the income tax return of the person who claims the exemption. **Form 2120, Multiple Support Declaration**, is used for this purpose.

**Example 1.** You, your sister, and your two brothers provide the entire support of your mother for the year. You provide 45%, your sister 35%, and your two brothers each provide 10%. Either you or your sister can claim an exemption for your mother. The other must sign a Form 2120 or a similar statement agreeing not to take an exemption for her. Because neither brother provides more than 10% of the support, neither can take the exemption. Your

brothers do not have to sign a Form 2120 or the written statement.

**Example 2.** You and your brother each provide 20% of your mother's support for the year. The remaining 60% of her support is provided equally by two persons who are not related to her. She does not live with them. Because more than half of her support is provided by persons who cannot claim an exemption for her, no one can take the exemption.

**Example 3.** Your father lives with you and receives 25% of his support from social security, 40% from you, 24% from his brother, and 11% from a friend. Either you or your uncle can take the exemption for your father. A Form 2120 or a similar statement from the one not taking the exemption must be attached to the return of the one who takes the exemption.

### **Support Test for Divorced or Separated Parents**

The support test for a child of divorced or separated parents is based on the special rules explained here and shown in *Figure 3-B*. However, these special rules apply only if all of the following are true.

- 1) The parents are divorced or legally separated under a decree of divorce or separate maintenance, or separated under a written separation agreement, or lived apart at all times during the last 6 months of the calendar year.
- 2) One or both parents provide more than half of the child's total support for the calendar year.
- 3) One or both parents have custody of the child for more than half of the calendar year.

"Child" is defined earlier under *Gross Income Test*.

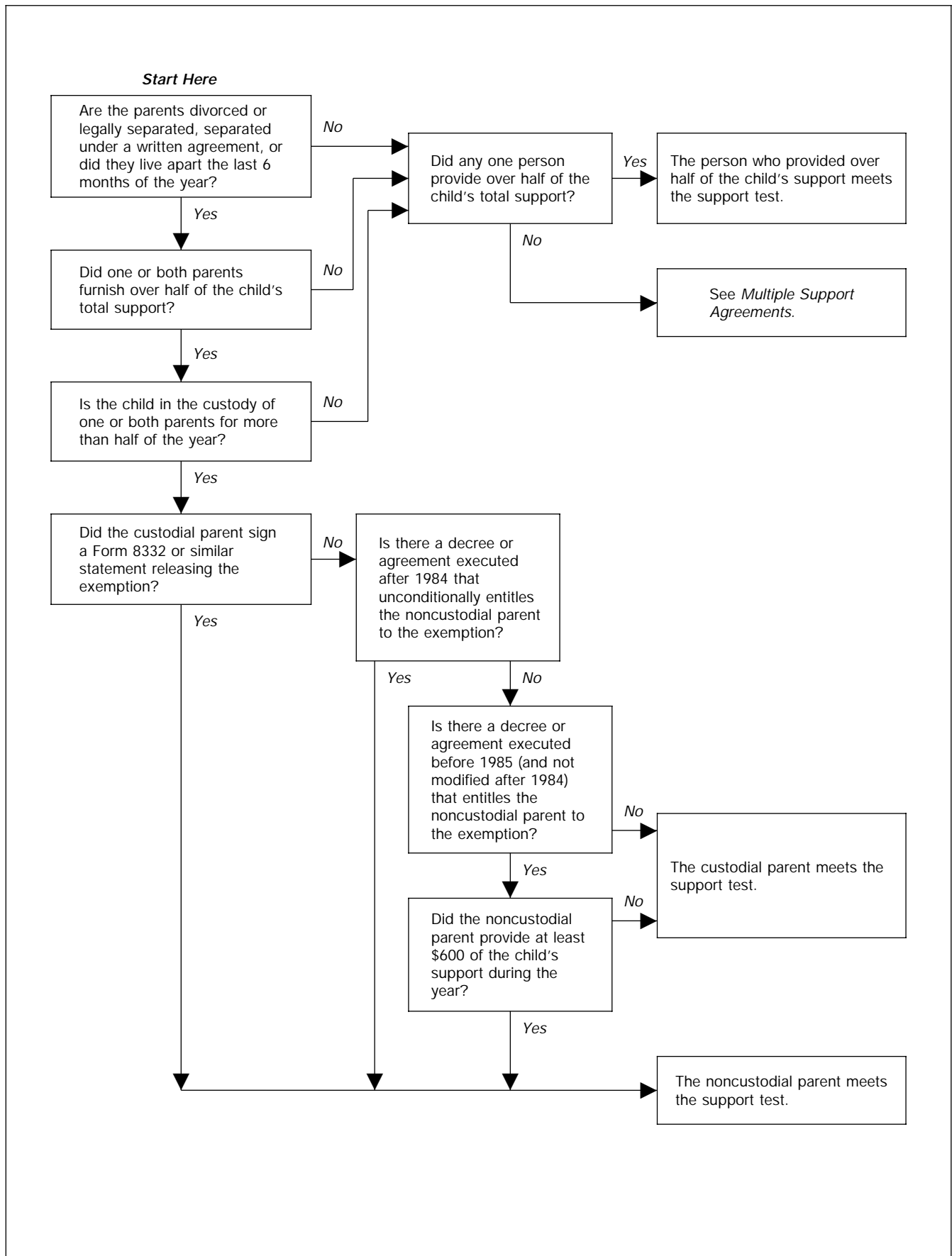
This discussion does not apply if the support of the child is determined under a multiple support agreement, discussed earlier.

**Custodial parent.** The parent who has custody of the child for the greater part of the year (the custodial parent) is generally treated as the parent who provides more than half of the child's support. It does not matter whether the custodial parent actually provided more than half of the support.

**Custody.** Custody is usually determined by the terms of the most recent decree of divorce or separate maintenance, or a later custody decree. If there is no decree, use the written separation agreement. If neither a decree nor agreement establishes custody, then the parent who has the physical custody of the child for the greater part of the year is considered to have custody of the child. This also applies if the validity of a decree or agreement awarding custody is uncertain because of legal proceedings pending on the last day of the calendar year.

If the parents are divorced or separated during the year and had joint custody of the child before the separation, the parent who has custody for the greater part of the rest of the year is considered to have custody of the child for the tax year.

Figure 3-B. Support Test for Children of Divorced or Separated Parents



**Example 1.** Under the terms of your divorce, you have custody of your child for 10 months of the year. Your former spouse has custody for the other 2 months. You and your former spouse provide the child's total support. You are considered to have provided more than half of the support of the child. However, see *Noncustodial parent*, later.

**Example 2.** You and your former spouse provided your child's total support for 1999. You had custody of your child under your 1993 divorce decree, but on August 31, 1999, a new custody decree granted custody to your former spouse. Because you had custody for the greater part of the year, you are considered to have provided more than half of your child's support.

**Noncustodial parent.** The noncustodial parent is the parent who has custody of the child for the shorter part of the year or who does not have custody at all.

The noncustodial parent will be treated as providing more than half of the child's support if:

- 1) The custodial parent signs a written declaration that he or she will not claim the exemption for the child, and the noncustodial parent attaches this written declaration to his or her return,
- 2) A decree or agreement went into effect after 1984 and states the noncustodial parent can claim the child as a dependent without regard to any condition, such as payment of support, or
- 3) A decree or agreement executed before 1985 provides that the noncustodial parent is entitled to the exemption, and he or she provides at least \$600 for the child's support during the year, unless the pre-1985 decree or agreement is modified after 1984 to specify that this provision will not apply.

**Example.** Under the terms of your 1983 divorce decree, your former spouse has custody of your child. The decree specifically states that you are entitled to the exemption. You provide at least \$600 in child support during the calendar year. You are considered to have provided more than half of the child's support.

**Written declaration.** The custodial parent should use **Form 8332**, or a similar statement, to make the written declaration to release the exemption to the noncustodial parent. The noncustodial parent must attach the form or statement to his or her tax return.

The exemption can be released for a single year, for a number of specified years (for example, alternate years), or for all future years, as specified in the declaration. If the exemption is released for more than one year, the original release must be attached to the return of the noncustodial parent for the first year of such release, and a copy must be attached for each later year.

**Divorce decree or separation agreement.** If your divorce decree or separation agreement went into effect after 1984 and it states you can claim the child as your dependent without regard to any condition, such as payment of support, you can attach a copy of the following pages from the decree or agreement instead of Form 8332.

- 1) Cover page (write the other parent's social security number on this page).
- 2) The page that states you can claim the child as your dependent.
- 3) Signature page with the other parent's signature and the date of the agreement.



If your divorce decree or separation agreement went into effect after 1984 and it states that you can claim the child as your dependent if you meet certain conditions, you must attach to your return **Form 8332** or a similar statement from the custodial parent releasing the exemption.

**Child support.** All child support payments actually received from the noncustodial parent are considered used for the support of the child.

**Example.** The noncustodial parent provides \$1,200 for the child's support. This amount is considered support provided by the noncustodial parent even if the \$1,200 was actually spent on things other than support.

**Paid in a later year.** If you fail to pay child support in the year it is due, but pay it in a later year, your payment of the overdue amount is not considered paid for the support of your child, either for the year the payment was due or for the year it is paid. It is payment of an amount you owed to the custodial parent, but it is not considered paid for the support of your child.

**Example.** You owed but failed to pay child support last year. This year, you pay all of the amount owed from last year and the full amount due for this year. Your payment of this year's child support counts as support for this year, but your payment of the amount owed from last year does not count as support either for this year or for last year.

**Third-party support.** Support provided by a third party for a divorced or separated parent is not included as support provided by that parent. However, see *Remarried parent*, later.

**Example.** You are divorced. During the entire year, you and your child live with your mother in a house she owns. The fair rental value of the lodging provided by your mother for your child is \$3,000. The home provided by your mother is not included in the amount of support you provide.

**Remarried parent.** If you remarry, the support provided by your new spouse is treated as provided by you.

**Example.** You have two children from a former marriage who live with you. You have remarried and are living in a home owned by your new spouse. The fair rental value of the home provided to the children by your new spouse is treated as provided by you.

**Home jointly owned.** If you and your former spouse have the right to use and live in the home, each of you is considered to provide half of your child's lodging. However, if the divorce decree gives only you the right to use and live in the home, you

are considered to provide your child's entire lodging. It does not matter if the legal title to the home remains in the names of both parents.

## Phaseout of Exemptions

The amount you can claim as a deduction for exemptions is phased out once your adjusted gross income (AGI) goes above a certain level for your filing status. These levels are as follows:

Filing Status	AGI Level Which Reduces Exemption Amount
Married filing separately	\$94,975
Single	126,600
Head of household	158,300
Married filing jointly	189,950
Qualifying widow(er)	189,950

You must reduce the dollar amount of your exemptions by 2% for each \$2,500, or part of \$2,500 (\$1,250 if you are married filing separately), that your AGI exceeds the amount shown for your filing status. If your AGI exceeds the amount shown by more than \$122,500 (\$61,250 if married filing separately), the amount of your deduction for exemptions is reduced to zero.

If your AGI exceeds the level for your filing status, use the *Deduction for Exemptions Worksheet* in the instructions for Form 1040 to figure the amount of your deduction for exemptions.

## Social Security Numbers for Dependents

You must list the social security number (SSN) of **any** person for whom you claim an exemption in column (2) of line 6c of your Form 1040 or Form 1040A.



If you do not list the dependent's SSN when required or if you list an incorrect SSN, the exemption may be disallowed.

**Note.** If your dependent does not have and cannot get an SSN, you must list the individual taxpayer identification number (ITIN) or adoption taxpayer identification number (ATIN) instead of an SSN. See *Taxpayer identification numbers for aliens, or Taxpayer identification number for adoptees*, later.

**No social security number.** If a person for whom you expect to claim an exemption on your return does not have an SSN, either you or that person should apply for an SSN as soon as possible by filing **Form SS-5, Application for a Social Security Card**, with the Social Security Administration (SSA). Information about applying for an SSN and Form SS-5 is available at your local SSA office.

It usually takes about 2 weeks to get an SSN. If you do not have a required SSN by the filing due date, you can file Form 4868 for an extension of time to file.



**Born and died in 1999.** If your child was born and died in 1999, and you do not have an SSN for the child, you may attach a copy of the child's birth certificate instead. If you do, enter "DIED" in column 2 of line 6c of your Form 1040 or Form 1040A.

**Taxpayer identification numbers for aliens.** If your dependent is a resident or nonresident alien who does not have and is not eligible to get an SSN, the IRS will issue

your dependent an individual taxpayer identification number (ITIN). Write the number in column (2) of line 6c of your Form 1040 or Form 1040A. To apply for an ITIN, use **Form W-7, Application for IRS Individual Taxpayer Identification Number.**

It usually takes about 30 days to get an ITIN.

**Taxpayer identification numbers for adoptees.** If you have a child who was placed with you by an authorized placement

agency, you may be able to claim an exemption for the child. However, if you cannot get an SSN or an ITIN for the child, you must get an adoption taxpayer identification number (ATIN) for the child from the IRS. You must be eligible to claim an exemption for the child to get an ATIN. See Form W-7A, *Application for Taxpayer Identification Number for Pending U.S. Adoptions*, for details.

## 4.

# Decedents

## Important Reminders

**Medical savings accounts (MSAs).** The treatment of a medical savings account (MSA), including a Medicare+Choice MSA, at the death of the account holder depends on who acquires the interest in the account. For details, see the discussion of MSAs under *How To Report Certain Income and Income in Respect of the Decedent*, later.

**Accelerated death benefits.** Certain payments received under a life insurance contract on the life of a terminally or chronically ill individual before the individual's death (an accelerated death benefit) can be excluded from income. For more information, see *Accelerated Death Benefits*, later.

**Consistent treatment of estate and trust items.** Beneficiaries must generally treat estate items the same way on their individual returns as they are treated on the estate's return. For more information, see *How and When To Report under Distributions to Beneficiaries From an Estate* in Publication 559, *Survivors, Executors, and Administrators*.

**65-day rule for estates.** The personal representative can elect to treat distributions paid or credited by the estate within 65 days after the close of the estate's tax year as having been paid or credited on the last day of that tax year. For more information, see *Distributions to Beneficiaries From an Estate* in Publication 559.

**Estates and beneficiaries treated as related persons for disallowance of certain items.** An estate and a beneficiary of that estate are treated as related persons. Various tax provisions are affected by this change, including the one that denies a deduction for a loss on the sale of an asset between the parties. This does not apply to a sale or exchange made to satisfy a pecuniary bequest.

For more information, see *Income To Include and Losses under Income Tax Return of an Estate—Form 1041* in Publication 559.

## Introduction

This chapter discusses the tax responsibilities of the person who is in charge of the property (estate) of an individual who has died (decedent). It also covers the following topics.

- Filing the decedent's final return.
- Tax effects on survivors.

This chapter does *not* discuss the requirements for filing an income tax return of an estate (Form 1041). For information on Form 1041, see *Income Tax Return of an Estate—Form 1041* in Publication 559.

This chapter also does not discuss the requirements for filing an estate tax return (Form 706). For information, see Form 706 and its instructions.

## Useful Items

You may want to see:

### Publication

- 559** Survivors, Executors, and Administrators

### Form (and Instructions)

- 56** Notice Concerning Fiduciary Relationship
- 706** United States Estate (and Generation-Skipping Transfer) Tax Return
- 1310** Statement of Person Claiming Refund Due a Deceased Taxpayer
- 4810** Request for Prompt Assessment Under Internal Revenue Code Section 6501(d)
- 5495** Request for Discharge From Personal Liability Under Internal Revenue Code Section 6905

## Personal Representative

A personal representative of an estate is an executor, administrator, or anyone who is in charge of the decedent's property.

**Executor.** Generally, an executor (or executrix) is named in a decedent's will to administer the estate (property and debts left by the decedent) and distribute properties as the decedent has directed.

**Administrator.** An administrator (or administratrix) is usually appointed by the court if no will exists, if no executor was named in the will, or if the named executor cannot or will not serve.

**Personal representative.** In general, an executor and an administrator perform the same duties and have the same responsibilities. Because a personal representative for a decedent's estate can be an executor, administrator, or anyone in charge of the decedent's property, the term "personal representative" will be used throughout this chapter.

The surviving spouse may or may not be the personal representative, depending on the terms of the decedent's will or the court appointment.

## Duties

The primary duties of a personal representative are to collect all of the decedent's assets, pay the creditors, and distribute the remaining assets to the heirs or other beneficiaries.

The personal representative also must perform the following duties.

- 1) Notify the IRS (as discussed below) that he or she is acting as the personal representative.

- 2) File any income tax return and estate tax return when due. (See *Final Return for the Decedent*, next.)
- 3) Pay any income tax and estate tax determined up to the date of discharge from duties.
- 4) Provide the payers of any interest and dividends the name(s) and identification number(s) of the new owner(s). (See *Interest and Dividend Income (Forms 1099)*, later.)

For more information on the duties and responsibilities of the personal representative, see *Duties under Personal Representatives* in Publication 559.

**Notifying the IRS.** File a written notice (or Form 56) with the IRS center where the returns are filed for the person (or estate) for whom you are acting. See the instructions for Form 56 for more information.

## Final Return for the Decedent

The same filing requirements that apply to individuals determine if a final income tax return must be filed for the decedent. Filing requirements are discussed in chapter 1.

**Filing to get a refund.** A return should be filed to obtain a refund if tax was withheld from salaries, wages, pensions, or annuities, or if estimated tax was paid, even if a return is not required to be filed. See *Claiming a refund*, later. Also, the decedent may be entitled to other credits that result in a refund. See chapters 37 and 38 for additional information on refundable credits.

**Determining income and deductions.** The method of accounting regularly used by the decedent before death generally determines what income you must include and what deductions you can take on the final return. Generally, individuals use one of two methods of accounting: cash or accrual.

**Cash method.** If the decedent used the cash method of accounting, include only the items of income actually or constructively received before death and deduct only the expenses the decedent paid before death. For an exception for certain medical expenses not paid before death, see *Medical Expenses, under Exemptions and Deductions* in Publication 559.

**Accrual method.** If the decedent used an accrual method of accounting, report only those items of income that the decedent accrued, or earned, before death. Deduct those expenses the decedent was liable for before death, regardless of whether the expenses were paid.

**Additional information.** For more information on the cash and accrual methods, see *Accounting Methods* in chapter 1.

**Who must file the return?** The personal representative (defined earlier) must file the final income tax return of the decedent for the year of death and any returns not filed for preceding years. A surviving spouse, under certain circumstances, may have to file the returns for the decedent. See *Joint Return*, later.

**Example.** Samantha Smith died on March 21, 1999, before filing her 1998 tax return. Her personal representative must file her 1998 return by April 15, 1999. Her final tax return is due April 17, 2000.

**Filing the return.** The word "DECEASED," the decedent's name, and the date of death should be written across the top of the tax return. In the name and address space, you should write the name and address of the decedent and the surviving spouse. If a joint return is not being filed, the decedent's name should be written in the name space and the personal representative's name and address should be written in the remaining space.

**Example 1.** John Stone died in early 1999. He was survived by his wife Jane. Their final joint return included the required information as shown later in the illustration of the top of Form 1040.

**Signing the return.** If a personal representative has been appointed, that person must sign the return. If it is a joint return, the surviving spouse must also sign it.

If no personal representative has been appointed, the surviving spouse (on a joint return) should sign the return and write in the signature area "Filing as surviving spouse." See *Joint return*, later.

If no personal representative has been appointed and if there is no surviving spouse, the person in charge of the decedent's property must file and sign the return as "personal representative."

**Example 2.** Assume in Example 1 that Mrs. Stone is filing as a surviving spouse. No personal representative has been appointed. She signs their final joint return as shown later in the illustration of the bottom of Form 1040.

**Claiming a refund.** Generally, a person who is filing a return for a decedent and claiming a refund must file Form 1310 with the return. However, if the person claiming the refund is a surviving spouse filing a joint return with the decedent, or a court-appointed or certified personal representative filing an original return for the decedent, Form 1310 is not needed. The personal representative must attach to the return a copy of the court certificate showing that he or she was appointed the personal representative.

**Example.** Assume that Mr. Green died on January 4, 1999, before filing his tax return. On April 3 of the same year, you were appointed the personal representative for Mr. Green's estate and you filed his Form 1040 showing a refund due. You do not need Form 1310 to claim the refund if you attach a copy of the court certificate showing you were appointed the personal representative.

**When and where to file.** The final individual income tax return is due at the same time the decedent's return would have been due had death not occurred. The final return for a decedent who was a calendar year taxpayer is generally due April 15 following the year death occurred. However, when the due date falls on a Saturday, Sunday, or legal holiday, you can file on the next business day.

Generally, you must file the final income tax return of the decedent with the Internal Revenue Service center for the place where you live. A tax return for a decedent cannot be electronically filed under the *e-file* or On-Line Filing Program. A paper tax return must be filed for the decedent.

**Request for prompt assessment (charge) of tax.** The IRS ordinarily has 3 years from the date an income tax return is filed, or its due date, whichever is later, to charge any additional tax that is due. However, as a personal representative, you may request a prompt assessment of tax after the return has been filed. This reduces the time for making the assessment to 18 months from the date the written request for prompt assessment was received. This request can be made for any income tax return of the decedent and for the income tax return of the decedent's estate. This may permit a quicker settlement of the tax liability of the estate and an earlier final distribution of the assets to the beneficiaries.

You can request prompt assessment of any of the decedent's taxes (other than federal estate taxes) for any years for which the statutory period for assessment is open. This applies even though the returns were filed before the decedent's death.

**Failure to report income.** If you or the decedent failed to report substantial amounts of gross income (more than 25% of the gross income reported on the return) or filed a false or fraudulent return, your request for prompt assessment will not shorten the period during which the IRS may assess the additional tax. However, such a request may relieve you of personal liability for the tax if you did not have knowledge of the unpaid tax.

**How to request.** You can use Form 4810, to make this request. It must be filed separately from any other document. The request should be filed with the IRS office where the return was filed. If Form 4810 is not used, you must clearly indicate that it is a request for prompt assessment under section 6501(d) of the Internal Revenue Code. You must identify the type of tax and the tax period for which the prompt assessment is requested.

**Request for discharge from personal liability for tax.** An executor can make a written request for a discharge from personal liability for a decedent's income and gift taxes. The request must be made after the returns for those taxes are filed. For this purpose an executor is an executor or administrator that is appointed, qualified, and acting within the United States.

Within 9 months after receipt of the request, the IRS will notify the executor of the amount of taxes due. If this amount is paid, the executor will be discharged from personal liability for any future deficiencies. If the IRS has not notified the executor, he or she will be discharged from personal liability at the end of the 9-month period.



*Even if the executor is discharged, the IRS will still be able to assess tax deficiencies against the executor to the extent that he or she still has any of the decedent's property.*

**Form 5495.** Form 5495 can be used for making this request. If Form 5495 is not used, you must clearly indicate that the re-

quest is for discharge from personal liability under section 6905 of the Internal Revenue Code.

**Joint return.** Generally, the personal representative and the surviving spouse can file a joint return for the decedent and the surviving spouse. However, the surviving spouse alone can file the joint return if no personal representative has been appointed before the due date for filing the final joint return for the year of death. This also applies to the return for the preceding year if the decedent died after the close of the preceding tax year and before the due date for filing that return. The income of the decedent that was includible on his or her return for the year up to the date of death and the income of the surviving spouse for the entire year must be included in the final joint return.

A final joint return with the decedent cannot be filed if the surviving spouse remarried before the end of the year of the decedent's death. The filing status of the decedent in this instance is "married filing separate return."

**Personal representative may revoke joint return election.** A court-appointed personal representative may revoke an election to file a joint return that was previously made by the surviving spouse alone. This is done by filing a separate return for the decedent within one year from the due date of the return (including any extensions). The joint return made by the surviving spouse will then be regarded as the separate return of that spouse by excluding the decedent's items and refiguring the tax liability.

## How To Report Certain Income

This section explains how to report certain types of income on the final return. The rules on income discussed in the other chapters of this publication also apply to a decedent's final return. See chapters 6 through 17, if they apply.

### Interest and Dividend Income (Forms 1099)

A Form 1099 should be received for the decedent reporting interest and dividends that were includible on his or her return before death. A separate Form 1099 should be received showing the interest and dividends includible on the returns of the estate or other recipient after the date of death and payable to the estate or other recipient. You can request corrected Forms 1099 if these forms do not properly reflect the right recipient or amounts.

The amount reported on Form 1099-INT, *Interest Income*, or Form 1099-DIV, *Dividends and Distributions*, may not necessarily be the correct amount that should be properly reported on each income tax return. For example, a Form 1099-INT reporting interest payable to a decedent may include income that should be reported on the final income tax return of the decedent, as well as income that the estate or other recipient should report, either as income earned after death or as income in respect of the decedent (discussed later). For income earned after death, you should ask the payer for a Form 1099 that properly identifies the recipient (by name and iden-

For the year Jan. 1–Dec. 31, 1999, or other tax year beginning , 1999, ending OMB No. 1545-0074

Label

(See instructions on page 18.)

Use the IRS label. Otherwise, please print or type.

LABEL HERE	LP	CAR-RT	SHORT**CRO1	30	IRS
	JOHN S & JANE M STONE		S29		
	1772 OAK ST SHERIDAN WY		82801	103	

Your social security number 765 : 00 : 4321

Spouse's social security number 123 : 00 : 4567

IMPORTANT! You must enter your SSN(s) above.

Presidential Election Campaign

(See page 18.)

Do you want \$3 to go to this fund? . . . . . If a joint return, does your spouse want \$3 to go to this fund? . . . . .

Yes	No	Note. Checking "Yes" will not change your tax or reduce your refund.

Filing Status

- 1  Single
- 2  Married filing joint return (even if only one had income)

69 Estimated tax penalty. Also include on line 68 . . . . . 69

Sign Here

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Joint return? See page 18. Keep a copy for your records.

Your signature Jane M. Stone	Date 4/1/00	Your occupation Engineer	Daytime telephone number (optional) ( )
Spouse's signature. If a joint return, BOTH must sign. Filing as Surviving Spouse	Date	Spouse's occupation	

Paid Preparer's Use Only

Preparer's signature	Date	Check if self-employed <input type="checkbox"/>	Preparer's SSN or PTIN
Firm's name (or yours if self-employed) and address			EIN : ZIP code

tification number) and the proper amount. If that is not possible, or if the form includes an amount that represents income in respect of the decedent, include an explanation, as shown next under How to report, describing the amounts that are properly reported on the decedent's final return.

How to report. If you are preparing the decedent's final return and you have received a Form 1099-INT or Form 1099-DIV for the decedent that includes amounts belonging to the decedent and to another recipient (the decedent's estate or another beneficiary), report the total interest shown on Form 1099-INT on Schedule 1 (Form 1040A) or on Schedule B (Form 1040). Next, enter a "subtotal" of the interest shown on Forms 1099 and the interest reportable from other sources for which you did not receive Forms 1099. Show any interest (including any interest you receive as a nominee) belonging to another recipient separately and subtract it from the subtotal. Identify this adjustment as a "Nominee Distribution" or other appropriate designation. Report dividend income on the appropriate schedule using the same procedure.

Note. If the decedent received amounts as a nominee, you must give the actual owner a Form 1099, unless the owner is the decedent's spouse.

Accelerated Death Benefits

Accelerated death benefits are amounts received under a life insurance contract before the death of the insured individual. These benefits also include amounts received on the sale or assignment of the contract to a viatical settlement provider. This exclusion applies only if the insured was a terminally or chronically ill individual.

Generally, if the decedent received accelerated death benefits either on his or her own life or on the life of another person, those benefits are not included in the decedent's income. For more information, see the discussion under Gifts, Insurance, and Inheritances under Other Tax Information in Publication 559.

Business Income

This section discusses some of the business income which may have to be included on the final return.

Partnership income. The death of a partner closes the partnership's tax year for that partner. Generally, it does not close the partnership's tax year for the remaining partners. The decedent's distributive share of partnership items must be figured as if the partnership's tax year ended on the date the partner died. To avoid an interim closing of the partnership books, the partners can agree to estimate the decedent's distributive share by prorating the amounts the partner would have included for the entire partnership tax year.

On the decedent's final return, include the decedent's distributive share of partnership items for the following periods.

- 1) The partnership tax year which ended within or with the decedent's last tax year (the year ending on the date of death).
- 2) The period, if any, from the end of that partnership tax year (item (1)) to the decedent's date of death.

S corporation income. If the decedent was a shareholder in an S corporation, you must include on the final return the decedent's share of the S corporation's items of income, loss, deduction, and credit for the corporation's tax year that ends within or with the decedent's last tax year (the year ending on the date of death). The final return must also include the decedent's pro rata share of these items for the period between the end of that corporation's tax year and the date of death.

Self-employment income. Include self-employment income actually or constructively received or accrued, depending on the decedent's accounting method. For self-employment tax purposes only, the decedent's self-employment income will include the decedent's distributive share of a partnership's income or loss through the end of the month in which death occurred. For this purpose, the partnership income or loss is considered to be earned ratably over the partnership's tax year. For more information

on how to compute self-employment income, see Publication 533, *Self-Employment Tax*.

## Medical Savings Account (MSA)

The treatment of a medical savings account (MSA), including a Medicare+Choice MSA, at the death of the account holder depends on who acquires the interest in the account. If the decedent's estate acquires the interest, the fair market value of the assets in the account on the date of death is included in gross income on the decedent's final return. The estate tax deduction, discussed later, does not apply to this amount.

If a beneficiary acquires the interest, see the discussion under *Income in Respect of the Decedent*, later. For other information on MSAs, see Publication 969, *Medical Savings Accounts (MSAs)*.

**Individual retirement arrangements (IRAs).** The treatment of a decedent's IRAs, including education IRAs and Roth IRAs, is covered in Publication 559.

## Exemptions, Deductions, and Credits

Generally, the rules for exemptions, deductions, and credits allowed to an individual also apply to the decedent's final income tax return. Show on the final return deductible items the decedent paid before death (or accrued, if the decedent reported deductions on an accrual method).

### Exemptions

You can claim the personal exemption in full on a final income tax return. If the decedent was another person's dependent (for example, a parent's), you cannot claim the personal exemption on the decedent's final return.

### Standard Deduction

If you do not itemize deductions on the final return, the full amount of the appropriate standard deduction is allowed regardless of the date of death. For information on the appropriate standard deduction, see chapter 21.

### Itemized Deductions

If the total of the decedent's itemized deductions is more than the decedent's standard deduction, the federal income tax will generally be less if you claim itemized deductions on the final return. See chapters 23 through 30 for the types of expenses that are allowed as itemized deductions.

**Medical expenses.** Medical expenses paid before death by the decedent are deductible, subject to limits, on the final income tax return if deductions are itemized. This includes expenses for the decedent as well as for the decedent's spouse and dependents.



*Qualified medical expenses paid before death by the decedent are not deductible if paid with a tax-free distribution from any medical savings account.*

For information on medical expenses that were not paid before death, see *Med-*

*ical Expenses under Exemptions and Deductions* in Publication 559.

**Unrecovered investment in pension.** If the decedent was receiving a pension or annuity and died without a surviving annuitant, you can take a deduction on the decedent's final return for the amount of the decedent's investment in the pension or annuity contract that remained unrecovered at death. The deduction is a miscellaneous itemized deduction that is not subject to the 2% limit on adjusted gross income. See chapter 30.

### Deduction for Losses

A decedent's net operating loss deduction from a prior year and any capital losses (capital losses include capital loss carryovers) can be deducted only on the decedent's final income tax return. A net operating loss on the decedent's final income tax return can be carried back to prior years. You cannot deduct any unused net operating loss or capital loss on the estate's income tax return.

### Credits

Any of the tax credits discussed in this publication also apply to the final return if the decedent was eligible for the credits at the time of death. These credits are discussed in chapters 33 through 38 of this publication.

**Tax withheld and estimated payments.** There may have been income tax withheld from the decedent's pay, pensions, or annuities before death and the decedent may have paid estimated income tax. To get credit for these tax payments, you must claim them on the decedent's final return. For more information, see *Credit for Withholding and Estimated Tax* in chapter 5.

## Tax Effect on Others

This section contains information about the effect of an individual's death on the income tax liability of the survivors (including the widow or widower and the beneficiaries) and the estate. Any survivor should coordinate the filing of his or her own tax return with the personal representative handling the decedent's estate. The personal representative can coordinate filing status, exemptions, income, and deductions so that the final return and the income tax returns of the survivors and the estate are all filed correctly.

**Gifts and inheritances.** Property received as a gift, bequest, or inheritance is not included in your income. However, if property you receive in this manner later produces income, such as interest, dividends, or rentals, that income is taxable to you. If the gift, bequest, or inheritance you receive is the income from property, that income is taxable to you.

If you inherited the right to receive income in respect of the decedent, see *Income in Respect of the Decedent*, later.

**Joint return by surviving spouse.** A surviving spouse can file a joint return for the year of death and may qualify for special tax rates for the following 2 years. For more

information, see *Qualifying Widow(er) With Dependent Child* in chapter 2.

**Decedent as your dependent.** If the decedent qualified as your dependent for the part of the year before death, you can claim the full exemption amount for the dependent on your tax return, regardless of when death occurred during the year.

If the decedent was your qualifying child, you may be able to claim the child tax credit.

## Income in Respect of the Decedent

All gross income that the decedent would have received had death not occurred and that was not properly includible on the final return, discussed earlier, is income in respect of the decedent.

### How To Report

Income in respect of a decedent must be included in the gross income of one of the following.

- The decedent's estate, if the estate receives it.
- The beneficiary, if the right to income is passed directly to the beneficiary and the beneficiary receives it.
- Any person to whom the estate properly distributes the right to receive it.



*If you have to include income in respect of the decedent in your gross income, you may be able to claim a deduction for the estate tax paid on that income. For more information, see Estate Tax Deduction, later.*

**Example 1.** Frank Johnson owned and operated an apple orchard. He used the cash method of accounting. He sold and delivered 1,000 bushels of apples to a canning factory for \$2,000, but did not receive payment before his death. When the estate was settled, payment had not been made and the estate transferred the right to the payment to his widow. When Frank's widow collects the \$2,000, she must include that amount in her return. It is not to be reported on the final return of the decedent nor on the return of the estate.

**Example 2.** Assume Frank Johnson used the accrual method of accounting in Example 1. The amount accrued from the sale of the apples would be included on his final return. Neither the estate nor the widow will realize income in respect of the decedent when the money is later paid.

**Example 3.** Bob Clark was entitled to a large salary payment at the date of his death. The amount was to be paid in five annual installments. The estate, after collecting two installments, distributed the right to the remaining installments to you, the beneficiary. None of the payments were includible in Bob's final return. The estate must include in its gross income the two installments it received, and you must include in your gross income each of the three installments as you receive them.

**Transferring your right to income.** If you transfer your right to income in respect of a decedent, you must include in your income the greater of:

- 1) The amount you receive for the right, or
- 2) The fair market value of the right at the time of the transfer.

**Fair market value (FMV).** FMV is the price at which the property would change hands between a buyer and a seller, neither having to buy or sell, and both having reasonable knowledge of all necessary facts.

**Giving your right to income as a gift.** If you give your right to receive income in respect of a decedent as a gift, you must include in your gross income the fair market value of the right at the time you make the gift.

**Type of income.** The character or type of income that you receive in respect of a decedent is the same as it would have been to the decedent if he or she were alive. If the income would have been a capital gain to the decedent, it will be a capital gain to you.

**Interest accrued on savings certificates.** The interest accrued on savings certificates (redeemable after death without forfeiture of interest) that is for the period from the date of the last interest payment to the date of the decedent's death, but not received as of that date, is income in respect of a decedent. Interest for a period after the decedent's death that becomes payable on the certificates after death is not income in respect of a decedent, but is taxable income includable in the gross income of the respective recipients.

**Installment obligations.** If the decedent had sold property using the installment method and you collect payments on an installment obligation you acquired from the decedent, use the same gross profit percentage the decedent used to figure the part of each payment that represents profit. Include in your income the same profit the

decedent would have included had death not occurred. For more information on installment sales, see Publication 537, *Installment Sales*.

If you dispose of an installment obligation acquired from a decedent (other than by transfer to the obligor), the rules explained in Publication 537 for figuring gain or loss on the disposition apply to you.

**Medical savings account (MSA).** The treatment of an MSA, including a Medicare+Choice MSA, at the death of the account holder depends on who acquires the interest in the account. If the decedent's estate acquired the interest, see the earlier discussion under *How to Report Certain Income*.

If the decedent's spouse is the designated beneficiary of the MSA, the MSA becomes that spouse's MSA. It is subject to the rules discussed in Publication 969.

Any other beneficiary (including a spouse that is not the designated beneficiary) must include in gross income the fair market value of the assets in the account on the decedent's date of death. This amount must be reported for the beneficiary's tax year that includes the decedent's date of death. The amount included in gross income is reduced by the qualified medical expenses for the decedent that are paid by the beneficiary within 1 year after the decedent's date of death. An estate tax deduction, discussed later, applies to the amount included in income by a beneficiary, other than the decedent's spouse.

**Individual retirement arrangements (IRAs).** The treatment of a decedent's IRAs, including education IRAs and Roth IRAs, is covered in Publication 559.

**Other income.** For examples of other income situations concerning decedents, see *Specific Types of Income in Respect of a Decedent* in Publication 559.

## Deductions in Respect of the Decedent

Items such as business expenses, income-producing expenses, interest, and taxes, for which the decedent was liable but which are not properly allowable as deductions on the decedent's final income tax return, will be allowed as a deduction when paid to one of the following.

- The estate.
- The person who acquired an interest in the decedent's property (subject to such obligations) because of the decedent's death, if the estate was not liable for the obligation.

## Estate Tax Deduction

Income that a decedent had a right to receive is included in the decedent's gross estate and is subject to estate tax. This income in respect of a decedent is also taxed when received by the recipient (estate or beneficiary). However, an income tax deduction is allowed to the recipient for the estate tax paid on the income.

The deduction for estate tax can be claimed only for the same tax year in which the income in respect of the decedent must be included in the recipient's gross income. (This also is true for income in respect of a prior decedent.)

You can claim the deduction only as a miscellaneous itemized deduction on Schedule A (Form 1040). This deduction is not subject to the 2% limit on miscellaneous itemized deductions as discussed in chapter 30.

If the income in respect of the decedent is capital gain income, the gain must be reduced, but not below zero, by any estate tax deduction attributable to that gain when figuring the maximum capital gain tax, the 50% exclusion for gain on small business stock, or any net capital loss limitation.

For more information, see *Estate Tax Deduction* in Publication 559.

## 5.

# Tax Withholding and Estimated Tax

## Important Change for 1999

**Excess social security or railroad retirement tax withholding.** You can claim a credit for excess social security or tier 1 railroad retirement tax withholding for 1999 only if your wages from two or more employers were more than \$72,600. See *Credit for Excess Social Security Tax or Railroad Retirement Tax Withheld* in chapter 38.

## Important Change for 2000

You should consider the item here and in Publication 553, *Highlights of 1999 Tax Changes*, when you figure your estimated tax or how much income tax you want withheld from your pay for 2000.

**Estimated tax safe harbor for higher income taxpayers.** For installment payments for tax years beginning in 2000, the estimated tax safe harbor for higher income individuals (other than farmers and fishermen) has been modified. If your 1999 adjusted gross income was more than \$150,000 (\$75,000 if you are married filing a separate return for 2000), you will have to deposit the smaller of 90% of your expected tax for 2000 or **106%** of the tax shown on your 1999 return to avoid an estimated tax penalty (provided your 1999 return covered all 12 months).



As this publication was being prepared for print, Congress was considering legislation that would increase the percentage (from 106%) that higher income taxpayers would have to deposit for 2000 in order to avoid an estimated tax penalty. For more information about this and other important tax changes, see Publication 553, *Highlights of 1999 Tax Changes*.

**Payment of estimated tax by credit card.** Beginning March 1, 2000, you may be able to pay your estimated tax using a pay-by-phone system to charge tax payments. For more information, see *Payment by Credit Card*.

## Important Reminders

**Unemployment compensation.** You can choose to have income tax withheld from your unemployment compensation. See

*Unemployment Compensation under Withholding*, later, for more information.

**Federal payments.** You can choose to have income tax withheld from certain federal payments you get. These payments include social security and tier 1 railroad retirement benefits. For more information, see *Federal Payments under Withholding*, later.

**Claiming withholding and estimated tax payments.** When you file a federal income tax return, be sure to take credit for all federal income tax and excess social security or railroad retirement taxes withheld from your salary, wages, pensions, etc., and any backup withholding shown on Forms 1099. Also take credit for all estimated tax payments you made for that year. For example, all estimated tax payments made for 1999 should be claimed on the tax return you file for the 1999 tax year. You should file a return and claim these credits even if you do not owe tax. See *Credit for Withholding and Estimated Tax*, later in this chapter.

## Introduction

This chapter discusses how to pay your tax as you earn or receive income during the year. In general, the federal income tax is a pay-as-you-go tax. There are two ways to pay as you go:

- **Withholding.** If you are an employee, your employer probably withholds income tax from your pay. Tax may also be withheld from certain other income — including pensions, bonuses, commissions, and gambling winnings. In each case, the amount withheld is paid to the Internal Revenue Service (IRS) in your name.
- **Estimated tax.** If you do not pay your tax through withholding, or do not pay enough tax that way, you might have to pay estimated tax. People who are in business for themselves generally will have to pay their tax this way. You may have to pay estimated tax if you receive income such as dividends, interest, capital gains, rent, and royalties. Estimated tax is used to pay not only income tax, but self-employment tax and alternative minimum tax as well.

This chapter explains both of these methods. In addition, it explains:

- **Credit for withholding and estimated tax.** When you file your 1999 income tax return, take credit for all the income tax withheld from your salary, wages, pensions, etc., and for the estimated tax you paid for 1999.
- **Underpayment penalty.** If you did not pay enough tax during the year either through withholding or by making estimated tax payments, you may have to pay a penalty. The IRS usually can figure this penalty for you. See *Underpayment Penalty*, near the end of this chapter.

## Useful Items

You may want to see:

### Publication

- 505** Tax Withholding and Estimated Tax
- 553** Highlights of 1999 Tax Changes
- 919** How Do I Adjust My Tax Withholding?

### Form (and Instructions)

- W-4** Employee's Withholding Allowance Certificate
- W-4P** Withholding Certificate for Pension or Annuity Payments
- W-4S** Request for Federal Income Tax Withholding From Sick Pay
- W-4V** Voluntary Withholding Request
- 1040-ES** Estimated Tax for Individuals
- 2210** Underpayment of Estimated Tax by Individuals, Estates, and Trusts

## Withholding

This chapter discusses withholding on these types of income:

- Salaries and wages,
- Tips,
- Taxable fringe benefits,
- Sick pay,
- Pensions and annuities,
- Gambling winnings,
- Unemployment compensation, and
- Certain federal payments.

This chapter explains in detail the rules for withholding tax from each of these types of income.

This chapter also covers backup withholding on interest, dividends, and other payments.

## Salaries and Wages

Income tax is withheld from the pay of most employees. Your pay includes bonuses, commissions, and vacation allowances, in addition to your regular pay. It also includes reimbursements and other expense allowances paid under a nonaccountable plan. See *Supplemental Wages*, later.

**Military retirees.** Military retirement pay is treated in the same manner as regular pay for income tax withholding purposes, even though it is treated as a pension or annuity for other tax purposes.

**Household workers.** If you are a household worker, you can ask your employer to withhold income tax from your pay. Tax is withheld only if you want it withheld and your employer agrees to withhold it. If you do not have enough income tax withheld, you may have to make estimated tax payments, as discussed later under *Estimated Tax*.

**Farmworkers.** Income tax is generally withheld from your cash wages for work on a farm unless your employer both:

- 1) Pays you cash wages of less than \$150 during the year, and
- 2) Has expenditures for agricultural labor totaling less than \$2,500 during the year.

If you receive either noncash wages or cash wages not subject to withholding, you can ask your employer to withhold income tax. If your employer does not agree to withhold tax, or if not enough is withheld, you may have to make estimated tax payments, as discussed later under *Estimated Tax*.

## Determining Amount of Tax Withheld

The amount of income tax your employer withholds from your regular pay depends on two things.

- 1) The amount you earn.
- 2) The information you give your employer on **Form W-4**.

Form W-4 includes three types of information that your employer will use to figure your withholding.

- 1) Whether to withhold at the single rate or at the lower married rate.
- 2) How many withholding allowances you claim (each allowance reduces the amount withheld).
- 3) Whether you want an additional amount withheld.

If your income is low enough that you will not have to pay income tax for the year, you may be exempt from withholding. See *Exemption From Withholding*, later.

**Note.** You must specify a filing status and a number of withholding allowances on Form W-4. You cannot specify only a dollar amount of withholding.

**New job.** When you start a new job, you must fill out Form W-4 and give it to your employer. Your employer should have copies of the form. If you later need to change the information you gave, you must fill out a new form.

If you work only part of the year (for example, you start working after the beginning of the year), too much tax may be withheld. You may be able to avoid overwithholding if your employer agrees to use the part-year method. See *Part-year method* in chapter 1 of Publication 505 for more information.

**Changing your withholding.** Events during the year may change your marital status or the exemptions, adjustments, deductions, or credits you expect to claim on your return. When this happens, you may need to give your employer a new Form W-4 to change your withholding status or number of allowances.

You **must** give your employer a new Form W-4 within 10 days after either of the following.

- 1) Your divorce, if you have been claiming married status.

- 2) Any event that decreases the number of withholding allowances you can claim.

Generally, you can submit a new Form W-4 at any time you wish to change the number of your withholding allowances for any other reason.

**Changing your withholding for 2001.** If events in 2000 will decrease the number of your withholding allowances for 2001, you must give your employer a new Form W-4 by December 1, 2000. If the event occurs in December 2000, submit a new Form W-4 within 10 days.

**Cumulative wage method.** If you change the number of your withholding allowances during the year, too much or too little tax may have been withheld for the period before you made the change. You may be able to compensate for this if your employer agrees to use the cumulative wage withholding method for the rest of the year. You must ask in writing that your employer use this method.

To be eligible, you must have been paid for the same kind of payroll period (weekly, biweekly, etc.) since the beginning of the year.

**Checking your withholding.** After you have given your employer a Form W-4, you can check to see whether the amount of tax withheld from your pay is too little or too much. See *Getting the Right Amount of Tax Withheld*, later. If too much or too little tax is being withheld, you should give your employer a new Form W-4 to change your withholding.

**Note.** You cannot give your employer a payment to cover withholding for past pay periods. Nor can you give your employer a payment for estimated tax.

## Completing Form W-4

Form W-4 has worksheets to help you figure how many withholding allowances you can claim. The worksheets are for your own records. Do not give them to your employer.

You do not have to use the worksheets if you use a more accurate method of figuring the number of withholding allowances. See *Alternative method of figuring withholding allowances* under *Completing Form W-4 and Worksheets* in chapter 1 of Publication 505 for more information.

**Two jobs.** If you have income from two jobs at the same time, complete only one set of Form W-4 worksheets. Then split your allowances between the Forms W-4 for each job. You cannot claim the same allowances with more than one employer at the same time. You can claim all your allowances with one employer and none with the other, or divide them in any other way you wish.

**Married individuals.** If both you and your spouse are employed and you expect to file a joint return, figure your withholding allowances using your combined income, adjustments, deductions, exemptions, and credits. Use only one set of worksheets. You can divide your total allowances in any way you wish, but you cannot claim an allowance that your spouse also claims.

If you and your spouse expect to file separate returns, figure your allowances

separately based on your own individual income, adjustments, deductions, exemptions, and credits.

**Personal allowances worksheet.** Use the *Personal Allowances Worksheet* on page 1 of Form W-4 to figure your withholding allowances for exemptions and any special allowances that apply.

**Deductions and adjustments worksheet.** Fill out this worksheet to adjust the number of your withholding allowances for deductions, adjustments to income, and tax credits. The *Deductions and Adjustments Worksheet* is on page 2 of Form W-4. Chapter 1 of Publication 505 explains this worksheet.

**Two-earner/two-job worksheet.** You may need to complete this worksheet if you have two jobs or a working spouse. You can also add to the amount, if any, on line 8 of this worksheet, any additional withholding necessary to cover any amount you expect to owe other than income tax, such as self-employment tax.

**For more information about Form W-4** and a filled-in example, see chapter 1 of Publication 505.

## Getting the Right Amount of Tax Withheld

In most situations, the tax withheld from your pay will be close to the tax you figure on your return if you follow these two rules.

- 1) You accurately complete all the Form W-4 worksheets that apply to you.
- 2) You give your employer a new Form W-4 when changes occur.

But because the worksheets and withholding methods do not account for all possible situations, you may not be getting the right amount withheld. This is most likely to happen in the following situations.

- You are married and both you and your spouse work.
- You have more than one job at a time.
- You have nonwage income, such as interest, dividends, alimony, unemployment compensation, or self-employment income.
- You will owe additional amounts with your return, such as self-employment tax.
- Your withholding is based on obsolete Form W-4 information for a substantial part of the year.
- Your earnings are more than \$150,000 if you are single or \$200,000 if you are married.

To make sure you are getting the right amount of tax withheld, get Publication 919. It will help you compare the total tax to be withheld during the year with the tax you can expect to figure on your return. It also will help you determine how much, if any, additional withholding is needed each payday to avoid owing tax when you file your return. If you do not have enough tax withheld, you may have to make estimated tax payments, as explained under *Estimated Tax*, later.



## Rules Your Employer Must Follow

The following are some of the withholding rules that can affect how you fill out your Form W-4 and how you handle problems that may arise. For other rules, see *Rules Your Employer Must Follow* in chapter 1 of Publication 505.

**New Form W-4.** When you start a new job, your employer should give you a Form W-4 to fill out. Your employer will use the information you give on the form to figure your withholding beginning with your first payday.

If you later fill out a new Form W-4, your employer can put it into effect as soon as it is practical to do so. The deadline for putting it into effect is the start of the first payroll period ending 30 or more days after you turn it in.

**No Form W-4.** If you do not give your employer a completed Form W-4, your employer must withhold at the highest rate—as if you were single and claimed no allowances.

**Repaying withheld tax.** If you find you are having too much tax withheld because you did not claim all the withholding allowances you are entitled to, you should give your employer a new Form W-4. Your employer cannot repay you any of the tax withheld under your old Form W-4.

However, if your employer has withheld more than the correct amount of tax for the Form W-4 you have in effect, you do not have to fill out a new Form W-4 to have your withholding lowered to the correct amount. Your employer can repay you the amount that was incorrectly withheld. If you are not repaid, you will receive credit on your tax return for the full amount actually withheld.

## Exemption From Withholding

If you claim exemption from withholding, your employer will not withhold federal income tax from your wages. The exemption applies only to income tax, not to social security or Medicare tax.

You can claim exemption from withholding for 2000 only if **both** the following situations apply.

- 1) For 1999 you had a right to a refund of all federal income tax withheld because you had no tax liability.
- 2) For 2000 you expect a refund of all federal income tax withheld because you expect to have no tax liability.

**Student.** If you are a student, you are not automatically exempt. See chapter 1 to see if you must file a return. If you work only part time or only during the summer, you may qualify for exemption from withholding.

**Age 65 or older or blind.** If you are 65 or older or blind, use one of the worksheets in chapter 1 of Publication 505, under *Exemption From Withholding*, to help you decide whether you can claim exemption from withholding. Do not use either of those worksheets if you will itemize deductions or claim dependents or tax credits on your 2000 return—see the following discussion instead.

**Itemizing deductions or claiming dependents or tax credits.** If you had no tax liability for 1999 and you will itemize your deductions or claim dependents or tax credits on your 2000 return, use the 2000 Estimated Tax Worksheet in Form 1040-ES (or see chapter 2 of Publication 505) to figure your 2000 expected tax liability. You can claim exemption from withholding only if your total expected tax liability is zero.

**Claiming exemption.** To claim exemption, you must give your employer a Form W-4. Write "EXEMPT" on line 7.

Your employer must send the IRS a copy of your Form W-4 if you claim exemption from withholding and your pay is expected to usually be more than \$200 a week. If it turns out that you do not qualify for exemption, the IRS will send both you and your employer a written notice.

If you claim exemption, but later your situation changes so that you will have to pay income tax after all, you must file a new Form W-4 within 10 days after the change. If you claim exemption in 2000, but you expect to owe income tax for 2001, you must file a new Form W-4 by December 1, 2000.

**An exemption is good for only one year.** You must give your employer a new Form W-4 by February 15 each year to continue your exemption.

## Supplemental Wages

Supplemental wages include bonuses, commissions, overtime pay, and certain sick pay. Your employer or other payer of supplemental wages may withhold income tax from these wages at a flat rate of 28%. The payer can also figure withholding using the same method used for your regular wages.

Also see *Sick Pay*, later.

**Expense allowances.** Reimbursements or other expense allowances paid by your employer under a nonaccountable plan are treated as supplemental wages.

Reimbursements or other expense allowances paid under an accountable plan that are more than your proven expenses are treated as paid under a nonaccountable plan. However, this does not apply if you return the excess payments within a reasonable period of time.

For more information about accountable and nonaccountable expense allowance plans, see *Reimbursements* in chapter 28.

## Penalties

You may have to pay a penalty of \$500 if both of the following apply.

- 1) You make statements or claim withholding allowances on your Form W-4 that reduce the amount of tax withheld.
- 2) You have no reasonable basis for those statements or allowances at the time you prepare your Form W-4.

There is also a criminal penalty for willfully supplying false or fraudulent information on your Form W-4 or for willfully failing to supply information that would increase the amount withheld. The penalty upon conviction can be either a fine of up to \$1,000 or imprisonment for up to one year, or both.

These penalties will apply if you deliberately and knowingly falsify your Form W-4 in an attempt to reduce or eliminate the

proper withholding of taxes. A simple error — an honest mistake — will not result in one of these penalties. For example, a person who has tried to figure the number of withholding allowances correctly, but claims seven when the proper number is six, will not be charged a W-4 penalty.

## Tips

The tips you receive while working on your job are considered part of your pay. You must include your tips on your tax return on the same line as your regular pay. However, tax is not withheld directly from tip income, as it is from your regular pay. Nevertheless, your employer will take into account the tips you report when figuring how much to withhold from your regular pay.

See chapter 7 for information on reporting your tips to your employer. For more information on the withholding rules for tip income, see Publication 531, *Reporting Tip Income*.

**How employer figures amount to withhold.** The tips you report to your employer are counted as part of your income for the month you report them. Your employer can figure your withholding in either of two ways.

- 1) By withholding at the regular rate on the sum of your pay plus your reported tips.
- 2) By withholding at the regular rate on your pay plus an amount equal to 28% of your reported tips.

**Not enough pay to cover taxes.** If your regular pay is too low for your employer to withhold all the tax (including social security tax, Medicare tax, or railroad retirement tax) due on your pay plus your tips, you can give your employer money to cover the shortage.

If you do not give your employer money to cover the shortage, your employer will first withhold as much social security tax, Medicare tax, or railroad retirement tax as possible, up to the proper amount, and then withhold income tax up to the full amount of your pay. If not enough tax is withheld, you may have to make estimated tax payments. When you file your return, you also may have to pay any social security tax, Medicare tax, or railroad retirement tax your employer could not withhold.

**Allocated tips.** Your employer should not withhold income tax, social security tax, Medicare tax, or railroad retirement tax on any allocated tips. Withholding is based only on your pay plus your **reported tips**. Your employer should refund to you any incorrectly withheld tax. See *Allocated Tips* in chapter 7 for more information.

## Taxable Fringe Benefits

The value of certain noncash fringe benefits you receive from your employer is considered part of your pay. Your employer generally must withhold income tax on these benefits from your regular pay for the period the benefits are paid or considered paid.

For information on taxable fringe benefits, see *Fringe Benefits* under *Employee Compensation* in chapter 6.

Your employer can choose not to withhold income tax on the value of your personal use of a car, truck, or other highway motor vehicle provided by your employer.

Your employer must notify you if this choice is made.

For more information on withholding on taxable fringe benefits, see chapter 1 of Publication 505.

## Sick Pay

“Sick pay” is a payment to you to replace your regular wages while you are temporarily absent from work due to sickness or personal injury. To qualify as “sick pay,” it must be paid under a plan to which your employer is a party.

If you receive sick pay from your employer or an agent of your employer, income tax must be withheld just as it is from your regular pay.

However, if you receive sick pay from a third party who is not acting as an agent of your employer, income tax will be withheld only if you choose to have it withheld. See *Form W-4S*, later.

If you receive payments under a plan in which your employer does not participate (such as an accident or health plan where you paid all the premiums), the payments are not sick pay and usually are not taxable.

**Union agreements.** If you receive sick pay under a collective bargaining agreement between your union and your employer, the agreement may determine the amount of income tax withholding. See your union representative or your employer for more information.

**Form W-4S.** If you choose to have income tax withheld from sick pay paid by a third party, such as an insurance company, you must fill out *Form W-4S, Request for Federal Income Tax Withholding From Sick Pay*. Its instructions contain a worksheet you can use to figure the amount you want withheld. They also explain restrictions that may apply.

Give the completed form to the payer of your sick pay. The payer must withhold according to your directions on the form.

If you do not request withholding on *Form W-4S*, or if you do not have enough tax withheld, you may have to make estimated tax payments. If you do not pay enough estimated tax or have enough income tax withheld, you may have to pay a penalty. See *Who Must Make Estimated Tax Payments and Underpayment Penalty*, later in this chapter.

## Pensions and Annuities

Income tax usually will be withheld from your pension or annuity distributions, unless you choose not to have it withheld. This rule applies to distributions from:

- Certain individual retirement arrangements (IRAs),
- A life insurance company under an endowment, annuity, or life insurance contract,
- A pension, annuity, or profit-sharing plan,
- A stock bonus plan, and
- Any other plan that defers the time you receive compensation.

The amount withheld depends on whether you receive payments spread out

over more than one year (periodic payments), within one year (nonperiodic payments), or as an eligible rollover distribution (ERD). You cannot choose not to have income tax withheld from an ERD.

**More information.** For more information on taxation of annuities and distributions (including eligible rollover distributions) from qualified retirement plans, see chapter 11. For information on IRAs, see chapter 18. For more information on withholding on pensions and annuities, including a discussion of **Form W-4P, Withholding Certificate for Pension or Annuity Payments**, see *Pensions and Annuities* in chapter 1 of Publication 505.

## Gambling Winnings

Income tax is withheld from certain kinds of gambling winnings. The amount withheld is 28% of the proceeds paid (the amount of your winnings minus the amount of your bet).

Gambling winnings of more than \$5,000 from the following sources are subject to income tax withholding.

- Any sweepstakes, wagering pool, or lottery.
- Any other wager, if the proceeds are at least 300 times the amount of the bet.

It does not matter whether your winnings are paid in cash, in property, or as an annuity. Winnings not in money are taken into account at their fair market value.

Gambling winnings from bingo, keno, and slot machines are not subject to income tax withholding. If you receive gambling winnings not subject to withholding, you may need to make estimated tax payments. (See *Estimated Tax*, later.)

If you do not pay enough tax through withholding or estimated tax payments, you may be subject to a penalty. (See *Underpayment Penalty*, later.)

**Form W-2G.** If a payer withholds income tax from your gambling winnings, you should receive a *Form W-2G, Certain Gambling Winnings*, showing the amount you won and the amount withheld.

**Reporting your winnings.** Report your winnings on line 21 of *Form 1040*. Report the tax withheld on line 57 of *Form 1040*. Gambling losses are deductible only to the extent they offset gambling winnings. You must use *Schedule A (Form 1040)* to deduct your losses and to deduct state tax withholding.

## Unemployment Compensation

You can choose to have income tax withheld from unemployment compensation. To make this choice, you will have to fill out **Form W-4V, Voluntary Withholding Request**, (or a similar form provided by the payer) and give it to the payer. The amount withheld will be 15% of each payment.

Unemployment compensation is taxable. So, if you do not have income tax withheld, you may have to make estimated tax payments. See *Estimated Tax*, later.

If you do not pay enough tax either through withholding or estimated tax, you

may have to pay a penalty. See *Underpayment Penalty*, later, for information.

## Federal Payments

You can choose to have income tax withheld from certain federal payments you receive. These payments are:

- 1) Social security benefits,
- 2) Tier 1 railroad retirement benefits,
- 3) Commodity credit loans you choose to include in your gross income, and
- 4) Payments under the Agricultural Act of 1949 (7 U.S.C. 1421 et. seq.), or title II of the Disaster Assistance Act of 1988, as amended, that are treated as insurance proceeds and that you receive because:
  - a) Your crops were destroyed or damaged by drought, flood, or any other natural disaster, or
  - b) You were unable to plant crops because of a natural disaster described in (a).

To make this choice, you will have to fill out **Form W-4V, Voluntary Withholding Request**, (or a similar form provided by the payer) and give it to the payer. You can choose to have 7%, 15%, 28%, or 31% of each payment withheld.

If you do not choose to have income tax withheld, you may have to make estimated tax payments. See *Estimated Tax*, later.

If you do not pay enough tax either through withholding or estimated tax, you may have to pay a penalty. See *Underpayment Penalty*, later, for information.

**More information.** For more information about the tax treatment of social security and railroad retirement benefits, see chapter 12. Get *Publication 225, Farmer's Tax Guide*, for information about the tax treatment of commodity credit loans or crop disaster payments.

## Backup Withholding

Banks and other businesses that pay you certain kinds of income must file an information return (*Form 1099*) with the IRS. The information return shows how much you were paid during the year. It also includes your name and taxpayer identification number (TIN). Your TIN generally is either a social security number or an employer identification number.

These payments generally are not subject to withholding. However, “backup” withholding is required in certain situations. And, backup withholding can apply to most kinds of payments that are reported on *Form 1099*.

Payments made to you are subject to backup withholding at a flat 31% rate in the following situations.

- You do not give the payer your TIN in the required manner.
- The IRS notifies the payer that the TIN you gave is incorrect.
- You are required, but fail, to certify that you are not subject to backup withholding.
- The IRS notifies the payer to start withholding on interest or dividends be-

cause you have underreported interest or dividends on your income tax return. The IRS will do this only after it has mailed you four notices over at least a 120-day period.

See *Backup Withholding* in chapter 1 of Publication 505 for more information.

**Penalties.** There are civil and criminal penalties for giving false information to avoid backup withholding. The civil penalty is \$500. The criminal penalty, upon conviction, is a fine of up to \$1,000, or imprisonment of up to one year, or both.

## Estimated Tax

Estimated tax is the method used to pay tax on income that is not subject to withholding. This includes income from self-employment, interest, dividends, alimony, rent, gains from the sale of assets, prizes, and awards. You also may have to pay estimated tax if the amount of income tax being withheld from your salary, pension, or other income is not enough. To figure estimated tax, use **Form 1040-ES, Estimated Tax for Individuals**.

Estimated tax is used to pay both income tax and self-employment tax, as well as other taxes and amounts reported on your tax return. If you do not pay enough through withholding or by making estimated tax payments, you may be charged a penalty. If you do not pay enough by the due date of each payment period (see *When To Pay Estimated Tax*, later), you may be charged a penalty even if you are due a refund when you file your tax return. For information on when the penalty applies, see *Underpayment Penalty*, later.

## Who Must Make Estimated Tax Payments

If you had a tax liability for 1999, you may have to pay estimated tax for 2000.

**General rule.** You must make estimated tax payments for 2000 if you expect to owe at least \$1,000 in tax for 2000 after subtracting your withholding and credits, and you expect your withholding and credits to be less than the smaller of:

- 1) 90% of the tax to be shown on your 2000 tax return, or
- 2) 100% of the tax shown on your 1999 tax return. Your 1999 tax return must cover all 12 months.

**Note.** If all your 2000 income will be subject to income tax withholding, you probably do not need to make estimated tax payments.

**Exceptions.** There are exceptions to the general rule for farmers, fishermen, and certain higher income taxpayers. See *Figure 5-A* and chapter 2 of Publication 505 for more information.

**To whom the rules apply.** The estimated tax rules apply to:

- U.S. citizens and residents,
- Residents of Puerto Rico, the Virgin Islands, Guam, the Commonwealth of the

Northern Mariana Islands, and American Samoa, and

- Nonresident aliens.

**Aliens.** Resident and nonresident aliens may have to make estimated tax payments. Resident aliens should follow the rules in this chapter unless noted otherwise. Nonresident aliens should get **Form 1040-ES(NR), U.S. Estimated Tax for Nonresident Alien Individuals**.

**Avoiding estimated tax.** If, in addition to income not subject to withholding, you also receive salaries or wages, you can avoid having to make estimated tax payments by asking your employer to take more tax out of your earnings. To do this, file a new Form W-4 with your employer.

**No tax liability last year.** You do not have to pay estimated tax for 2000 if you meet all three of the following conditions:

- 1) You had no tax liability for your 1999 tax year.
- 2) You were a U.S. citizen or resident for the whole year.
- 3) Your 1999 tax year covered a 12-month period.

You had no tax liability for 1999 if your total tax (defined later) was zero or you did not have to file an income tax return.

**Married taxpayers.** To figure whether you must make estimated tax payments for 2000, apply the rules discussed here to your 2000 separate estimated income. If you can make joint estimated tax payments, you can apply these rules on a joint basis.

You and your spouse can make joint payments of estimated tax even if you are not living together.

You and your spouse cannot make joint estimated tax payments if you are legally separated under a decree of divorce or separate maintenance. Also, you cannot make joint estimated tax payments if either spouse is a nonresident alien or if you have different tax years.

Whether you and your spouse make joint estimated tax payments or separate payments will not affect your choice of filing a joint tax return or separate returns for 2000.

**1999 separate returns and 2000 joint return.** If you plan to file a joint return with your spouse for 2000, but you filed separate returns for 1999, your 1999 tax is the total of the tax shown on your separate returns. You filed a separate return for 1999 if you filed as single, head of household, or married filing separately.

**1999 joint return and 2000 separate returns.** If you plan to file a separate return for 2000, but you filed a joint return for 1999, your 1999 tax is your share of the tax on the joint return. You file a separate return for 2000 if you file as single, head of household, or married filing separately. To figure your share, first figure the tax both you and your spouse would have paid had you filed separate returns for 1999 using the same filing status as for 2000. Then multiply your joint tax liability by the following fraction:

$$\frac{\text{Your separate tax liability}}{\text{Both spouses' separate tax liabilities}}$$

**Example.** Joe and Heather filed a joint return for 1999 showing taxable income of \$48,000 and a tax of \$7,851. Of the \$48,000 taxable income, \$40,000 was Joe's and the rest was Heather's. For 2000, they plan to file married filing separately. Joe figures his share of the tax on the 1999 joint return as follows:

Tax on \$40,000 based on a separate return .....	\$ 8,409
Tax on \$8,000 based on a separate return .....	1,204
Total .....	\$ 9,613
Joe's portion of total (\$8,409 ÷ \$9,613) .....	88%
Joe's share of joint return tax (\$7,851 × 88%) .....	<u>\$ 6,909</u>

## How To Figure Estimated Tax

To figure your estimated tax, you must figure your expected adjusted gross income, taxable income, taxes, and credits for the year.

When figuring your 2000 estimated tax, it may be helpful to use your income, deductions, and credits for 1999 as a starting point. Use your 1999 federal tax return as a guide. You can use Form 1040-ES to figure your estimated tax.

You must make adjustments both for changes in your own situation and for recent changes in the tax law. For 2000, there are several changes in the law. These changes are discussed in Publication 553, *Highlights of 1999 Tax Changes*.

Form 1040-ES includes a worksheet to help you figure your estimated tax. Keep the worksheet for your records.

For more complete information and examples of how to figure your estimated tax for 2000, see chapter 2 of Publication 505.

## When To Pay Estimated Tax

For estimated tax purposes, the year is divided into four payment periods. Each period has a specific payment due date. If you do not pay enough tax by the due date of each of the payment periods, you may be charged a penalty even if you are due a refund when you file your income tax return. The following chart gives the payment periods and due dates for estimated tax payments.

<u>For the period:</u>	<u>Due date:</u>
Jan. 1* through Mar. 31	April 15
April 1 through May 31	June 15
June 1 through Aug. 31	September 15
Sept. 1 through Dec. 31	January 15 next year**

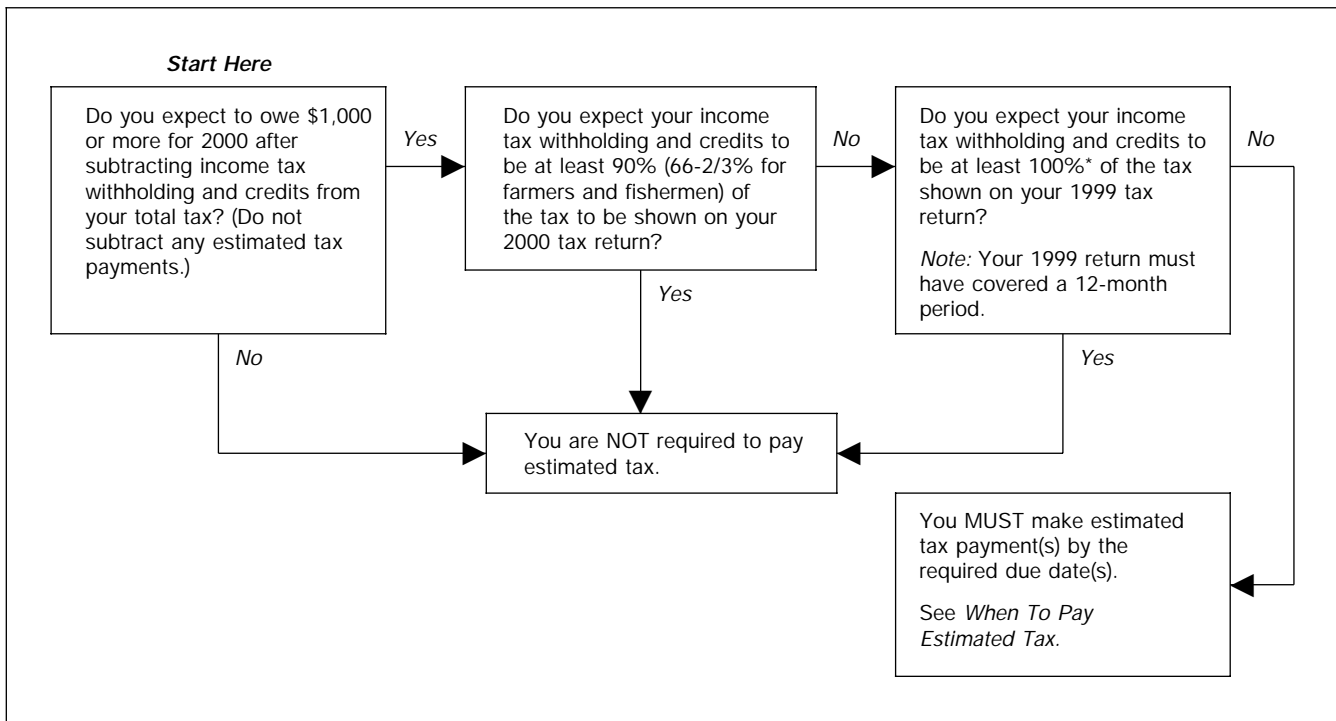
\*If your tax year does not begin on January 1, see *Fiscal year taxpayers*, later.

\*\*See *January payment*, later.

**Saturday, Sunday, holiday rule.** If the due date for making an estimated tax payment falls on a Saturday, Sunday, or legal holiday, the payment will be on time if you make it on the next day that is not a Saturday, Sunday, or legal holiday. For example, a payment due Saturday, April 15, 2000, will be on time if you make it by Monday, April 17, 2000.

**January payment.** If you file your 2000 return by January 31, 2001, and pay the rest of the tax you owe, you do not need to make

Figure 5-A. Do You Have To Pay Estimated Tax?



\* 106% if less than two-thirds of your gross income for 1999 and 2000 is from farming or fishing and your 1999 adjusted gross income was more than \$150,000 (\$75,000 if your filing status for 2000 is married filing a separate return).

your estimated tax payment that would be due on January 15, 2001.

**Fiscal year taxpayers.** If your tax year does not start on January 1, see the Form 1040-ES instructions for your payment due dates.

**When To Start**

You do not have to make estimated tax payments until you have income on which you will owe the tax. If you have income subject to estimated tax during the first payment period, you must make your first payment by the due date for the first payment period. You can pay all your estimated tax at that time, or you can pay it in four installments. If you choose to pay in installments, make your first payment by the due date for the first payment period. Make your remaining installment payments by the due dates for the later periods.

**No income subject to estimated tax during first period.** If you first have income subject to estimated tax during a later payment period, you must make your first payment by the due date for that period. You can pay your entire estimated tax by the due date for that period, or you can pay it in installments by the due date for that period and the due dates for the remaining periods. The following chart shows when to make installment payments:

If you first have income on which you must pay estimated tax:	Make a payment by:	Make later installments by:
Before Apr. 1	Apr. 15	June 15 Sep. 15 Jan. 15 next year*

After Mar. 31 and before June 1	June 15	Sep. 15 Jan. 15 next year*
After May 31 and before Sep. 1	Sep. 15	Jan. 15 next year*
After Aug. 31	Jan. 15 next year*	(None)

\*See January payment, and Saturday, Sunday, holiday rule under When To Pay Estimated Tax, earlier.

**Change in estimated tax.** After making your first estimated tax payment, changes in your income, adjustments, deductions, credits, or exemptions may make it necessary for you to refigure your estimated tax. Pay the unpaid balance of your amended estimated tax by the next payment due date after the change or in installments by that date and the due dates for the remaining payment periods.

**How much to pay to avoid a penalty.** To determine how much you should pay by each payment due date, see *How To Figure Each Payment*, next. If the earlier discussions of *No income subject to estimated tax during first period* or *Change in estimated tax* apply to you, you may need to read the explanation of the *Annualized Income Installment Method*, in Publication 505, to avoid a penalty.

**How To Figure Each Payment**

You should pay enough estimated tax by the due date of each payment period to avoid a penalty for that period. You can figure your required payment for each pe-

riod by using either the regular installment method or the annualized income installment method. These methods are described in Publication 505. If you do not pay enough each payment period, you may be charged a penalty even if you are due a refund when you file your tax return. See *Underpayment Penalty*, later in this chapter.

**File Form 2210 to avoid a penalty.** If your estimated tax payment for a previous period is less than one-fourth of your amended estimated tax, you may be charged a penalty for underpayment of estimated tax for that period when you file your tax return. To avoid the penalty, you must file Form 2210 with your 2000 tax return. You must also show that the total of your withholding and estimated tax payment for the period was at least as much as your annualized income installment. See *Form 2210*, later, under *Underpayment Penalty*, for more information.

**Estimated Tax Payments Not Required**

You do not have to make estimated tax payments if your withholding in each payment period is at least one-fourth of your required annual payment or at least your required annualized income installment for that period. You also do not have to make estimated tax payments if you will pay enough through withholding to keep the amount you owe with your return under \$1,000.

**How To Pay Estimated Tax**

There are four ways to make estimated tax payments.

- 1) By crediting an overpayment on your 1999 return to your 2000 estimated tax.

- 2) By sending in your payment with a payment-voucher from **Form 1040-ES**.
- 3) By paying electronically using the Electronic Federal Tax Payment System (EFTPS).
- 4) Beginning March 1, 2000, by credit card using a pay-by-phone system.

- Your signature (and spouse's signature),
- Your old address (and spouse's old address if different),
- Your new address, and
- Your social security number (and spouse's social security number).

You can use Form 8822, *Change of Address*, for this purpose.

You can continue to use your old preprinted payment-vouchers until the IRS sends you new ones. However, **DO NOT** correct the address on the old voucher.

### Payment by Credit Card

Beginning March 1, 2000, you can generally pay part or all of your estimated tax by using a credit card (American Express® Card, MasterCard®, or Discover® Card). To do this, call **1-888-2PAY-TAX** (1-888-272-9829), toll free. Based on the amount of your payment, you will be charged a convenience fee. The IRS will not receive this fee. You will be told the amount of the fee during the call. Then, you will have the option to continue or cancel the call. You can also look up the amount of convenience fee on the Internet at **www.8882paytax.com**.

If you decide to continue, you will be given a confirmation number at the end of the call. Make a record of the confirmation number. **Do not** include the amount of the convenience fee as part of the estimated tax payment. There is nothing to send in when you pay by credit card.

## Credit for Withholding and Estimated Tax

When you file your 1999 income tax return, take credit for all the income tax and excess social security or railroad retirement tax withheld from your salary, wages, pensions, etc. Also, take credit for the estimated tax you paid for 1999. These credits are subtracted from your tax. You should file a return and claim these credits even if you do not owe tax.

If you had two or more employers and were paid wages of more than \$72,600 during 1999, too much social security or railroad retirement tax may have been withheld from your wages. See *Credit for Excess Social Security Tax or Railroad Retirement Tax Withheld* in chapter 38.

### Withholding

If you had income tax withheld during 1999, you should receive a statement by January 31, 2000, showing your income and the tax withheld. Depending on the source of your income, you will receive:

- Form W-2, *Wage and Tax Statement*,
- Form W-2G, *Certain Gambling Winnings*, or
- A form in the 1099 series.

**Forms W-2 and W-2G.** You file Form W-2 with your income tax return. File Form W-2G with your return if it shows any fed-

eral income tax withheld from your winnings.

You should get at least two copies of each form you receive. Attach Copy B to the front of your federal income tax return. Copy C is for your records. You should also receive copies to file with your state and local returns.

### Form W-2

Your employer should give you a Form W-2 for 1999 by January 31, 2000. You should receive a separate Form W-2 from each employer you worked for.

If you stop working before the end of the year, your employer can give you your Form W-2 at any time after you leave your job. However, your employer must give it to you by January 31 of the following year (or the next day that is not a Saturday, Sunday, or holiday if January 31 is a Saturday, Sunday, or holiday). If you ask for the form, your employer must give it to you within 30 days after receiving your written request or within 30 days after your final wage payment, whichever is later.

If you have not received your Form W-2 by February 1, 2000, you should ask your employer for it. If you do not receive it by February 15, call the IRS. The number is listed in the Form 1040, Form 1040A, and Form 1040EZ instructions. You will be asked to give your employer's name, address, and telephone number, and, if known, your employer's identification number. You will also be asked for your address, social security number, daytime telephone number, dates of employment, and your best estimate of your total wages and federal income tax withheld.

Form W-2 shows your total pay and other compensation and the income tax, social security tax, and Medicare tax that was withheld during the year. Take credit for the federal income tax withheld on:

- Line 57 if you file Form 1040,
- Line 35 if you file Form 1040A, or
- Line 7 if you file Form 1040EZ.

Form W-2 is also used to report any taxable sick pay you received and any income tax withheld from your sick pay.

### Form W-2G

If you had gambling winnings, the payer may have withheld 28% as income tax. If tax was withheld, the payer will give you a Form W-2G showing the amount you won and the amount of tax withheld. Report the amounts you won on line 21 of Form 1040. Take credit for the tax withheld on line 57 of Form 1040. If you had gambling winnings, you must use Form 1040; you cannot use Form 1040A or Form 1040EZ. See *Deductions Not Subject to the 2% Limit* in chapter 30 for information on how to deduct gambling losses.

### The 1099 Series

Most forms in the 1099 series are not filed with your return. You should receive these forms by February 1, 2000. Keep these forms for your records. There are several different forms in this series, including:

- Form 1099-B, *Proceeds From Broker and Barter Exchange Transactions*,

### Crediting an Overpayment

When you file your Form 1040 or Form 1040A for 1999 and you have an overpayment of tax, you can apply part or all of it to your estimated tax for 2000. On line 67 of Form 1040, or line 42 of Form 1040A, write the amount you want credited to your estimated tax rather than refunded. The amount you have credited should be taken into account when figuring your estimated tax payments.

You can use all the credited amount toward your first payment, or you can spread it out in any way you choose among any or all of your payments.

If you ask that an overpayment be credited to your estimated tax for the next year, the payment is considered to have been made on the due date of the first estimated tax installment (April 15 for calendar year taxpayers). You cannot have any of that amount refunded to you after that due date until the close of that tax year. You also cannot use that overpayment in any other way after that date.

### Using the Payment-Vouchers

Each payment of estimated tax must be accompanied by a payment-voucher from Form 1040-ES. If you made estimated tax payments last year, you should receive a copy of the 2000 Form 1040-ES in the mail. It will have payment-vouchers preprinted with your name, address, and social security number. Using the preprinted vouchers will speed processing, reduce the chance of error, and help save processing costs.

If you did not pay estimated tax last year, you will have to get a copy of Form 1040-ES from the IRS. After you make your first payment, a Form 1040-ES package with the preprinted vouchers will be mailed to you. Follow the instructions in the package to make sure you use the vouchers correctly.

Use the window envelopes that came with your Form 1040-ES package. If you use your own envelope, make sure you mail your payment-vouchers to the address shown in the Form 1040-ES instructions for the place where you live. **Do not** use the address shown in the Form 1040 or Form 1040A instructions.

If you file a joint return and you are making joint estimated tax payments, please enter the names and social security numbers on the payment voucher in the same order as they will appear on the joint return.

**Change of address.** You must notify the IRS if you are making estimated tax payments and you changed your address during the year. You must send a clear and concise written statement to the IRS Service Center where you filed your last return and provide all of the following:

- Your full name (and your spouse's full name),

- Form 1099-DIV, *Dividends and Distributions*,
- Form 1099-G, *Certain Government and Qualified State Tuition Program Payments*,
- Form 1099-INT, *Interest Income*,
- Form 1099-MISC, *Miscellaneous Income*,
- Form 1099-OID, *Original Issue Discount*,
- Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.*,
- Form SSA-1099, *Social Security Benefit Statement*, and
- Form RRB-1099, *Payments by the Railroad Retirement Board*.

For some types of income reported on forms in the 1099 series, you may not be able to use Form 1040A or Form 1040EZ. See the instructions to these forms for details.

**Form 1099-R.** Attach Form 1099-R to your return if box 4 shows federal income tax withheld. Include the amount withheld in the total on line 57 of Form 1040 or line 35 of Form 1040A.

**Backup withholding.** If you were subject to backup withholding on income you received during 1999, include the amount withheld, as shown on your Form 1099, in the total on line 57 of Form 1040, or line 35 of Form 1040A.

### Form Not Correct

If you receive a form with incorrect information on it, you should ask the payer for a corrected form. Call the telephone number or write to the address given for the payer on the form. The corrected Form W-2G or Form 1099 you receive will be marked "CORRECTED." A special form, Form W-2c, *Corrected Wage and Tax Statement*, is used to correct a Form W-2.

### Form Received After Filing

If you file your return and you later receive a form for income that you did not include on your return, you should report the income and take credit for any income tax withheld by filing Form 1040X, *Amended U.S. Individual Income Tax Return*. See *Amended Returns and Claims for Refund* in chapter 1.

### Separate Returns

If you are married but file a separate return, you can take credit only for the tax withheld from your own income. Do not include any amount withheld from your spouse's income. However, different rules may apply if you live in a community property state.

**Community property states.** Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin are community property states. If you live in a community property state and file a separate return, you and your spouse must each report half of all community income in addition to your own separate income. Each of you takes credit for half of all taxes with-

held on the community income. If you were divorced during the year, each of you generally must report half the community income and can take credit for half the withholding on that community income for the period before the divorce.

For more information on these rules, and some exceptions, see Publication 555, *Community Property*.

### Fiscal Years

If you file your tax return on the basis of a fiscal year (a 12-month period ending on the last day of any month except December), you must follow special rules to determine your credit for federal income tax withholding. For a discussion of how to take credit for withholding on a fiscal year return, see *Fiscal Years* in chapter 3 of Publication 505.

### Estimated Tax

Take credit for all your estimated tax payments for 1999 on line 58 of Form 1040 or line 36 of Form 1040A. Include any overpayment from 1998 that you had credited to your 1999 estimated tax. You must use Form 1040 or Form 1040A if you paid estimated tax. You cannot use Form 1040EZ.

**Name changed.** If you changed your name, and you made estimated tax payments using your old name, attach a brief statement to the front of your tax return indicating:

- When you made the payments,
- The amount of each payment,
- Which IRS address you sent the payments to,
- Your name when you made the payments, and
- Your social security number.

The statement should cover payments you made jointly with your spouse as well as any you made separately.

### Separate Returns

If you and your spouse made separate estimated tax payments for 1999 and you file separate returns, you can take credit only for your own payments.

If you made joint estimated tax payments, you must decide how to divide the payments between your returns. One of you can claim all of the estimated tax paid and the other none, or you can divide it in any other way you agree on. If you cannot agree, you must divide the payments in proportion to each spouse's individual tax as shown on your separate returns for 1999.

### Divorced Taxpayers

If you made joint estimated tax payments for 1999, and you were divorced during the year, either you or your former spouse can claim all of the joint payments, or you each can claim part of them. If you cannot agree on how to divide the payments, you must divide them in proportion to each spouse's individual tax as shown on your separate returns for 1999.

If you claim any of the joint payments on your tax return, enter your former spouse's social security number (SSN) in the space provided on the front of Form 1040 or Form 1040A. If you divorced and

remarried in 1999, enter your present spouse's SSN in that space and write your former spouse's SSN, followed by "DIV," to the left of line 58, Form 1040, or line 36, Form 1040A.

## Underpayment Penalty

If you did not pay enough tax either through withholding or by making estimated tax payments, you will have an underpayment of estimated tax and you may have to pay a penalty. Generally, you will **not** have to pay a penalty for 1999 if any of the following situations apply to you.

- The total of your withholding and estimated tax payments was at least as much as your 1998 tax, you are not subject to the special rule limiting use of the prior year's tax, and you paid all required estimated tax payments on time.
- The tax balance due on your return is no more than 10% of your total 1999 tax, and you paid all required estimated tax payments on time.
- Your total 1999 tax (defined later) minus your withholding is less than \$1,000.
- You did not owe tax for 1998.
- You did not have any withholding taxes and your current year tax less any household employment taxes is less than \$1,000.

Special rules apply if you are a farmer or fisherman. See *Farmers and Fishermen* in chapter 4 of Publication 505 for more information.

**IRS can figure the penalty for you.** If you think you owe the penalty but you do not want to figure it yourself when you file your tax return, you may not have to. Generally, the IRS will figure the penalty for you and send you a bill. However, you must complete Form 2210 and file it with your return if you check any of the boxes in Part I of the form. See *Reasons for filing* later in this section.

### General Rule

In general, you may owe a penalty for 1999 if the total of your withholding and estimated tax payments did not equal at least the **smaller** of:

- 1) 90% of your 1999 tax, or
- 2) 100% of your 1998 tax. (Your 1998 tax return must cover a 12-month period.)

**Special rules for certain individuals.** There are special rules for farmers and fishermen and for certain higher income taxpayers.

**Farmers and fishermen.** If at least two-thirds of your gross income for 1998 or 1999 is from farming or fishing, substitute 66⅔% for 90% in (1) above.

See *Farmers and Fishermen* in chapter 4 of Publication 505 for more information.

**Higher income taxpayers.** If less than two-thirds of your gross income for 1998 and 1999 is from farming or fishing and your

adjusted gross income (AGI) for 1998 was more than \$150,000 (\$75,000 if your filing status is married filing a separate return in 1999), substitute 105% for 100% in (2) above.

For 1998, AGI is the amount shown on Form 1040 — line 34; Form 1040A — line 19; and Form 1040EZ — line 4.

**Penalty figured for each period.** Because the penalty is figured separately for each payment period, you may owe a penalty for an earlier payment period even if you later paid enough to make up the underpayment. If you did not pay enough tax by the due date of each of the payment periods, you may owe a penalty even if you are due a refund when you file your income tax return.

**Example.** You did not make estimated tax payments during 1999 because you thought you had enough tax withheld from your wages. Early in January 2000, you made an estimate of your total 1999 tax. You then realized that your withholding was \$2,000 less than the amount needed to avoid a penalty for underpayment of estimated tax.

On January 11, you made an estimated tax payment of \$3,000, the difference between your withholding and your estimate of your total tax. Your final return shows your total tax to be \$50 less than your estimate, so you are due a refund.

You do not owe a penalty for your payment due January 15, 2000. However, you may owe a penalty through January 11 for your underpayments for the earlier payment periods.

**Minimum required each period.** You will owe a penalty for any 1999 payment period for which your estimated tax payment plus your withholding for the period and overpayments for previous periods was less than the **smaller** of:

- 1) 22.5% of your 1999 tax, or
- 2) 25% of your 1998 tax. (Your 1998 tax return must cover a 12-month period.)

**Note.** If you are subject to the rule for higher income taxpayers, discussed earlier, substitute 26.25% for 25% in (2) above.

**When penalty is charged.** If you miss a payment or you paid less than the minimum required in a period, you may be charged an underpayment penalty from the date the amount was due to the date the payment is made.

**1998 separate returns and 1999 joint return.** If you file a joint return with your spouse for 1999, but you filed separate returns for 1998, your 1998 tax is the total of the tax shown on your separate returns. You filed a separate return for 1998 if you filed as single, head of household, or married filing separately.

**1998 joint return and 1999 separate returns.** If you file a separate return for 1999, but you filed a joint return with your spouse for 1998, your 1998 tax is your share of the tax on the joint return. You filed a separate return for 1999 if you filed as single, head of household, or married filing separately. To figure your share, first figure the tax both

you and your spouse would have paid had you filed separate returns for 1998, using the same filing status as in 1999. Then multiply your joint tax liability by the following fraction:

$$\frac{\text{Your separate tax liability}}{\text{Both spouses' separate tax liabilities}}$$

**Example.** Lisa and Paul filed a joint return for 1998 showing taxable income of \$48,000 and a tax of \$7,942. Of the \$48,000 taxable income, \$40,000 was Lisa's and the rest was Paul's. For 1999, they file married filing separately. Lisa figures her share of the tax on the 1998 joint return as follows:

Tax on \$40,000 based on a separate return .....	\$ 8,454
Tax on \$8,000 based on a separate return .....	1,204
Total .....	\$ 9,658
Lisa's portion of total (\$8,454 ÷ \$9,658) .....	88%
Lisa's share of 1998 joint return tax (\$7,942 × 88%) .....	<u>\$ 6,989</u>

**Form 2210.** In most cases, you do not need to file Form 2210. The IRS will figure the penalty for you and send you a bill. If you want to figure your penalty, complete Part I, Part II, and either Part III or Part IV of Form 2210. **Do not** file Form 2210 unless you must file it, as explained later under *Reasons for filing*. If you use Form 2210, you cannot file Form 1040EZ.

On Form 1040, enter the amount of your penalty on line 69. If you owe tax on line 68, add the penalty to your tax due and show your total payment on line 68. If you are due a refund, subtract the penalty from the overpayment you show on line 65.

On Form 1040A, enter the amount of your penalty on line 44. If you owe tax on line 43, add the penalty to your tax due and show your total payment on line 43. If you are due a refund, subtract the penalty from the overpayment you show on line 40.

**Reasons for filing.** You may be able to lower or eliminate your penalty if you file Form 2210. You **must** file Form 2210 with your return if any of the following applies.

- You request a waiver. See *Waiver of Penalty*, later.
- You use the annualized income installment method.
- You use your actual withholding for each payment period for estimated tax purposes.
- You base any of your required installments on the tax shown on your 1998 return and you filed or are filing a joint return for either 1998 or 1999 but not for both years.

For help in completing Form 2210, including illustrated examples, see chapter 4 of Publication 505.

**Annualized income installment method.** If you did not receive your income evenly throughout the year (for example, your income from a repair shop you operated was much larger in the summer than it was during the rest of the year), you may be able to lower or eliminate your penalty by figuring your underpayment using the annualized income installment method. Under this method, your required installment for one or more payment periods may be

less than one-fourth of your required annual payment.

To figure your underpayment using this method, complete Schedule AI of Form 2210. Also check the box on line 1b in Part I of Form 2210. You must file the form and Schedule AI with your return. This method is explained in chapter 4 of Publication 505.

**Actual withholding method.** Instead of using one-fourth of your withholding to figure your payments, you can choose to establish how much was actually withheld by the due dates and use those amounts. You can make this choice separately for the tax withheld from your wages and for all other withholding.

Using your actual withholding may result in a smaller penalty if most of your withholding occurred early in the year.

If you use your actual withholding, you must check the box on line 1c, Part I of the Form 2210. Complete Form 2210 and file it with your return.

**Short method for figuring the penalty.** You may be able to use the short method in Part III of Form 2210 to figure your penalty for underpayment of estimated tax. If you qualify to use this method, it will result in the same penalty amount as the regular method, but with fewer computations.

You can use the short method **only** if you meet one of the following requirements.

- 1) You made no estimated tax payments for 1999. It does not matter whether you had income tax withholding; or
- 2) You paid estimated tax in four **equal** amounts on the due dates.

**Note.** If any payment was made earlier than the due date, you can use the short method, but using it may cause you to pay a larger penalty than using the regular method. If the payment was only a few days early, the difference is likely to be small.

If you do not meet either requirement, figure your penalty using the regular method in Part IV, Form 2210.

**Note.** If you use the short method in Part III, you cannot use the annualized income installment method or the actual withholding method.

## Exceptions

Generally, you do not have to pay an underpayment penalty if either of the following conditions apply:

- Your total tax due is less than \$1,000, or
- You had no tax liability last year.

## Less Than \$1,000 Due

You do not owe a penalty if the total tax shown on your return minus the amount you paid through withholding (including excess social security and railroad retirement tax withholding) is less than \$1,000.

**Total tax for 1999.** For 1999, your total tax on Form 1040 is the amount on line 56 reduced by the total of the following seven amounts.

- 1) Any recapture of a federal mortgage subsidy from Form 8828 included on line 56.

- 2) Any social security or Medicare tax on tips not reported to your employer on line 52.
- 3) Any tax on excess contributions to IRAs and medical savings accounts, and any tax on excess accumulations in qualified retirement plans from Form 5329 included on line 53.
- 4) Any uncollected social security, Medicare, or railroad retirement tax included on line 56.
- 5) Any earned income credit on line 59a.
- 6) Any additional child tax credit on line 60.
- 7) Any credit for federal tax on fuels from Form 4136 included on line 63.

Your total tax on Form 1040A for 1999 is the amount on line 34 minus the amount on lines 37a and 38. Your total tax on Form 1040EZ is the amount on line 10 minus the amount on line 8a.

### No Tax Liability Last Year

You do not owe a penalty if you had no tax liability last year and you were a U.S. citizen or resident for the whole year. For this rule to apply, your tax year must have included all 12 months of the year.

You had no tax liability for 1998 if your total tax was zero or you did not need to file an income tax return.

**Example.** Ray, who is single and age 22, was unemployed for most of 1998. He earned \$2,700 in wages before he was laid off, and he received \$2,500 in unemployment compensation afterwards. He had no other income. Even though he had gross income of \$5,200, he did not have to pay income tax because his gross income was less than the filing requirement for a single person under age 65 (\$6,950 for 1998). He filed a return only to have his withheld income tax refunded to him.

In 1999, Ray began regular work as an independent contractor. Ray made no estimated tax payments in 1999. Even though he did owe tax at the end of the year, Ray does not owe the underpayment penalty for 1999 because he had no tax liability in 1998.

**Total tax for 1998.** For 1998, your total tax on Form 1040 is the amount on line 56 reduced by the total of the following seven amounts.

- 1) Any recapture of a federal mortgage subsidy from Form 8828 included on line 56.
- 2) Any social security or Medicare tax on tips not reported to your employer on line 52.
- 3) Any tax on excess contributions to IRAs and medical savings accounts, and any tax on excess accumulations in qualified retirement plans from Form 5329 included on line 53.
- 4) Any uncollected social security, Medicare, or railroad retirement tax included on line 56.
- 5) Any earned income credit on line 59a.
- 6) Any additional child tax credit on line 60.
- 7) Any credit for federal tax on fuels from Form 4136 included on line 63.

Your total tax on Form 1040A is the amount on line 34 minus the amount on lines 37a and 38. Your total tax on Form 1040EZ is the amount on line 10 minus the amount on line 8a.

### Waiver of Penalty

The IRS can waive the penalty for underpayment if:

- 1) You did not make a payment because of a casualty, disaster, or other unusual circumstance, and it would be inequitable to impose the penalty, or
- 2) You retired (after reaching age 62) or became disabled during the tax year a payment was due or during the preceding tax year, and both the following requirements are met:
  - a) You had a reasonable cause for not making the payment, and
  - b) Your underpayment was not due to willful neglect.

To claim a waiver, follow the procedures explained in the instructions for Form 2210.



# Part Two.

## Income

The eight chapters in this part discuss many kinds of income. They explain which income is and is not taxed. See Part Three for information on gains and losses you report on Schedule D (Form 1040) and for information on selling your home.

### 6.

## Wages, Salaries, and Other Earnings

### Important Reminder

**Foreign source income.** If you are a U.S. citizen, you must report all income from sources outside the United States (foreign income) on your tax return unless it is exempt by U.S. law. This is true whether you reside inside or outside the United States and whether or not you receive a Form W-2 or 1099 from the foreign payer. This applies to earned income (such as wages and tips) as well as unearned income (such as interest, dividends, capital gains, pensions, rents and royalties). This rule also applies to resident aliens.

If you reside outside the United States, you may be able to exclude part or all of your foreign source earned income. For details, see Publication 54, *Tax Guide for U.S. Citizens and Resident Aliens Abroad*.

### Introduction

This chapter discusses wages, salaries, fringe benefits, and other compensation received for services as an employee. The chapter explains what income is included in the employee's gross income and what is not included.

### Useful Items

You may want to see:

#### Publication

- 463** Travel, Entertainment, Gift, and Car Expenses
- 503** Child and Dependent Care Expenses
- 505** Tax Withholding and Estimated Tax
- 525** Taxable and Nontaxable Income

## Employee Compensation

This section explains many types of employee compensation followed by a detailed explanation of *Fringe Benefits* and *Sickness and Injury Benefits*.

If you are an employee, you should receive a Form W-2 from your employer showing the pay you received for your services. Include your pay on line 7 of Form 1040 or Form 1040A, or on line 1 of Form 1040EZ, even if you do not receive a Form W-2.

If you are not an employee, you generally will not receive a Form W-2. Nonemployee compensation is generally reported on Form 1099-MISC, *Miscellaneous Income*. For information on reporting nonemployee compensation, see the instructions on the back of Form 1099-MISC.

**Child-care services.** 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 are not an employee, you are probably self-employed and must include payments for your services on Schedule C or Schedule C-EZ of Form 1040. You are generally not an employee unless you are subject to the will and control of the person who employs you as to what you are to do and how you are to do it.

**Babysitting.** If you babysit for relatives or neighborhood children, whether on a regular basis or only periodically, the rules for child-care providers apply to you.

## Miscellaneous Compensation

This section explains many types of employee compensation. The subjects are arranged in alphabetical order.

**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.

If you repay unearned commissions or other amounts in the same year you receive them, reduce the amount to include in your income by the repayment. However, if you repay the unearned commissions or other amounts in a later tax year, you can deduct the repayment as an itemized deduction on your Schedule A (Form 1040), or you may be able to take a credit for that year. See *Repayments* in chapter 13.

**Allowances and reimbursements.** If you receive travel, transportation, or other business expense allowances or reimbursements from your employer, get Publication 463. If you are reimbursed for moving expenses, get Publication 521, *Moving Expenses*.

**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 damages, 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.** Bonuses or awards you receive for outstanding work 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. However, if your employer merely promises to pay you a bonus or award at some future time, it is not taxable until you receive it or it is made available to you.

**Employee achievement award.** If you receive tangible personal property (other than cash, gift certificate, or equivalent item) as an award for length of service or safety achievement, you can exclude its value from your income to the extent of your employer's cost for all such awards you receive during the year up to \$1,600 (\$400 for awards that are not qualified plan awards). Your employer can tell you whether your award is a qualified plan award. Your employer must make the award as part of a meaningful presentation, under conditions and circumstances that do not create a significant likelihood of it being disguised pay.

However, the exclusion does not apply to the following awards.

- A length-of-service award if you received it for fewer than 5 years of service or if you received another length-of-service award during the year or the previous 4 years.
- A safety achievement award if you are a manager, administrator, clerical employee, or other professional employee or if more than 10% of eligible employees previously received safety achievement awards during the year.

**Government cost-of-living allowances.** Cost-of-living allowances are generally included in your income. However, these allowances are generally not included in your income if you are a federal civilian employee or a federal court employee who is stationed

in Alaska, Hawaii, or outside the United States.

Allowances and differentials that increase your basic pay as an incentive for taking a less desirable post of duty are part of your compensation and must be included in your income. For example, your compensation includes Foreign Post, Foreign Service, and Overseas Tropical differentials. For more information, get Publication 516, *U.S. Government Civilian Employees Stationed Abroad*.

**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 include the value of that gift as extra salary or wages regardless of the amount involved.

**Note received for services.** If your employer gives you a secured note as payment for your services, you must include the fair market value (usually the discount value) of the note in your income for the year you receive it. When you later receive payments on the note, a proportionate part of each payment is the recovery of the fair market value that you previously included in your income. Do not include that part again in your income. Include the rest of the payment in your income in the year of payment.

If your employer gives you an unsecured note as payment for your services, payments on the note that are credited toward the principal amount of the note are compensation income when you receive them.

**Railroad retirement annuities.** The following types of payments are treated as pension or annuity income and are taxable under the rules explained in chapter 11.

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

**Restricted property received for services.** Generally, if you receive property for your services, you must include its fair market value in your income in the year you receive the property. However, if you receive stock or other property that has certain restrictions that affect its value, you may not have to include the value of the property in your income in the year you receive it. For details, see *Restricted Property Received for Services* in Publication 525.

**Dividends received on restricted stock.** Dividends you receive on restricted stock are extra compensation to you. Your employer should include these payments on your Form W-2. If they are also reported on Form 1099-DIV, *Dividends and Distributions*, you should list them on Schedule B (Form 1040), *Interest and Ordinary Dividends*, with a statement that you have to include them as wages. Do not include them in total dividends received.

**Stock you chose to include in income.** Dividends you receive on restricted stock you chose to include in your income in the year transferred are treated the same as any other dividends. You should receive a Form 1099-DIV showing these dividends.

Do not include the dividends in your wages on your return. Report them as dividends. For a discussion of dividends, see chapter 9.

**Retirement plan contributions.** You must include in income amounts you pay into a retirement plan through payroll deductions. You recover your contributions tax free when you retire and receive benefits from the plan. See chapter 11 for more information about the tax treatment of retirement plan benefits.

**Employer's contributions to qualified plan.** Your employer's contributions to a qualified retirement plan for you are not included in income at the time contributed. (Your employer can tell you whether your retirement plan is qualified.) However, the cost of life insurance coverage included in the plan may have to be included. See *Group-Term Life Insurance*, later, under *Fringe Benefits*.

**Elective deferrals.** If you chose to set aside part of your pay for retirement under a qualified deferred compensation arrangement (for example, a section 401(k) plan), the amount you set aside is treated as an employer contribution to a qualified plan, subject to a limit. For 1999, this limit is \$10,000 for all elective deferrals. If you set aside more than \$10,000, the excess must be included in your income for that year. See Publication 575 for a discussion of the tax treatment of corrective distributions of excess deferrals.

Elective deferrals are not excluded from wages for social security and Medicare taxes and benefits.

If you are a federal employee, this treatment applies to your contributions to the Thrift Savings Plan.

**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. However, if your interest is subject to a substantial risk of forfeiture (you have a good chance of losing it) at the time of contribution, you do not have to include the value of your interest in your income until it is no longer subject to a substantial risk of forfeiture.

**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 in gross income.

**Accrued leave payment.** If you are a federal employee and receive a lump-sum payment for accrued annual leave when you retire or resign, this amount will be included on your Form W-2.

If you resign from one agency and are reemployed by another agency, you may have to repay part of your lump-sum annual leave payment to the second agency. You can reduce gross wages by the amount you repaid in the same tax year in which you received it. You should attach to your tax return a copy of the receipt or statement furnished by the agency to which you make repayment to explain the difference between the wages on the return and the wages on your Forms W-2.

**Outplacement services.** If you choose to accept a reduced amount of severance pay so that you can receive outplacement

services (such as training in resumé writing and interview techniques), you must include the unreduced amount of the severance pay in income.

However, you can deduct the value of these outplacement services (up to the difference between the severance pay included in income and the amount actually received) as a miscellaneous deduction (subject to the 2% limit) on Schedule A (Form 1040).

**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) A state sickness or disability fund.
- 4) An association of employers or employees.
- 5) 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.

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

If you received income because of a disability, see *Sickness and Injury Benefits*, later.

**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 payments 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.** Do not include a stock appreciation right granted by your employer 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 your income in the year you use the right.

**Stock options.** If you receive a nonstatutory option to buy stock or other property as payment for your services, you will usually have income when you receive the option or when you exercise (use) the option. However, if your option is a statutory stock option (an incentive stock option or an option granted under an employee stock purchase plan), special rules generally delay the tax until you sell or exchange your shares of stock. Your employer can tell you which kind of option you hold. For details, get Publication 525.

**Unemployment compensation.** You must include in your income all unemployment compensation you receive. You should receive a Form 1099-G, *Certain Government and Qualified State Tuition Program Payments*, showing the amount paid to you. Generally, you enter unemployment compensation on line 19 of Form 1040, line 12 of Form 1040A, or line 3 of Form 1040EZ.

**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.

- 1) Benefits paid by a state or the District of Columbia from the Federal Unemployment Trust Fund.
- 2) State unemployment insurance benefits.
- 3) Railroad unemployment compensation benefits.
- 4) Disability payments from a government program paid as a **substitute** for unemployment compensation. Amounts received as workers' compensation for injuries or illness are **not** unemployment compensation.
- 5) Trade readjustment allowances under the Trade Act of 1974.
- 6) Benefits under the Airline Deregulation Act of 1978.
- 7) Unemployment assistance under the Disaster Relief Act Amendments 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.

**Supplemental unemployment benefits.** Benefits received from an employer-financed fund (to which the employees did not contribute) are not unemployment compensation. They are taxable as wages and are subject to withholding for income tax and social security and Medicare taxes. Report these payments on line 7 of Form 1040 or Form 1040A or on line 1 of Form 1040EZ.

You may have to repay some of your supplemental unemployment benefits to qualify for trade readjustment allowances under the Trade Act of 1974. If you repay supplemental unemployment benefits in the same year you receive them, reduce the total benefits by the amount you repay. If you repay the benefits in a later year, you must include the full amount of the benefits received in your income for the year you received them.

Deduct the repayment in the later year as an adjustment to gross income on Form 1040. (You cannot use Form 1040A or 1040EZ.) Include the repayment on line 32 of Form 1040, and put "Sub-Pay TRA" and the amount on the dotted line next to line 32. If the amount you repay in a later year is more than \$3,000, you may be able to take a credit against your tax for the later

year instead of deducting the amount repaid. For more information on this, see *Repayments* in chapter 13.

**Private unemployment fund.** Unemployment benefit payments from a private fund to which you voluntarily contribute are taxable only if the amounts you receive are more than your total payments into the fund. Report the taxable amount on line 21 of Form 1040.

**Payments by a union.** Benefits paid to you as an unemployed member of a union from regular union dues are included in your gross income on line 21 of Form 1040.

**Guaranteed annual wage.** Payments you receive from your employer during periods of unemployment, under a union agreement that guarantees you full pay during the year, are taxable as wages.

**State employees.** Payments similar to a state's unemployment benefits may be made by the state to its employees who are not covered by the state's unemployment compensation law. Although the payments are fully taxable, do not report them as unemployment benefits. Report these payments on line 21 of Form 1040.

**Repayment of unemployment compensation benefits.** If you repaid in 1999 unemployment compensation benefits you received in 1999, subtract the amount you repaid from the total amount you received and enter the difference on line 19 of Form 1040, line 12 of Form 1040A, or line 3 of Form 1040EZ. Also, enter "Repaid" and the amount you repaid on the dotted line next to line 19, line 12, or line 3. If, in 1999, you repaid unemployment compensation that you included in gross income in an earlier year, you may deduct the amount repaid on Schedule A (Form 1040) if you itemize deductions. For more information, see *Repayments* in chapter 13.

**Tax withholding.** You can choose to have federal income tax withheld from your unemployment compensation. To make this choice, complete Form W-4V, *Voluntary Withholding Request*, and give it to the paying office. Tax will be withheld at 15% of your payment.



If you do not choose to have tax withheld from your unemployment compensation, you may be liable for estimated tax. For more information on estimated tax, see chapter 5.

**Union benefits and dues.** Amounts deducted from your pay for union dues, assessments, contributions, or other payments to a union cannot be excluded from your gross income.

You may be able to deduct some of these payments as a miscellaneous deduction subject to the 2% limit if they are related to your job and if you itemize your deductions on Schedule A (Form 1040). For more information, see *Union Dues and Expenses* in chapter 30.

**Strike and lockout benefits.** Benefits paid to you by a union as strike or lockout benefits, including both cash and the fair market value of other property, are usually included in your income as compensation. You can exclude these benefits from your income only if the facts clearly show that the union intended them as gifts to you.

## 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. Abstaining from the performance of services (for example, under a covenant not to compete) is treated as the performance of services for purposes of these rules.

**Accounting period.** You must use the same accounting period your employer uses to report your taxable noncash fringe benefits. Your employer has the option to report taxable fringe benefits by using either of the following rules.

- 1) The general rule: benefits are reported for a full calendar year (January 1–December 31).
- 2) The special accounting period rule: benefits provided during the last 2 months of the calendar year (or any shorter period) are treated as paid during the following calendar year. For example, each year your employer reports the value of benefits provided during the last 2 months of the prior year and the first 10 months of the current year.

Your employer does not have to use the same accounting period for each fringe benefit, but must use the same period for all employees who receive a particular benefit.

You must use the same accounting period that you use to report the benefit to claim an employee business deduction (for use of a car, for example).

**Form W-2.** Your employer reports your taxable fringe benefits in box 1 (*Wages, tips, other compensation*) of Form W-2. The total value of your fringe benefits may also be noted in box 12. The value of your fringe benefits may be added to your other compensation on one Form W-2, or you may receive a separate Form W-2 showing just the value of your fringe benefits in box 1 with a notation in box 12.

## Accident or Health Plan

Generally, the value of accident or health plan coverage provided to you by your employer is not included in your gross income. Benefits you receive from the plan are generally taxable, as explained later under *Sickness and Injury Benefits*.

**Long-term care coverage.** Contributions by your employer to provide coverage for long-term care services are generally not included in income. However, contributions made through a flexible spending or similar arrangement (such as a cafeteria plan) must be included in your income. This amount will be reported as wages in box 1 of your Form W-2.

Contributions you make to the plan are discussed in Publication 502, *Medical and Dental Expenses*.

**Medical savings account (MSA) contributions.** Contributions by your employer to your medical savings account are not included in your income. This amount will,

however, be reported in box 13 of Form W-2 with code R designating that the amounts are excludable from income. You must report this amount on Form 8853, *Medical Savings Accounts and Long-Term Care Insurance Contracts*, and attach the form to your return.

If your employer does not make contributions to your MSA, you can make your own contributions to your MSA. These contributions are discussed in Publication 969, *Medical Savings Accounts (MSAs)*. Also, see Form 8853, *Medical Savings Accounts and Long-Term Care Insurance Contracts*.

## Adoption Assistance

You may be able to exclude from gross income amounts paid or expenses incurred by your employer for qualified adoption expenses in connection with your adoption of an eligible child. The amounts must be paid or the expenses must be incurred before January 1, 2002, as part of an adoption assistance program. See Publication 968, *Tax Benefits for Adoption*, for more information.

Adoption benefits are reported by your employer in box 13 of Form W-2 with code T. They are also included as social security and Medicare wages in boxes 3 and 5. However, they are not included as wages in box 1. To determine the taxable and nontaxable amounts, you must complete part III of Form 8839, *Qualified Adoption Expenses*. Attach the form to your return.

## Group-Term Life Insurance

Generally, the cost of up to \$50,000 of group-term life insurance coverage that is provided to you by your employer (or former employer) is not included in your income. However, you must include in your income the cost of employer-provided insurance to the extent it is more than the cost of \$50,000 of coverage reduced by any amount you pay towards the purchase of the insurance.

For exceptions to this rule, see *Entire cost excluded* and *Entire cost taxed*, later.

If your employer provided more than \$50,000 of coverage, the amount included in your income is reported as part of your wages in box 1 of your Form W-2. It is also shown separately in box 13 with code C. See *Your payment*, later.

**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 for each employee based on a formula that prevents individual selection.

**Permanent benefits.** If your group-term life insurance policy includes permanent benefits, such as a paid-up or cash surrender value, you must include in your income, as wages, the cost of the permanent benefits minus the amount you pay for them.

Your employer should be able to tell you the amount to include in your income.

**Accidental death benefits.** Insurance that provides accidental or other death benefits but does not provide general death benefits (travel insurance, for example) is not group-term life insurance.

**Figuring the taxable cost.** You figure the taxable cost for each month of coverage by multiplying the number of thousands of dollars of insurance coverage for the month (figured to the nearest tenth), less 50, by the cost from the following table. Use your age on the last day of the tax year. You must prorate the cost from the table if less than a full month of coverage is involved.

### COST PER \$1,000 OF PROTECTION FOR ONE MONTH

#### Insurance Provided Before July 1999:

Age	Cost
Under 30	\$ .08
30 through 34	.09
35 through 39	.11
40 through 44	.17
45 through 49	.29
50 through 54	.48
55 through 59	.75
60 through 64	1.17
65 through 69	2.10
70 and older	3.76

#### Insurance Provided After June 1999:

Age	Cost
Under 25	\$ .05
25 through 29	.06
30 through 34	.08
35 through 39	.09
40 through 44	.10
45 through 49	.15
50 through 54	.23
55 through 59	.43
60 through 64	.66
65 through 69	1.27
70 and older	2.06

You figure the total taxable cost by multiplying the monthly taxable cost by the number of full months coverage at that cost.

**Your payment.** If you pay any part of the cost of the insurance, your entire payment reduces, dollar for dollar, the amount you would otherwise include in your income. However, you cannot reduce the amount to include in your income by:

- 1) Payments for coverage in a different tax year,
- 2) Payments for coverage through a cafeteria plan, unless the payments are after-tax contributions, or
- 3) Payments for coverage not taxed to you because of the exceptions discussed later under *Entire cost excluded*.

**Example.** You are 51 years old and work for employers A and B. Both employers provide group-term life insurance coverage for you for the entire year. Your coverage is \$35,000 with employer A and \$45,000 with employer B. You pay premiums of \$4.15 a month under the employer B group plan. You figure the amount to include in your income for the insurance provided before July 1999 as follows:

Employer A coverage (in thousands) .....	\$35
Employer B coverage (in thousands) .....	+ 45
Total coverage (in thousands) .....	\$80
Minus: Exclusion (in thousands) .....	- 50
Excess amount (in thousands) .....	\$30
Multiply by cost per \$1,000 per month, age 51 (from table) .....	x .48
Cost of excess insurance for 1 month ...	\$14.40
Multiply by number of full months coverage at this cost .....	x 6
Cost of excess insurance provided before July 1999 .....	\$86.40
Minus: Premiums you paid .....	-24.90
<b>Cost to include in your income as wages</b> .....	<b>\$61.50</b>

You figure the amount to include in your income for the insurance provided after June 1999 as follows:

Excess amount (in thousands) .....	\$30
Multiply by cost per \$1,000 per month, age 51 (from table) .....	x .23
Cost of excess insurance for 1 month ...	\$6.90
Multiply by number of full months coverage at this cost .....	x 6
Cost of excess insurance provided after June 1999 .....	\$41.40
Minus: Premiums you paid .....	-24.90
<b>Cost to include in your income as wages</b> .....	<b>\$16.50</b>

The total amount to include in income for the cost of excess group-term life insurance is \$78 (\$61.50 + \$16.50). Because neither employer provided over \$50,000 insurance coverage, the wages shown on your Forms W-2 do not include any part of that \$78. You must add it to the wages shown on your Forms W-2 and include the total on your return.

**Entire cost excluded.** You are not taxed on the cost of group-term life insurance if any of the following apply.

- 1) You are permanently and totally disabled and have ended your employment.
- 2) Your employer is the beneficiary of the policy for the entire period the insurance is in force during the tax year.
- 3) A charitable organization (defined in chapter 26) to which contributions are deductible is the only beneficiary of the policy for the entire period the insurance is in force during the tax year. You are not entitled to a deduction for a charitable contribution for naming a charitable organization as the beneficiary of your policy.
- 4) The plan existed on January 1, 1984, and—
  - a) You retired before January 2, 1984, and were covered by the plan when retired, or
  - b) You reached age 55 before January 2, 1984, and were employed by the employer or its predecessor in 1983.

**Entire cost taxed.** You are taxed on the entire cost of group-term life insurance if either of the following apply.

- 1) The insurance is provided by your employer through a qualified employees' trust, such as a pension trust or a qualified annuity plan.
- 2) You are a key employee and your employer's plan discriminates in favor of key employees.

## Transportation

If your employer provides you with a qualified transportation fringe benefit, it can 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, or
- 3) Qualified parking.

Cash reimbursement by your employer for these expenses under a bona fide reimbursement arrangement is also excludable. However, cash reimbursement for a transit pass is excludable only if a voucher or similar item that can be exchanged only for a transit pass is not readily available for direct distribution to you.

**Exclusion limit.** The exclusion for commuter highway vehicle transportation and transit pass fringe benefits cannot be more than a total of \$65 a month, regardless of the total value of both benefits.

The exclusion for the qualified parking fringe benefit cannot be more than \$175 a month, regardless of its value. If the benefits have a value that is more than these limits, the excess must be included in your income.

**Commuter highway vehicle.** This is a highway vehicle that seats at least six adults (not including the driver). At least 80% of the vehicle's mileage must reasonably be expected to be:

- 1) For transporting employees between their homes and work place, and
- 2) On trips during which employees occupy at least half of the vehicle's adult seating capacity (not including the driver).

**Transit pass.** This is any pass, token, farecard, voucher, or similar item entitling a person to ride mass transit (whether public or private) free or at a reduced rate or to ride in a commuter highway vehicle operated by a person in the business of transporting persons for compensation.

**Qualified parking.** This is parking provided to an employee at or near the employer's place of business. It also includes parking provided on or near a location from which the employee commutes to work in a commuter highway vehicle or carpool. It does not include parking at or near the employee's home.

**Employer-provided vehicles.** If your employer provides a car (or other highway motor vehicle) to you, your personal use of the car is usually a taxable noncash fringe benefit.

## Sickness and Injury Benefits

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


However, certain payments may not be taxable to you. For information on nontaxable payments and payments for sickness and injury other than disability pensions and annuities, see *Military and Government Disability Pensions*, later, and *Other Sickness and Injury Benefits* in chapter 13.

**Cost paid by you.** If you pay the entire cost of an accident or health plan, do not include any amounts you receive from the plan for personal injury or sickness 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. See *Reimbursement in a later year* in chapter 23.

**Cafeteria plans.** Generally, if you are covered by an accident or health insurance plan through a cafeteria plan, and the amount of the insurance premiums was not included in your income, you are not considered to have paid the premiums and 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 Pensions

If you retired on disability, you must include in income any disability pension you receive under a plan that is paid for by your employer. You must report your taxable disability payments as wages on line 7 of Form 1040 or Form 1040A 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.

 **TIP** You may be entitled to a tax credit if you were permanently and totally disabled when you retired. For information on this credit, see chapter 34.

Beginning on the day after you reach minimum retirement age, payments you receive are taxable as a pension or annuity. Report the payments on lines 16a and 16b of Form 1040, or on lines 11a and 11b of Form 1040A. The rules for reporting pensions and annuities are explained in chapter 11.

**Retirement and profit-sharing plans.** If you receive payments from a retirement or profit-sharing plan that does not provide for disability retirement, do not treat the payments as a disability pension. The payments must be reported as a pension or annuity. For more information on pensions, see chapter 11.

**Accrued leave payment.** If you retire on disability, any lump-sum payment you receive for accrued annual leave is a salary payment. The payment is not a disability payment. You must report it as wages in the tax year you receive it.

## 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 were a member of a listed government service or its reserve component, or were under a binding written commitment to become a member, on September 24, 1975.
- 3) 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.
- 4) You would be entitled to receive disability compensation from the Department of Veterans Affairs (VA) if you filed an application for it. Your exclusion under this condition is equal to the amount you would be entitled to receive from the VA.

**Pension based on years of service.** If you receive a disability pension based on years of service, you generally must include it in your income. But if it is a result of active service in one of the listed government services and one of the listed conditions applies, do not include in income the part of your pension that you would have received if the pension had been based on a percentage of disability. You must include the rest of your pension in your income.

**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. You can claim a refund of any tax paid on the excludable amount (subject to the statute of limitations) by filing an amended return on Form 1040X for each previous year during the retroactive period.

If you receive a lump-sum disability severance payment and are later awarded VA disability benefits, do not include in your income the portion of the severance payment equal to the VA benefit you would have been entitled to receive in that same year. 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 if you are later given a retroactive disability rating by the VA.

**Terrorist attack.** 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. For your disability payments to be tax exempt, the Secretary of State must determine the attack was a terrorist attack.

## Special Rules for Certain Employees

This section deals with special rules for people in certain types of employment. It includes members of the clergy, people working for foreign employers, military personnel, veterans, 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. See chapter 26.

**Pension.** A pension or retirement pay for a member of the clergy is usually treated the same as any other pension or annuity. It must be reported on lines 16a and 16b of Form 1040 or on lines 11a and 11b of Form 1040A.

**Members of religious orders.** If you are a member of a religious order who has taken a vow of poverty, how you treat the earnings that you renounce and turn over to the order depends on whether your services are performed for the order.

**Services performed for the order.** If you are performing the services as an agent of the order in the exercise of duties required by the order, do not include in your income the amounts you turn over to the order.

If your order directs you to perform services for another agency of the supervising church or an associated institution, you are considered to be performing the services as an agent of the order. Any wages you earn as an agent of an order that you turn over to the order are not included in your gross income.

**Example.** You are a member of a church order and have taken a vow of poverty. You renounce any claims to your earnings and turn over to the order any salaries or wages you earn. You are a registered nurse, so your order assigns you to work in a hospital that is an associated institution of the church. However, you remain under the general direction and control of the order. You are considered to be an agent of the order and any wages you earn at the hospital that you turn over to your order are not included in your gross income.

**Services performed outside the order.** If you are directed to work outside the order, the work will not constitute the exercise of duties required by the order unless the services you perform meet both of the following requirements:

- 1) The services are the kind that are ordinarily the duties of members of the order, and
- 2) The services are part of the duties that must be exercised for, or on behalf of, the religious order as its agent.

If you are an employee of a third party, the services you perform for the third party will not be considered directed or required of you by the order. Amounts you receive for these services are included in your gross income, even if you have taken a vow of poverty.

**Example.** Mark Brown is a member of a religious order and has taken a vow of poverty. He renounces all claims to his earnings and turns over his earnings to the order.

Mark is a school teacher. He was instructed by the superiors of the order to get a job with a private tax-exempt school. Mark became an employee of the school, and, at his request, the school made the salary payments directly to the order.

Because Mark is an employee of the school, he is performing services for the school rather than as an agent of the order. The wages Mark earns working for the school are included in his gross income.

**Housing.** Special rules apply to members of the clergy. Under these rules, you do not include in your income the rental value of a home (including utilities) or a housing allowance provided to you as part of your pay. The home or allowance must be provided as compensation for your duties as an ordained, licensed, or commissioned minister. However, you must include the rental value of the home or the housing allowance as earnings from self-employment on Schedule SE (Form 1040) if you are subject to the self-employment tax.

**Housing allowance.** The amount of a housing allowance you can exclude from your income cannot be more than either:

- The reasonable compensation for your services as a minister, or
- Your expenses, in the year the allowance is received, to provide a home or to pay utilities for a home you are provided. 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.

**Designation requirement.** The church or organization that employs you must officially designate the payment as a housing allowance before the payment is made. A definite amount must be designated; the amount of the housing allowance cannot be determined at a later date.


If you are employed and paid by a local congregation, a resolution by a national church agency of your denomination does not effectively designate a housing allowance for you. The local congregation must officially designate the part of your salary that is to be a housing allowance. However,

a resolution of a national church agency can designate your housing allowance if you are directly employed by the agency. If no part has been officially designated, you must include your total salary in your income.

**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. See chapters 24 and 25.

**Teachers or administrators.** If you are a minister employed as a teacher or administrator by a church school, college, or university, you are performing ministerial services for purposes of the housing exclusion. However, if you perform services as a teacher or administrator on the faculty of a nonchurch college, you cannot exclude from your income a housing allowance or the value of a home that is provided to you.

 **TIP** If you live in qualified campus housing as an employee of an educational institution or an academic health center, all or part of the value of that housing may be nontaxable. See Faculty lodging in Publication 525.

If you serve as a minister of music or minister of education, or serve in an administrative or other function of your religious organization, but are not authorized to perform substantially all of the religious duties of an ordained minister in your church (even if you are commissioned as a "minister of the gospel"), you cannot exclude from your income a housing allowance or the value of a home provided to you.

**Theological students.** You cannot exclude a housing allowance from your income if you are a theological student serving a required internship as an assistant pastor, unless you are ordained, commissioned, or licensed as a minister.

**Traveling evangelists.** If you are an ordained minister and are providing evangelistic services, you can exclude amounts received from out-of-town churches that are designated as a housing allowance, provided you actually use them to maintain your permanent home.

**Retired members of the clergy.** The rental value of a home provided rent free by your church for your past services is not income if you are a retired minister. In addition, a housing allowance paid to you is not income to the extent you spend it for utilities, maintenance, repairs, and similar expenses that are directly related to providing a home. These amounts are also not included in net earnings from self-employment.

The general convention of a national religious denomination can designate a housing allowance for retired ministers that can be excluded from income. This applies if the local congregations authorize the general convention to establish and maintain a unified pension system for all retired clergy members of the denomination for their past services to the local churches.

A surviving spouse of a retired minister cannot exclude a housing allowance from income. If these payments were reported to you on Form 1099-R, include them on lines 16a and 16b of Form 1040, or on lines 11a and 11b of Form 1040A. Otherwise, include them on line 21 of Form 1040.

## Foreign Employer

Special rules apply if you work for a foreign employer.

**U.S. citizen.** If you are a U.S. citizen who works 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. This rule also applies if you are an employee of a qualifying wholly-owned instrumentality of a foreign government.

**Non-U.S. citizen.** If you are not a U.S. citizen, or if you are a U.S. citizen but also a citizen of the Philippines, and you work for an international organization, your salary from that source is exempt from tax. If you work for a foreign government in the United States, your salary from that source is exempt from tax if your work is like the work done by employees of the United States in that foreign country and the foreign government gives an equal exemption to employees of the United States in that country.

**Waiver of alien status.** If you are an alien who works for a foreign government or international organization and you file a waiver under section 247(b) of the Immigration and Nationality Act to keep your immigrant status, different rules may apply. See *Foreign Employer* in Publication 525.

**Employment abroad.** For information on the tax treatment of income earned abroad, get Publication 54.

## 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. For more information on the tax treatment of military allowances and

benefits, get Publication 3, *Armed Forces' Tax Guide*.

**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 on lines 16a and 16b of Form 1040, or on lines 11a and 11b of Form 1040A. Do not include in your income the amount of reduction in retirement or retainer pay to provide a survivor annuity for your spouse or children under the Retired Serviceman's Family Protection Plan or the Survivor Benefit Plan.

For more information on survivor annuities, see chapter 11.

**Disability.** If you are retired on disability, see *Military and Government Disability Pensions* under *Sickness and Injury Benefits*, earlier.

**Veterans' benefits.** Veterans' benefits paid under any law, regulation, or administrative practice 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 paid either to veterans or their families.
- 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' insurance proceeds and dividends paid either to veterans or their beneficiaries, including proceeds of a veteran's endowment policy paid before death.
- 6) Interest on insurance dividends you leave on deposit with the VA.

**Rehabilitative program payments.** VA payments to hospital patients and resident veterans for their services under the VA's therapeutic or rehabilitative programs are included as income other than wages. These payments are reported on line 21 of Form 1040.

## Volunteers

The tax treatment of amounts you receive as a volunteer worker for the Peace Corps or similar agency is covered in the following discussions.

**Peace Corps.** If you are a Peace Corps volunteer or volunteer leader, living allowances for housing, utilities, household supplies, food, and clothing are exempt from tax.

**Taxable allowances.** The following allowances you receive must be included in your income and reported as wages.

- 1) Allowances paid to the spouse and minor children of a volunteer leader while training in the United States.
- 2) Living allowances designated by the Director of the Peace Corps as basic compensation. These are allowances for personal items such as domestic help, laundry and clothing maintenance, entertainment and recreation, transportation, and other miscellaneous expenses.
- 3) Leave allowances.
- 4) Readjustment allowances or "termination payments." These are considered received by you when credited to your account.

**Example.** Gary Carpenter, a Peace Corps volunteer, gets \$175 a month as a readjustment allowance during his period of service, to be paid to him in a lump sum at the end of his tour of duty. Although the allowance is not available to him until the end of his service, Gary must include it in his income on a monthly basis as it is credited to his account.

**Volunteers in Service to America (VISTA).** If you are a VISTA volunteer, you must include meal and lodging allowances paid to you in your income as wages.

**National Senior Service Corps programs.** Do not include in your income amounts you receive for supportive services or reimbursements for out-of-pocket expenses from the following programs.

- Retired Senior Volunteer Program (RSVP).
- Foster Grandparent Program.
- Senior Companion Program.

**Service Corps of Retired Executives (SCORE).** If you receive amounts for supportive services or reimbursements for out-of-pocket expenses from SCORE, do not include these amounts in your gross income.

**Volunteer tax counseling.** You do not include in your income any reimbursements you receive for transportation, meals, and other expenses you have in training for, or actually providing, volunteer federal income tax counseling for the elderly (TCE).

You can deduct as a charitable contribution your unreimbursed out-of-pocket expenses in taking part in the volunteer income tax assistance (VITA) program.

# 7.

## Tip Income

### Introduction

This chapter is for employees who receive tips from customers. If you are self-employed and receive tip income, see Publication 334, *Tax Guide for Small Business*, for more information.

All tips you receive are income and are subject to federal income tax. You must include in gross income all tips you receive directly from customers, tips from charge customers that are paid to you by your employer, and your share of any tips you receive under a tip-splitting arrangement.

The value of noncash tips, such as tickets, passes, or other items of value are also income and subject to tax.

Reporting your tip income correctly is not difficult. You must do three things.

- 1) Keep a daily tip record.
- 2) Report tips to your employer.
- 3) Report all your tips on your income tax return.

This chapter will show you how to do these three things, and what to do on your tax return if you have not done the first two. This chapter will also show you how to treat allocated tips.

### Useful Items

You may want to see:

#### Publication

- 531** Reporting Tip Income
- 1244** Employee's Daily Record of Tips and Report to Employer

#### Form (and Instructions)

- 4137** Social Security and Medicare Tax on Unreported Tip Income

## Keeping a Daily Tip Record

**Why keep a daily tip record?** You must keep a daily tip record so you can:

- Report your tips accurately to your employer,
- Report your tips accurately on your tax return, and
- Prove your tip income if your return is ever questioned.

**How to keep a daily tip record.** There are two ways to keep a daily tip record. You can either:

- 1) Write information about your tips in a tip diary, or

- 2) Keep copies of documents that show your tips, such as restaurant bills and credit card charge slips.

You should keep your daily tip record with your personal records.

If you keep a tip diary, you can use Form 4070A, *Employee's Daily Record of Tips*. To get a year's supply of the form, ask the Internal Revenue Service (IRS) or your employer for Publication 1244, *Employee's Daily Record of Tips and Report to Employer*. Each day, write in the information asked for on the form.

If you do not use Form 4070A, start your records by writing your name, your employer's name, and the name of the business if it is different from your employer's name. Then, each workday, write the date and the following information.

- Cash tips you get directly from customers or from other employees.
- Tips from credit card charge customers that your employer pays you.
- The value of any noncash tips you get, such as tickets, passes, or other items of value.
- The amount of tips you paid out to other employees through tip pools or tip splitting, or other arrangements, and the names of the employees to whom you paid the tips.



**Do not write in your tip diary the amount of any service charge that your employer adds to a customer's bill and then pays to you and treats as wages. This is part of your wages, not a tip.**

**Electronic tip record.** You may use an electronic system provided by your employer to record your daily tips. You must receive and keep a paper copy of this record.

## Reporting Tips to Your Employer

**Why report tips to your employer?** You must report tips to your employer so that:

- Your employer can withhold federal income tax and social security and Medicare taxes, or railroad retirement tax,
- Your employer can report the correct amount of your earnings to the Social Security Administration or Railroad Retirement Board (which affects your benefits when you retire or if you become disabled, or your family's benefits if you die), and
- You can avoid the penalty for not reporting tips to your employer (explained later).

**What tips to report.** Report to your employer only cash, check, or credit card tips you receive. If your total tips for any one month from any one job are less than \$20, do not report them to your employer. Do not report the value of any noncash tips, such as tickets or passes, to your employer. You do not have to pay social security and Medicare taxes, or railroad retirement tax on these tips.

**How to report.** You can use Form 4070, *Employees' Report of Tips to Employer*. To get a year's supply of the form, ask the IRS or your employer for Publication 1244. Fill in the information asked for on the form, sign and date the form, and give it to your employer.

If you do not use Form 4070, give your employer a statement with the following information.

- Your name, address, and social security number.
- Your employer's name, address, and business name (if it is different from the employer's name).
- The month (or the dates of any shorter period) in which you received tips.
- The total tips required to be reported for that period.

You must sign and date the statement. You should keep a copy with your personal records.

Your employer may require you to report your tips more than once a month. However, the statement cannot cover a period of more than one calendar month.

**Electronic tip statement.** Your employer can have you furnish your tip statements electronically.

**When to report.** Give your report for each month to your employer by the 10th of the next month. If the 10th falls on a Saturday, Sunday, or legal holiday, give your employer the report by the next day that is not a Saturday, Sunday, or legal holiday.

**Example 1.** You must report your tips received in January 2000 by February 10, 2000.

**Example 2.** You must report your tips received in May 2000 by June 12, 2000. June 10 is on a Saturday, and the 12th is the next day that is not a Saturday, Sunday, or legal holiday.

**Final report.** If your employment ends during the month, you can report your tips when your employment ends.

**Penalty for not reporting tips.** If you do not report tips to your employer as required, you may be subject to a penalty equal to 50% of the social security and Medicare taxes or railroad retirement tax you owe on the unreported tips. (For information about these taxes, see *Reporting social security and Medicare taxes on tips not reported to your employer* under *Reporting Tips on Your Tax Return*, later.) The penalty amount is in addition to the taxes you owe.

You can avoid this penalty if you can show reasonable cause for not reporting the tips to your employer. To do so, attach a statement to your return explaining why you did not report them.

**Giving your employer money for taxes.** Your regular pay may not be enough for your employer to withhold all the taxes you owe on your regular pay plus your reported tips. If this happens, you can give your employer money until the close of the calendar year to pay the rest of the taxes.

If you do not give your employer enough money, your employer will apply your regu-



lar pay and any money you give to the taxes, in the following order:

- 1) All taxes on your regular pay,
- 2) Social security and Medicare taxes or railroad retirement tax on your reported tips, and
- 3) Federal, state, and local income taxes on your reported tips.

Any taxes that remain unpaid can be collected by your employer from your next paycheck. If withholding taxes remain uncollected at the end of the year, you may be subject to a penalty for underpayment of estimated taxes. See Publication 505, *Tax Withholding and Estimated Tax*, for more information.



*You must report on your tax return any social security and Medicare taxes or railroad retirement tax that remained uncollected at the end of 1999. See Reporting uncollected social security and Medicare taxes on tips under Reporting Tips on Your Tax Return, later. These uncollected taxes will be shown in box 13 of your Form W-2 (codes A and B).*

## Reporting Tips on Your Tax Return

**How to report tips.** Report your tips with your wages on line 1, Form 1040EZ, or line 7, Form 1040A or Form 1040.

**What tips to report.** You must report all tips you received in 1999, including both cash tips and noncash tips, on your tax return. Any tips you reported to your employer for 1999 are included in the wages shown in box 1 of your Form W-2. Add to the amount in box 1 only the tips you did not report to your employer.



*If you received \$20 or more in cash and charge tips in a month and did not report all of those tips to your employer, see Reporting social security and Medicare taxes on tips not reported to your employer, later.*



*If you did not keep a daily tip record as required and an amount is shown in box 8 of your Form W-2, see Allocated Tips, later.*

If you kept a daily tip record and reported tips to your employer as required under the rules explained earlier, add the following

tips to the amount in box 1 of your Form W-2:

- Cash and charge tips you received that totaled less than \$20 for any month, and
- The value of noncash tips, such as tickets, passes, or other items of value.

**Example.** John Allen began working at the Diamond Restaurant (his only employer in 1999) on June 30 and received \$10,000 in wages during the year. John kept a daily tip record showing that his tips for June were \$18 and his tips for the rest of the year totaled \$7,000. He was not required to report his June tips to his employer, but he reported all of the rest of his tips to his employer as required.

John's Form W-2 from Diamond Restaurant shows \$17,000 (\$10,000 wages plus \$7,000 reported tips) in box 1. He adds the \$18 unreported tips to that amount and reports \$17,018 as wages on his tax return.

**Reporting social security and Medicare taxes on tips not reported to your employer.** If you received \$20 or more in cash and charge tips in a month from any one job and did not report all of those tips to your employer, you must report the social security and Medicare taxes on the unreported tips as additional tax on your return. To report these taxes, you must file a return even if you would not otherwise have to file. You must use Form 1040. (You cannot file Form 1040EZ or Form 1040A.)

Use **Form 4137** to figure these taxes. Enter the tax on line 52, Form 1040, and attach the Form 4137 to your return.

**Reporting uncollected social security and Medicare taxes on tips.** If your employer could not collect all the social security and Medicare taxes or railroad retirement tax you owe on tips reported to your employer, the uncollected taxes will be shown in box 13 of your Form W-2 (codes A and B). You must report these amounts as additional tax on your return. You may have uncollected taxes if your regular pay was not enough for your employer to withhold all the taxes you owe and you did not give your employer enough money to pay the rest of the taxes.

To report these uncollected taxes, you must file a return even if you would not otherwise have to file. You must use Form 1040. (You cannot file Form 1040EZ or Form 1040A.) Include the taxes in your total tax amount on line 56, and write "UT" and the total of the uncollected taxes on the dotted line next to line 56.

## Allocated Tips

**What are allocated tips?** These are tips that your employer assigned to you in addition to the tips you reported to your employer for the year. Your employer will have done this only if:

- You worked in a restaurant, cocktail lounge, or similar business that must allocate tips to employees, and
- The tips you reported to your employer were less than your share of 8% of food and drink sales.

If your employer allocated tips to you, they are shown separately in box 8 of your Form W-2. They are not included in box 1 with your wages and reported tips. If box 8 is blank, this discussion does not apply to you.

**How were your allocated tips figured?** The tips allocated to you are your share of an amount figured by subtracting the reported tips of all employees from 8% (or an approved lower rate) of food and drink sales (other than carryout sales and sales with a service charge of 10% or more). Your share of that amount was figured using either a method provided by an employer-employee agreement or a method provided by IRS regulations based on employees' sales or hours worked. For information about the exact allocation method used, ask your employer.

**Must you report your allocated tips on your return?** You must report allocated tips on your return unless either of the following exceptions applies.

- 1) You kept a daily tip record as required under rules explained earlier.
- 2) Your tip record is incomplete, but it shows that your actual tips were more than the tips you reported to your employer plus the allocated tips.

If either exception applies, report your actual tips on your return. Do not report the allocated tips. See *What tips to report* under *Reporting Tips on Your Tax Return*, earlier.

**How to report allocated tips.** If you must report allocated tips on your return, add the amount in box 8 of your Form W-2 to the amount in box 1. Report the total as wages on line 7 of Form 1040. (You cannot file Form 1040EZ or Form 1040A.)

Because social security and Medicare taxes were not withheld from the allocated tips, you must report those taxes as additional tax on your return. Complete Form 4137, and include the allocated tips on line 1 of the form. See *Reporting social security and Medicare taxes on tips not reported to your employer* under *Reporting Tips on Your Tax Return*, earlier.

## 8.

# Interest Income

## Important Reminder

**Foreign-source income.** If you are a U.S. citizen with investment income from sources outside the United States (foreign income), you must report all that income on your tax return unless it is exempt by U.S. law. This is true whether you reside inside or outside the United States and whether or not you receive a Form 1099 from the foreign payer.

## Introduction

This chapter discusses:

- Different types of interest income,
- What interest is taxable and what interest is nontaxable,
- When to report interest income, and
- How to report interest income on your tax return.

In general, any interest that you receive or that is credited to your account and can be withdrawn is taxable income. (It does not have to be entered in your passbook.) Exceptions to this rule are discussed later in this chapter.



**Recordkeeping.** As an important part of your records, you should keep a list showing sources and amounts of interest received during the year.

You may be able to deduct expenses you have in earning this income on Schedule A (Form 1040) if you itemize your deductions. See chapter 30.

## Useful Items

You may want to see:

### Publication

- 537** Installment Sales
- 550** Investment Income and Expenses
- 1212** List of Original Issue Discount Instruments

### Form (and Instructions)

- Schedule B (Form 1040)** Interest and Ordinary Dividends
- Schedule 1 (Form 1040A)** Interest and Ordinary Dividends for Form 1040A Filers
- 3115** Application for Change in Accounting Method
- 8815** Exclusion of Interest From Series EE and I U.S. Savings Bonds Issued After 1989

- 8818** Optional Form To Record Redemption of Series EE and I U.S. Savings Bonds Issued After 1989

## General Information

A few items of general interest are covered here.

**Passive activity income and losses.** There are tax rules that limit the amount of losses and tax credits from passive activities you can claim. Generally, you can use losses from passive activities only to offset income from passive activities. You generally cannot use passive activity losses to offset your other income, such as your wages or your portfolio income (that is, any gross income from interest, dividends, etc., that is not derived in the ordinary course of a trade or business). For more information about determining and reporting income and losses from passive activities, see Publication 925, *Passive Activity and At-Risk Rules*.

**Tax on investment income of a child under age 14.** Part of a child's 1999 investment income may be taxed at the parent's tax rate. This may happen if all the following are true.

- 1) The child was under age 14 on January 1, 2000.
- 2) The child had more than \$1,400 of investment income (such as taxable interest and dividends) and has to file a tax return.
- 3) Either parent was alive at the end of 1999.

If all these statements are true, **Form 8615, Tax for Children Under Age 14 Who Have Investment Income of More Than \$1,400**, must be completed and attached to the child's tax return. If any of these statements is not true, Form 8615 is not required and the child's income is taxed at his or her own tax rate.

However, the parent can choose to include the child's interest and dividends on the parent's return if certain requirements are met. Use **Form 8814, Parents' Election To Report Child's Interest and Dividends**, for this purpose.

For more information about the tax on investment income of children and the parents' election, see chapter 32.

**Beneficiary of an estate or trust.** Interest, dividends, and other investment income you receive as a beneficiary of an estate or trust is generally taxable income. You should receive a **Schedule K-1** (Form 1041), *Beneficiary's Share of Income, Deductions, Credits, etc.*, from the fiduciary. Your copy of Schedule K-1 and its instructions will tell you where to report the items on your Form 1040.

**Social security number (SSN).** You must give your name and SSN to any person required by federal tax law to make a return, statement, or other document that relates to you. This includes payers of interest.

**SSN for joint account.** If the funds in a joint account belong to one person, list that person's name first on the account and give that person's SSN to the payer. (For information on who owns the funds in a joint account, see *Joint accounts*, later.) If the joint account contains combined funds, give the SSN of the person whose name is listed first on the account.

These rules apply both to joint ownership by a married couple and to joint ownership by other individuals. For example, if you open a joint savings account with your child using funds belonging to the child, list the child's name first on the account and give the child's SSN.

**Custodian account for your child.** If your child is the actual owner of an account that is recorded in your name as custodian for the child, give the child's SSN to the payer. For example, you must give your child's SSN to the payer of dividends on stock owned by your child, even though the dividends are paid to you as custodian.

**Penalty for failure to supply SSN.** If you do not give your SSN to the payer of interest, you may have to pay a penalty. See *Failure to supply social security number* under *Penalties* in chapter 1. Backup withholding also may apply.

**Backup withholding.** Your investment income is generally not subject to regular withholding. However, it may be subject to backup withholding to ensure that income tax is collected on this income.

When you open a new account you must certify under penalties of perjury that your SSN is correct and that you are not subject to backup withholding. Your payer will give you a **Form W-9, Request for Taxpayer Identification Number and Certification**, or a similar form, to make this certification. If you fail to make this certification, backup withholding may begin immediately on your new account or investment.

Backup withholding may also be required if the Internal Revenue Service (IRS) has determined that you underreported your interest or dividend income. For more information, see *Backup Withholding* in chapter 5.

**Reporting backup withholding.** If backup withholding is deducted from your interest income, the payer must give you a Form 1099-INT for the year that indicates the amount withheld. The Form 1099-INT will show any backup withholding as "Federal income tax withheld."

**Joint accounts.** In a joint account, two or more persons hold property as joint tenants, tenants by the entirety, or tenants in common. That property can include a savings account or bond. Each person may receive a share of any interest from the property. Each person's share is determined by local law.

**Income from property given to a child.** Property you give as a parent to your child under the Model Gifts of Securities to Minors Act, the Uniform Gifts to Minors Act, or any similar law, becomes the child's property.

Income from the property is taxable to the child unless it is used in any way to satisfy a legal obligation to support that child. The income is taxable to the person having the legal obligation to support the

child (the parent or guardian) to the extent that it is used for the child's support.

**Savings account with parent as trustee.** Interest income from a savings account opened for a child who is a minor, but placed in the name and subject to the order of the parents as trustees, is taxable to the child if, under the law of the state in which the child resides, both of the following are true.

- 1) The savings account legally belongs to the child.
- 2) The parents are not legally permitted to use any of the funds to support the child.

**Form 1099-INT.** Interest income is generally reported to you on Form 1099-INT, *Interest Income*, or a similar statement, by banks, savings and loans, and other payers of interest. This form shows you the interest you received during the year. Keep this form for your records. You do not have to attach it to your tax return.

Report on your tax return the total amount of interest income that is shown on any Form 1099-INT that you receive for the tax year. You must also report all of your interest income for which you did not receive a Form 1099-INT.

**Nominees.** Generally, if someone receives interest as a nominee for you, that person will give you a Form 1099-INT showing the interest received on your behalf.

If you receive a Form 1099-INT that includes amounts belonging to another person, see the discussion on nominee distributions under *How To Report Interest Income* in chapter 1 of Publication 550, or see the Schedule 1 (Form 1040A) or Schedule B (Form 1040) instructions.

**Incorrect amount.** If you receive a Form 1099-INT that shows an incorrect amount (or other incorrect information), you should ask the issuer for a corrected form. The new Form 1099-INT you receive will be marked "CORRECTED."

**Form 1099-OID.** Reportable interest income may also be shown on Form 1099-OID, *Original Issue Discount*. For more information about amounts shown on this form, see *Original Issue Discount (OID)*, later in this chapter.

**Exempt-interest dividends.** Exempt-interest dividends you receive from a regulated investment company (mutual fund) are not included in your taxable income. (However, see *Information-reporting requirement*, next.) You will receive a notice from the mutual fund telling you the amount of the exempt-interest dividends that you received. Exempt-interest dividends are not shown on Form 1099-DIV or Form 1099-INT.

**Information-reporting requirement.** Although exempt-interest dividends are not taxable, you must show them on your tax return if you have to file. This is an information reporting requirement and does not change the exempt-interest dividends to taxable income.

**Note.** Exempt-interest dividends paid from specified private activity bonds may be subject to the alternative minimum tax.

See *Alternative Minimum Tax* in chapter 31 for more information. Chapter 1 of Publication 550 contains a discussion on private activity bonds, under *State or Local Government Obligations*.

**Interest on VA dividends.** Interest on insurance dividends that you leave on deposit with the Department of Veterans Affairs (VA) is not taxable. This includes interest paid on dividends on converted United States Government Life Insurance and on National Service Life Insurance policies.

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## Taxable Interest

Taxable interest includes interest you receive from bank accounts, loans you make to others, and interest from most other sources. The following are some other sources of taxable interest.

**Dividends that are actually interest.** Certain distributions commonly called dividends are actually interest. You must report as interest so-called "dividends" on deposits or on share accounts in:

- Cooperative banks,
- Credit unions,
- Domestic building and loan associations,
- Domestic savings and loan associations,
- Federal savings and loan associations, and
- Mutual savings banks.

**Money market funds.** Generally, amounts you receive from money market funds should be reported as dividends, not as interest.

**Money market certificates, savings certificates, and other deferred interest accounts.** If you open any of these accounts, and interest is paid at fixed intervals of 1 year or less during the term of the account, you generally must include this interest in your income when you actually receive it or are entitled to receive it without paying a substantial penalty. The same is true for accounts that mature in 1 year or less and pay interest in a single payment at maturity. If interest is deferred for more than 1 year, see *Original Issue Discount (OID)*, later.

**Interest subject to penalty for early withdrawal.** If you made a deposit in a deferred interest account that has a term of 1 year or less, and you paid a penalty because you withdrew funds before the end of the term, you must include in income all the interest shown in box 1 of the Form 1099-INT you receive. You can deduct the entire penalty shown in box 2 on line 30 of Form 1040, even if it is more than your interest income.

**Money borrowed to invest in money market certificate.** The interest you pay on money borrowed from a bank or savings institution to meet the minimum deposit required for a money market certificate from the institution and the interest you earn on the certificate are two separate items. You must report the total interest you earn on the

certificate in your income. If you itemize deductions, you can deduct the interest you pay as investment interest, up to the amount of your net investment income. See *Interest Expenses* in chapter 3 of Publication 550.

**Example.** You deposited \$5,000 with a bank and borrowed \$5,000 from the bank to make up the \$10,000 minimum deposit required to buy a 6-month money market certificate. The certificate earned \$575 at maturity in 1999, but you received only \$265, which represented the \$575 you earned minus \$310 interest charged on your \$5,000 loan. The bank gives you a Form 1099-INT for 1999 showing the \$575 interest you earned. The bank also gives you a statement showing that you paid \$310 interest for 1999. You must include the \$575 in your income. If you itemize your deductions on Schedule A (Form 1040), you can deduct \$310, subject to the net investment income limit.

**Gift for opening account.** The fair market value of gifts or services you receive for making long-term deposits or for opening an account in a savings institution is interest. Report it in income in the year you receive it.

**Example.** You open a savings account at your local bank. The account earns \$20 interest. You also receive a \$10 calculator. If no other interest is credited to your account during the year, the Form 1099-INT you receive will show \$30 interest income for the year.

**Interest on insurance dividends.** Interest on insurance dividends on deposit with an insurance company that can be withdrawn annually is taxable to you in the year it is credited to your account. However, if you can withdraw it only on the anniversary date of the policy (or other specified date), the interest is taxable in the year that date occurs.

**Prepaid insurance premiums.** Any increase in the value of prepaid insurance premiums, advance premiums, or premium deposit funds is interest if it is applied to the payment of premiums due on insurance policies or made available for you to withdraw.

**U.S. obligations.** Interest on U.S. obligations, such as U.S. Treasury bills, notes, and bonds, issued by any agency or instrumentality of the United States is taxable for federal income tax purposes.

Treasury bills generally have a 13-week, 26-week, or 52-week maturity period. They are issued at a discount in the amount of \$1,000 and multiples of \$1,000. The difference between the discounted price you pay for the bills and the face value you receive at maturity is interest income. Generally, you report this interest income when the bill is paid at maturity.

Treasury notes have maturity periods of more than 1 year, ranging up to 10 years. Maturity periods for Treasury bonds are longer than 10 years. Both notes and bonds generally pay interest every 6 months. Generally, you report this interest for the year paid. For more information, see *U.S. Treasury Bills, Notes, and Bonds* in Publication 550.



For other information on Treasury notes or bonds, write to:

Bureau of the Public Debt  
Attn: Customer Information  
P.O. Box 1328  
Parkersburg, WV 26106-1328



Or, on the Internet, visit:  
[www.publicdebt.treas.gov](http://www.publicdebt.treas.gov)

For information on series EE and series HH savings bonds, see *U.S. Savings Bonds*, later.

**Interest on tax refunds.** Interest you receive on tax refunds is taxable income.

**Interest on condemnation award.** If the condemning authority pays you interest to compensate you for a delay in paying an award, the interest is taxable.

**Installment sale payments.** If a contract for the sale or exchange of property provides for deferred payments, it also usually provides for interest payable with the deferred payments. That interest is taxable when you receive it.

If little or no interest is provided for in a deferred contract, part of each payment may be treated as interest. See *Unstated Interest and Original Issue Discount* in Publication 537, *Installment Sales*.

**Interest on annuity contract.** Accumulated interest on an annuity contract you sell before its maturity date is taxable.

**Usurious interest.** Usurious interest is taxable unless state law automatically changes it to a payment on the principal. Usurious interest is interest charged at an illegal rate.

**Individual retirement arrangements (IRAs).** Interest on a Roth IRA or education IRA generally is not taxable. Interest on a traditional IRA is tax-deferred. You generally do not include it in your income until you make withdrawals from the IRA. Nor is it included in the amount to be reported as tax-exempt interest. See chapter 18.

**Interest income on frozen deposits.** Exclude from your gross income interest credited on frozen deposits. A deposit is frozen if, at the end of the 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 must exclude is the interest that was credited on the frozen deposits minus the sum of:

- 1) The net amount you withdrew from these deposits during the year, and
- 2) The amount you could have withdrawn as of the end of the year (not reduced by any penalty for premature withdrawals of a time deposit).

If you receive a Form 1099-INT for interest income on deposits that were frozen at the end of 1999, see *Frozen deposits* under *How To Report Interest Income* in chapter 1 of Publication 550, for information about reporting this interest income exclusion on your 1999 tax return.

The interest you exclude must be reported in the later tax year when you can withdraw it from your account.

**Example.** \$100 of interest was credited on your frozen deposit during the year. You withdrew \$80 but could not withdraw any more as of the end of the year. Your net amount withdrawn was \$80. You must exclude \$20. You must include \$80 in your income for the year.

**Bonds traded flat.** If you buy a bond when interest has been defaulted or when the interest has accrued but has not been paid, that interest is not income and is not taxable as interest if paid later. When you receive a payment of that interest, it is a return of capital that reduces the remaining cost basis. Interest that accrues after the date of purchase, however, is taxable interest income for the year in which received or accrued. See *Bonds Sold Between Interest Dates*, later, for more information.

**Below-market loans.** A below-market loan is a loan on which no interest is charged or on which interest is charged at a rate below the applicable federal rate. See *Rules for below-market loans* in chapter 1 of Publication 550 for more information.

## U.S. Savings Bonds

This section provides tax information on U.S. savings bonds. It explains how to report the interest income on these bonds and how to treat transfers of these bonds.



For other information on U.S. savings bonds, write to:

Bureau of the Public Debt  
Attn: Customer Information  
P.O. Box 1328  
Parkersburg, WV 26106-1328



Or, on the Internet, visit:  
[www.publicdebt.treas.gov](http://www.publicdebt.treas.gov)

**Cash-method taxpayers.** If you use the cash method of accounting, as most individual taxpayers do, you generally report the interest on U.S. savings bonds when you receive it. The cash method of accounting is explained in chapter 1 under *Accounting Methods*.

**Accrual-method taxpayers.** If you use an accrual method of accounting, you must report interest on U.S. savings bonds each year as it accrues. You cannot postpone reporting interest until you receive it or the bonds mature. Accrual methods of accounting are explained in chapter 1 under *Accounting Methods*.

**Series HH Bonds.** These bonds are issued at face value. Interest is paid twice a year by direct deposit to your bank account. If you are a cash method taxpayer, you must

report interest on these bonds as income in the year you receive it.

Series HH Bonds were first offered in 1980. Before 1980, **series H bonds** were issued. Series H bonds are treated the same as series HH bonds. If you are a cash method taxpayer, you must report the interest when you receive it.

**Series EE and series I bonds.** Interest on these bonds is payable when you redeem the bonds. The difference between the purchase price and the redemption value is taxable interest.

Series EE bonds were first offered in July 1980. They have a maturity period of 30 years. Before July 1980, **series E bonds** were issued. The original 10-year maturity period of series E bonds has been extended to 40 years for bonds issued before December 1965 and 30 years for bonds issued after November 1965. Series EE and series E bonds are issued at a discount. The face value is payable to you at maturity.

Series I bonds were first offered in 1998. These are inflation-indexed bonds issued at their face amount with a maturity period of 30 years. The face value plus accrued interest is payable to you at maturity.

If you use the cash method of reporting income, you can report the interest on series EE, series E, and series I bonds in either of the following ways.

- 1) **Method 1.** Postpone reporting the interest until the earlier of the year you cash or dispose of the bonds or the year they mature. (However, see *Savings bonds traded*, later.) **Note.** Series E bonds issued in 1959 and 1969 matured in 1999. If you have used method 1, you generally must report the interest on these bonds on your 1999 return.
- 2) **Method 2.** Choose to report the increase in redemption value as interest each year.

You must use the same method for all series EE, series E, and series I bonds you own. If you do not choose method 2 by reporting the increase in redemption value as interest each year, you must use method 1.



**TIP** If you plan to cash your bonds in the same year that you will pay for higher education expenses, you may want to use method 1 because you may be able to exclude the interest from your income. To learn how, see *Education Savings Bond Program*, later.

**Change from method 1.** If you want to change your method of reporting the interest from method 1 to method 2, you can do so without permission from the IRS. In the year of change you must report all interest accrued to date and not previously reported for all your bonds.

Once you choose to report the interest each year, you must continue to do so for all series EE, series E, and series I bonds you own and for any you get later, unless you request permission to change, as explained next.

**Change from method 2.** To change from method 2 to method 1, you must request permission from the IRS. Permission for the change is automatically granted if

you send the IRS a statement that meets all the following requirements.

- 1) You have typed or printed at the top, "Change in Method of Accounting Under Section 6.01 of the Appendix of Rev. Proc. 98-60 (or later update)."
- 2) It includes your name and social security number under the label in (1).
- 3) It identifies the savings bonds for which you are requesting this change.
- 4) It includes your agreement to:
  - a) Report all interest on any bonds acquired during or after the year of change when the interest is realized upon disposition, redemption, or final maturity, whichever is earliest, and
  - b) Report all interest on the bonds acquired before the year of change when the interest is realized upon disposition, redemption, or final maturity, whichever is earliest, with the exception of the interest reported in prior tax years.
- 5) It includes a statement that you agree to all the terms and conditions of Revenue Procedure 98-60 (or later update).
- 6) It includes your signature.

You must attach this statement to your tax return for the year of change, which you must file by the due date (including extensions).

You can have an automatic extension of 6 months from the due date of your return (including extensions) to file the statement with an amended return. To get this extension, you must have filed your original return by the due date (including extensions). At the top of the statement, write "Filed Pursuant To Reg. 301.9100-2."



By the date you file the original statement, you must also send a copy to the address below.

Commissioner of Internal Revenue  
Attn: CC:DOM:IT&A (Automatic Rulings Branch)  
P.O. Box 7604  
Benjamin Franklin Station  
Washington, DC 20044

(If you use a private delivery service, send the copy to the Commissioner of Internal Revenue, CC:DOM:IT&A (Automatic Rulings Branch), 1111 Constitution Avenue, NW, Washington, DC 20224.)

Instead of filing this statement, you can request permission to change from method 2 to method 1 by filing **Form 3115**. In that case, follow the form instructions for an automatic change. No user fee is required.

**Co-owners.** If a U.S. savings bond is issued in the names of co-owners, such as you and your child or you and your spouse, interest on the bond is generally taxable to the co-owner who bought the bond.

**One co-owner's funds used.** If you used your funds to buy the bond, you must pay the tax on the interest. This is true even if you let the other co-owner redeem the bond and keep all the proceeds. Under these circumstances, since the other co-owner will receive a Form 1099-INT at the

Table 8-1. Who Pays Tax on U.S. Savings Bond Interest

IF ...	THEN tax on the bond interest must be paid by ...
You use your funds to buy a bond in your name and the name of another person as co-owners	You.
You buy a bond in the name of another person, who is the sole owner of the bond	The person for whom you bought the bond.
You and another person buy a bond as co-owners, each contributing part of the purchase price	Both you and the other co-owner, in proportion to the amount each paid for the bond.
You and your spouse, who live in a community property state, buy a bond that is community property	You and your spouse. If you file separate returns, both you and your spouse generally pay tax on one-half.

time of redemption, the other co-owner must provide you with another Form 1099-INT showing the amount of interest from the bond that is taxable to you. The co-owner who redeemed the bond is a "nominee." See *Nominee distributions*, under *How To Report Interest Income* in chapter 1 of Publication 550, for more information about how a person who is a nominee reports interest income belonging to another person.

**Both co-owners' funds used.** If you and the other co-owner each contribute part of the purchase price, interest on the bond is generally taxable to each of you, in proportion to the amount each of you paid.

**Community property.** If you and your spouse live in a community property state and hold bonds as community property, one-half of the interest is considered received by each of you. If you file separate returns, each of you must report one-half of the bond interest. For more information about community property, see Publication 555, *Community Property*.

**Table 8-1.** These rules are also shown in *Table 8-1*.

**Ownership transferred.** If you bought series E, series EE, or series I bonds **entirely with your own funds** and had them reissued in your co-owner's name or beneficiary's name alone, you must include in your gross income for the year of reissue all interest that you earned on these bonds and have not previously reported. But, if the bonds were reissued in your name alone, you do not have to report the interest accrued at that time.

This same rule applies when bonds (other than bonds held as community property) are transferred between spouses incident to divorce.

**Purchased jointly.** If you and a co-owner each contributed funds to buy series E, series EE, or series I bonds **jointly** and later have the bonds reissued in the co-owner's name alone, you must include in your gross income for the year of reissue your share of all the interest earned on the bonds that you have not previously reported. At the time of reissue, the former co-owner does not have to include in gross income his or her share of the interest earned that was not reported before the transfer. This interest, however, as well as all interest earned after the reissue, is income to the former co-owner.

This income-reporting rule also applies when the bonds are reissued in the name of your former co-owner and a new co-owner. But the new co-owner will report

only his or her share of the interest earned after the transfer.

If bonds that you and a co-owner bought **jointly** are reissued to each of you separately in the same proportion as your contribution to the purchase price, neither you nor your co-owner has to report at that time the interest earned before the bonds were reissued.

**Example 1.** You and your spouse each spent an equal amount to buy a \$1,000 series EE savings bond. The bond was issued to you and your spouse as co-owners. You both postpone reporting interest on the bond. You later have the bond reissued as two \$500 bonds, one in your name and one in your spouse's name. At that time neither you nor your spouse has to report the interest earned to the date of reissue.

**Example 2.** You bought a \$1,000 series EE savings bond entirely with your own funds. The bond was issued to you and your spouse as co-owners. You both postpone reporting interest on the bond. You later have the bond reissued as two \$500 bonds, one in your name and one in your spouse's name. You must report half the interest earned to the date of reissue.

**Transfer to a trust.** If you own series E, series EE, or series I bonds and transfer them to a trust, giving up all rights of ownership, you must include in your income for that year the interest earned to the date of transfer if you have not already reported it. However, if you are considered the owner of the trust and if the increase in value both before and after the transfer continues to be taxable to you, you can continue to defer reporting the interest earned each year. You must include the total interest in your income in the year you cash or dispose of the bonds or the year the bonds finally mature, whichever is earlier.

The same rules apply to previously unreported interest on series EE or series E bonds if the transfer to a trust consisted of series HH or series H bonds you acquired in a trade for the series EE or series E bonds. See *Savings bonds traded*, later.

**Decedents.** The manner of reporting interest income on series E, series EE, or series I bonds, after the death of the owner, depends on the accounting and income-reporting method previously used by the decedent.

**Decedent who reported interest each year.** If the bonds transferred because of death were owned by a person who used

an accrual method, or who used the cash method and had chosen to report the interest each year, the interest earned in the year of death up to the date of death must be reported on that person's final return. The person who acquires the bonds includes in income only interest earned after the date of death.

**Decedent who postponed reporting interest.** If the transferred bonds were owned by a decedent who had used the cash method and had not chosen to report the interest each year, and who had bought the bonds entirely with his or her own funds, all interest earned before death must be reported in one of the following ways.

- 1) The surviving spouse or personal representative (executor, administrator, etc.) who files the final income tax return of the decedent can choose to include on that return all of the interest earned on the bonds before the decedent's death. The person who acquires the bonds then includes in income only interest earned after the date of death.
- 2) If the choice in (1) is not made, the interest earned up to the date of death is income in respect of a decedent. It should not be included in the decedent's final return. All of the interest earned both before and after the decedent's death is income to the person who acquires the bonds. If that person uses the cash method and does not choose to report the interest each year, he or she can postpone reporting any of it until the year the bonds are cashed or disposed of or the year they finally mature, whichever is earlier. In the year that person reports the interest, he or she can claim a deduction for any federal estate tax paid that was for the part of the interest included in the decedent's estate.

For more information on income in respect of a decedent, see chapter 4.

**Savings bonds traded.** If you postponed reporting the interest on your series EE or series E bonds, you did not recognize taxable income when you traded the bonds for series HH or series H bonds, unless you received cash in the trade. (You cannot trade series I bonds for series HH bonds.) Any cash you received is income to the extent of the interest earned on the bonds traded. When your series HH or series H bonds mature, or if you dispose of them before maturity, you report as interest the difference between their redemption value and your cost. Your cost is the sum of the amount you paid for the traded series EE or series E bonds plus any amount you had to pay at the time of the trade.

**Example.** You own series E bonds with accrued interest of \$523 and a redemption value of \$2,723 and have postponed reporting the interest. You trade the bonds for \$2,500 in series HH bonds and \$223 in cash. You must report the \$223 as taxable income in the year of the trade.

**Choice to report interest in year of trade.** You can choose to treat all of the previously unreported accrued interest on the series EE or series E bonds traded for series HH bonds as income in the year of the trade. If you make this choice, it is

treated as a change from method 1. See *Change from method 1* under *Series EE and series I bonds*, earlier.

**Form 1099-INT for U.S. savings bonds interest.** When you cash a bond, the bank or other payer that redeems it must give you a Form 1099-INT if the interest part of the payment you receive is \$10 or more. Box 3 of your Form 1099-INT should show the interest as the difference between the amount you received and the amount paid for the bond. However, your Form 1099-INT may show more interest than you have to include on your income tax return. For example, this may happen if any of the following are true.

- 1) You chose to report the increase in the redemption value of the bond each year. The interest shown on your Form 1099-INT will not be reduced by amounts previously included in income.
- 2) You received the bond from a decedent. The interest shown on your Form 1099-INT will not be reduced by any interest reported by the decedent before death, or on the decedent's final return, or by the estate on the estate's income tax return.
- 3) Ownership of the bond was transferred. The interest shown on your Form 1099-INT will not be reduced by interest that accrued before the transfer.
- 4) You were named as a co-owner and the other co-owner contributed funds to buy the bond. The interest shown on your Form 1099-INT will not be reduced by the amount you received as nominee for the other co-owner. (See *Co-owners*, earlier in this chapter, for more information about the reporting requirements.)
- 5) You received the bond in a taxable distribution from a retirement or profit-sharing plan. The interest shown on your Form 1099-INT will not be reduced by the interest portion of the amount taxable as a distribution from the plan and not taxable as interest. (This amount is generally shown on Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.*, for the year of distribution.)

You must report your interest income even if you did not get a Form 1099-INT.

For information on including the correct amount of interest on your return for (1), (2), (3), and (4) above, see *How To Report Interest Income*, later. Publication 550 includes examples showing how to report these amounts.

If you received a taxable distribution of bonds from a retirement or profit-sharing plan ((5), above), see *How To Report Interest Income* in Publication 550 for information on how to report the interest.

**TIP** *Interest on U.S. savings bonds is exempt from state and local taxes. The Form 1099-INT you receive will indicate the amount that is for U.S. savings bond interest in box 3. Do not include this amount on your state or local income tax return.*

**Education Savings Bond Program.** You may be able to exclude from income all or part of the interest you receive on the redemption of qualified U.S. savings bonds during the year if you pay qualified higher educational expenses during the same year. This exclusion is known as the *Education Savings Bond Program*.

If you are married, you can qualify for this exclusion only if you file a joint return with your spouse.

**Form 8815.** Use Form 8815 to figure your exclusion. Attach the form to your Form 1040 or Form 1040A.

**Qualified U.S. savings bonds.** A qualified U.S. savings bond is a series EE bond **issued after 1989** or a series I bond. The bond must be issued either in your name (sole owner) or in your and your spouse's names (co-owners). You must be at least 24 years old before the bond's issue date.

**CAUTION** *The date a bond is issued may be earlier than the date the bond is purchased because bonds are issued as of the first day of the month in which they are purchased.*

**Beneficiary.** You can designate any individual (including a child) as a beneficiary of the bond (payable on death).

**Verification by IRS.** If you claim the exclusion, IRS will check it by using bond redemption information from Department of the Treasury records.

**Qualified expenses.** Qualified higher educational expenses are tuition and fees required for you, your spouse, or your dependent (for whom you can claim an exemption) to attend an eligible educational institution.

Qualified expenses include any contribution you make to a qualified state tuition program or to an education IRA.

Qualified expenses do not include expenses for room and board or for courses involving sports, games, or hobbies that are not part of a degree program.

**Eligible educational institutions.** These institutions include most public and nonprofit universities and colleges and certain vocational schools that are eligible to participate in student aid programs.

**Reduction for certain benefits.** You must reduce your qualified higher educational expenses by certain benefits the student may have received. These benefits include:

- 1) Qualified scholarships that are exempt from tax (see chapter 13 for information on qualified scholarships), and
- 2) Any other nontaxable payments (other than gifts, bequests, or inheritances) received for educational expenses, such as:
  - a) Veterans' educational assistance benefits,
  - b) Benefits under a qualified state tuition program, or
  - c) Certain employer-provided educational assistance benefits.

**Effect of other tax benefits.** Do not include in your qualified expenses any expenses used to:

- 1) Claim an education credit on Form 8863, or
- 2) Figure how much of a distribution from an education IRA you can exclude from your income.

**Amount excludable.** If the total proceeds (interest and principal) from the qualified U.S. savings bonds you redeem during the year are not more than your qualified higher educational expenses for the year, you can exclude all of the interest. If the proceeds are more than the expenses, you can exclude only part of the interest.

To determine the excludable amount, multiply the interest part of the proceeds by a fraction. The numerator (top part) of the fraction is the qualified higher educational expenses you paid during the year. The denominator (bottom part) of the fraction is the total proceeds you received during the year.

**Example.** In February 1999, Mark and Joan, a married couple, cashed a qualified series EE U.S. savings bond they bought in November 1992. They received proceeds of \$7,132, representing principal of \$5,000 and interest of \$2,132. In 1999, they paid \$4,000 of their daughter's college tuition. They are not claiming an education credit for that amount, and they do not have an education IRA. They can exclude \$1,196 ( $\$2,132 \times (\$4,000 \div \$7,132)$ ) of interest in 1999. They must pay tax on the remaining \$936 ( $\$2,132 - \$1,196$ ) interest.

**Modified adjusted gross income limit.**

The interest exclusion is limited if your modified adjusted gross income (modified AGI) is:

- \$53,100 to \$68,100 for taxpayers filing single or head of household, and
- \$79,650 to \$109,650 for married taxpayers filing jointly or for a qualifying widow(er) with dependent child.

You do not qualify for the interest exclusion if your modified AGI is equal to or more than the upper limit for your filing status.

Modified AGI, for purposes of this exclusion, is adjusted gross income (line 18 of Form 1040A or line 33 of Form 1040) figured before the interest exclusion, and modified by adding back any:

- 1) Foreign earned income exclusion,
- 2) Foreign housing exclusion or deduction,
- 3) Exclusion of income for bona fide residents of American Samoa,
- 4) Exclusion for income from Puerto Rico,
- 5) Exclusion for adoption benefits received under an employer's adoption assistance program, and
- 6) Deduction for student loan interest.

Use the worksheet in the instructions for line 9, Form 8815, to figure your modified AGI. If you claim any of the exclusion or deduction items listed above, add the amount of the exclusion or deduction to the amount on line 5 of the worksheet, and enter the total on Form 8815, line 9, as your modified AGI.

If you have investment interest expense incurred to earn royalty income, see *Edu-*

*cation Savings Bond Program* in chapter 1 of Publication 550.



**Recordkeeping.** If you claim the interest exclusion, you must keep a written record of the qualified U.S. savings bonds that you redeem. Your record must include the serial number, issue date, face value, and the total redemption proceeds of each bond. You can use **Form 8818, *Optional Form To Record Redemption of Series EE and I U.S. Savings Bonds Issued After 1989***, to keep this information. You should also keep bills, receipts, canceled checks, or other documentation that shows you paid qualified higher educational expenses during the year.

## Bonds Sold Between Interest Dates

If you sell a bond between interest payment dates, part of the sales price represents interest accrued to the date of sale. You must report that part of the sales price as interest income for the year of sale.

If you buy a bond between interest payment dates, part of the purchase price represents interest accrued before the date of purchase. When that interest is paid to you, treat it as a return of your capital investment, rather than interest income, by reducing your basis in the bond. See *Accrued interest on bonds* under *How To Report Interest Income* in chapter 1 of Publication 550 for information on reporting the payment.

## Insurance

Life insurance proceeds paid to you as beneficiary of the insured person are not usually taxable. But if you receive the proceeds in installments, you must usually report a part of each installment payment as interest income.

For more information about insurance proceeds received in installments, see Publication 525, *Taxable and Nontaxable Income*.

**Annuity.** If you buy an annuity with life insurance proceeds, the annuity payments you receive are taxed as pension and annuity income, not as interest income. See chapter 11 for information on pension and annuity income.

## Original Issue Discount (OID)

Original issue discount (OID) is a form of interest. You generally include the OID in your income as it accrues over the term of the debt instrument, whether or not you receive any payments from the issuer.

A debt instrument, such as a bond, note, or other evidence of indebtedness, generally has OID when the instrument is issued for a price that is less than its stated redemption price at maturity. The amount of OID is the difference between the stated redemption price at maturity and the issue price.

All instruments that pay no interest before maturity are presumed to be issued at a discount. Zero coupon bonds are one example of these instruments.

The OID accrual rules generally do not apply to short-term obligations (those with a fixed maturity date of 1 year or less from date of issue). See *Discount on Short-Term Obligations* in Publication 550.

**De minimis OID.** You can treat the discount as zero if it is less than one-fourth of 1% (.0025) of the stated redemption price at maturity multiplied by the number of full years from the date of original issue to maturity. This small discount is known as "de minimis" OID.

**Example 1.** You bought a 10-year bond, with a stated redemption price at maturity of \$1,000, issued at \$980 and having OID of \$20. One-fourth of 1% of \$1,000 (stated redemption price) times 10 (the number of full years from the date of original issue to maturity) equals \$25. Because the \$20 discount is less than \$25, the OID is treated as zero. (If you hold the bond at maturity, you will recognize \$20 (\$1,000 - \$980) of capital gain.)

**Example 2.** The facts are the same as in Example 1, except that the bond was issued at \$950. The OID is \$50. Because the \$50 discount is more than the \$25 figured in Example 1, you must include the OID in income as it accrues over the term of the bond.

**Debt instrument bought after original issue.** If you buy a debt instrument with de minimis OID at a premium, the discount is not includible in income. If you buy a debt instrument with de minimis OID at a discount, the discount is reported under the market discount rules. See *Market Discount Bonds* in chapter 1 of Publication 550.

**Exceptions to reporting OID.** The OID rules discussed in this chapter do not apply to the following debt instruments.

- 1) Tax-exempt obligations. (However, see *Stripped tax-exempt obligations* under *Stripped Bonds and Coupons* in chapter 1 of Publication 550).
- 2) U.S. savings bonds.
- 3) Short-term debt instruments (those with a fixed maturity date of not more than 1 year from the date of issue).
- 4) Obligations issued by an individual before March 2, 1984.
- 5) Loans between individuals, if all the following are true.
  - a) The lender is not in the business of lending money.
  - b) The amount of the loan, plus the amount of any outstanding prior loans, is \$10,000 or less.
  - c) Avoiding any federal tax is not one of the principal purposes of the loan.

**Form 1099-OID.** The issuer of the debt instrument (or your broker, if you held the instrument through a broker) should give you Form 1099-OID, *Original Issue Discount*, or a similar statement, if the total OID for the calendar year is \$10 or more. Form 1099-OID will show, in box 1, the amount of OID for the part of the year that you held the bond. It also will show, in box 2, other interest that you must include in your in-

come. A copy of Form 1099–OID will be sent to the IRS. Do not file your copy with your return. Keep it for your records.

In most cases, you must report the entire amount in boxes 1 and 2 of Form 1099–OID as interest income. But see *Refiguring OID shown on Form 1099–OID*, later in this discussion, for more information.

**Nominee.** If someone else is the holder of record (the registered owner) of an OID instrument that belongs to you and receives a Form 1099–OID on your behalf, that person must give you a Form 1099–OID.

**Refiguring OID shown on Form 1099–OID.** You must refigure the OID shown in box 1 of Form 1099–OID if either of the following apply.

- 1) You bought the debt instrument after its original issue and paid a premium or an acquisition premium.
- 2) The debt instrument is a stripped bond or a stripped coupon (including certain zero coupon instruments).

For information about figuring the correct amount of OID to include in your income, see *Figuring OID on Long-Term Debt Instruments* in Publication 1212.

**Form 1099–OID not received.** If you had OID for the year but did not receive a Form 1099–OID, see Publication 1212, which lists total OID on certain debt instruments. If your debt instrument is not listed in Publication 1212, consult the issuer for information about the OID that accrued for the year.

**Refiguring periodic interest shown on Form 1099–OID.** If you disposed of a debt instrument or acquired it from another holder during the year, see *Bonds Sold Between Interest Dates*, earlier, for information about the treatment of periodic interest that may be shown in box 2 of Form 1099–OID for that instrument.

**Certificates of deposit (CDs).** If you buy a CD with a maturity of more than 1 year, you must include in income each year a part of the total interest due and report it in the same manner as other OID.

This also applies to similar deposit arrangements with banks, building and loan associations, etc., including:

- Time deposits,
- Bonus plans,
- Savings certificates,
- Deferred income certificates,
- Bonus savings certificates, and
- Growth savings certificates.

**Bearer CDs.** These are not issued in the depositor's name and are transferable from one individual to another.

Banks must provide the IRS and the person redeeming the bearer certificate with a Form 1099–INT.

CDs issued after 1982 generally must be in registered form. For more information about this requirement, see *Bearer Obligations* under *Capital Gains and Losses* in chapter 4 of Publication 550.

**More information.** See chapter 1 of Publication 550 for more information about OID and related topics, such as market discount bonds.

## State or Local Government Obligations

Generally, interest on obligations used to finance government operations is not taxable if the obligations are issued by a state, the District of Columbia, a possession of the United States, or any of their political subdivisions. This includes interest on certain obligations issued after 1982 by an Indian tribal government treated as a state.

Interest on arbitrage bonds issued by state or local governments after October 9, 1969, and interest on private activity bonds generally is taxable.

For more information on whether such interest is taxable or tax exempt, see *State or Local Government Obligations* in chapter 1 of Publication 550.

**Information reporting requirement.** If you must file a tax return, you are required to show any tax-exempt interest you received on your return. This is an information-reporting requirement only. It does not change tax-exempt interest to taxable interest.

## When To Report Interest Income

When you report your interest income depends on whether you use the cash method or an accrual method to report income.

**Cash method.** If you use this method, you generally report your interest income in the year in which you actually or constructively receive it. Most individual taxpayers use this method. However, there are special rules for reporting the discount on certain debt instruments. See *U.S. Savings Bonds*, and *Original Issue Discount*, earlier.

**Example.** On September 1, 1997, you loaned another individual \$2,000 at 12%, compounded annually. You are not in the business of lending money. The note stated that principal and interest would be due on August 31, 1999. In 1999, you received \$2,508.80 (\$2,000 principal and \$508.80 interest). If you use the cash method, you must include in income on your 1999 return the \$508.80 interest you received in that year.

**Constructive receipt.** You constructively receive income when it is credited to your account or made available to you. You do not need to have physical possession of it. For example, you are considered to receive interest, dividends, or other earnings on any deposit or account in a bank, savings and loan, or similar financial institution, or interest on life insurance policy dividends left to accumulate, when they are credited to your account and subject to your withdrawal. This is true even if they are not yet entered in your passbook.

You constructively receive income on the deposit or account even if you must:

- 1) Make withdrawals in multiples of even amounts,

- 2) Give a notice to withdraw before making the withdrawal,
- 3) Withdraw all or part of the account to withdraw the earnings, or
- 4) Pay a penalty on early withdrawals, unless the interest you are to receive on an early withdrawal or redemption is substantially less than the interest payable at maturity.

**Accrual method.** If you use an accrual method, you report your interest income when you earn it, whether or not you have received it. Interest is earned over the term of the debt instrument.

**Example.** If, in the previous example, you use an accrual method, you must include the interest in your income as you earn it. You would report the interest as follows: 1997, \$80; 1998, \$249.60; and 1999, \$179.20.

**Coupon bonds.** Interest on coupon bonds is taxable in the year the coupon becomes due and payable. It does not matter when you mail the coupon for payment.

## How To Report Interest Income

Generally, you report all of your taxable interest income on line 8a, Form 1040; line 8a, Form 1040A; or line 2, Form 1040EZ.

You cannot use Form 1040EZ if your interest income is more than \$400. Instead, you must use Form 1040A or Form 1040.

**Form 1040A.** You must complete Part I of Schedule 1 (Form 1040A) if you file Form 1040A and any of the following are true.

- 1) Your taxable interest income is more than \$400.
- 2) You are claiming the interest exclusion under the Education Savings Bond Program.
- 3) You received interest from a seller-financed mortgage, and the buyer used the property as a home.
- 4) You received a Form 1099–INT for tax-exempt interest.
- 5) You received a Form 1099–INT for U.S. savings bond interest that includes amounts you reported before 1999.
- 6) You received, as a nominee, interest that actually belongs to someone else.
- 7) You received a Form 1099–INT for interest or frozen deposits.

List each payer's name and the amount of interest income received from each payer on line 1. If you received a Form 1099–INT or Form 1099–OID from a brokerage firm, list the brokerage firm as the payer.

You cannot use Form 1040A if you must use Form 1040, as described next.

**Form 1040.** You must use Form 1040 instead of Form 1040A or Form 1040EZ if:

- 1) You forfeited interest income because of the early withdrawal of a time deposit,



- 2) You received or paid accrued interest on securities transferred between interest payment dates,
- 3) You had a financial account in a foreign country, unless the combined value of all foreign accounts was \$10,000 or less or the accounts were with certain U.S. military banking facilities,
- 4) You acquired taxable bonds after 1987 and choose to reduce interest income from the bonds by any amortizable bond premium (see *Bond Premium Amortization* in chapter 3 of Publication 550), or
- 5) You are reporting OID in an amount more or less than the amount shown on Form 1099-OID.
- 7) You received, as a nominee, interest that actually belongs to someone else.
- 8) You received a Form 1099-INT for interest on frozen deposits.
- 9) You received a Form 1099-INT for interest on a bond that you bought between interest payment dates.
- 10) Statement (4) or (5) in the preceding list is true.

On line 1, Part I, list each payer's name and the amount received from each. If you received a Form 1099-INT or Form 1099-OID from a brokerage firm, list the brokerage firm as the payer.

**Form 1099-INT.** Your taxable interest income, except for interest from U.S. savings bonds and Treasury obligations, is shown in box 1 of Form 1099-INT. Add this amount to any other taxable interest income you received. You must report all of your taxable interest income even if you do not receive a Form 1099-INT.

If you forfeited interest income because of the early withdrawal of a time deposit, the deductible amount will be shown on Form 1099-INT in box 2. See *Penalty on early withdrawal of savings* in chapter 1 of Publication 550.

Box 3 of Form 1099-INT shows the amount of interest income you received from U.S. savings bonds, Treasury bills, Treasury notes, and Treasury bonds. Include the amount shown in box 3 in your total taxable interest income, unless it includes an amount previously included in interest income. If part of the amount shown in box 3 was previously included in interest

income, see *U.S. savings bond interest previously reported*, next.

Box 4 of Form 1099-INT (federal income tax withheld) will contain an amount if you were subject to backup withholding. You may have been subject to backup withholding if, for example, you did not furnish your social security number to a payer. Report the amount from box 4 on Form 1040EZ, line 7, on Form 1040A, line 35, or on Form 1040, line 57 (federal income tax withheld).

Box 5 of Form 1099-INT shows investment expenses you may be able to deduct as an itemized deduction. See chapter 3 of Publication 550 for more information about how to deduct these expenses.

**U.S. savings bond interest previously reported.** If you received a Form 1099-INT for U.S. savings bond interest, the form may show interest you do not have to report. See *Form 1099-INT for U.S. savings bonds interest*, earlier, under *U.S. Savings Bonds*.

On line 1, Part I of Schedule B (Form 1040), or on line 1, Part I of Schedule 1 (Form 1040A), report all the interest shown on your Form 1099-INT. Then make the following adjustment. Several lines above line 2, enter a subtotal of all interest listed on line 1. Below the subtotal write "U.S. Savings Bond Interest Previously Reported" and enter amounts previously reported or interest accrued before you received the bond. Subtract these amounts from the subtotal and enter the result on line 2.

**More information.** For more information about how to report interest income, see chapter 1 of Publication 550 or the instructions for the form you must file.

**Schedule B.** You must complete Part I of Schedule B (Form 1040) if you file Form 1040 and any of the following apply.

- 1) Your taxable interest income is more than \$400.
- 2) You are claiming the interest exclusion under the Education Savings Bond Program.
- 3) You had a foreign account.
- 4) You received interest from a seller-financed mortgage and the buyer used the property as a home.
- 5) You received a Form 1099-INT for tax-exempt interest.
- 6) You received a Form 1099-INT for U.S. savings bond interest that includes amounts you reported before 1999.

## 9.

# Dividends and Other Corporate Distributions

## Important Reminder

**Reporting dividends on Schedule B.** Report in Part II of Schedule B (Form 1040) only ordinary dividends, not capital gain distributions or nontaxable distributions. For more information, see *How To Report Dividend Income*, later.

**Foreign-source income.** If you are a U.S. citizen with investment income from sources outside the United States (foreign income), you must report all that income on your tax return unless it is exempt by U.S. law. This is true whether you reside inside or outside the United States and whether or not you receive a Form 1099 from the foreign payer.

## Introduction

This chapter discusses the tax treatment of:

- Dividend income,
- Capital gain distributions,
- Nontaxable distributions, and
- Other distributions you may receive from a corporation or a mutual fund.

This chapter also explains how to report dividend income on your tax return.

Dividends are distributions of money, stock, or other property paid to you by a corporation. You also may receive dividends through a partnership, an estate, a trust, or an association that is taxed as a corporation. However, some amounts you receive that are called dividends are actually interest income. See *Dividends that are actually interest* under *Taxable Interest* in chapter 8.

Most distributions that you receive are paid in cash (or check). However, you may receive more stock, stock rights, other property, or services. These distributions are also discussed in this chapter.

## Useful Items

You may want to see:

### Publication

- 514** Foreign Tax Credit for Individuals
- 550** Investment Income and Expenses
- 564** Mutual Fund Distributions

### Form (and Instructions)

- Schedule B (Form 1040)** Interest and Ordinary Dividends

- Schedule 1 (Form 1040A)** Interest and Ordinary Dividends for Form 1040A Filers

## General Information

This section discusses general rules on dividend income.

**Passive activity income and losses.** There are tax rules that limit the amount of losses and tax credits from passive activities you can claim. Generally, you can use losses from passive activities only to offset income from passive activities. You generally cannot use passive activity losses to offset your other income, such as your wages or your portfolio income. **Portfolio income** is any gross income from interest, dividends, etc., that is not derived in the ordinary course of a trade or business. For more information about determining and reporting income and losses from passive activities, see Publication 925, *Passive Activity and At-Risk Rules*.

**Tax on investment income of a child under age 14.** Part of a child's 1999 investment income may be taxed at the parent's tax rate. This may happen if all of the following are true.

- 1) The child was under age 14 on January 1, 2000.
- 2) The child had more than \$1,400 of investment income (such as taxable interest and dividends) and has to file a tax return.
- 3) Either parent was alive at the end of 1999.

If all of these statements are true, **Form 8615, Tax for Children Under Age 14 Who Have Investment Income of More Than \$1,400**, must be completed and attached to the child's tax return. If any of these statements is not true, Form 8615 is not required and the child's income is taxed at his or her own tax rate.

However, the parent can choose to include the child's interest and dividends on the parent's return if certain requirements are met. Use **Form 8814, Parents' Election To Report Child's Interest and Dividends**, for this purpose.

For more information about the tax on investment income of children and the parents' election, see chapter 32.

**Beneficiary of an estate or trust.** Interest, dividends, and other investment income you receive as a beneficiary of an estate or trust is generally taxable income. You should receive a **Schedule K-1 (Form 1041)**, *Beneficiary's Share of Income, Deductions, Credits, etc.*, from the fiduciary. Your copy of Schedule K-1 and its instructions will tell you where to report the items on your Form 1040.

**Social security number (SSN).** You must give your name and SSN (or individual taxpayer identification number (ITIN)) to any person required by federal tax law to make a return, statement, or other document that relates to you. This includes payers of dividends.

For more information on SSNs and ITINs, see *Social security number (SSN)* in chapter 8.

**Penalty for failure to supply SSN.** If you do not give your SSN or ITIN to the payer of dividends, you may have to pay a penalty. See *Failure to supply social security number* under *Penalties* in chapter 1. Backup withholding also may apply.

**Backup withholding.** Your investment income is generally not subject to regular withholding. However, it may be subject to backup withholding to ensure that income tax is collected on this income.

When you open a new account paying dividends, you must certify under penalties of perjury that your social security number (SSN) is correct and that you are not subject to backup withholding. Your payer will give you a **Form W-9, Request for Taxpayer Identification Number and Certification**, or a similar form, to make this certification. If you fail to make this certification, backup withholding may begin immediately on your new account or investment.

Backup withholding may also be required if the Internal Revenue Service (IRS) has determined that you underreported your interest or dividend income. For more information, see *Backup Withholding* in chapter 5.

**Stock certificate in two or more names.** If two or more persons hold stock as joint tenants, tenants by the entirety, or tenants in common, each person may receive a share of any dividends from the stock. Each person's share is determined by local law.

**Form 1099-DIV.** Most corporations use Form 1099-DIV, *Dividends and Distributions*, to show you the distributions you received from them during the year. Keep this form with your records. You do not have to attach it to your tax return. Even if you do not receive Form 1099-DIV, you must report all of your taxable dividend income.

**Reporting tax withheld.** If tax is withheld from your dividend income, the payer must give you a Form 1099-DIV that indicates the amount withheld.

**Nominees.** If someone receives distributions as a nominee for you, that person will give you a Form 1099-DIV, which will show distributions received on your behalf.

**Form 1099-MISC.** Certain substitute payments in lieu of dividends or tax-exempt interest that are received by a broker on your behalf must be reported to you on Form 1099-MISC, *Miscellaneous Income*, or a similar statement. See *Reporting Substitute Payments* under *Short Sales* in chapter 4 of Publication 550 for more information about reporting these payments.

**Incorrect amount shown on a Form 1099.** If you receive a Form 1099 that shows an incorrect amount (or other incorrect information), you should ask the issuer for a corrected form. The new Form 1099 you receive will be marked "CORRECTED."

**Dividends on stock sold.** If stock is sold, exchanged, or otherwise disposed of after a dividend is declared, but before it is paid, the owner of record (usually the payee shown on the dividend check) must include the dividend in income.

**Dividends received in January.** If a regulated investment company (mutual fund) or real estate investment trust (REIT) declares a dividend (including any exempt-interest dividend) in October, November, or December payable to shareholders of record on a specified date in one of those months but actually pays the dividend during January of the next calendar year, you are considered to have received the dividend on December 31. You report the dividend in the year it was declared.

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## Ordinary Dividends

Ordinary (taxable) dividends are the most common type of distribution from a corporation. They are paid out of the earnings and profits of a corporation and are ordinary income to you. This means they are not capital gains. You can assume that any dividend you receive on common or preferred stock is an ordinary dividend unless the paying corporation tells you otherwise. Ordinary dividends will be shown in box 1 of the Form 1099-DIV you receive.

**Dividends used to buy more stock.** The corporation in which you own stock may have a **dividend reinvestment plan**. This plan lets you choose to use your dividends to buy (through an agent) more shares of stock in the corporation instead of receiving the dividends in cash. If you are a member of this type of plan and you use your dividends to buy more stock at a price equal to its fair market value, you must report the dividends as income.

If you are a member of a dividend reinvestment plan that lets you buy more stock at a price less than its fair market value, you must report as dividend income the fair market value of the additional stock on the dividend payment date.

You also must report as dividend income any service charge subtracted from your cash dividends before the dividends are used to buy the additional stock. But you may be able to deduct the service charge. See chapter 30 for more information about deducting expenses of producing income.

In some dividend reinvestment plans, you can invest more cash to buy shares of stock at a price less than fair market value. If you choose to do this, you must report as dividend income the difference between the cash you invest and the fair market value of the stock you buy. When figuring this amount, use the fair market value of the stock on the dividend payment date.

**Money market funds.** Report amounts you receive from money market funds as dividend income. Money market funds are a type of mutual fund and should not be confused with bank money market accounts that pay interest.

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## Capital Gain Distributions

Capital gain distributions (also called capital gain dividends) are paid to you or credited to your account by **regulated investment companies** (commonly called **mutual funds**) and **real estate investment trusts (REIT)**. They will be shown in box 2a of the

Form 1099-DIV you receive from the mutual fund or REIT. Report capital gain distributions as long-term capital gains regardless of how long you owned your shares in the mutual fund or REIT.

If you receive capital gain distributions on mutual fund or REIT stock you hold 6 months or less and sell at a loss, see *Loss on mutual fund or REIT stock held 6 months or less* under *Holding Period* in chapter 15.

**Undistributed capital gains of mutual funds and REITs.** Some mutual funds and REITs keep their long-term capital gains and pay tax on them. You must treat your share of these gains as distributions, even though you did not actually receive them. However, they are not included on Form 1099-DIV. Instead, your share of the undistributed capital gains and tax paid will be reported to you on Form 2439, *Notice to Shareholder of Undistributed Long-Term Capital Gains*.

Report undistributed capital gains as long-term capital gains on line 11 of Schedule D (Form 1040). You take credit for the tax paid by the mutual fund or REIT by including it on line 63, Form 1040, and checking "box a" on that line. Attach Copy B of Form 2439 to your return, and keep Copy C for your records.

**Basis adjustment.** Increase your basis in your mutual fund stock, or your interest in a REIT, by the difference between the gain you report and the credit you claim for the tax paid.

**Additional information.** For more information on the treatment of distributions from mutual funds, see Publication 564.

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## Nontaxable Distributions

You may receive a return of capital or a tax-free distribution of more shares of stock or stock rights. These distributions are not treated the same as ordinary dividends or capital gain distributions.

### Return of Capital

A return of capital is a distribution that is not paid out of the earnings and profits of a corporation. It is a return of your investment in the stock of the company. You should receive a Form 1099-DIV or other statement from the corporation showing you what part of the distribution is a return of capital. On Form 1099-DIV, a nontaxable return of capital will be shown in box 3. If you do not receive such a statement, you report the distribution as an ordinary dividend.

**Basis adjustment.** A return of capital reduces the basis of your stock. It is not taxed until your basis in the stock is fully recovered. If you buy stock in a corporation in different lots at different times, and you cannot definitely identify the shares subject to the return of capital, reduce the basis of your earliest purchases first.

When the basis of your stock has been reduced to zero, report any additional return of capital that you receive as a capital gain. Whether you report it as a long-term or short-term capital gain depends on how

long you have held the stock. See *Holding Period* in chapter 15.

**Example.** You bought stock in 1987 for \$100. In 1989, you received a return of capital of \$80. You did not include this amount in your income, but you reduced the basis of your stock to \$20. You received a return of capital of \$30 in 1999. The first \$20 of this amount reduced your basis to zero. You report the other \$10 as a long-term capital gain for 1999. You must report as a long-term capital gain any return of capital you receive on this stock in later years.

**Liquidating distributions.** Liquidating distributions, sometimes called liquidating dividends, are distributions you receive during a partial or complete liquidation of a corporation. These distributions are, at least in part, one form of a return of capital. They may be paid in one or more installments. You will receive a Form 1099-DIV from the corporation showing you the amount of the liquidating distribution in box 8 or 9.

For more information on liquidating distributions, see chapter 1 of Publication 550.

## Distributions of Stock and Stock Rights

Distributions by a corporation of its own stock are commonly known as stock dividends. Stock rights (also known as "stock options") are distributions by a corporation of rights to acquire the corporation's stock. Generally, stock dividends and stock rights are not taxable to you, and you do not report them on your return.

**Taxable stock dividends and stock rights.** Distributions of stock dividends and stock rights are taxable to you if any of the following apply.

- 1) You or any other shareholder has the choice to receive cash or other property instead of stock or stock rights.
- 2) The distribution gives cash or other property to some shareholders and an increase in the percentage interest in the corporation's assets or earnings and profits to other shareholders.
- 3) The distribution is in convertible preferred stock and has the same result as in (2).
- 4) The distribution gives preferred stock to some common stock shareholders and gives common stock to other common stock shareholders.
- 5) The distribution is on preferred stock. (The distribution, however, is not taxable if it is an increase in the conversion ratio of convertible preferred stock made solely to take into account a stock dividend, stock split, or similar event that would otherwise result in reducing the conversion right.)

The term "stock" includes rights to acquire stock, and the term "shareholder" includes a holder of rights or of convertible securities.

If you receive taxable stock dividends or stock rights, include their fair market value at the time of the distribution in your income.

**Preferred stock redeemable at a premium.** If you hold preferred stock having a redemption price higher than its issue price, the difference (the redemption premium) generally is taxable as a constructive distribution of additional stock on the preferred stock. For more information, see chapter 1 of Publication 550.

**Basis.** Your basis in stock or stock rights received in a taxable distribution is their fair market value when distributed. If you receive stock or stock rights that are not taxable to you, see *Stocks and Bonds* under *Basis of Investment Property* in chapter 4 of Publication 550 for information on how to figure their basis.

**Fractional shares.** You may not own enough stock in a corporation to receive a full share of stock if the corporation declares a stock dividend. However, with the approval of the shareholders, the corporation may set up a plan in which fractional shares are not issued, but instead are sold, and the cash proceeds are given to the shareholders. Any cash you receive for fractional shares under such a plan is treated as an amount realized on the sale of the fractional shares. You must determine your gain or loss and report it as a capital gain or loss on Schedule D (Form 1040). Your gain or loss is the difference between the cash you receive and the basis of the fractional shares sold.

**Example.** You own one share of common stock that you bought on January 3, 1991, for \$100. The corporation declared a common stock dividend of 5% on June 30, 1999. The fair market value of the stock at the time the stock dividend was declared was \$200. You were paid \$10 for the fractional-share stock dividend under a plan described in the above paragraph. You figure your gain or loss as follows:

Fair market value of old stock .....	\$200.00
Fair market value of stock dividend (cash received) .....	10.00
Fair market value of old stock and stock dividend .....	<u>\$210.00</u>
Basis (cost) of old stock after the stock dividend $((\$200 \div \$210) \times \$100)$ ..	\$95.24
Basis (cost) of stock dividend $((\$10 \div \$210) \times \$100)$ .....	4.76
Total .....	<u>\$100.00</u>
Cash received .....	\$10.00
Basis (cost) of stock dividend .....	4.76
<b>Gain</b> .....	<u>\$5.24</u>

Because you had held the share of stock more than 1 year at the time the stock dividend was declared, your gain on the stock dividend is a long-term capital gain.

**Scrip dividends.** A corporation that declares a stock dividend may issue you a scrip certificate that entitles you to a fractional share. The certificate is generally nontaxable when you receive it. If you choose to have the corporation sell the certificate for you and give you the proceeds, your gain or loss is the difference between the proceeds and the portion of your basis in the corporation's stock that is allocated to the certificate.

However, if you receive a scrip certificate that you can choose to redeem for cash instead of stock, the certificate is taxable when you receive it. You must include in income its fair market value on the date you receive it.

## Other Distributions

You may receive any of the following distributions during the year.

**Exempt-interest dividends.** Exempt-interest dividends you receive from a regulated investment company (mutual fund) are not included in your taxable income. You will receive a notice from the mutual fund telling you the amount of the exempt-interest dividends you received. Exempt-interest dividends are not shown on Form 1099-DIV or Form 1099-INT. See *Gains and Losses* in Publication 564 for information about the loss treatment of mutual fund stock on which you received exempt-interest dividends.

**Information reporting requirement.** Although these dividends are not taxable, you must show them on your tax return if you have to file. This is an information reporting requirement and does not change tax-exempt dividends to taxable income.

**Alternative minimum tax treatment.** Exempt-interest dividends paid from specified private activity bonds may be subject to the alternative minimum tax. See *Alternative Minimum Tax* in chapter 31 for more information.

**Dividends on insurance policies.** Insurance policy dividends that the insurer keeps and uses to pay your premiums are not taxable. However, you must report as taxable interest income the interest that is paid or credited on dividends left with an insurance company.

If dividends on an insurance contract (other than a modified endowment contract) are distributed to you, they are a partial return of the premiums you paid. Do not include them in your gross income until they are more than the total of all net premiums you paid for the contract. (For information on the treatment of a distribution from a modified endowment contract, see *Distribution Before Annuity Starting Date From a Nonqualified Plan* under *Taxation of Non-periodic Payments* in Publication 575, *Pension and Annuity Income*.) Report any taxable distributions on insurance policies on line 16b (Form 1040) or line 11b (Form 1040A).

**Dividends on veterans' insurance.** Dividends you receive on veterans' insurance policies are not taxable. In addition, do not report as taxable income interest on dividends left with the Department of Veterans Affairs.

**Patronage dividends.** Generally, patronage dividends you receive in money from a cooperative organization are included in your income.

Do not include in your income patronage dividends you receive on:

- 1) Property bought for your personal use, or
- 2) Capital assets or depreciable property bought for use in your business. But you must reduce the basis (cost) of the items bought. If the dividend is more than the adjusted basis of the assets, you must report the excess as income.

These rules are the same whether the cooperative paying the dividend is a taxable or tax-exempt cooperative.

**Alaska Permanent Fund dividends.** Do not report these amounts as dividends. Instead, report them on line 21 of Form 1040, line 12 of Form 1040A, or line 3 of Form 1040EZ.

## How To Report Dividend Income

Generally, you can use either Form 1040 or Form 1040A to report your dividend income. However, you must use Form 1040 if you receive capital gain distributions or nontaxable distributions required to be reported as capital gains. You cannot use Form 1040EZ if you receive any dividend income.

Report the total of your taxable dividend income on line 9 of Form 1040 or Form 1040A.

**Form 1099-DIV.** If you owned stock on which you received \$10 or more in dividends and other distributions, you should receive a Form 1099-DIV. Even if you do not receive Form 1099-DIV, you must report all of your taxable dividend income.

See Form 1099-DIV for more information on how to report dividend income.

**Form 1040A.** You must complete Part II of Schedule 1 (Form 1040A) and attach it to your Form 1040A, if:

- 1) Your ordinary dividends (box 1 of Form 1099-DIV) are more than \$400, or
- 2) You received, as a nominee, dividends that actually belong to someone else.

List on line 5 each payer's name and the amount of ordinary dividends you received. If you received a Form 1099-DIV from a brokerage firm, list the brokerage firm as the payer.

Enter on line 6 the total of the amounts listed on line 5. Also enter this total on line 9, Form 1040A.

**Form 1040.** You must fill in Part II of Schedule B and attach it to your Form 1040, if:

- 1) Your ordinary dividends (box 1 of Form 1099-DIV) are more than \$400, or
- 2) You received, as a nominee, dividends that actually belong to someone else.

If your ordinary dividends are more than \$400, you must also complete Part III of Schedule B.

List on line 5, Part II of Schedule B, each payer's name and the amount of ordinary dividends you received. If your securities are held by a brokerage firm (in "street name"), list the name of the brokerage firm that is shown on Form 1099-DIV as the payer. If your stock is held by a nominee who is the owner of record, and the nominee credited or paid you dividends on the stock, show the name of the nominee and the dividends you received or for which you were credited.

Enter on line 6 the total of the amounts listed on line 5. Also enter this total on line 9, Form 1040.

**Expenses related to dividend income.** You may be able to deduct expenses related to dividend income if you itemize your

deductions on Schedule A (Form 1040). See chapter 30 for general information about deducting expenses of producing income.

**More information.** For more information about how to report dividend income, see chapter 1 of Publication 550 or the instructions for the form you must file.

# 10.

## Rental Income and Expenses

### Important Change

**Depreciating appliances, etc., used in a rental activity.** Appliances, carpets, furniture, etc., used in a rental real estate activity are classified as 5-year property. Before 1999, however, IRS publications and Form 4562, *Depreciation and Amortization*, classified such property as 7-year property. If you previously claimed depreciation based on that classification, you can continue to do so for that property. Alternatively, you can choose to change your depreciation to base it on the property's classification as 5-year property. For more information on how to make that change, see Publication 527, *Residential Rental Property*.

### Introduction

This chapter discusses rental income and expenses. It covers the following topics.

- Rental income.
- Rental expenses.
- Vacation homes and other dwelling units.
- Depreciation.
- Limits on rental losses.
- How to report your rental income and expenses.

If you sell or otherwise dispose of your rental property, see Publication 544, *Sales and Other Dispositions of Assets*.

If you have a loss from damage to, or from theft of, rental property, see Publication 547, *Casualties, Disasters, and Thefts (Business and Nonbusiness)*.

If you rent out a condominium or a cooperative apartment, some special rules apply to you even though you receive the same tax treatment as other owners of rental property. See Publication 527 for more information.

### Useful Items

You may want to see:

#### Publication

- 527** Residential Rental Property
- 534** Depreciating Property Placed in Service Before 1987
- 535** Business Expenses
- 925** Passive Activity and At-Risk Rules
- 946** How To Depreciate Property

### Form (and Instructions)

- 4562** Depreciation and Amortization
- 6251** Alternative Minimum Tax—Individuals
- 8582** Passive Activity Loss Limitations
- Schedule E (Form 1040)** Supplemental Income and Loss

### Rental Income

You generally must include in your gross income all amounts you receive as rent.

Rental income is any payment you receive for the use or occupation of property. In addition to amounts you receive as normal rent payments, there are other amounts that may be rental income.

**When to report.** Report rental income on your return for the year you actually or constructively receive it (if you are a cash-basis taxpayer). You are considered to constructively receive income when it is made available to you, for example, by being credited to your bank account.

For more information about when you constructively receive income, see *Accounting Methods* in chapter 1.

**Advance rent.** Advance rent is any amount you receive before the period that it covers. Include advance rent in your rental income in the year you receive it regardless of the period covered or the method of accounting you use.

**Example.** You sign a 10-year lease to rent your property. In the first year, you receive \$5,000 for the first year's rent and \$5,000 as rent for the last year of the lease. You must include \$10,000 in your income in the first year.

**Security deposits.** Do not include a security deposit in your income when you receive it if you plan to return it to your tenant at the end of the lease. But if you keep part or all of the security deposit during any year because your tenant does not live up to the terms of the lease, include the amount you keep in your income for that year.

If an amount called a security deposit is to be used as a final payment of rent, it is advance rent. Include it in your income when you receive it.

**Payment for canceling a lease.** If your tenant pays you to cancel a lease, the amount you receive is rent. Include the payment in your income in the year you receive it regardless of your method of accounting.

**Expenses paid by tenant.** If your tenant pays any of your expenses, the payments are rental income. You must include them in your income. You can deduct the expenses if they are deductible rental expenses. See *Rental Expenses*, later, for more information.

**Property or services.** If you receive property or services, instead of money, as rent, include the fair market value of the property or services in your rental income.

If the services are provided at an agreed upon or specified price, that price is the fair

market value unless there is evidence to the contrary.

### Rental of property also used as a home.

If you rent property that you also use as your home and you rent it for fewer than 15 days during the tax year, do not include the rent you receive in your gross income. You cannot deduct rental expenses. However, you can include the interest, taxes, and casualty and theft losses that are allowed for non-rental property on Schedule A of Form 1040. See *Personal Use of Vacation Home or Dwelling Unit*, later.

**Part interest.** If you own a part interest in rental property, you must report your part of the rental income from the property.

### Rental Expenses

This part discusses repairs and certain other expenses of renting property that you ordinarily can deduct from your gross rental income. It includes information on the expenses you can deduct if you rent part of your property, or if you change your property to rental use. Depreciation, which you can also deduct from your gross rental income, is discussed later.

**When to deduct.** You generally deduct your rental expenses in the year you pay or incur them.

**Vacant rental property.** If you hold property for rental purposes, you may be able to deduct your ordinary and necessary expenses for managing, conserving, or maintaining the property while the property is vacant. However, you cannot deduct any loss of rental income for the period the property is vacant.

**Pre-rental expenses.** You can deduct your ordinary and necessary expenses for managing, conserving, or maintaining rental property from the time you make it available for rent.

**Expenses for rental property sold.** If you sell property you held for rental purposes, you can deduct the ordinary and necessary expenses for managing, conserving, or maintaining the property until it is sold.

**Personal use of rental property.** If you sometimes use your rental property for personal purposes, you must divide your expenses between rental and personal use. Also, your rental expense deductions may be limited. See *Personal Use of Vacation Home or Dwelling Unit*, later.

**Part interest.** If you own a part interest in rental property, you can deduct your part of the expenses that you paid.

### Repairs and Improvements

You can deduct the cost of repairs that you make to your rental property. You cannot deduct the cost of improvements. You recover the cost of improvements by taking depreciation (explained later).



Separate the costs of repairs and improvements, and keep accurate records. You will need to know the cost of improvements when you sell or depreciate your property.

**Repairs.** A repair keeps your property in good operating condition. It does not materially add to the value of your property or substantially prolong its life. Repainting your property inside or out, fixing gutters or floors, fixing leaks, plastering, and replacing broken windows are examples of repairs.

If you make repairs as part of an extensive remodeling or restoration of your property, the whole job is an improvement.

**Improvements.** An improvement adds to the value of your property, prolongs its useful life, or adapts it to new uses. Improvements include the following items.

- Putting a recreation room in an unfinished basement.
- Paneling a den.
- Adding a bathroom or bedroom.
- Putting decorative grillwork on a balcony.
- Putting up a fence.
- Putting in new plumbing or wiring.
- Putting in new cabinets.
- Putting on a new roof.
- Paving a driveway.

If you make an improvement to property, the cost of the improvement must be capitalized. The capitalized cost can generally be depreciated as if the improvement were separate property.

## Other Expenses

Other expenses you can deduct from your gross rental income include advertising, janitor and maid service, utilities, fire and liability insurance, taxes, interest, commissions for the collection of rent, ordinary and necessary travel and transportation, and other expenses, discussed next.

**Rental payments for property.** You can deduct the rent you pay for property that you use for rental purposes. If you buy a leasehold for rental purposes, you can deduct an equal part of the cost each year over the term of the lease.

**Rental of equipment.** You can deduct the rent you pay for equipment that you use for rental purposes. However, in some cases, lease contracts are actually purchase contracts. If so, you cannot deduct these payments. You can recover the cost of purchased equipment through depreciation.

**Insurance premiums.** You can deduct insurance premiums you pay for rental property. If you pay a premium for more than one year in advance, each year you can deduct the part of the premium payment that will apply to that year. You cannot deduct the total premium in the year you pay it.

**Local benefit taxes.** Generally, you cannot deduct charges for local benefits that increase the value of your property, such as charges for putting in streets, sidewalks, or water and sewer systems. These charges are capital expenditures that you cannot depreciate. You must add them to the basis of your property. You can deduct local benefit taxes if they are for maintaining, repairing, or paying interest charges for the benefits.

**Charges for services.** You can deduct charges you pay for services provided for your rental property, such as water, sewer, and trash collection.

**Travel expenses.** You can deduct the ordinary and necessary costs of traveling away from home if the primary purpose of the trip was to collect rental income or to manage, conserve, or maintain your rental property. You must properly allocate your expenses between rental and nonrental activities. For information on travel expenses, see chapter 28.



To deduct travel expenses, you must keep records that follow the rules in chapter 28.

**Local transportation expenses.** You can deduct your ordinary and necessary local transportation expenses if you incur them to collect rental income or to manage, conserve, or maintain your rental property.

Generally, if you use your personal car, pickup truck, or light van for rental activities, you can deduct the expenses using one of two methods: actual expenses or the standard mileage rate. For 1999, the standard mileage rate for all business miles is:

- 32.5 cents a mile through March 31, 1999, and
- 31 cents a mile starting on April 1, 1999.

For more information, see chapter 28.



To deduct car expenses under either method, you must keep records that follow the rules in chapter 28. In addition, you must complete Part V of Form 4562 and attach it to your tax return.

**Tax return preparation.** You can deduct, as a rental expense, the part of tax return preparation fees you paid to prepare Part I of Schedule E (Form 1040). You can also deduct, as a rental expense, any portion of the total expense you paid to resolve a tax underpayment related to your rental activities. On your 1999 Schedule E, you can deduct fees paid in 1999 to prepare Part I of your 1998 Schedule E.

## Not Rented for Profit

If you do not rent your property to make a profit, you can deduct your rental expenses only up to the amount of your rental income. You cannot carry forward any of your rental expenses that are more than your rental income. For more information about the rules for an activity not engaged in for profit, see chapter 1 of Publication 535.

**Where to report.** Report your not-for-profit rental income on line 21, Form 1040. Include your mortgage interest, real estate taxes, and casualty losses on the appropriate lines of Schedule A (Form 1040).

Claim your other expenses, subject to the rules explained in chapter 1 of Publication 535, as miscellaneous itemized deductions on line 22 of Schedule A. You can deduct these expenses only if they, together with certain other miscellaneous itemized deductions, total more than 2% of your adjusted gross income. For more information

about miscellaneous deductions, see chapter 30.

## Property Changed to Rental Use

If you change your home or other property, (or a part of it), to rental use at any time other than at the beginning of your tax year, you must divide yearly expenses, such as depreciation, taxes, and insurance, between rental use and personal use.

You can deduct as rental expenses only the part of the expense that is for the part of the year the property was used or held for rental purposes.

You cannot deduct depreciation or insurance for the part of the year the property was held for personal use. However, you can include the interest and tax expenses for the part of the year the property was held for personal use as an itemized deduction on Schedule A (Form 1040).

**Example.** Your tax year is a calendar year. You moved from your home in May and started renting it out on June 1. You can deduct as rental expenses seven-twelfths of your yearly expenses, such as taxes and insurance.

Starting with June, you can deduct as rental expenses, the amounts you pay for items generally billed monthly, such as utilities.

## Renting Part of Property

If you rent part of your property, you must divide certain expenses between the part of the property used for rental purposes and the part of the property used for personal purposes as though you actually had two separate pieces of property.

You can deduct a part of some expenses, such as mortgage interest and property taxes, as a rental expense. You can deduct the other part, subject to certain limitations, only if you itemize your deductions. You can also deduct as a rental expense a part of other expenses that normally are nondeductible personal expenses, such as expenses for electricity or painting the outside of your house. You cannot deduct any part of the cost of a single phone line even if your tenants have unlimited use of it.

You do not have to divide the expenses that belong only to the rental part of your property. If you paint a room that you rent, or if you pay premiums for liability insurance in connection with renting a room in your home, your entire cost is a rental expense. If you install a second phone line strictly for your tenants' use, all of the cost of the second line is deductible as a rental expense. You can deduct depreciation, discussed later, on the part of the property used for rental purposes as well as on the furniture and equipment you use for these purposes.

**How to divide expenses.** If an expense is for both rental use and personal use, such as mortgage interest or heat for the entire house, you must divide the expense be-

tween the rental use and the personal use. You can use any reasonable method for dividing the expense. It may be reasonable to divide the cost of some items (for example, water) based on the number of people using them. However, the two most common methods for dividing an expense are one based on the number of rooms in your home and one based on the square footage of your home.

## Personal Use of Vacation Home or Dwelling Unit

If you have any personal use of a vacation home or other dwelling unit that you rent out, you must divide your expenses between the rental use and the personal use. See *Figuring Days of Personal Use and How To Divide Expenses*, later.

If your expenses for rental use are more than your rental income, you may not be able to deduct all of the rental expenses. See *How To Figure Rental Income and Deductions*, later.

**Exception for minimal rental use.** If you use the dwelling unit as a home and you rent it for fewer than 15 days during the year, do not include any of the rent in your income and do not deduct any of the rental expenses. See *Dwelling Unit Used as Home*, later.

**Dwelling unit.** The rules in this section apply to vacation homes and other dwelling units. A dwelling unit includes a house, apartment, condominium, mobile home, boat, or similar property. A dwelling unit has basic living accommodations, such as sleeping space, a toilet, and cooking facilities. A dwelling unit does not include property used solely as a hotel, motel, inn, or similar establishment.

Property is used solely as a hotel, motel, inn, or similar establishment if it is regularly available for occupancy by paying customers and is not used by an owner as a home during the year.

**Example.** You rent out a room in your home that is always available for short-term occupancy by paying customers. You do not use the room yourself, and you only allow paying customers to use the room. The room is used solely as a hotel, motel, inn, or similar establishment and is not a dwelling unit.

## Dwelling Unit Used as Home

The tax treatment of rental income and expenses for a dwelling unit that you also use for personal purposes depends on whether you use it as a home. (See *How To Figure Rental Income and Deductions*, later.)

You use a dwelling unit as a home during the tax year if you use it for personal purposes more than the greater of:

- 1) 14 days, or
- 2) 10% of the total days it is rented to others at a fair rental price.

See *Figuring Days of Personal Use*, later.

If a dwelling unit is used for personal purposes on a day it is rented at a fair rental price, do not count that day as a day of rental in applying (2) above. Instead, count it as a day of personal use in applying both (1) and (2) above. This rule does not apply when dividing expenses between rental and personal use.

**Fair rental price.** A fair rental price for your property generally is an amount that a person who is not related to you would be willing to pay. The rent you charge is not a fair rental price if it is substantially less than the rents charged for other properties that are similar to your property.

## Examples

The following examples show how to determine whether you used your rental property as a home.

**Example 1.** You converted the basement of your home into an apartment with a bedroom, a bathroom, and a small kitchen. You rent the apartment at a fair rental price to college students during the regular school year. You rent to them on a 9-month (273 days) lease.

During the summer, your brothers stay with you for a month (30 days) and live in the apartment rent free.

Your basement apartment is used as a home because you use it for personal purposes for 30 days. That is more than the greater of 14 days or 10% of the total days it is rented (27 days).

**Example 2.** You rent out the guest bedroom in your home at a fair rental price during the local college's homecoming, commencement, and football weekends (a total of 27 days). Your sister-in-law stays in the room, rent free, for the last three weeks (21 days) in July.

The room is used as a home because you use it for personal purposes for 21 days. That is more than the greater of 14 days or 10% of the total days it is rented (3 days).

**Example 3.** You own a cottage in a resort area. You rented it out at a fair rental price for a total of 170 days during the year. For 12 of these days, the tenant was not able to use the cottage and allowed you to use it even though you did not refund any of the rent. Your family actually used the cottage for 10 of those days. Therefore, the cottage is treated as having been rented for 160 (170 - 10) days. Your family also used the cottage for 7 other days during the year.

You used the cottage as a home because you used it for personal purposes for 17 days. That is more than the greater of 14 days or 10% of the total days it is rented (16 days).

## Use As Main Home Before or After Renting

Use the following special rule when determining if you used your property as a home. Do not count as days of personal use the days you used the property as your main home before or after renting it or offering it for rent in either of the following circumstances.

- 1) You rented or tried to rent the property for 12 or more consecutive months.

- 2) You rented or tried to rent the property for a period of less than 12 consecutive months and the period ended because you sold or exchanged the property.

This special rule does not apply when dividing expenses between rental and personal use.

## Figuring Days of Personal Use

A day of personal use of a dwelling unit is any day that it is used by any of the following persons.

- 1) You or any other person who has an interest in it, unless you rent it to another owner as his or her main home under a shared equity financing agreement (defined later).
- 2) A member of your family or a member of the family of any other person who has a financial interest in it, unless the family member uses the dwelling unit as his or her main home and pays a fair rental price. Family includes only brothers and sisters, half-brothers and half-sisters, spouses, ancestors (parents, grandparents, etc.) and lineal descendants (children, grandchildren, etc.).
- 3) Anyone under an arrangement that lets you use some other dwelling unit.
- 4) Anyone at less than a fair rental price.

**Main home.** If the other owner or member of the family in (1) or (2) above has more than one home, his or her main home is the one lived in most of the time.

**Shared equity financing agreement.** This is an agreement under which two or more persons acquire undivided interests for more than 50 years in an entire dwelling unit, including the land, and one or more of the co-owners is entitled to occupy the unit as his or her main home upon payment of rent to the other co-owner or owners.

**Donation of use of property.** You use a dwelling unit for personal purposes if:

- You donate the use of the unit to a charitable organization,
- The organization sells the use of the unit at a fund-raising event, and
- The purchaser uses the unit.

## Examples

The following examples show how to determine days of personal use.

**Example 1.** You and your neighbor are co-owners of a condominium at the beach. You rent the unit out to vacationers whenever possible. The unit is not used as a main home by anyone. Your neighbor uses the unit for two weeks every year.

Because your neighbor has an interest in the unit, both of you are considered to have used the unit for personal purposes during those two weeks.

**Example 2.** You and your neighbors are co-owners of a house under a shared equity financing agreement. Your neighbors live in the house and pay you a fair rental price.



Even though your neighbors have an interest in the house, the days your neighbors live there are not counted as days of personal use by you. This is because your neighbors rent the house as their main home under a shared equity financing agreement.

**Example 3.** You own a rental property that you rent to your son. Your son has no interest in this dwelling unit. He uses it as his main home. He pays you a fair rental price for the property.

Your son's use of the property is not personal use by you because your son is using it as his main home, he has no interest in the property, and he is paying you a fair rental price.

**Example 4.** You rent your beach house to Joshua. Joshua rents his house in the mountains to you. You each pay a fair rental price.

You are using your house for personal purposes on the days that Joshua uses it because your house is used by Joshua under an arrangement that allows you to use his house.

## Days Not Counted as Personal Use

Some days you spend at the dwelling unit are not counted as days of personal use.

**Repairs and maintenance.** Any day that you spend working substantially full time repairing and maintaining your property is not counted as a day of personal use. Do not count such a day as a day of personal use even if family members use the property for recreational purposes on the same day.

## How To Divide Expenses

If you use a dwelling unit for both rental and personal purposes, divide your expenses between the rental use and the personal use based on the number of days used for each purpose. Expenses for the rental use of the unit are deductible under the rules explained in *How To Figure Rental Income and Deductions*, next.

When dividing your expenses follow these rules.

- Any day that the unit is rented at a fair rental price is a day of rental use even if you used the unit for personal purposes that day. This rule does not apply when determining whether you used the unit as a home.
- Any day that the unit is held out for rent but not actually rented is not a day of rental use.

**Example.** You offer your beach cottage for rent from June 1 through August 31 (92 days). Your family uses the cottage during the last 2 weeks in May (14 days). You were unable to find a renter for the first week in August (7 days). The person who rented the cottage for July allowed you to use it over a weekend (2 days) without any reduction in or refund of rent. The cottage was not used at all before May 17 or after August 31.

You figure the part of the cottage expenses to treat as rental expenses as follows.

- 1) The cottage was used for rental a total of 85 days (92 – 7). The days it was held out for rent but not rented (7 days) are not days of rental use. The July weekend (2 days) you used it is rental use because you received a fair rental price for the weekend.
- 2) You used the cottage for personal purposes for 14 days (the last 2 weeks in May).
- 3) The total use of the cottage was 99 days (14 days personal use + 85 days rental use).
- 4) Your rental expenses are 85/99 (86%) of the cottage expenses.

When determining whether you used the cottage as a home, the July weekend (2 days) you used it is personal use even though you received a fair rental price for the weekend. Therefore, you had 16 days of personal use and 83 days of rental use for this purpose. Because you used the cottage for personal purposes more than 14 days and more than 10% of the days of rental use, you used it as a home. If you have a net loss, you may not be able to deduct all of the rental expenses. See *Property Used as a Home* in the following discussion.

## How To Figure Rental Income and Deductions

How you figure your rental income and deductions depends on whether the dwelling unit was used as a home and, if used as a home, how many days the property was rented.

### Property Not Used as a Home

If you do not use a dwelling unit as a home, report all the rental income and deduct all the rental expenses. See *How To Report Rental Income and Expenses*, later.

Your deductible rental expenses can be more than your gross rental income. However, see *Limits on Rental Losses*, later.

### Property Used as a Home

If you use a dwelling unit as a home during the year (see *Dwelling Unit Used as Home*, earlier), how you figure your rental income and deductions depends on how many days the unit was rented.

**Rented fewer than 15 days.** If you use a dwelling unit as a home and you rent it for fewer than 15 days during the year, you do not include in income any of the rental income. Also, you cannot deduct any expenses as rental expenses.

**Rented 15 days or more.** If you use a dwelling unit as a home and rent it for 15 days or more during the year, you include all your rental income in your gross income. See *How To Report Rental Income and Expenses*, later. If you had a net profit from the rental property for the year (that is, if your rental income is more than the total of your rental expenses, including depreciation), deduct all of your rental expenses. However, if you had a net loss, you may not be able to deduct all of your rental expenses.

Use *Table 10–1* to figure your deductible expenses.

## Depreciation

When you use your property to produce income, such as rents, you can recover (get back) some or all of what you paid for the property through tax deductions. You do this by **depreciating** the property; that is, by deducting some of your cost on your tax return each year.

Several factors determine how much depreciation you can deduct. The main factors are: (1) your basis in the property, (2) the recovery period for the property, and (3) the depreciation method (including convention) used.

You can deduct depreciation only on the part of your property used for rental purposes. Depreciation reduces your basis for figuring gain or loss on a later sale or exchange.

You may have to use **Form 4562**, to figure and report your depreciation. See *How To Report Rental Income and Expenses*, later.

**Claiming the correct amount of depreciation.** You should claim the correct amount of depreciation each tax year. If, in an earlier year, you did not claim depreciation that you were entitled to deduct, you must still reduce your basis in the property by the amount of depreciation that you should have deducted. You generally cannot deduct the unclaimed depreciation in the current year or any later tax year. However, you may be able to claim the correct amount of depreciation on an amended return (Form 1040X) for the earlier year. See *Claiming the correct amount of depreciation* in Publication 527 for more information.

**Changing your accounting method to deduct unclaimed depreciation.** If you claimed less depreciation than allowable in an earlier year, you can change your accounting method to take a deduction in the current year for the unclaimed depreciation. To change your accounting method, you must have the consent of the IRS. In some instances, you can receive automatic consent. For more information, see chapter 1 of Publication 946.

**Land.** You can never depreciate land. The costs of clearing, grading, planting, and landscaping are usually all part of the cost of land and are not depreciable.

## Depreciation Systems

There are three ways to figure depreciation. The depreciation system you use depends on the type of asset and when the asset was placed in service. For property used in rental activities you use:

- MACRS if placed in service after 1986.
- ACRS if placed in service after 1980 but before 1987.
- Useful lives and either straight line or an accelerated method of depreciation, such as the declining balance method, if placed in service before 1981.



This chapter discusses MACRS only. If you are depreciating property placed in service before 1987, see Publication 534.

Table 10-1. **Worksheet for Figuring the Limit on Rental Deductions for a Dwelling Unit Used as a Home**

Use this worksheet only if you answer "yes" to all of the following questions.

- Did you use the dwelling unit as a home this year? (See *Dwelling Unit Used as Home*.)
- Did you rent the dwelling unit 15 days or more this year?
- Are the total of your rental expenses and depreciation more than your rental income?

1.	Enter rents received . . . . .	_____	
2.a.	Enter the rental portion of deductible home mortgage interest (see instructions) . . . . .	_____	
b.	Enter the rental portion of real estate taxes . . . . .	_____	
c.	Enter the rental portion of deductible casualty and theft losses (see instructions) . . . . .	_____	
d.	Enter direct rental expenses (see instructions) . . . . .	_____	
e.	<b>Fully deductible rental expenses.</b> Add lines 2a-2d . . . . .	_____	
3.	Subtract line 2e from line 1. If zero or less, enter zero . . . . .	_____	
4.a.	Enter the rental portion of expenses directly related to operating or maintaining the dwelling unit (such as repairs, insurance, and utilities) . . . . .	_____	
b.	Enter the rental portion of excess mortgage interest (see instructions) . . . . .	_____	
c.	Add lines 4a and 4b . . . . .	_____	
d.	<b>Allowable operating expenses.</b> Enter the smaller of line 3 or line 4c . . . . .	_____	
5.	Subtract line 4d from line 3. If zero or less, enter zero . . . . .	_____	
6.a.	Enter the rental portion of excess casualty and theft losses (see instructions) . . . . .	_____	
b.	Enter the rental portion of depreciation of the dwelling unit . . . . .	_____	
c.	Add lines 6a and 6b . . . . .	_____	
d.	<b>Allowable excess casualty and theft losses and depreciation.</b> Enter the smaller of line 5 or line 6c. . . . .	_____	
7.a.	<b>Operating expenses to be carried over to next year.</b> Subtract line 4d from line 4c . . . . .	_____	
b.	<b>Excess casualty and theft losses and depreciation to be carried over to next year.</b> Subtract line 6d from line 6c. . . . .	_____	

Enter the amounts on **lines 2e, 4d, and 6d** on the appropriate lines of Schedule E (Form 1040), Part I.

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**Worksheet Instructions**

Follow these instructions for the worksheet above. If you were unable to deduct all your expenses last year, because of the rental income limit, add these unused amounts to your expenses for this year.

**Line 2a.** Figure the mortgage interest on the dwelling unit that you could deduct on Schedule A (Form 1040) if you had not rented the unit. **Do not** include interest on a loan that did not benefit the dwelling unit. For example, **do not** include interest on a home equity loan used to pay off credit cards or other personal loans, buy a car, or pay college tuition. Include interest on a loan used to buy, build, or improve the dwelling unit, or to refinance such a loan. Enter the rental portion of this interest on line 2a of the worksheet.

**Line 2c.** Figure the casualty and theft losses related to the dwelling unit that you could deduct on Schedule A (Form 1040) if you had not rented the dwelling unit. To do this, complete Section A of Form 4684, treating the losses as personal losses. On line 17 of Form 4684, enter 10% of your adjusted gross income figured **without** your rental income and expenses from the dwelling unit. Enter the rental portion of the result from line 18 of Form 4684 on line 2c of this worksheet. **Note.** Do **not** file this Form 4684 or use it to figure your personal losses on Schedule A. Instead, figure the personal portion on a separate Form 4684.

**Line 2d.** Enter the total of your rental expenses that are directly related only to the rental activity. These include interest on loans used for rental activities other than to buy, build, or improve the dwelling unit. Also include rental agency fees, advertising, office supplies, and depreciation on office equipment used in your rental activity.

**Line 4b.** On line 2a, you entered the rental portion of the mortgage interest you could deduct on Schedule A if you had rented out the dwelling unit. Enter on line 4b of this worksheet the rental portion of the mortgage interest you could not deduct on Schedule A because it is **more than** the limit on home mortgage interest. **Do not** include interest on a loan that did not benefit the dwelling unit (as explained in the line 2a instructions).

**Line 6a.** To find the rental portion of excess casualty and theft losses, use the Form 4684 you prepared for line 2c of this worksheet.

**A.** Enter the amount from line 10 of Form 4684 . . . . . \_\_\_\_\_

**B.** Enter the rental portion of (A) \_\_\_\_\_

**C.** Enter the amount from line 2c of this worksheet . . . . . \_\_\_\_\_

**D.** Subtract (C) from (B). Enter the result here and on line 6a of this worksheet. . . . . \_\_\_\_\_

**Allocating the limited deduction.** If you cannot deduct all of the amount on line 4c or 6c this year, you can allocate the allowable deduction in any way you wish among the expenses included on line 4c or 6c. Enter the amount you allocate to each expense on the appropriate line of Schedule E, Part I.

If you placed property in service before 1999, continue to use the same method of figuring depreciation that you used in the past.

**Section 179 election.** You cannot claim the section 179 deduction for property held to produce rental income (unless renting property is your trade or business). See chapter 2 of Publication 946.

**Cannot be more than basis.** The total of all your yearly depreciation deductions cannot be more than the cost or other basis

of the property. For this purpose, your yearly depreciation deductions include any depreciation that you were allowed to claim, even if you did not claim it.

**Cooperative apartments.** If you rent your cooperative apartment to others, you can deduct your share of the cooperative housing corporation's depreciation. See *Cooperative apartments* in Publication 527 for information on how to figure your depreciation deduction.

**Modified Accelerated Cost Recovery System (MACRS)**

In general the modified accelerated cost recovery system (MACRS) applies to all tangible property placed in service during 1999.

MACRS consists of two systems that determine how you depreciate your property. The main system is called the **General Depreciation System (GDS)**. The second system is called the **Alternative Depreciation System (ADS)**. GDS is used to figure your depreciation deduction for property

used in most rental activities, unless you elect ADS.

To figure your MACRS deduction, you need to know the following information about your property:

- 1) Its recovery period,
- 2) Its placed-in-service date, and
- 3) Its depreciable basis.

**Personal home changed to rental use.** You must use MACRS to figure the depreciation on property you used as your home and changed to rental property in 1999.

**Excluded property.** You cannot use MACRS for certain personal property placed in service before 1987 (before August 1, 1986, if election made) that is transferred after 1986 (after July 31, 1986, if election made). However, you generally must use MACRS to depreciate property you or a related party used before 1987, or that you acquired from a related party, if the property had previously been depreciated under ACRS and the MACRS deduction would be less than the deduction under ACRS.

In addition, you may elect to exclude certain property from the application of MACRS. See Publication 534 for more information. Property that does not come under MACRS must be depreciated under ACRS or one of the other methods of depreciation, such as straight line or declining balance.

### Recovery Periods Under GDS

Each item of property that can be depreciated is assigned to a property class. The recovery period of the property depends on the class the property is in. The property classes are:

- 3-year property,
- 5-year property,
- 7-year property,
- 10-year property,
- 15-year property,
- 20-year property,
- Nonresidential real property, and
- Residential rental property.

Recovery periods for property used in rental activities are shown in *Table 10-2*.

The class to which property is assigned is determined by its class life. For more information on class lives and recovery periods, see Publication 946.

#### Additions or improvements to property.

Treat depreciable additions or improvements you make to any property as separate property items for depreciation purposes. The recovery period for an addition or improvement begins on the later of:

- 1) The date the addition or improvement is placed in service, or
- 2) The date the property to which the addition or improvement was made is placed in service.

The class and recovery period of the addition or improvement is the one that would apply to the underlying property if it were placed in service at the same time as the addition or improvement.

**Table 10-2. MACRS Recovery Periods for Property Used in Rental Activities**

Type of Property	MACRS Recovery Period To Use	
	General Depreciation System	Alternative Depreciation System
Computers and their peripheral equipment . . . . .	5 years	5 years
Office machinery, such as:		
Typewriters		
Calculators		
Copiers . . . . .	5 years	6 years
Automobiles . . . . .	5 years	5 years
Light trucks . . . . .	5 years	5 years
Appliances, such as:		
Stoves		
Refrigerators . . . . .	5 years	9 years
Carpets . . . . .	5 years	9 years
Furniture used in rental property . . . . .	5 years	9 years
Office furniture and equipment, such as:		
Desks		
Files . . . . .	7 years	10 years
Any property that does not have a class life and that has not been designated by law as being in any other class. . . . .	7 years	12 years
Fences . . . . .	15 years	20 years
Roads . . . . .	15 years	20 years
Shrubbery . . . . .	15 years	20 years
Residential rental property (buildings or structures) and structural components such as furnaces, water pipes, venting, etc. . . . .	27.5 years	40 years
Improvements and additions, such as a new roof. . . . .	The recovery period of the property to which the addition or improvement is made, determined as if the property were placed in service at the same time as the improvement or addition.	

**Example.** You own a residential rental house that you have been renting out since 1980 and are depreciating under ACRS. If you put an addition onto the house, and you place the improvement in service after 1986, you use MACRS for the addition. Under MACRS, the addition would be depreciated as residential rental property.

#### Placed-in-Service Date

You can begin to depreciate property when you place it in service in your trade or business or for the production of income. Property is considered placed in service in a rental activity when it is ready and available for a specific use in that activity.

#### Cost Basis

To deduct the proper amount of depreciation each year, you must first determine your basis in the property you intend to depreciate. The basis used for figuring depreciation is your original basis in the property increased by any improvements made to the property. Your original basis is usually your cost. However, if you acquire the property in some other way, such as by inheriting it, getting it as a gift, or building it yourself, you may have to figure your original basis in another way. Other adjustments could also affect your basis. See chapter 14.

#### Conventions

In the year that you place property in service or in the year that you dispose of property, you are allowed to claim depreciation for only part of the year. The part of the year (or convention) depends on the class of the property.

For residential rental property, use a mid-month convention in all situations. Use half-year convention for property used in rental activities, other than residential rental property. (However, in certain circumstances, you must use a mid-quarter convention.)

**Half-year convention.** The half-year convention treats all property placed in service, or disposed of, during a tax year as placed in service, or disposed of, in the middle of that tax year.

A half year of depreciation is allowable for the first year property is placed in service, regardless of when the property is placed in service during the tax year. For each of the remaining years of the recovery period, you will take a full year of depreciation. If you hold the property for the entire recovery period, a half year of depreciation is allowable for the year in which the recovery period ends. If you dispose of the property before the end of the recovery pe-

riod, a half year of depreciation is allowable for the year of disposition.

**Mid-quarter convention.** Under a mid-quarter convention, all property placed in service, or disposed of, during any quarter of a tax year is treated as placed in service, or disposed of, in the middle of the quarter.

A mid-quarter convention must be used in certain circumstances for property used in rental activities, other than residential rental property. This convention applies if the total basis of such property that is placed in service in the last 3 months of a tax year is more than 40% of the total basis of all such property you place in service during the year.

Do not include in the total basis any property placed in service and disposed of during the same tax year.

**Example.** During the tax year, Jordan Gregory purchased the following items to use in his rental property.

- A dishwasher for \$400, which he placed in service in January.
- Used furniture for \$100, which he placed in service in September.
- A refrigerator for \$500, which he placed in service in October.

Jordan uses the calendar year as his tax year. The total basis of all property placed in service in that year is \$1,000. The \$500 basis of the refrigerator placed in service during the last 3 months of his tax year exceeds \$400 (40% × \$1,000). Jordan must use the mid-quarter convention for all three items.

**Mid-month convention.** Under a mid-month convention, residential rental property placed in service, or disposed of, during any month is treated as placed in service, or disposed of, in the middle of that month.

## MACRS Depreciation Under GDS

You can figure your MACRS depreciation deduction under GDS in one of two ways. The deduction is substantially the same both ways. (The difference, if any, is slight.) You can either:

- 1) Use the percentage from the optional MACRS tables, or
- 2) Actually figure the deduction using the depreciation method and convention that apply over the recovery period of the property.

Publication 946 discusses computing depreciation using the proper method and convention.

## Using the Optional Tables

You can use the tables in *Table 10-3* to compute annual depreciation under MACRS. The tables show the percentages for the first 6 years. The percentages in *Tables 10-3-A, 10-3-B, and 10-3-C* make the change from declining balance to straight line in the year that straight line will yield a larger deduction. See *Appendix A* of Publication 946 for complete tables.

If you elect to use the straight line method for 5-, 7-, or 15-year property, or the

**Table 10-3. Optional MACRS Tables**

**Table 10-3-A. MACRS 5-Year property**

Year	Half-year convention	Mid-quarter convention			
		First quarter	Second quarter	Third quarter	Fourth quarter
1	20.00%	35.00%	25.00%	15.00%	5.00%
2	32.00	26.00	30.00	34.00	38.00
3	19.20	15.60	18.00	20.40	22.80
4	11.52	11.01	11.37	12.24	13.68
5	11.52	11.01	11.37	11.30	10.94
6	5.76	1.38	4.26	7.06	9.58

**Table 10-3-B. MACRS 7-Year property**

Year	Half-year convention	Mid-quarter convention			
		First quarter	Second quarter	Third quarter	Fourth quarter
1	14.29%	25.00%	17.85%	10.71%	3.57%
2	24.49	21.43	23.47	25.51	27.55
3	17.49	15.31	16.76	18.22	19.68
4	12.49	10.93	11.97	13.02	14.06
5	8.93	8.75	8.87	9.30	10.04
6	8.92	8.74	8.87	8.85	8.73

**Table 10-3-C. MACRS 15-Year property**

Year	Half-year convention	Mid-quarter convention			
		First quarter	Second quarter	Third quarter	Fourth quarter
1	5.00%	8.75%	6.25%	3.75%	1.25%
2	9.50	9.13	9.38	9.63	9.88
3	8.55	8.21	8.44	8.66	8.89
4	7.70	7.39	7.59	7.80	8.00
5	6.93	6.65	6.83	7.02	7.20
6	6.23	5.99	6.15	6.31	6.48

**Table 10-3-D. Residential Rental Property (27.5-year)**

	Use the row for the month of the taxable year placed in service.					
	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Jan.	3.485%	3.636%	3.636%	3.636%	3.636%	3.636%
Feb.	3.182	3.636	3.636	3.636	3.636	3.636
March	2.879	3.636	3.636	3.636	3.636	3.636
Apr.	2.576	3.636	3.636	3.636	3.636	3.636
May	2.273	3.636	3.636	3.636	3.636	3.636
June	1.970	3.636	3.636	3.636	3.636	3.636
July	1.667	3.636	3.636	3.636	3.636	3.636
Aug.	1.364	3.636	3.636	3.636	3.636	3.636
Sept.	1.061	3.636	3.636	3.636	3.636	3.636
Oct.	0.758	3.636	3.636	3.636	3.636	3.636
Nov.	0.455	3.636	3.636	3.636	3.636	3.636
Dec.	0.152	3.636	3.636	3.636	3.636	3.636

150% declining balance method for 5- or 7-year property, use the tables in *Appendix A* of Publication 946.

**How to use the tables.** The following section explains how to use the optional tables. Figure the depreciation deduction by multiplying your unadjusted basis in the property by the percentage shown in the appropriate table. Your **unadjusted basis** is your depreciable basis without reduction for depreciation previously claimed.

Once you begin using an optional table to figure depreciation, you must continue to use it for the entire recovery period unless there is an adjustment to the basis of your property for a reason other than:

- 1) Depreciation allowed or allowable, or
- 2) An addition or improvement that is depreciated as a separate item of property.

If there is an adjustment for any other reason (for example, because of a deductible

casualty loss), you can no longer use the table. For the year of the adjustment and for the remaining recovery period, figure depreciation using the property's adjusted basis at the end of the year and the appropriate depreciation method, as explained in *MACRS Depreciation Under GDS* in Publication 527.

#### Tables 10-3-A, 10-3-B, and 10-3-C.

The percentages in these tables take into account the half-year and mid-quarter conventions. Use Table 10-3-A for 5-year property, Table 10-3-B for 7-year property, and Table 10-3-C for 15-year property. Use the percentage in the second column (half-year convention) unless you must use the mid-quarter convention (explained earlier). If you must use the mid-quarter convention, use the column that corresponds to the calendar year quarter in which you placed the property in service.

**Example 1.** You purchased a stove and refrigerator and placed them in service in February. Your basis in the stove is \$300, and your basis in the refrigerator is \$500. Assume that both are 5-year property. Using the half-year convention column in Table 10-3-A, you find the depreciation percentage for year 1 is 20%. For that year, your depreciation deduction is \$60 ( $\$300 \times .20$ ) for the stove, and is \$100 ( $\$500 \times .20$ ) for the refrigerator.

For the second tax year, you find your depreciation percentage is 32%. That year's depreciation deduction will be \$96 ( $\$300 \times .32$ ) for the stove and \$160 ( $\$500 \times .32$ ) for the refrigerator.

**Example 2.** Assume the same facts as in Example 1, except you buy the refrigerator in October instead of February. You must use the mid-quarter convention to figure depreciation on the stove and refrigerator. The refrigerator was placed in service in the last 3 months of the tax year and its basis (\$500) is more than 40% of the total basis of all property placed in service during the year ( $\$800 \times .40 = \$320$ ).

Because you placed the stove in service in February, you use the first quarter column of Table 10-3-A and find that the depreciation percentage for year 1 is 35%. For that year, your depreciation deduction for the stove is \$105 ( $\$300 \times .35$ ).

Because you placed the refrigerator in service in October, you use the fourth quarter column of Table 10-3-A and find that the depreciation percentage for year 1 is 5%. Your depreciation deduction for the refrigerator is \$25 ( $\$500 \times .05$ ).

**Table 10-3-D.** Use this table for residential rental property. Find the row for the month that you placed the property in service. Use the percentages listed for that month to figure your depreciation deduction. The mid-month convention is taken into account in the percentages shown in the table.

**Example.** You purchased a single family rental house and placed it in service in February. Your basis in the house is \$80,000. Using Table 10-3-D, you find that the percentage for property placed in service in February of year 1 is 3.182%. That year's depreciation deduction is \$2,546 ( $\$80,000 \times .03182$ ).

## MACRS Depreciation Under ADS

If you choose, you can use the ADS method for most property. Under ADS, you use the straight line method of depreciation.

Table 10-2 shows the recovery periods for property used in rental activities that you depreciate under ADS. See *Appendix B* in Publication 946 for other property. If your property is not listed, it is considered to have no class life.

Use the mid-month convention for residential rental property. For all other property, use the half-year or mid-quarter convention.

**Election.** You choose to use ADS by entering the depreciation on line 16, Part II of Form 4562.

The election of ADS for one item in a class of property generally applies to all property in that class that is placed in service during the tax year of the election. However, the election applies on a property-by-property basis for residential rental property.

Once you choose to use ADS, you cannot change your election.

## Other Rules About Depreciable Property

In addition to the rules about what methods you can use, there are other rules you should be aware of with respect to depreciable property.

**Gain disposition.** If you dispose of depreciable property at a gain, you may have to report, as ordinary income, all or part of the gain. See Publication 544, *Sales and Other Dispositions of Assets*.

**Alternative minimum tax.** If you use accelerated depreciation, you may have to file **Form 6251**. Accelerated depreciation includes MACRS and ACRS and any other method that allows you to deduct more depreciation than you could deduct using a straight line method.

## Limits on Rental Losses

Rental real estate activities are generally considered passive activities, and the amount of loss you can deduct is limited. Generally, you cannot deduct losses from rental real estate activities unless you have income from other passive activities. See *Passive Activity Limits*, later.

Losses from passive activities are first subject to the at-risk rules. At-risk rules limit the amount of deductible losses from holding most real property placed in service after 1986.

**Exception.** If your rental losses are less than \$25,000 (\$12,500 if married filing separately), the passive activity limits probably do not apply to you. See *Losses From Rental Real Estate Activities*, later.

**Property used as a home.** If you used the rental property as a home during the year, the passive activity rules do not apply to that home. Instead, you must follow the rules

explained earlier under *Personal Use of Vacation Home or Dwelling Unit*.

## At-Risk Rules

The at-risk rules place a limit on the amount you can deduct as losses from activities often described as tax shelters. Losses from holding real property (other than mineral property) placed in service before 1987 are not subject to the at-risk rules.

Generally, any loss from an activity subject to the at-risk rules is allowed only to the extent of the total amount you have at risk in the activity at the end of the tax year. You are considered at risk in an activity to the extent of cash and the adjusted basis of other property you contributed to the activity and certain amounts borrowed for use in the activity. See Publication 925 for more information.

## Passive Activity Limits

In general, rental activities (except those meeting the exception for real estate professionals, below) are passive activities. For this purpose, a rental activity is an activity from which you receive income mainly for the use of tangible property, rather than for services.

**Passive activity rules.** Deductions for losses from passive activities are limited. You generally cannot offset income, other than passive income, with losses from passive activities. Nor can you offset taxes on income, other than passive income, with credits resulting from passive activities. Any excess loss or credit is carried forward to the next tax year.

For a detailed discussion of these rules, see Publication 925.

You may have to complete **Form 8582**, *Passive Activity Loss Limitations*, to figure the amount of any passive activity loss for the current year for all activities and the amount of the passive activity loss allowed on your tax return.

**Exception for real estate professionals.** Rental activities in which you **materially participated** during the year are not passive activities if, during that year, you were a real estate professional because you met two requirements. For a detailed discussion of these requirements, see Publication 527.

## Losses From Rental Real Estate Activities

If you **actively participated** in a passive rental real estate activity, you may be able to deduct up to \$25,000 of loss from the activity from nonpassive income. This special allowance cannot be more than \$12,500 if you were married, file a separate return, and lived apart from your spouse at all times during the year. It is not available if you were married, file a separate return, and did not live apart from your spouse at all times during the year.

The maximum amount of the special allowance is reduced if your modified adjusted gross income is more than \$100,000 (\$50,000 if married filing separately).

**Active participation.** You actively participated in a rental real estate activity if you (and your spouse) owned at least 10% of the rental property and you made manage-

ment decisions in a significant and bona fide sense. Management decisions include approving new tenants, deciding on rental terms, approving expenditures, and similar decisions.

**More information.** See Publication 925 for more information on the passive loss limits, including information on the treatment of unused disallowed passive losses and credits and the treatment of gains and losses realized on the disposition of a passive activity.

## How To Report Rental Income and Expenses

If you rent out buildings, rooms, or apartments, and provide only heat and light, trash collection, etc., you normally report your rental income and expenses in Part I of Schedule E (Form 1040), *Supplemental Income and Loss*. However, do not use that schedule to report a not-for-profit activity. See *Not Rented For Profit*, earlier.

If you provide significant services that are primarily for your tenant's convenience, such as regular cleaning, changing linen, or maid service, you report your rental income and expenses on Schedule C (Form 1040), *Profit or Loss From Business* or Schedule C-EZ, *Net Profit From Business*. Significant services do not include the furnishing of heat and light, cleaning of public areas, trash collection, etc. For information, see Publication 334. You also may have to pay self-employment tax on your rental income. See Publication 533.

**Form 1098.** If you paid \$600 or more of mortgage interest on your rental property to any one person, you should receive a Form 1098, *Mortgage Interest Statement*, or a similar statement showing the interest you paid for the year. If you and at least one

other person (other than your spouse if you file a joint return) were liable for, and paid interest on the mortgage, and the other person received the Form 1098, report your share of the interest on line 13 of Schedule E. Attach a statement to your return showing the name and address of the other person. In the left margin of Schedule E, next to line 13, write "See attached."

## Schedule E

Use Part I of Schedule E (Form 1040) to report your rental income and expenses. List your total income, expenses, and depreciation for each rental property. Be sure to answer the question on line 2.

If you have more than three rental or royalty properties, complete and attach as many Schedules E as are needed to list the properties. Complete lines 1 and 2 for each property. However, fill in the "Totals" column on only one Schedule E. The figures in the "Totals" column on that Schedule E should be the combined totals of all Schedules E.

Page 2 of Schedule E is used to report income or loss from partnerships, S corporations, estates, trusts, and real estate mortgage investment conduits. If you need to use page 2 of Schedule E, use page 2 of the same Schedule E you used to enter the combined totals in Part I.

On page 1, line 20 of Schedule E, enter the depreciation you are claiming. You must complete and attach Form 4562 for rental activities only if you are claiming:

- Depreciation on property placed in service during 1999,
- Depreciation on any property that is listed property (such as a car), regardless of when it was placed in service, or
- Any car expenses (actual or the standard mileage rate).

Otherwise, figure your depreciation on your own worksheet. You do not have to attach these computations to your return.

**Example.** On January 1, Justin Cole bought a townhouse and placed it in service as residential rental property. He receives \$1,100 a month rental income. His rental expenses for the year are as follows:

Fire insurance (1-year policy) .....	\$200
Mortgage interest .....	5,000
Fee paid to real estate company for collecting monthly rent .....	572
General repairs .....	175
Real estate taxes imposed and paid .....	800

Justin's basis for depreciation of the townhouse is \$65,000. He is using MACRS with a 27.5-year recovery period. On April 1, Justin bought a new refrigerator for the rental property at a cost of \$425. He uses the MACRS method with a 5-year recovery period.

Justin uses the percentage for January in *Table 10-3-D* to figure his depreciation deduction for the townhouse. He uses the percentage under "Half-year convention" in *Table 10-3-A* to figure his depreciation deduction for the refrigerator. He must report the depreciation on Form 4562.

Justin figures his net rental income or loss for the townhouse as follows:

Total rental income received	
(\$1,100 × 12) .....	\$13,200
Minus Expenses:	
Fire insurance (1-year policy) .	\$200
Mortgage interest .....	5,000
Rent collection fee .....	572
General repairs .....	175
Real estate taxes .....	800
Total expenses .....	6,747
Balance .....	\$6,453
Minus Depreciation:	
On townhouse	
(\$65,000 × 3.485%) .....	\$2,265
On refrigerator	
(\$425 × 20%) .....	85
Total depreciation .....	2,350
<b>Net rental income for townhouse</b> .....	<b>\$4,103</b>

# Retirement Plans, Pensions, and Annuities

## Important Changes

**Hardship distributions no longer treated as eligible rollover distributions.** Beginning in 1999, hardship distributions from 401(k) plans and similar employer-sponsored retirement plans will no longer be treated as eligible rollover distributions.

**5-year tax option repealed after 1999.** For tax years beginning after 1999, the 5-year tax option for figuring the tax on lump-sum distributions from a qualified retirement plan is repealed. However, a plan participant can continue to choose the 10-year tax option or capital gain treatment for a lump-sum distribution that qualifies for the special treatment.

## Introduction

This chapter discusses the tax treatment of distributions you receive from:

- 1) An employee pension or annuity from a qualified plan,
- 2) A disability retirement, and
- 3) A purchased commercial annuity.

**What is not covered in this chapter.** The following topics are not discussed in this chapter:

- 1) **The General Rule.** This is the method generally used to determine the tax treatment of pension and annuity income from nonqualified plans. If your annuity starting date is after November 18, 1996, you generally cannot use the General Rule for a qualified plan. For more information about the General Rule, get Publication 939.
- 2) **Civil service retirement benefits.** If you are retired from the federal government (either regular or disability retirement), get Publication 721, *Tax Guide to U.S. Civil Service Retirement Benefits*. Publication 721 also covers the information that you need if you are the survivor or beneficiary of a federal employee or retiree who died.
- 3) **Individual retirement arrangements (IRAs).** Information on the tax treatment of amounts you receive from an individual retirement arrangement (IRA), as well as general information on traditional and Roth IRAs, is in chapter 18.

## Useful Items

You may want to see:

### Publications

- 575** Pension and Annuity Income
- 721** Tax Guide to U.S. Civil Service Retirement Benefits
- 939** General Rule for Pensions and Annuities

### Forms and Instructions

- W-4P** Withholding Certificate for Pension or Annuity Payments
- 1099-R** Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.
- 4972** Tax on Lump-Sum Distributions
- 5329** Additional Taxes Attributable to IRAs, Other Qualified Retirement Plans, Annuities, Modified Endowment Contracts, and MSAs

## Employee Pensions and Annuities

Generally, if you did not pay any part of the cost of your employee pension or annuity and your employer did not withhold part of the cost of the contract from your pay while you worked, the amounts you receive each year are fully taxable. You must report them on your income tax return.

**Partly taxable payments.** If you paid part of the cost of your annuity, you are not taxed on the part of the annuity you receive that represents a return of your cost. The rest of the amount you receive is taxable. Your annuity starting date (defined later) determines which method you must or may use.

If you contributed to your pension or annuity plan, you figure the tax-free and the taxable parts of your annuity payments under either the Simplified Method or the General Rule. If your annuity starting date is **after November 18, 1996**, and your payments are from a qualified plan, you **must** use the Simplified Method. Generally, you must use the General Rule only for nonqualified plans.

If your annuity starting date is **after July 1, 1986, but before November 19, 1996**, you **can** use either the General Rule or, if you qualify, the Simplified Method.

**More than one program.** If you receive benefits from more than one program, such as a pension plan and a profit-sharing plan, you must figure the taxable part of each separately. Make separate computations even if the benefits from both are included in the same check. For example, benefits from one of your programs could be fully taxable, while the benefits from your other program could be taxable under the General Rule or the Simplified Method. Your former employer or the plan administrator should be able to tell you if you have more than one pension or annuity contract.

**Railroad retirement benefits.** Part of the railroad retirement benefits you receive is treated for tax purposes like social security benefits, and part is treated like an employee pension. For information about railroad retirement benefits treated as an employee pension, see *Railroad Retirement* in Publication 575.

**Credit for the elderly or the disabled.** If you receive a pension or annuity, you may be able to take the credit for the elderly or the disabled. See chapter 34.

**Withholding and estimated tax.** The payer of your pension, profit-sharing, stock bonus, annuity, or deferred compensation plan will withhold income tax on the taxable parts of amounts paid to you. You can choose not to have tax withheld except for amounts paid to you that are eligible rollover distributions. See *Eligible rollover distributions* under *Rollovers*, later. You make this choice by filing Form W-4P.

For payments other than eligible rollover distributions, you can tell the payer how to withhold by filing Form W-4P. If an eligible rollover distribution is paid directly to you, 20% will generally be withheld. There is no withholding on a direct rollover of an eligible rollover distribution. See *Direct rollover option* under *Rollovers*, later. If you choose not to have tax withheld or you do not have enough tax withheld, you may have to pay estimated tax.

For more information, see *Pensions and Annuities* under *Withholding* in chapter 5.

**Loans.** If you borrow money from your qualified pension or annuity plan, tax-sheltered annuity program, government plan, or contract purchased under any of these plans, you may have to treat the loan as a nonperiodic distribution. This means that you may have to include in income all or part of the amount borrowed unless certain exceptions apply. Even if you do not have to treat the loan as a nonperiodic distribution, you may not be able to deduct the interest on the loan in some situations. For details, see *Loans Treated as Distributions* in Publication 575. For information on the deductibility of interest, see chapter 25.

**Elective deferrals.** Some retirement plans allow you to choose (elect) to have part of your compensation (pay) contributed by your employer to a retirement fund, rather than have it paid to you. You do not pay tax on this money until you receive it in a distribution from the plan. Generally, you may not defer more than a total of \$10,000 for all qualified plans by which you are covered.

Elective deferrals generally include elective employer contributions to cash or deferred arrangements (known as **section 401(k) plans**) and elective contributions to section 501(c)(18)(D) plans, salary reduction simplified employee pension (SARSEP) plans, SIMPLE plans, and tax-sheltered annuities.



**CAUTION** Certain deferrals that are not included in your gross income are included in compensation. Therefore, the amounts deferred in certain employee benefit plans will increase the tax-deferred amount that can be contributed by the employer at the election of the employee.

For information on the tax treatment of elective deferrals, including their limits, see *Limits on Exclusion for Elective Deferrals* in Publication 575. For information about tax-sheltered annuities, see Publication 571, *Tax-Sheltered Annuity Programs for Employees of Public Schools and Certain Tax-Exempt Organizations*.

**Keogh plans.** Keogh plans (also called H.R. 10 plans) are retirement plans that can only be set up by a sole proprietor or a partnership (but not a partner). They can cover self-employed persons, such as the sole proprietor or partners, as well as regular (common-law) employees.

Distributions from a Keogh plan are usually fully taxable because most recipients have no cost basis. If you have an investment (cost) in the plan, however, your pension or annuity payments from a qualified plan are taxed under the Simplified Method. For more information about Keogh plans, see Publication 560, *Retirement Plans for Small Business*.

**Deferred compensation plans of state and local governments and tax-exempt organizations.** If you participate in one of these nonqualified plans (known as **Section 457 plans**), you will not be taxed currently on your pay that is deferred under the plan. You or your beneficiary will be taxed on this deferred pay only when it is distributed or otherwise made available to either of you.

Distributions of deferred pay are not eligible for the 5- or 10-year tax option and rollover treatment (discussed later). Distributions are, however, subject to the tax for failure to make minimum distributions, discussed later.

For general information on these deferred compensation plans and their limits, see *Section 457 Deferred Compensation Plans* in Publication 575.

## Cost

Before you can figure how much, if any, of your pension or annuity benefits is taxable, you must determine your cost in the plan (your investment). Your total cost in the plan includes everything that you paid. It also includes amounts your employer paid that were taxable at the time paid. Cost does not include any amounts you deducted or excluded from income.

From this total cost paid or considered paid by you, subtract any refunds of premiums, rebates, dividends, unrepaid loans, or other tax-free amounts you received by the later of the annuity starting date or the date on which you received your first payment.

The **annuity starting date** is the later of the first day of the first period for which you receive a payment from the plan or the date on which the plan's obligation becomes fixed.

Your employer or the organization that pays you the benefits (plan administrator) should show your cost in Box 5 of your Form 1099-R.

**Foreign employment contributions.** If you worked in a foreign country and your employer contributed to your retirement plan, a part of those payments may be considered part of your cost. This applies to contributions that were made either:

- 1) Before 1963, or
- 2) After December 1996 if you performed the services of a foreign missionary.

For details, see *Foreign employment contributions under Investment in the Contract (Cost)* in Publication 575.

## Simplified Method

Under the Simplified Method, you figure the tax-free part of each monthly annuity payment by dividing your cost by the total number of expected monthly payments. For an annuity that is payable for the lives of the annuitants, this number is based on the annuitants' ages on the annuity starting date and is determined from a table. For any other annuity, this number is the number of monthly annuity payments under the contract.

**Who must use the Simplified Method.** You must use the Simplified Method if your annuity starting date is after November 18, 1996, and you receive pension or annuity payments from a qualified plan or annuity unless you were at least 75 years old and entitled to annuity payments from a qualified plan that are guaranteed for 5 years or more.

**Who must use the General Rule.** You must use the General Rule if you receive pension or annuity payments from:

- 1) A nonqualified plan (such as a private annuity, a purchased commercial annuity, or a nonqualified employee plan), or
- 2) A qualified plan if you are age 75 or older on your annuity starting date and your annuity payments are guaranteed for at least 5 years (regardless of your annuity starting date).

**You can use the General Rule** for a qualified plan if your annuity starting date is before November 19, 1996 (but after July 1, 1986), and you do not qualify to use, or choose not to use, the Simplified Method.

**You cannot use the General Rule** for a qualified plan if your annuity starting date is after November 18, 1996. Complete information on the General Rule, including the tables you need, is contained in Publication 939.

**TIP** If you are age 75 or older, and your annuity starting date is after November 18, 1996, you must use the General Rule if the payments are guaranteed for at least 5 years. You must use the Simplified Method if the payments are guaranteed for fewer than 5 years.

**Note.** If you are not sure whether your retirement plan is a qualified plan (that meets certain Internal Revenue Code requirements), ask your employer or plan administrator.

**Guaranteed payments.** Your annuity contract provides guaranteed payments if a minimum number of payments or a minimum amount (for example, the amount of your investment) is payable even if you and any survivor annuitant do not live to receive the minimum. If the minimum amount is

less than the total amount of the payments you are to receive, barring death, during the first 5 years after payments begin (figured by ignoring any payment increases), you are entitled to fewer than 5 years of guaranteed payments.

If you are the survivor of a deceased retiree, you can use the Simplified Method if the retiree used it.

**Exclusion limit.** Your annuity starting date determines the total amount that you can exclude from your taxable income over the years.

If your annuity starting date is after 1986, your exclusion is limited to your cost. If it was after July 1, 1986 (and before January 1, 1987), you can continue to take your monthly exclusion for as long as you receive your annuity.

In both cases, any unrecovered cost at your (or the last annuitant's) death is allowed as a miscellaneous itemized deduction on the final return of the decedent. This deduction is not subject to the 2%-of-adjusted-gross-income limit.

**How to use it.** Complete the Simplified Method Worksheet to figure your taxable annuity for 1999. If the annuity is payable only over your life, use your age at the birthday preceding your annuity starting date. For annuity starting dates beginning in 1998, if your annuity is payable over your life and the lives of other individuals, use your combined ages at the birthdays preceding the annuity starting date.

**CAUTION** If your annuity starting date begins in 1998 and your annuity is payable over the lives of more than one annuitant, the total number of monthly annuity payments expected to be received is based on the combined ages of the annuitants at the annuity starting date. However, if your annuity starting date began before January 1, 1998, the total number of monthly annuity payments expected to be received is based on the primary annuitant's age at the annuity starting date.

**TIP** Be sure to keep a copy of the completed worksheet; it will help you figure your taxable annuity in later years.

**Example.** Bill Kirkland, age 65, began receiving retirement benefits on January 1, 1999, under a joint and survivor annuity. Bill's annuity starting date is January 1, 1999. The benefits are to be paid for the joint lives of Bill and his wife, Kathy, age 65. Bill had contributed \$31,000 to a qualified plan and had received no distributions before the annuity starting date. Bill is to receive a retirement benefit of \$1,200 a month, and Kathy is to receive a monthly survivor benefit of \$600 upon Bill's death.

Bill must use the Simplified Method to figure his taxable annuity because his payments are from a qualified plan. Because his annuity is payable over the lives of more than one annuitant, he uses his and Kathy's combined ages and Table 2 at the bottom of the worksheet in completing line 3 of the worksheet. His completed worksheet is shown in Table 11-1.

Bill's tax-free monthly amount is \$100 (\$31,000 ÷ 310 as shown on line 4 of the worksheet). Upon Bill's death, if Bill has not recovered the full \$31,000 investment,



**Table 11-1. Simplified Method Worksheet**  
(Keep for Your Records)

1. Enter the total pension or annuity payments received this year. Also, enter this amount on Form 1040, line 16a, or Form 1040A, line 11a . . . . .	1. <u>14,400</u>
2. Enter your cost in the plan at the annuity starting date plus any death benefit exclusion . . . . .	2. <u>31,000</u>
3. Enter the appropriate number from <b>Table 1</b> below. <b>But</b> if your annuity starting date was <b>after 1997</b> and the payments are for your life and that of your beneficiary, enter the appropriate number from <b>Table 2</b> below . . . . .	3. <u>310</u>
4. Divide line 2 by the number on line 3	4. <u>100</u>
5. Multiply line 4 by the number of months for which this year's payments were made. If your annuity starting date was <b>before 1987</b> , skip lines 6 and 7 and enter this amount on line 8. Otherwise, go to line 6 . . . . .	5. <u>1,200</u>
6. Enter the amount, if any, recovered tax free in years after 1986 . . . . .	6. <u>-0-</u>
7. Subtract line 6 from line 2 . . . . .	7. <u>31,000</u>
8. Enter the <b>smaller</b> of line 5 or line 7 . . . . .	8. <u>1,200</u>
9. <b>Taxable amount.</b> Subtract line 8 from line 1. Enter the result, but not less than zero. Also, enter this amount on Form 1040, line 16b, or Form 1040A, line 11b. If your Form 1099-R shows a larger amount, use the amount on this line instead of the amount from Form 1099-R . . . . .	9. <u>13,200</u>

**TABLE 1 FOR LINE 3 ABOVE**

IF the age at annuity starting date was...	AND your annuity starting date was—	
	before November 19, 1996, enter on line 3...	after November 18, 1996, enter on line 3...
55 or under	300	360
56-60	260	310
61-65	240	260
66-70	170	210
71 or older	120	160

**TABLE 2 FOR LINE 3 ABOVE**

IF the combined ages at annuity starting date were...	THEN enter on line 3...
110 or under	410
111-120	360
121-130	310
131-140	260
141 or older	210

Kathy will also exclude \$100 from her \$600 monthly payment. The full amount of any annuity payments received after 310 payments are paid must be included in gross income.

If Bill and Kathy die before 310 payments are made, a miscellaneous itemized deduction will be allowed for the unrecovered cost on the final income tax return of the last to die. This deduction is not subject to the 2%-of-adjusted-gross-income limit.

**TIP** Had Bill's retirement annuity payments been from a nonqualified plan, he would have used the General Rule. He uses the Simplified Method

*Worksheet because his annuity payments are from a qualified plan.*

**Survivors**

If you receive a survivor annuity because of the death of a retiree who had reported the annuity under the **Three-Year Rule**, include the total received in income. (The retiree's cost has already been recovered tax free.)

If the retiree was reporting the annuity payments under the **General Rule**, apply the same exclusion percentage the retiree used to your initial payment called for in the contract. The resulting tax-free amount will

then remain fixed. Any increases in the survivor annuity are fully taxable.

If the retiree was reporting the annuity payments under the **Simplified Method**, the part of each payment that is tax free is the same as the tax-free amount figured by the retiree at the annuity starting date. See *Simplified Method*, earlier.

In both cases, if the annuity starting date is after 1986, the total exclusion over the years cannot be more than the cost.

If you are the survivor of an employee, or former employee, who died before becoming entitled to any annuity payments, you must figure the taxable and tax-free parts of your annuity payments. You may qualify for the \$5,000 death benefit exclusion if the deceased individual died **before** August 21, 1996.

**Estate tax.** If your annuity was a joint and survivor annuity that was included in the decedent's estate, an estate tax may have been paid on it. You can deduct, as a miscellaneous itemized deduction, the part of the total estate tax that was based on the annuity. This deduction is not subject to the 2%-of-adjusted-gross-income limit. The deceased annuitant must have died after the annuity starting date. (For details, see section 1.691(d)-1 of the regulations.) This amount cannot be deducted in one year. It must be deducted in equal amounts over your remaining life expectancy.

**How To Report**

If you file Form 1040, report your total annuity on line 16a and the taxable part on line 16b. If your pension or annuity is fully taxable, enter it on line 16b; do not make an entry on line 16a.

If you file Form 1040A, report your total annuity on line 11a and the taxable part on line 11b. If your pension or annuity is fully taxable, enter it on line 11b; do not make an entry on line 11a.

**More than one annuity.** If you receive more than one annuity and at least one of them is not fully taxable, enter the total amount received from **all** annuities on line 16a, Form 1040, or line 11a, Form 1040A, and enter the taxable part on line 16b, Form 1040, or line 11b, Form 1040A. If all the annuities you receive are fully taxable, enter the total of all of them on line 16b, Form 1040, or line 11b, Form 1040A.

**Joint return.** If you file a joint return and you and your spouse each receive one or more pensions or annuities, report the total of the pensions and annuities on line 16a, Form 1040, or line 11a, Form 1040A, and report the taxable part on line 16b, Form 1040, or line 11b, Form 1040A.

**Lump-Sum Distributions**

You may be able to elect optional methods of figuring the tax on lump-sum distributions you receive from a qualified retirement plan (an employer's qualified pension, stock bonus, or profit-sharing plan). A qualified plan is a plan that meets certain requirements of the Internal Revenue Code. For information on a distribution you receive that includes employer securities, see *Distributions of employer securities* under *Taxation of Nonperiodic Payments* in Publication 575.

**Distributions that qualify.** A lump-sum distribution is paid within a single tax year. It is the distribution or payment of a plan participant's **entire balance** from all of the employer's qualified plans of one kind (i.e., pension, profit-sharing, or stock bonus plans). The participant's entire balance does not include deductible voluntary employee contributions or certain forfeited amounts.

The distribution is paid:

- 1) Because of the plan participant's death,
- 2) After the participant reaches age 59½,
- 3) Because the participant, if an employee, separates from service, or
- 4) After the participant, if a self-employed individual, becomes totally and permanently disabled.

**Tax treatment.** The taxable part of a lump-sum distribution is the employer's contributions and income earned on your account. You may recover your **cost** in the lump sum tax free. Also, you may be entitled to special tax treatment for the remaining part of the distribution.

**Cost.** In general, your **cost** consists of:

- 1) The plan participant's total nondeductible contributions to the plan,
- 2) The total of the plan participant's taxable costs of any life insurance contract distributed,
- 3) Any employer contributions that were taxable to the plan participant, and
- 4) Repayments of loans that were taxable to the plan participant.

You must reduce this cost by amounts previously distributed tax free.

**Capital gain treatment.** Only a plan participant who was born before 1936 can elect to treat a portion of the taxable part of a lump-sum distribution as a capital gain that is taxable at a 20% (.20) rate. This treatment applies to the portion you receive for the participation in the plan before 1974. You can elect this treatment only once for any plan participant. Use Form 4972, *Tax on Lump-Sum Distributions*, to make this choice.

**5- or 10-year tax option.** If the plan participant was born before 1936, you can elect to use the 5- or 10-year option to figure the tax on the ordinary income portion of the distribution. (This also includes the capital gain portion of the distribution if you do not elect the capital gain treatment for it.) To qualify, you must elect to use the 5- or 10-year tax option for all lump-sum distributions received in the tax year.



*If the plan participant was born after 1935 only the 5-year tax option can be used, and only the distribution was made on or after the date the participant reached age 59½.*

To qualify for the 5- or 10-year option for a distribution you receive for your own participation in the retirement plan, you must have been a participant in the plan for at least 5 full tax years. You can only make one lifetime election to use this option for any plan participant.

If you can elect to use the 5-year tax option, figure your tax using Form 4972 as

though the distribution were received over 5 years.



*For tax years beginning after 1999, the 5-year tax option for figuring the tax on lump-sum distributions from a qualified retirement plan is repealed. However, a plan participant can continue to choose the 10-year tax option or the capital gain treatment for a lump-sum distribution that qualifies for the special tax treatment.*

If you choose the 10-year tax option, you can treat the distribution as though it were received over 10 years using special tax rates. Form 4972 shows how to make this computation. The Form 4972 instructions contain a special tax rate schedule that you must use in making the 10-year tax option computation. Publication 575 illustrates how to complete Form 4972 to figure the separate tax.

**Form 1099-R.** If you receive a total distribution from a plan, you should receive a Form 1099-R. If the distribution qualifies as a lump-sum distribution, box 3 shows the capital gain, and box 2a minus box 3 is the ordinary income. If you do not get a Form 1099-R, or if you have questions about it, contact your plan administrator.

## Rollovers

Generally, a rollover is a tax-free distribution to you of cash or other assets from a qualified retirement plan that you transfer to an **eligible retirement plan**. However, see *Direct rollover option*, later.

An eligible retirement plan is an IRA, a qualified employee retirement plan, or a qualified annuity plan. See chapter 18 for information on rollovers from an IRA.



*This discussion applies only to traditional IRAs. Roth IRAs are discussed in chapter 18.*

In general, the most you can roll over is the part that would be taxable if you did not roll it over. You cannot roll over your contributions, other than your deductible employee contributions. You do not pay tax on the amount that you roll over. This amount, however, is generally taxable later when it is paid to you or your survivor.

You must complete the rollover by the 60th day following the day on which you receive the distribution. (This 60-day period is extended for the period during which the distribution is in a frozen deposit in a financial institution.) For all rollovers to an IRA, you must irrevocably elect rollover treatment by written notice to the trustee or issuer of the IRA.

**Eligible rollover distributions.** Generally, you can roll over any part of the taxable portion of most nonperiodic distributions from a qualified retirement plan, unless it is a required minimum distribution.

**Hardship distributions.** Beginning in 1999, hardship distributions from 401(k) plans and similar employer-sponsored retirement plans will no longer be treated as eligible rollover distributions.

**Direct rollover option.** You can choose to have the administrator of your old plan transfer the distribution directly from your old plan to the new plan (if permitted) or traditional IRA. If you decide on a rollover,

it is generally to your advantage to choose this direct rollover option. Under this option, the plan administrator would not withhold tax from your distribution.

**Withholding tax.** If you choose to have the distribution paid to you, it is taxable in the year distributed unless you roll it over to a new plan or IRA within 60 days. The plan administrator must withhold income tax of 20% from the taxable distribution paid to you. (See *Pensions and Annuities* under *Withholding* in chapter 5.) This means that, if you decide to roll over an amount equal to the distribution before withholding, your contribution to the new plan or IRA must include other money (for example, from savings or amounts borrowed) to replace the amount withheld. The administrator should give you a written explanation of your distribution options within a reasonable period of time before making an eligible rollover distribution.

**Deductible voluntary employee contributions.** If you receive an eligible rollover distribution from your employer's qualified plan of part of the balance of your accumulated deductible voluntary employee contributions, you can roll over tax free any part of this distribution. The rollover can be either to a traditional IRA or to certain other qualified plans.

**Rollover by surviving spouse or other beneficiary.** You may be entitled to roll over into a traditional IRA part or all of a retirement plan distribution you receive as the surviving spouse of a deceased employee. The rollover rules apply to you as if you were the employee. However, you cannot roll it over to another qualified retirement plan.

A beneficiary other than the employee's surviving spouse cannot roll over a distribution.

**Alternate payee under qualified domestic relations order.** You may be able to roll over all or any part of a distribution from a qualified employer plan that you receive under a qualified domestic relations order (QDRO). If you receive the distribution as an employee's spouse or former spouse under a QDRO, the rollover rules apply to you (the alternate payee) as if you were the employee. You can rollover the distribution from the plan into a traditional IRA or to another eligible retirement plan. See Publication 575 for more information on benefits received under a QDRO.

**Retirement bonds.** If you redeem a retirement bond, you can defer the tax on the amount received by rolling it over to an IRA or qualified employer plan as discussed under *Rollovers* in chapter 18.

**For more information** on the rules for rolling over distributions, see Publication 575.

## Tax on Early Distributions

Distributions you receive from your **qualified retirement plan or deferred annuity contract** before you reach age 59½ (and amounts you receive when you cash in retirement bonds before you reach age 59½) are usually subject to an additional tax of 10%. The tax applies to the taxable part of the distribution.

For this purpose, a **qualified retirement plan** is:

- 1) A qualified employee plan,
- 2) A qualified employee annuity plan,
- 3) A tax-sheltered annuity plan for employees of public schools or tax-exempt organizations, or
- 4) An IRA, (other than an education (Ed) IRA).

**25% rate on certain early distributions from SIMPLE IRA plans.** An early withdrawal from a SIMPLE IRA is generally subject to an additional tax of 10%. However, if the distribution is made within the first two years of participation in the SIMPLE plan, the additional tax is 25%. Your Form 1099-R should show distribution code S in box 7 if the 25% rate applies.

**5% rate on certain early distributions from deferred annuity contracts.** If an early withdrawal from a deferred annuity is otherwise subject to the 10% additional tax, a 5% rate may apply instead. A 5% rate applies to distributions under a written election providing a specific schedule for the distribution of your interest in the contract if, as of March 1, 1986, you had begun receiving payments under the election. On line 4 of Form 5329, multiply by 5% instead of 10%. Attach an explanation to your return.

**Exceptions to tax.** The early distribution tax does not apply to distributions:

- 1) Made to you on or after the date on which you reach age 59½,
- 2) Made to a beneficiary or to the estate of the plan participant or annuity holder on or after his or her death,
- 3) Made because you are totally and permanently disabled,
- 4) Made as part of a series of substantially equal periodic (at least annual) payments over your life expectancy or the joint life expectancy of you and your beneficiary (if from a qualified employee plan, payments must begin after separation from service),
- 5) Made **from an IRA only** to pay for qualified higher education expenses for yourself, your spouse, your children, or grandchildren to the extent that the distribution does not exceed the qualified higher education expenses for the taxable year,
- 6) Made **from an IRA only** to pay for a first-time home for yourself, your spouse, your children, your grandchildren, or your ancestors to the extent that the distribution is used by you within 120 days from the date of the distribution,
- 7) Made to you after you separated from service if the separation occurred during or after the calendar year in which you reached age 55,
- 8) Paid to you to the extent you have deductible medical expenses (the medical expense that exceeds 7.5% of your adjusted gross income) whether or not you itemize deductions for the tax year,
- 9) Paid to alternate payees under qualified domestic relations orders,

- 10) Made to you if, as of March 1, 1986, you separated from service and began receiving benefits from the qualified plan under a written election that provides a specific schedule of benefit payments,
- 11) Made to correct excess deferrals, excess contributions, or excess aggregate contributions,
- 12) Allocable to investment in a deferred annuity contract before August 14, 1982,
- 13) From an annuity contract under a qualified personal injury settlement,
- 14) Made under an immediate annuity contract (a single premium contract providing substantially equal annuity payments that start within one year from the date of purchase and are paid at least annually), or
- 15) Made under a deferred annuity contract purchased by your employer upon the termination of a qualified employee retirement plan or qualified annuity that is held by your employer until you separate from the service of the employer.

**TIP** *Exceptions 7, 9, 10, and 11 do not apply to IRAs. Exceptions 5 and 6 do not apply to qualified employee plans; they apply only to IRAs. However, Exceptions 1, 2, 3, 4, and 8 apply to both IRAs and qualified employee plans.*

**Reporting tax or exception.** If distribution code 1 is shown in box 7 of Form 1099-R, multiply the taxable part of the early distribution by 10% and enter the result on line 53 of Form 1040 and write "No" on the dotted line. You do not have to file Form 5329.

However, if you owe this tax and also owe any other additional tax on a distribution, you must file Form 5329 to report the taxes.

You do not have to file Form 5329 if you qualify for an exception to the 10% tax and distribution code 2, 3, or 4 is shown in box 7 of Form 1099-R. However, you must file Form 5329 if the code is not shown or the code shown is incorrect (e.g., code 1 is shown although you meet an exception).

## Tax on Excess Accumulation

To make sure that most of your retirement benefits are paid to you during your lifetime, rather than to your beneficiaries after your death, the payments that you receive from qualified retirement plans must begin no later than on your **required beginning date** (defined next).

Unless the rule for 5% owners and IRAs applies, you must begin to receive distributions from your qualified retirement plan by April 1 of the year that follows the **later of**:

- 1) The calendar year in which you reach age 70½, or
- 2) The calendar year in which you retire.

The additional tax applies to qualified employee plans, qualified employee annuity plans, deferred compensation plans under section 457, tax-sheltered annuity programs

(for benefits accruing after 1986), and IRAs (other than education (Ed) IRAs and Roth IRAs).

**Age 70½.** You reach age 70½ on the date that is 6 calendar months after the date of your 70th birthday.

For example, if you are retired and your 70th birthday was on July 1, 1998, you were age 70½ on January 1, 1999. Your required beginning date is April 1, 2000. If your 70th birthday was on June 30, 1998, you were age 70½ on December 30, 1998, and your required beginning date is April 1, 1999 unless you had not yet retired.

**Exception (5% owners).** If you are a 5% (or more) owner of the company maintaining the plan, you must begin to receive distributions by April 1 of the calendar year after the year in which you reach age 70½, regardless of when you retire.

**Minimum distributions.** These are regular periodic distributions that are large enough to use up the entire interest over your life expectancy or over the joint life expectancies of you and a designated surviving beneficiary (or over a shorter period).

**Additional information.** For more information on this rule and how to figure the required amount to be distributed, see *Tax on Excess Accumulation* in Publication 575.

**Tax on failure to distribute.** If you do not receive these required minimum distributions, you, as the payee, are subject to an additional excise tax. The tax equals 50% of the difference between the amount that must be distributed and the amount that was distributed during the tax year. You can get this excise tax excused if you establish that the shortfall in distributions was due to reasonable error and that you are taking reasonable steps to remedy the shortfall.

**State insurer delinquency proceedings.** You might not receive the minimum distribution because of state insurer delinquency proceedings for an insurance company. If your payments are reduced below the minimum due to these proceedings, you should contact your plan administrator. Under certain conditions, you will not have to pay the excise tax.

**Form 5329.** You must file a Form 5329 if you owe a tax because you did not receive a minimum required distribution from your qualified retirement plan.

## Disability Income

Generally, if you retire on disability, you must report your pension or annuity as income.

If you were 65 or older at the end of the tax year, or if you were under 65, retired on permanent and total disability, and you received taxable disability income, you may be able to claim the credit for the elderly or the disabled. See chapter 34 for more information about the credit.

**How to report.** You must report all your taxable disability income on line 7, Form 1040, or line 7, Form 1040A, until you reach minimum retirement age.

If you made contributions to your pension or annuity plan, your payments are

taxable under the rules discussed earlier, beginning with the day after you reach the **minimum retirement age**.

Generally, minimum retirement age is the age at which you would have first received a pension or annuity were you not disabled.

For more information on how to report disability pensions, including military and certain government disability pensions, see chapter 6.

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## Purchased Annuities

If you privately purchased an annuity contract from a commercial organization, such as an insurance company, you generally must use the General Rule to figure the tax-free part of each annuity payment. For more information about the General Rule, get Publication 939. Also, see *Variable Commercial Annuities* in Publication 575 for the special provisions of the General Rule that apply to these annuity contracts.

**Sale of annuity.** Gain on the sale of an annuity contract before its maturity date is ordinary income to the extent that the gain is due to interest accumulated on the contract. You do not recognize gain or loss on an exchange of an annuity contract solely for another annuity contract if the insured or annuitant remains the same.

See *Transfers of Annuity Contracts* in Publication 575 for more information about exchanges of annuity contracts. The publication also contains a brief discussion of the main features of variable commercial annuities and the rules that apply to these contracts to figure the tax-free part of each annuity payment.

# 12.

## Social Security and Equivalent Railroad Retirement Benefits

### Introduction

This chapter discusses the taxability of any social security or equivalent tier 1 railroad retirement benefits you may have received. It also explains:

- How to figure whether your benefits are taxable,
- How to use the social security benefits worksheet (with examples),
- How to report your taxable benefits on Form 1040 and Form 1040A (with examples), and
- How to treat repayments that are more than the benefits you received during the year.

Social security benefits include monthly survivor and disability benefits. They do not include supplemental security income (SSI) payments, which are not taxable.

Equivalent tier 1 railroad retirement benefits are the part of tier 1 benefits that a railroad employee or beneficiary would have been entitled to receive under the social security system. They are commonly called the social security equivalent benefit (SSEB) portion of tier 1 benefits.

If you received these benefits during 1999, you should have received a Form SSA-1099 or Form RRB-1099 (Form SSA-1042S or Form RRB-1042S if you are a nonresident alien) showing the amount.

**Note.** When the term "benefits" is used in this chapter, it applies to both social security benefits and equivalent tier 1 railroad retirement benefits.

**What is not covered in this chapter.** This chapter does not cover the tax rules for the following railroad retirement benefits:

- Non-social security equivalent benefit (NSSEB) portion of tier 1 benefits,
- Tier 2 benefits,
- Vested dual benefits, and
- Supplemental annuity benefits.

For information on these benefits see Publication 575, *Pension and Annuity Income*.

This chapter also does not cover the tax rules for foreign social security or railroad retirement benefits. These are taxable as annuities, unless they are exempt from U.S.

tax under a treaty.

### Useful Items

You may want to see:

#### Publication

- 575** Pension and Annuity Income
- 590** Individual Retirement Arrangements (IRAs) (Including Roth IRAs and Education IRAs)
- 915** Social Security and Equivalent Railroad Retirement Benefits

#### Forms (and Instructions)

- 1040-ES** Estimated Tax for Individuals
- W-4V** Voluntary Withholding Request

## Are Any of Your Benefits Taxable?

To find out whether any of your benefits are taxable, compare the **base amount** for your filing status with the total of:

- 1) One-half of your benefits, plus
- 2) All your other income, including tax-exempt interest.

**Exclusions.** When making this comparison, do not reduce your income by any exclusions for:

- Interest from qualified U.S. savings bonds,
- Employer-provided adoption benefits,
- Foreign earned income or foreign housing, or
- Income earned in American Samoa or Puerto Rico by bona fide residents.

**TIP** RRB issues Form RRB-1099 and Form RRB-1042S while SSA issues Form SSA-1099 and Form SSA-1042S. These forms (tax statements) report the amounts paid, repaid, and taxes withheld for a tax year. You may receive more than one Form RRB-1099, Form RRB-1042S, Form SSA-1099, and/or Form SSA-1042S for the same tax year. You should add the amounts shown on all forms you receive from the SSA and/or RRB for the same tax year to determine the total amounts paid, repaid, and taxes withheld for that tax year. See the Appendix at the end of Publication 915 for more information on these forms.

**Figuring total income.** To figure the total of one-half of your benefits plus your other income, use the worksheet later in this discussion. If the total is more than your base amount, part of your benefits is taxable.

**TIP** If the only income you received during 1999 was your social security or the SSEB portion of tier 1 railroad retirement benefits, your benefits generally are not taxable and you probably do not have to file a return. If you have income in addition to your benefits, you may have to file a return even if none of your benefits are taxable.

If you are married and file a joint return for 1999, you and your spouse must combine your incomes and your benefits to figure whether any of your combined benefits are taxable. Even if your spouse did not receive any benefits, you must add your spouse's income to yours to figure whether any of your benefits are taxable.

**Base amount.** Your base amount is:

- \$25,000 if you are single, head of household, or qualifying widow(er),
- \$25,000 if you are married filing separately and **lived apart** from your spouse for **all** of 1999,
- \$32,000 if you are married filing jointly, or
- \$-0- if you are married filing separately and **lived with** your spouse at any time during 1999.

**Worksheet.** You can use the following worksheet to figure the amount of income to compare with your base amount. This is a quick way to check whether some of your benefits may be taxable.

- Write in the amount from **box 5** of all your Forms SSA-1099 and RRB-1099. Include the full amount of any lump-sum benefit payments received in 1999, for 1999 and earlier years. (If you received more than one form, combine the amounts from box 5 and write in the total.) A. \_\_\_\_\_
- Enter one-half of the amount on line A B. \_\_\_\_\_
- Add your taxable pensions, wages, interest, dividends, and other taxable income and write in the total ... C. \_\_\_\_\_
- Write in any tax-exempt interest income (such as interest on municipal bonds) plus any exclusions from income shown in the list under **Exclusions**, earlier. D. \_\_\_\_\_
- Add lines B, C, and D and write in the total E. \_\_\_\_\_

**Note.** Compare the amount on line E to your **base amount** for your filing status. If the amount on line E equals or is less than the **base amount** for your filing status, none of your benefits are taxable this year. If the amount on line E is more than your **base amount**, some of your benefits may be taxable. You need to complete Worksheet 1 in Publication 915 (or in your tax form instruction booklet) to find out if they are.

**Example.** You and your spouse are filing a joint return for 1999, and you both received social security benefits during the year. In January 2000, you received a Form SSA-1099 showing net benefits of \$6,600 in box 5. Your spouse received a Form SSA-1099 showing net benefits of \$2,400 in box 5. You also received a taxable pension of \$10,000 and interest income of \$500. You did not have any tax-exempt interest income. Your benefits are not taxable for 1999 because your income, as figured in the following worksheet, is not more than your base amount (\$32,000).

A. Write in the amount from **box 5** of all your Forms SSA-1099 and RRB-1099. Include the full amount of any lump-sum benefit payments received in 1999, for 1999 and earlier years. (If you received more than one form, combine the amounts from box 5 and write in the total.) A. \$ 9,000

**Note.** If the amount on line A is zero or less, stop here; none of your benefits are taxable this year.

B. Enter one-half of the amount on line A ..... B. 4,500

C. Add your taxable pensions, wages, interest, dividends, and other taxable income and write in the total ... C. 10,500

D. Write in any tax-exempt interest income (such as interest on municipal bonds) plus any exclusions from income shown in the list under Exclusions, earlier. .... D. -0-

E. Add lines B, C, and D and write in the total ..... E. \$15,000


**Note.** Compare the amount on line E to your **base amount** for your filing status. If the amount on line E equals or is less than the **base amount** for your filing status, none of your benefits are taxable this year. If the amount on line E is more than your **base amount**, some of your benefits may be taxable. You need to complete Worksheet 1 in Publication 915 (or in your tax form instruction booklet) to find out if they are.

**Who is taxed.** The person who has the legal right to receive the benefits must determine whether the benefits are taxable. For example, if you and your child receive benefits, but the check for your child is made out in your name, you must use only your part of the benefits to see whether any benefits are taxable to you. The part that belongs to your child must be added to your child's other income to see whether any of those benefits are taxable to the child.

**Repayment of benefits.** Any repayment of benefits you made during 1999 must be subtracted from the gross benefits you received in 1999. It does not matter whether the repayment was for a benefit you received in 1999 or in an earlier year. If you repaid more than the gross benefits you received in 1999, see *Repayments More Than Gross Benefits*, later.

Your gross benefits are shown in box 3 of Form SSA-1099 or RRB-1099. Your repayments are shown in box 4. The amount in box 5 shows your net benefits for 1999 (box 3 minus box 4). Use the amount in box 5 to figure whether any of your benefits are taxable.

**Tax withholding and estimated tax.** You can choose to have federal income tax withheld from your social security benefits and/or the SSEB portion of your tier 1 railroad retirement benefits. If you choose to do this, you must complete a Form W-4V. You can choose withholding at 7%, 15%, 28%, or 31% of your total benefit payment.

 If part of your benefits is taxable, you may have to request additional withholding from other income or pay estimated tax during the year. For details, get Publication 505 or the instructions for Form 1040-ES.

## How To Report Your Benefits

If part of your benefits is taxable, you must use Form 1040 or Form 1040A. You cannot use Form 1040EZ.

**Reporting on Form 1040.** Report your net benefits (the amount in box 5 of your Form SSA-1099 or Form RRB-1099) on line 20a and the taxable part on line 20b. If you are married filing separately and you lived apart from your spouse for all of 1999, also enter "D" to the left of line 20a.

**Reporting on Form 1040A.** Report your net benefits (the amount in box 5 of your Form SSA-1099 or Form RRB-1099) on line 13a and the taxable part on line 13b. If you are married filing separately and you lived apart from your spouse for all of 1999, also enter "D" to the right of the word "benefits" on line 13a.

**Benefits not taxable.** If none of your benefits are taxable, do not report any of them on your tax return. But if you are married filing separately and you lived apart from your spouse for all of 1999, make the following entries. On Form 1040, enter "D" to the left of line 20a and "-0-" on line 20b. On Form 1040A, enter "D" to the right of the word "benefits" on line 13a and "-0-" on line 13b.

## How Much Is Taxable?

If part of your benefits is taxable, how much is taxable depends on the total amount of your benefits and other income. Generally, the higher that total amount, the greater the taxable part of your benefits.

**Maximum taxable part.** The taxable part of your benefits cannot usually be more than 50%. However, up to 85% of your benefits can be taxable, if either of the following situations applies to you.

- 1) The total of one-half of your benefits and all your other income is more than \$34,000 (\$44,000 if you are married filing jointly).
- 2) You are married filing separately and **lived with your spouse** at any time during 1999.


**Which worksheet to use.** A worksheet to figure your taxable benefits is in the instructions for your tax form. You can use either that worksheet or Worksheet 1 in Publication 915, unless any of the following situations applies to you.

- 1) You contributed to a traditional individual retirement arrangement (IRA) and your IRA deduction is limited because you or your spouse is covered by a retirement plan at work. In this situation you **must** use the special worksheets in Appendix B of Publication 590 to figure both your IRA deduction and your taxable benefits.
- 2) Situation (1) does not apply and you take an exclusion for interest from qualified U.S. savings bonds (Form 8815), for adoption benefits (Form

8839), for foreign earned income or housing (Form 2555 or Form 2555-EZ), or for income earned in American Samoa (Form 4563) or Puerto Rico by bona fide residents. In this situation, you **must** use Worksheet 1 in Publication 915 to figure your taxable benefits.


- 3) You received a lump-sum payment for an earlier year. In this situation, also complete Worksheet 2 or 3 and Worksheet 4 in Publication 915. See *Lump-sum election*.

**Lump-sum election.** You must include the taxable part of a lump-sum (retroactive) payment of benefits received in 1999 in your 1999 income, even if the payment includes benefits for an earlier year.

 This type of lump-sum benefit payment should not be confused with the lump-sum death benefit that both the SSA and RRB pay to many of their beneficiaries. No part of the lump-sum death benefit is subject to tax.

Generally, you use your 1999 income to figure the taxable part of the total benefits received in 1999. However, you may be able to figure the taxable part of a lump-sum payment for an earlier year separately, using your income for the earlier year. You can elect this method if it lowers your taxable benefits.

**Making the election.** If you received a lump-sum benefit payment in 1999 that includes benefits for one or more earlier years, follow the instructions in Publication 915 under *Lump-Sum Election* to see whether making the election will lower your taxable benefits. That discussion also explains how to make the election.

 Since the earlier year's taxable benefits are included in your 1999 income, no adjustment is made to the earlier year's return. **Do not** file an amended return for the earlier year.

## Examples

Following are a few examples you can use as a guide to figure the taxable part of your benefits.

**Example 1.** George White is single and files Form 1040 for 1999. He received the following income in 1999:

Fully taxable pension .....	\$18,600
Wages from part-time job .....	9,400
Taxable Interest income .....	990
Total .....	<u>\$28,990</u>

George also received social security benefits during 1999. The Form SSA-1099 he received in January 2000 shows \$5,980 in box 5. To figure his taxable benefits, George completes the worksheet shown here.

Worksheet 1. Social Security and Equivalent Railroad Retirement Benefits

1. Enter the total amount from **box 5** of **ALL your Forms SSA-1099 and RRB-1099** ..... 5,980

**Note.** If line 1 is zero or less, stop here; none of your benefits are taxable. Otherwise, go on to line 2.

2. Enter one-half of line 1 ..... 2,990  
 3. Enter the total of the amounts from:  
**Form 1040:** Lines 7, 8a, 8b, 9-14, 15b, 16b, 17-19, and 21.  
**Form 1040A:** lines 7, 8a, 8b, 9, 10b, 11b, and 12 ..... 28,990

4. **Form 1040A filers:** Enter the total of any exclusions for qualified U.S. savings bond interest (Form 8815, line 14) or for adoption benefits (Form 8839, line 30).

**Form 1040 filers:** Enter the total of any exclusions/adjustments for:

- Qualified U.S. savings bond interest ( Form 8815, line 14),
- Adoption benefits ( Form 8839, line 30),
- Foreign earned income or housing ( Form 2555, lines 43 and 48, or Form 2555-EZ, line 18),
- Certain income of bona fide residents of American Samoa (Form 4563, line 15) or Puerto Rico

5. Add lines 2, 3, and 4 ..... 31,980  
 6. **Form 1040A filers:** Enter the amount from Form 1040A, line 15  
**Form 1040 filers:** Enter the amount from Form 1040, line 32, minus any amount on Form 1040, line 24 ..... -0-  
 7. Subtract line 6 from line 5 ..... 31,980  
 8. Enter \$25,000 (\$32,000 if married filing jointly; \$0 if married filing separately and you lived with your spouse at any time during 1999) ..... 25,000  
 9. Subtract line 8 from line 7. If zero or less, enter -0- ..... 6,980

**Note.** If line 9 is zero or less, stop here; none of your benefits are taxable. (Do not enter any amounts on Form 1040, line 20a or 20b, or on Form 1040A, line 13a or 13b. But if you are married filing separately and you lived apart from your spouse for all of 1999, enter "D" to the left of line 20a, Form 1040, or to the right of the word "benefits" on line 13a, Form 1040A. Also enter -0- on Form 1040, line 20b or on Form 1040A, line 13b.) Otherwise, go on to line 10.

10. Enter \$9,000 (\$12,000 if married filing jointly; \$0 if married filing separately and you lived with your spouse at any time in 1999) ..... 9,000  
 11. Subtract line 10 from line 9. If zero or less, enter -0- ..... -0-  
 12. Enter the **smaller** of line 9 or line 10 ..... 6,980  
 13. Enter one-half of line 12 ..... 3,490  
 14. Enter the **smaller** of line 2 or line 13 ..... 2,990  
 15. Multiply line 11 by 85% (.85). If line 11 is zero, enter -0- ..... -0-  
 16. Add lines 14 and 15 ..... 2,990  
 17. Multiply line 1 by 85% (.85) ..... 5,083

18. **Taxable benefits.** Enter the smaller of line 16 or line 17 ..... 2,990  
 • Enter the amount from line 1 above on Form 1040, line 20a or on Form 1040A, line 13a.  
 • Enter the amount from line 18 above on Form 1040, line 20b or on Form 1040A, line 13b

The amount on line 18 of George's worksheet shows that \$2,990 of his social security benefits is taxable. On line 20a of his Form 1040, George enters his net benefits of \$5,980. On line 20b, he enters his taxable part of \$2,990.

**Example 2.** Ray and Alice Hopkins file a joint return on Form 1040A for 1999. Ray is retired and received a fully taxable pension of \$15,500. Ray also received social security benefits and his Form SSA-1099 for 1999 shows net benefits of \$5,600 in box 5. Alice worked during the year and had wages of \$14,000. She made a deductible payment to her IRA account of \$1,000. Ray and Alice have two savings accounts with a total of \$250 in interest income. They complete Worksheet 1 and find that none of Ray's social security benefits are taxable. They leave lines 13a and 13b of their Form 1040A blank.

Worksheet 1. Social Security and Equivalent Railroad Retirement Benefits

1. Enter the total amount from **box 5** of **ALL your Forms SSA-1099 and RRB-1099** ..... 5,600

**Note.** If line 1 is zero or less, stop here; none of your benefits are taxable. Otherwise, go on to line 2.

2. Enter one-half of line 1 ..... 2,800  
 3. Enter the total of the amounts from:  
**Form 1040:** Lines 7, 8a, 8b, 9-14, 15b, 16b, 17-19, and 21.  
**Form 1040A:** lines 7, 8a, 8b, 9, 10b, 11b, and 12 ..... 29,750

4. **Form 1040A filers:** Enter the total of any exclusion for qualified U.S. savings bond interest (Form 8815, line 14) or adoption benefits (Form 8839, line 30).

**Form 1040 filers:** Enter the total of any exclusions/adjustments for:

- Qualified U.S. savings bond interest (Form 8815, line 14),
- Adoption benefits ( Form 8839, line 30),
- Foreign earned income or housing (Form 2555, lines 43 and 48, or Form 2555-EZ, line 18), and
- Certain income of bona fide residents of American Samoa (Form 4563, line 15) or Puerto Rico

5. Add lines 2, 3, and 4 ..... 32,550  
 6. **Form 1040A filers:** Enter the amount from Form 1040A, line 15  
**Form 1040 filers:** Enter the amount from Form 1040, line 32, minus any amount on Form 1040, line 24 ..... 1,000  
 7. Subtract line 6 from line 5 ..... 31,550  
 8. Enter \$25,000 (\$32,000 if married filing jointly; \$0 if married filing separately and you lived with your spouse at any time during 1999) ..... 32,000  
 9. Subtract line 8 from line 7. If zero or less, enter -0- ..... -0-

**Note.** If line 9 is zero or less, stop here; none of your benefits are taxable. (Do not enter any amounts on Form 1040, line 20a or 20b, or on Form 1040A, line 13a or 13b. But if you are married filing separately and you lived apart from your spouse for all of 1999, enter "D" to the left of line 20a, Form 1040, or to the right of the word "benefits" on line 13a, Form 1040A. Also enter -0- on Form 1040, line 20b or on Form 1040A, line 13b.) Otherwise, go on to line 10.

10. Enter \$9,000 (\$12,000 if married filing jointly; \$0 if married filing separately and you lived with your spouse at any time in 1999) .....  
 11. Subtract line 10 from line 9. If zero or less, enter -0- .....  
 12. Enter the **smaller** of line 9 or line 10 .....  
 13. Enter one-half of line 12 .....  
 14. Enter the **smaller** of line 2 or line 13 .....

15. Multiply line 11 by 85% (.85). If line 11 is zero, enter -0- .....  
 16. Add lines 14 and 15 .....  
 17. Multiply line 1 by 85% (.85) .....  
 18. **Taxable benefits.** Enter the smaller of line 16 or line 17 .....  
 • Enter the amount from line 1 above on Form 1040, line 20a or on Form 1040A, line 13a.  
 • Enter the amount from line 18 above on Form 1040, line 20b or on Form 1040A, line 13b

**Example 3.** Joe and Betty Johnson file a joint return on Form 1040 for 1999. Joe is a retired railroad worker and in 1999 received the social security equivalent benefit (SSEB) portion of tier 1 railroad retirement benefits. Joe's Form RRB-1099 shows \$10,000 in box 5. Betty is a retired government worker and receives a fully taxable pension of \$38,000. They had \$2,300 in interest income plus interest of \$200 on a qualified U.S. savings bond. The savings bond interest qualified for exclusion. They figure their taxable benefits by completing Worksheet 1.

Worksheet 1. Social Security and Equivalent Railroad Retirement Benefits

1. Enter the total amount from **box 5** of **ALL your Forms SSA-1099 and RRB-1099** ..... 10,000

**Note.** If line 1 is zero or less, stop here; none of your benefits are taxable. Otherwise, go on to line 2.

2. Enter one-half of line 1 ..... 5,000  
 3. Enter the total of the amounts from:  
**Form 1040:** Lines 7, 8a, 8b, 9-14, 15b, 16b, 17-19, and 21.  
**Form 1040A:** lines 7, 8a, 8b, 9, 10b, 11b, and 12 ..... 40,300

4. **Form 1040A filers:** Enter the total of any exclusion for qualified U.S. savings bond interest (Form 8815, line 14) or adoption benefits (Form 8839, line 30).

**Form 1040 filers:** Enter the total of any exclusions/adjustments for:

- Qualified U.S. savings bond interest (Form 8815, line 14),
- Adoption benefits ( Form 8839, line 30),
- Foreign earned income or housing (Form 2555, lines 43 and 48, or Form 2555-EZ, line 18), and
- Certain income of bona fide residents of American Samoa (Form 4563, line 15) or Puerto Rico

5. Add lines 2, 3, and 4 ..... 45,500  
 6. **Form 1040A filers:** Enter the amount from Form 1040A, line 15  
**Form 1040 filers:** Enter the amount from Form 1040, line 32, minus any amount on Form 1040, line 24 ..... -0-  
 7. Subtract line 6 from line 5 ..... 45,500  
 8. Enter \$25,000 (\$32,000 if married filing jointly; \$0 if married filing separately and you lived with your spouse at any time during 1999) ..... 32,000

9. Subtract line 8 from line 7. If zero or less, enter -0- .....	13,500
<b>Note.</b> If line 9 is zero or less, stop here; none of your benefits are taxable. (Do not enter any amounts on Form 1040, line 20a or 20b, or on Form 1040A, line 13a or 13b. But if you are married filing separately and you lived apart from your spouse for all of 1999, enter "D" to the left of line 20a, Form 1040, or to the right of the word "benefits" on line 13a, Form 1040A. Also enter -0- on Form 1040, line 20b or on Form 1040A, line 13b.) Otherwise, go on to line 10.	
10. Enter \$9,000 (\$12,000 if married filing jointly; \$0 if married filing separately and you lived with your spouse at any time in 1999) .....	12,000
11. Subtract line 10 from line 9. If zero or less, enter -0- .....	1,500
12. Enter the <b>smaller</b> of line 9 or line 10 .....	12,000
13. Enter one-half of line 12 .....	6,000
14. Enter the <b>smaller</b> of line 2 or line 13 .....	5,000
15. Multiply line 11 by 85% (.85). If line 11 is zero, enter -0- .....	1,275
16. Add lines 14 and 15 .....	6,275
17. Multiply line 1 by 85% (.85) .....	8,500
18. <b>Taxable benefits.</b> Enter the <b>smaller</b> of line 16 or line 17 .....	6,275
<ul style="list-style-type: none"> <li>• Enter the amount from line 1 above on Form 1040, line 20a or on Form 1040A, line 13a.</li> <li>• Enter the amount from line 18 above on Form 1040, line 20b or on Form 1040A, line 13b.</li> </ul>	

## Deductions Related to Your Benefits

You may be entitled to deduct certain amounts related to the benefits you receive.

**Disability payments.** You may have received disability payments from your employer or an insurance company that you included as income on your tax return in an earlier year. If you received a lump-sum

payment from SSA or RRB, and you had to repay the employer or insurance company for the disability payments, you can take an itemized deduction for the part of the payments you included in gross income in the earlier year. If the amount you repay is more than \$3,000, you may be able to claim a tax credit instead. Claim the deduction or credit in the same way explained under *Repayments More Than Gross Benefits*, later.

**Legal expenses.** You can usually deduct legal expenses that you pay or incur to produce or collect taxable income or in connection with the determination, collection, or refund of any tax.

## Repayments More Than Gross Benefits

In some situations, your Form SSA-1099 or Form RRB-1099 will show that the total benefits you repaid (box 4) are more than the gross benefits (box 3) you received. If this occurred, your net benefits in box 5 will be a negative figure (a figure in parentheses) and none of your benefits will be taxable. If you receive more than one form, a negative figure in box 5 of one form is used to offset a positive figure in box 5 of another form for that same year.

If you have any questions about this negative figure, contact your local SSA office or your local U.S. RRB field office.

**Joint return.** If you and your spouse file a joint return, and your Form SSA-1099 or RRB-1099 has a negative figure in box 5, but your spouse's does not, subtract the amount in box 5 of your form from the amount in box 5 of your spouse's form. You do this to get your net benefits when figuring if your combined benefits are taxable.

**Example.** John and Mary file a joint return for 1999. John received Form SSA-1099 showing \$3,000 in box 5. Mary also received Form SSA-1099 and the amount in box 5 was (\$500). John and Mary will use \$2,500 (\$3,000 minus \$500) as the amount of their net benefits when figuring if any of their combined benefits are taxable.

**Repayment of benefits received in an earlier year.** If the total amount shown in box 5 of all of your Forms SSA-1099 and RRB-1099 is a negative figure, you can take an itemized deduction for the part of this negative figure that represents benefits you included in gross income in an earlier year.

If this deduction is **\$3,000 or less**, it is subject to the 2%-of-adjusted-gross-income limit that applies to certain miscellaneous itemized deductions. Claim it on line 22, Schedule A (Form 1040).

If this deduction is **more than \$3,000**, you should figure your tax two ways:

- 1) Figure your tax for 1999 with the itemized deduction. This more-than-\$3,000 deduction is **not** subject to the 2%-of-adjusted-gross-income limit that applies to certain miscellaneous itemized deductions.
- 2) Figure your tax for 1999 in the following steps:
  - a) Figure the tax without the itemized deduction.
  - b) For each year after 1983 for which part of the negative figure represents a repayment of benefits, refigure your taxable benefits as if your total benefits for the year were reduced by that part of the negative figure. Then refigure the tax for that year.
  - c) Subtract the total of the refigured tax amounts in (b) from the total of your actual tax amounts.
  - d) Subtract the result in (c) from the result in (a).

Compare the tax figured in methods (1) and (2). Your tax for 1999 is the smaller of the two amounts. If method (1) results in less tax, take the itemized deduction on line 27, Schedule A (Form 1040). If method (2) results in less tax, claim a credit for the applicable amount on line 63 of Form 1040 and write "I.R.C. 1341" in the margin to the left of line 63. If both methods produce the same tax, deduct the repayment on line 27, Schedule A (Form 1040).



# 13.

## Other Income

### Introduction

This chapter discusses many kinds of income and explains whether they are taxable or nontaxable.

- Income that is taxable must be reported on your tax 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.

You must include on your return all income you receive in the form of money, property, and services unless the tax law states that you do not include them. Some items, however, are only partly excluded from income. They are listed and discussed briefly in this chapter.

### Useful Items

You may want to see:

#### Publication

- 520** Scholarships and Fellowships
- 525** Taxable and Nontaxable Income
- 544** Sales and Other Dispositions of Assets
- 550** Investment Income and Expenses

### Miscellaneous Taxable Income

This section begins with brief discussions of many income items arranged in alphabetical order. These discussions are followed by discussions of other taxable income items which are discussed in greater detail as follows:

- Bartering,
- Canceled debts,
- Recoveries (including state income tax refunds),
- Rental of personal property,
- Repayments, and
- Royalties.

**TIP** When you report miscellaneous taxable income on line 21 of Form 1040, write a brief description of the income on the dotted line next to line 21.

**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. Enter this income on line 21 of Form 1040. 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). See *Not-for-Profit Activities* in chapter 1 of Publication 535, *Business Expenses*, for information on whether an activity is considered carried on for a profit.

**Alaska Permanent Fund dividend income.** If you received a payment from Alaska's mineral income fund (Alaska Permanent Fund dividend), you should report this amount on line 21 of Form 1040. The state of Alaska sends each recipient a document that shows this amount with the check. The amount is also reported to IRS.

**TIP** If you otherwise qualify to use Form 1040A or 1040EZ, you can report the Alaska Permanent Fund dividend on line 12 of Form 1040A or line 3 of Form 1040EZ. See your form instructions.

**Alimony.** Include in your income on line 11 of Form 1040 any alimony payments you receive. Amounts you receive for child support are not income to you. Alimony and child support payments are discussed in chapter 20.

**Court awards and damages.** 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. See *Punitive damages*, later.
- 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) Back pay and damages for emotional distress received to satisfy a claim under Title VII of the Civil Rights Act of 1964.

Do not include in your income compensatory damages for personal physical injury or physical sickness (whether received in a lump sum or installments).

**Emotional distress.** Damages you receive for emotional distress due to a physical injury or sickness are treated as received for the physical injury or sickness. Do not include them in your income. If the emotional distress is due to a personal injury that is unrelated to a physical injury or sickness (for example, employment discrimination or injury to reputation), you must include the damages in your income, except for any damages you receive for medical care due to that emotional distress. 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.

For more information on punitive damages, get Publication 525.

**Credit card insurance.** Generally, if you receive benefits under a credit card disability or unemployment insurance plan, the benefits are taxable to you. These plans make the minimum monthly payment on your credit card account if you cannot make the payment due to injury, illness, disability, or unemployment. Report on line 21 of Form 1040 the amount of benefits you receive during the year that is more than the amount of the premiums you paid during the year.

**Estate and trust income.** An estate or trust, unlike a partnership, may have to pay federal income tax. If you are a beneficiary of an estate or trust, you may be taxed on your share of its income distributed or required to be distributed to you. However, there is never a double tax. Estates and trusts file their returns on Form 1041, *U.S. Income Tax Return for Estates and Trusts*, and your share of the income is reported to you on Schedule K-1 of Form 1041.

**Current income required to be distributed.** If you are the beneficiary of a trust that must distribute all of its current income, you must report your share of the distributable net income whether or not you have actually received it.

**Current income not required to be distributed.** If you are the beneficiary of an estate or trust and the fiduciary has the choice of whether to distribute all or part of the current income, you must report:

- 1) All income that is required to be distributed to you, whether or not it is actually distributed, plus
- 2) All other amounts actually paid or credited to you,

up to the amount of your share of distributable net income.

**How to report.** Treat each item of income the same way that the estate or trust would treat it. For example, if a trust's dividend income is distributed to you, you report the distribution as dividend income on your return. The same rule applies to distributions of tax-exempt interest and capital gains.

The fiduciary of the estate or trust must tell you the type of items making up your share of the estate or trust income and any credits you are allowed on your individual income tax return.

**Losses.** Losses of estates and trusts generally are not deductible by the beneficiaries.

**Grantor trust.** Income earned by a grantor trust is taxable to the grantor, not the beneficiary, if the grantor keeps certain control over the trust. This rule applies if the property (or income from the property) put into the trust will or may revert (be returned) to the grantor or the grantor's spouse. The grantor is the one who transferred property to the trust.

Generally, a trust is a grantor trust if the grantor has a reversionary interest valued (at the date of transfer) at more than 5% of the value of the transferred property.

**Fees for services.** Include all fees for your services in your gross income. Examples of these fees are amounts you receive for services you perform as:

- 1) A corporate director,
- 2) An executor or administrator of an estate,
- 3) A notary public, or
- 4) An election precinct official.



*If you are not an employee and the fees for your services from the same payer total \$600 or more for the year, you may receive a Form 1099-MISC.*

**Corporate director.** Corporate director fees are self-employment income. Report these payments on Schedule C (Form 1040) or Schedule C-EZ (Form 1040).

**Executor or administrator of an estate.** If you are not in the trade or business of being an executor (for instance, you are the executor of a friend's or relative's estate), report these fees on line 21 of Form 1040. If you provide the services as a trade or business, report them as self-employment income on Schedule C (Form 1040) or Schedule C-EZ (Form 1040).

**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.

**Election precinct official.** You should receive a Form W-2 showing payments for services performed as an election official or election worker. Report these payments on line 7 of Form 1040 or Form 1040A, or on line 1 of Form 1040EZ.

**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 line 21 of Form 1040, if you are not in the trade or business of organizing tours. You cannot deduct your expenses in serving as the voluntary leader of the group at the group's request. If you organize tours as a trade or business, report the tour's value on Schedule C (Form 1040) or Schedule C-EZ (Form 1040).

**Gambling winnings.** You must include your gambling winnings in income on line 21 of 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. See chapter 30 for information on recordkeeping.

**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.



*If you win a state lottery prize payable in installments, see Publication 525 for more information.*

**Form W-2G.** You may have received a Form W-2G showing the amount of your gambling winnings and any tax taken out of them. Include the amount from box 1 on line 21 of Form 1040. Be sure to include any amount from box 2 on line 57 of Form 1040.

**Hobby losses.** Losses from a hobby are not deductible from other income. A hobby is an activity from which you do not expect to make a profit. See *Activity not for profit*, earlier.



*If you collect stamps, coins, or other items as a hobby for recreation and pleasure, and you sell any of the items, your gain is taxable as a capital gain. (See chapter 17.) However, if you sell items from your collection at a loss, you cannot deduct a net loss.*

**Illegal income.** Illegal income, such as stolen or embezzled funds, must be included in your gross income on line 21 of Form 1040, or on Schedule C or Schedule C-EZ (Form 1040) if from your self-employment activity.

**Indian fishing rights.** If you are a member of a qualified Indian tribe that has fishing rights secured by treaty, executive order, or an Act of Congress as of March 17, 1988, do not include in your income amounts you receive from activities related to those fishing rights. The income is not subject to income tax, self-employment tax, or employment taxes.

**Jury duty.** Jury duty pay you receive must be included in your income on line 21 of 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 your income. Include the amount you repay your employer on line 32 of Form 1040. Write "Jury Pay" and the amount on the dotted line next to line 32.

**Kickbacks.** You must include kickbacks, side commissions, push money, or similar payments you receive in your income on line 21 of Form 1040, or on Schedule C or Schedule C-EZ (Form 1040), if from your self-employment activity.

**Example.** You sell cars and help arrange car insurance for buyers. Insurance brokers pay back part of their commissions to you for referring customers to them. You must include the kickbacks in your income.

**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 line 21 of Form 1040. If you refuse to accept a prize, do not include its value in your income.

Prizes and awards in goods or services must be included in your income at their fair market value.

**Employee awards or bonuses.** Cash awards or bonuses given to you by your employer for good work or suggestions generally must be included in your income as wages. However, certain noncash employee achievement awards can be excluded from your income. See *Bonuses and awards* in chapter 6.

**Pulitzer, Nobel, and similar prizes.** If you were awarded a prize in recognition of past accomplishments in religious, charitable, scientific, artistic, educational, literary, or civic fields, you generally must include

the value of the prize in your income. However, you do not include this prize in your income if you meet **all** of the following requirements.

- 1) You were selected without any action on your part to enter the contest or proceeding.
- 2) You are not required to perform substantial future services as a condition to receiving the prize or award.
- 3) The prize or award is transferred by the payer directly to a governmental unit or tax-exempt charitable organization as designated by you.

See Publication 525 for more information about the conditions that apply to the transfer.

**State tuition programs.** If you receive distributions from a qualified state tuition program, only the amount that is more than the amount contributed to the program is taxable.

Qualified state tuition programs are defined in Publication 525. For more information on a specific program, contact the state or agency that established and maintains it.

**Sale of personal items.** If you sold an item you owned for personal use, such as a car, refrigerator, furniture, stereo, jewelry, or silverware, your gain is taxable as a capital gain. Report it on Schedule D (Form 1040). You cannot deduct a loss.

However, if you sold an item you held for investment, such as gold or silver bullion, coins, or gems, any gain is taxable as a capital gain and any loss is deductible as a capital loss.

## 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.

Generally, you report this income on Schedule C or Schedule C-EZ (Form 1040). But if the barter involves exchange of something other than services, you may have to use another form or schedule instead.

**Example 1.** You are a self-employed attorney who performs legal services for a client, a small corporation. The corporation gives you shares of its stock as payment for your services. You must include the fair market value of the shares in your income on Schedule C or Schedule C-EZ (Form 1040) in the year that you receive them.

**Example 2.** You are self-employed and a member of a barter club. The club uses "credit units" as a means of exchange. It adds credit units to your account for goods or services you provide to members, which you can use to purchase goods and services offered by other members of the barter club. The club subtracts credit units from your account when you receive goods or services from other members. You must in-

clude in income the value of credit units that are added to your account, even though you may not actually receive goods or services from other members until a later tax year.

**Example 3.** You own a small apartment building. In return for 6 months' rent-free use of an apartment, an artist gives you a work of art that she created. You must report as rental income on Schedule E (Form 1040) the fair market value of the art work, and the artist must report as income on Schedule C or Schedule C-EZ (Form 1040) the fair rental value of the apartment.

**Form 1099-B from barter exchange.** If you exchanged property or services through a barter exchange, you should receive Form 1099-B or a similar statement from the barter exchange by January 31, 2000. It should show the value of cash, property, services, credits, or scrip you received from exchanges during the year. The IRS will also receive a copy of Form 1099-B.

## 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.

If the debt is a nonbusiness debt, report the canceled amount on line 21 of Form 1040. If it is a business debt, report the amount on Schedule C or C-EZ (Form 1040) (or on Schedule F (Form 1040) if you are a farmer).

**Form 1099-C.** If a federal government agency, financial institution, or credit union cancels or forgives a debt you owe of \$600 or more, you will receive a Form 1099-C, *Cancellation of Debt*. The amount of the canceled debt is shown in box 2.

**Interest included in canceled debt.** If any interest is forgiven and included in the amount of canceled debt in box 2, the amount of interest will also be shown in box 3. Whether or not you must include the interest portion of the canceled debt in your gross income depends on whether the interest would be deductible if you paid it. See *Deductible debts*, under *Exceptions*, later.

If the interest would not be deductible (such as interest on a personal loan), include in your income the amount from box 2 of Form 1099-C. If the interest would be deductible (such as on a business loan), include in your income the net amount of the canceled debt (the amount shown in box 2 less the interest amount shown in box 3).

**Discounted 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.

**Stockholder debt.** If you are a stockholder in a corporation and the corporation cancels or forgives your debt to it, the canceled debt is dividend income to you.

If you are a stockholder in a corporation and you cancel a debt owed to you by the

corporation, you generally do not realize income. This is because the canceled debt is considered as a contribution to the capital of the corporation equal to the amount of debt principal that you canceled.

## Exceptions

There are several exceptions to the inclusion of canceled debt in income. These are explained next.

**Nonrecourse debt.** If you are not personally liable for the debt (nonrecourse debt), different rules apply. You may have a gain or loss if nonrecourse debt is canceled or forgiven in conjunction with the foreclosure or repossession of property to which the debt attaches. See Publication 544 for more information.

**Student loans.** Certain student loans contain a provision that all or part of the debt incurred to attend the qualified educational institution will be canceled if you work for a certain period of time in certain professions for any of a broad class of employers.

You do not have income if your student loan is canceled after you agreed to this provision and then performed the services required. To qualify, the loan must have been made by:

- 1) The government—federal, state, or local, or an instrumentality, agency, or subdivision thereof,
- 2) A tax-exempt public benefit corporation that has assumed control of a state, county, or municipal hospital, and whose employees are considered public employees under state law, or
- 3) An educational institution:
  - a) Under an agreement with an entity described in (1) or (2) that provided the funds to the institution to make the loan, or
  - b) As part of a program of the institution designed to encourage students to serve in occupations or areas with unmet needs and under which the services provided are for or under the direction of a governmental unit or a tax-exempt section 501(c)(3) organization.

A loan to refinance a qualified student loan will also qualify if it was made by an educational institution or a tax-exempt 501(c)(3) organization under its program designed as described in (3)(b) above.

Section 501(c)(3) organizations are defined in Publication 525.

**Deductible debt.** You do not have income from the cancellation of a debt if your payment of the debt would be deductible. This exception applies only if you use the cash method of accounting. For more information, see chapter 5 of Publication 334, *Tax Guide for Small Business*.

**Price reduced after purchase.** Generally, if the seller reduces the amount of debt you owe for property you purchased, you do not have income from the reduction. The reduction of the debt is treated as a purchase

price adjustment and reduces your basis in the property.


**Excluded debt.** Do not include a canceled debt in your gross income in the following situations.

- 1) The debt is canceled in a bankruptcy case under title 11 of the U.S. Code. See Publication 908, *Bankruptcy Tax Guide*.
- 2) The debt is canceled when you are insolvent. However, this does not apply to the extent the debt exceeds the amount by which you are insolvent. See Publication 908.
- 3) The debt is qualified farm debt and is canceled by a qualified person. See chapter 4 of Publication 225, *Farmer's Tax Guide*.
- 4) The debt is qualified real property business debt. See chapter 5 of Publication 334.

## Partnership Income

A partnership is not a taxable entity. The income, gains, losses, deductions, and credits of a partnership are "passed through" to the partners based on each partner's distributive share of these items.

The partnership must file an information return on Form 1065, *U.S. Partnership Return of Income*, and send Schedule K-1 (Form 1065) to each partner. In addition, the partnership will send each partner a copy of the *Partner's Instructions for Schedule K-1 (Form 1065)* to help each partner report his or her share of the partnership's income, deductions, credits, and tax preference items.


 **TIP** Keep Schedule K-1 (Form 1065) for your records. Do not attach it to your Form 1040.

For more information on partnerships, get Publication 541, *Partnerships*.

## S Corporation Income

In general, an S corporation does not pay tax on its income. Instead, the income, losses, deductions, and credits of the corporation are "passed through" to the shareholders.

An S corporation must file a return on Form 1120S, *U.S. Income Tax Return for an S Corporation*, and send Schedule K-1 (Form 1120S) to each shareholder. In addition, the S corporation will send each shareholder a copy of the *Shareholder's Instructions for Schedule K-1 (Form 1120S)* to help each shareholder report his or her share of the S corporation's income, credits, and deductions.

 **TIP** Do not attach Schedule K-1 (Form 1120S) to your Form 1040. Keep it for your records.

For more information on S corporations and their shareholders, see the instructions for Form 1120S.

## Recoveries

A recovery is a return of an amount you deducted or took a credit for in an earlier year. The most common recoveries are refunds, reimbursements, and rebates of deductions itemized on Schedule A (Form 1040). You may also have recoveries of non-itemized deductions such as payments on previously deducted bad debts and recoveries of items for which you previously claimed a tax credit.

**Tax benefit rule.** You must include a recovery in your income in the year you receive it to the extent that the deduction or credit you took for the recovered amount reduced your tax in the earlier year. For this purpose, any increase to an amount carried over to the current year that resulted from the deduction or credit is considered to have reduced your tax in the earlier year. For more information, get Publication 525.

**Federal income tax refund.** Refunds of federal income taxes are not included in your income because they are never allowed as a deduction from income.

**State income tax refund.** If you received a state or local income tax refund (or credit or offset) in 1999, you should receive a statement, Form 1099-G, *Certain Government and Qualified State Tuition Program Payments*, from the payer by January 31, 2000. The IRS will also receive a copy of the Form 1099-G.

**Mortgage interest refund.** If you received a refund or credit in 1999 of mortgage interest paid in an earlier year, the amount should be shown in box 3 of your Form 1098, *Mortgage Interest Statement*. Do not subtract the refund amount from the interest you paid in 1999. You may have to include it in your income under the rules explained in the following discussion.

**Interest on recovery.** Interest on any of the amounts you recover must be reported as interest income in the year received.

**Recovery and expense in same year.** If the refund or other recovery and the expense occur in the same year, the recovery reduces the deduction or credit and is not reported as income.

**Recovery for 2 or more years.** If you receive a refund or other recovery that is for amounts you paid in 2 or more separate years, you must allocate, on a pro rata basis, the recovered amount between the years in which it was paid.

This allocation is necessary to determine the amount of recovery from any earlier years and to determine the amount, if any, of your allowable deduction for this item for the current year. For information on how to compute the allocation, see *Recoveries* in Publication 525.

## Itemized Deduction Recoveries

If you recover any amount that you deducted in an earlier year on Schedule A (Form 1040), you must generally include the full amount of the recovery in your income in the year you receive it.

**Where to report.** Enter your state and local income tax refund on line 10 of Form 1040, and the total of all other recoveries as other income on line 21 of Form 1040. You cannot use Form 1040A or Form 1040EZ.

**Example.** For 1998, you filed a joint return. Your taxable income was \$20,000 and you were not entitled to any tax credits. Your standard deduction was \$7,100, and you had itemized deductions of \$9,000. In 1999, you received the following recoveries for amounts deducted on your 1998 return:

Medical expenses .....	\$200
State and local income tax refund .....	400
Refund of mortgage interest .....	325
<b>Total recoveries .....</b>	<b>\$925</b>

None of the recoveries were more than the deductions taken for 1998.

Because your total recoveries are less than the amount by which your itemized deductions exceeded the standard deduction ( $\$9,000 - 7,100 = \$1,900$ ), you must include your total recoveries in your income for 1999. Report the state and local income tax refund of \$400 on line 10 of Form 1040 and the balance of your recoveries, \$525, on line 21 of Form 1040.

**Standard deduction limit.** You are generally allowed to claim the standard deduction if you do not itemize your deductions. Only your itemized deductions that are more than your standard deduction are subject to the recovery rule (unless you are required to itemize your deductions). If your total deductions on the earlier year return were not more than your income for that year, include in your income this year the smaller of:

- 1) Your recoveries, or
- 2) The amount by which your itemized deductions exceeded the standard deduction.

**Standard deduction for earlier years.** To determine if amounts recovered in 1999 must be included in your income, you must know the standard deduction for your filing status for the year the deduction was claimed. Standard deduction amounts for 1998, 1997, and 1996 are in Publication 525.

**Example.** You filed a joint return for 1998 with taxable income of \$25,000. Your itemized deductions were \$8,700. The standard deduction that you could have claimed was \$7,100. In 1999 you recover \$2,400 of your 1998 itemized deductions. None of the recoveries were more than the actual deductions for 1998. Include \$1,600 of the recoveries in your 1999 income. This is the smaller of your recoveries (\$2,400) or the amount by which your itemized deductions were more than the standard deduction ( $\$8,700 - 7,100 = \$1,600$ ).

**Recovery limited to deduction.** You do not include in your income any amount of your recovery that is more than the amount you deducted in the earlier year. The amount you include in your income is limited to the smaller of:

- 1) The amount deducted on Schedule A (Form 1040), or
- 2) The amount recovered.

**Example.** During 1998 you paid \$1,700 for medical expenses. From this amount you subtracted \$1,500, which was 7.5% of your adjusted gross income. Your actual medical expense deduction was \$200. In 1999, you received a \$500 reimbursement from your medical insurance for your 1998 expenses. The only amount of the \$500 reimbursement that must be included in your income in 1999 is \$200—the amount actually deducted.

**Other recoveries.** See *Recoveries* in Publication 525 if:

- 1) You have recoveries of items other than itemized deductions, or
- 2) You received a recovery for an item for which you claimed a tax credit (other than investment credit or foreign tax credit) in a prior year.

## Rental of Personal Property

If you rent out personal property, such as equipment or vehicles, how you report your income and expenses is generally determined by:

- 1) Whether or not the rental activity is a business, and
- 2) Whether or not the rental activity is conducted for profit.

Generally, if your primary purpose is income or profit and you are involved in the rental activity with continuity and regularity, your rental activity is a business. See Publication 535 for details on deducting expenses for both business and not-for-profit activities.

**Reporting business income and expenses.** If you are in the business of renting personal property, report your income and expenses on Schedule C or C-EZ. The form instructions have information on how to complete them.

**Reporting nonbusiness income.** If you are not in the business of renting personal property, report your rental income on line 21 of Form 1040. List the type and amount of the income on the dotted line to the left of the amount you report on line 21.

**Reporting nonbusiness expenses.** If you rent personal property for a profit, report your rental expenses on line 32 of Form 1040. Enter the amount and "PPR" on the dotted line to the left and include the amount of your deductible expenses in the total amount you enter on line 32.

If you do not rent personal property for a profit, your deductions are limited and you cannot report a loss to offset other income. You report these rental expenses on Schedule A (Form 1040).

## Repayments

If you had to repay an amount that you included in your income in an earlier year, you may be able to deduct the amount repaid from your income in the year in which you repaid it. If the amount you repaid is more than \$3,000, you may be able to take a credit against your tax in the year in which you repaid it. To claim a deduction or credit, the repayment generally must qualify as an

expense or loss incurred in your trade or business or in a for-profit transaction.

**Type of deduction.** The type of deduction you are allowed in the year of repayment depends on the type of income you included in the earlier year. For instance, if you repay an amount that you previously reported as a capital gain, deduct the repayment as a capital loss.

**Repayment \$3,000 or less.** If the amount you repaid was \$3,000 or less, deduct it from your income in the year you repaid it. If you repaid an amount that you reported as wages, unemployment compensation, or other nonbusiness ordinary income, enter it on line 22 of Schedule A (Form 1040). If you repaid an amount that you reported as a capital gain, deduct it on Schedule D (Form 1040).

**Repayment over \$3,000.** If the amount you repaid was more than \$3,000, you can deduct the repayment, as described earlier. However, you can instead choose to take a tax credit for the year of repayment if you included the income under a **claim of right**. This means that at the time you included the income, it appeared that you had an unrestricted right to it. If you qualify for this choice, figure your tax under both methods and compare the results. Use the method (deduction or credit) that results in less tax.

**Method 1.** Figure your tax for 1999 claiming a deduction for the repaid amount.

**Method 2.** Follow these steps.

- 1) Figure your tax for 1999 **without** deducting the repaid amount.
- 2) Refigure your tax from the earlier year without including in income the amount you repaid in 1999.
- 3) Subtract the tax in (2) from the tax shown on your return for the earlier year. This is the credit.
- 4) Subtract the answer in (3) from the tax for 1999 figured without the deduction (Step 1).

If using Method 1 results in less tax, deduct the amount repaid on the same form or schedule on which you previously reported it. For example, if you reported it as self-employment income, deduct it as a business deduction on Schedule C or Schedule C-EZ (Form 1040). If you reported it as wages, deduct it as an individual deduction on line 27 of Schedule A (Form 1040).

If using Method 2 results in less tax, claim the credit on line 63 of Form 1040, and write "I.R.C. 1341" next to line 63.

An example of this computation can be found in Publication 525.

**Repaid social security benefits.** If you repaid social security benefits, see *Repayment of benefits* in chapter 12.

## Royalties

Royalties from copyrights, patents, and oil, gas, and mineral properties are taxable as ordinary income.

You generally report royalties in Part I 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).

**Copyrights and patents.** Royalties from copyrights on literary, musical, or artistic works, and similar property, or from patents on inventions, are amounts paid to you for the right to use your work over a specified period of time. Royalties are generally based on the number of units sold, such as the number of books, tickets to a performance, or machines sold.

**Oil, gas, and minerals.** Royalty income from oil, gas, and mineral properties is the amount you receive when natural resources are extracted from your property. The royalties are based on units, such as barrels, tons, etc., and are paid to you by a person or company who leases the property from you.

**Depletion.** If you are the owner of an economic interest in mineral deposits or oil and gas wells, you can recover your investment through the depletion allowance. For information on this subject, see chapter 13 of Publication 535.

**Coal and iron ore.** Under certain circumstances, you can treat amounts you receive from the disposal of coal and iron ore as payments from the sale of a capital asset, rather than as royalty income. For information about gain or loss from the sale of coal and iron ore, get Publication 544, *Sales and Other Dispositions of Assets*.

**Interest in the property sold.** If you sell your complete interest in the oil, gas, or mineral rights, the amount you receive is considered payment for the sale of your property, not royalty income. Under certain circumstances, the sale is subject to capital gain or loss treatment on Schedule D (Form 1040).

**Part of future production sold.** If you own mineral property but sell part of the future production, you generally treat the money you receive from the buyer at the time of the sale as a loan from the buyer. Do not include it in your income or take depletion based on it.

When production begins, you include all the proceeds in your income, deduct all the production expenses, and deduct depletion from that amount to arrive at your taxable income from the property.

**Retained interest.** If you retain a royalty, an overriding royalty, or a net profit interest in a mineral property for the life of the property, you have made a lease or a sublease, and any cash you receive for the assignment is ordinary income subject to a depletion allowance.

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## Income Not Taxed

You generally should not report the following items on your return. However, some of the items are only partly excluded from your income. A discussion of other totally and partly excluded items follows this list.

**Accident and health insurance proceeds.**

**"Black lung" benefits.**

**Casualty insurance and other reimbursements** (chapter 27).

**Child support payments** (chapter 20).

**Compensatory damages awarded for physical injury or physical sickness.**

**Federal Employees' Compensation Act payments.**

**Government cost-of-living allowances** for civilian employees stationed outside the continental U.S. (or in Alaska)(chapter 6).

**Housing allowance for members of the clergy** (chapter 6).

**Interest on state or local government obligations** (chapter 8).

**Meals and lodging provided by employer.**

**Military allowances** (get Publication 3).

**Moving expense reimbursements** (chapter 19).

**Scholarship and fellowship grants** (get Publication 520).

**Supplemental security income (SSI).**

**Veterans' benefits** (chapter 6).

**Welfare benefits.**

**Workers' compensation.**

**Campaign contributions.** These contributions are not income to a candidate unless they are diverted to his or her personal use. To be exempt from tax, the contributions must be spent for campaign purposes or kept in a fund for use in future campaigns. However, interest earned on bank deposits, dividends received on contributed securities, and net gains on sales of contributed securities are taxable and must be reported on Form 1120-POL, *U.S. Income Tax Return for Certain Political Organizations*. Excess campaign funds transferred to an office account must be included in the officeholder's income on line 21 of Form 1040, in the year transferred.

**Cash rebates.** 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.

**Energy conservation subsidies.** You can exclude from gross income any subsidy provided, either directly or indirectly, by public utilities for the purchase or installation of an energy conservation measure for a dwelling unit.

**Energy conservation measure.** This includes installations or modifications that are primarily designed to reduce consumption of electricity or natural gas, or improve the management of energy demand.

**Dwelling unit.** This includes a house, apartment, condominium, mobile home, boat, or similar property. If a building or structure contains both dwelling and other units, any subsidy must be properly allocated.

**Foster-care providers.** Payments you receive from a state, political subdivision, or tax-exempt child-placement agency for pro-

viding care to qualified foster individuals in your home generally are not included in your income. You must include in your income payments received for the care of more than 5 individuals age 19 or older and certain difficulty-of-care payments.

A qualified foster individual is a person who:

- 1) Is living in a foster family home, and
- 2) Was placed there by:
  - a) An agency of a state or one of its political subdivisions, or
  - b) If the individual is under age 19, a tax-exempt child placement agency licensed by a state or one of its political subdivisions.

**Difficulty-of-care payments.** These are additional payments that are designated by the payer as compensation for providing the additional care that is required for physically, mentally, or emotionally handicapped qualified foster individuals. A state must determine that the additional compensation is needed, and the care for which the payments are made must be provided in your home.

You must include in your income difficulty-of-care payments received for more than:

- 1) 10 qualified foster individuals under age 19, or
- 2) 5 qualified foster individuals age 19 or older.

**Maintaining space in home.** If you are paid to maintain space in your home for emergency foster-care, you must include the payment in your income.

**Reporting taxable payments.** If you receive payments that you must include in your income, you are in business as a foster-care provider and you are self-employed. Report the payments on Schedule C or Schedule C-EZ (Form 1040). Get Publication 587, *Business Use of Your Home*, to help you determine the amount you can deduct for the use of your home.

**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.

**Inherited pension or IRA.** If you inherited a pension or an individual retirement arrangement (IRA), you may have to include part of the inherited amount in your income. See chapter 11 if you inherited a pension. See chapter 18 if you inherited an IRA.

**Interest on frozen deposits.** In general, you exclude from your income the amount of interest earned on a frozen deposit. See *Interest income on frozen deposits* in chapter 8.

**Interest on qualified savings bonds.** You may be able to exclude from your income the interest from qualified U.S. savings bonds you redeem if you pay qualified

higher educational expenses in the same year. For more information on this exclusion, see *Education Savings Bond Program* under *U.S. Savings Bonds* in chapter 8.

**Interview expenses.** If a prospective 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 in income only the amount you receive that is more than your actual expenses.

**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 can exclude is limited to your actual expenses to keep the same standard of living your family had before the casualty, minus the normal living expenses you would have had.

**Sale of home.** You may be able to exclude from income all or part of any gain from the sale or exchange of your main home. See chapter 16.

**Transporting school children.** Do not include in your income a school board mileage allowance for taking children to and from school if you are not in the business of taking children to school. You cannot deduct expenses for providing this transportation.

**Utility rebates.** If you are a customer of an electric utility company and you participate in the utility's energy conservation program, you may receive on your monthly electric bill either:

- 1) A reduction in the purchase price of electricity furnished to you (rate reduction), or
- 2) A nonrefundable credit against the purchase price of the electricity.

The amount of the rate reduction or nonrefundable credit is not included in your income.

## 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.

**Proceeds received in installments.** If you receive life insurance proceeds in installments, you can exclude part of each installment from your income.

To determine the excluded part, divide the amount held by the insurance company (generally the total lump sum payable at the death of the insured person) by the number of installments to be paid. Include anything over this excluded part in your income as interest.

**Surviving spouse.** If your spouse died before October 23, 1986, and insurance proceeds paid to you because of the death of your spouse are received in installments, you can exclude up to \$1,000 a year of the interest included in the installments. If you remarry, you can continue to take the exclusion.

**More information.** For more information, see *Life Insurance Proceeds* in Publication 525.

**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 cost of the life insurance policy. In general, your cost (or investment in the contract) is the total premiums that you paid for the life insurance policy, less any refunded premiums, rebates, dividends, or unrepaid loans that were not included in your income. This is explained more fully in Publication 575.

You should receive a Form 1099-R showing the total proceeds and the taxable part. Report these amounts on lines 16a and 16b of Form 1040, or lines 11a and 11b of Form 1040A.

**Endowment proceeds.** Endowment proceeds paid in a lump sum to you at maturity are taxable only if the proceeds are more than the cost of the policy. To determine your cost, see *Endowment proceeds* in Publication 525.

**Deceased public safety officers.** If you are a survivor of a public safety officer who died in the line of duty, you may be able to exclude from income certain amounts you receive.

**Bureau of Justice Assistance payments.** If you are a surviving dependent of a public safety officer (law enforcement officer or firefighter) who died in the line of duty, do not include in your income the death benefit paid to you by the Bureau of Justice Assistance.

**Governmental plan annuity.** If you receive a survivor annuity as the child (or former spouse) of a public safety officer who was killed in the line of duty after 1996, you generally do not have to include it in income. The annuity is excluded to the extent it is based on the officer's service as a public safety officer.

For this purpose, the term public safety officer includes police and law enforcement officers, firefighters, rescue squads or ambulance crews. See Publication 525 for more information.

## Accelerated Death Benefits

Certain payments received under a life insurance contract on the life of a terminally or chronically ill individual before the individual's death (an accelerated death benefit) can be excluded from income. See *Exception*, later. For a chronically ill individual, the payments must be for costs incurred for qualified long-term care services or made on a periodic basis without regard to the costs.

In addition, if any portion of a death benefit under a life insurance contract on the life of a terminally or chronically ill individual is sold or assigned to a viatical settlement provider, the amount received is also excluded from income. Generally, a viatical settlement provider is one who regularly engages in the business of buying or taking assignment of life insurance contracts on the lives of insured individuals who are terminally or chronically ill.

To claim an exclusion for accelerated death benefits made on a per diem basis, you must file Form 8853, *Medical Savings Accounts and Long-term Care Insurance Contracts*, with your return.

**Terminally or chronically ill defined.** A terminally ill person is one who has been certified by a physician as having an illness or physical condition that can reasonably be expected to result in death within 24 months from the date of the certification. A chronically ill person is one who is not terminally ill but has been certified by a licensed health care practitioner as meeting either of the following conditions.

- 1) The person is unable to perform (without substantial help) at least two activities of daily living for a period of 90 days or more because of a loss of functional capacity.
- 2) The person requires substantial supervision to protect himself or herself from threats to health and safety due to severe cognitive impairment.

**Exception.** The exclusion does not apply to any amount paid to a person other than the insured if that other person has an insurable interest in the life of the insured:

- Because the insured is a director, officer, or employee of the other person, or
- Because the insured has a financial interest in the business of the other person.

**Limit on exclusion.** The amount of accelerated death benefits you may exclude may be limited if:

- 1) They are paid on account of chronic illness, and
- 2) They are received as periodic payments.

For 1999, the most you can exclude is \$190 per day (\$69,350 a year).

There is no limit on amounts paid on account of the exclusion for terminal illness.

## Long-Term Care Insurance Contracts

Long-term care insurance contracts are generally treated as accident and health insurance contracts. Amounts you receive from them (other than policyholder dividends or premium refunds) generally are excludable from income as amounts received for personal injury or sickness.

To claim an exclusion for payments made on a per diem or other periodic basis under a long-term care insurance contract, you must file Form 8853 with your return.

A long-term care insurance contract is any insurance contract that only provides

coverage of qualified long-term care services. The contract:

- 1) Must be guaranteed renewable,
- 2) Must not provide for a cash surrender value or other money that can be paid, assigned, pledged, or borrowed,
- 3) Must provide that refunds, other than refunds on the death of the insured or complete surrender or cancellation of the contract, and dividends under the contract may be used only to reduce future premiums or increase future benefits, and
- 4) Generally must not pay or reimburse expenses incurred for services or items that would be reimbursed under Medicare, except where Medicare is a secondary payer or the contract makes per diem or other periodic payments without regard to expenses.

**Qualified long-term care services.** Qualified long-term care services are:

- 1) Necessary diagnostic, preventive, therapeutic, curing, treating, mitigating, and rehabilitative services, and
- 2) Maintenance or personal care services required by a chronically ill individual as prescribed by a licensed health care practitioner.

**Chronically ill individual.** A chronically ill individual is one who has been certified as one of the following.

- 1) An individual who, for at least 90 days, is unable to perform at least two activities of daily living without substantial assistance due to loss of functional capacity. Activities of daily living are eating, toileting, transferring, bathing, dressing, and continence.
- 2) An individual who requires substantial supervision to be protected from threats to health and safety due to severe cognitive impairment.

The certification must have been made by a licensed health care practitioner within the previous 12 months.

**Limit on exclusion.** You can generally exclude from gross income up to \$190 a day (\$69,350 a year) for 1999. The \$190 is indexed for inflation.

## Medical Savings Accounts (MSAs)

Do not include in income amounts you withdraw from your MSA if you use the money to pay for qualified medical expenses for you, your spouse, or your dependents. Generally, qualified medical expenses are those you can deduct on Schedule A (Form 1040), *Itemized Deductions*. You must have paid these expenses yourself. For more information about qualified medical expenses, see Publication 502, *Medical and Dental Expenses*. For more information about MSAs, see Publication 969.



**You cannot buy health insurance with distributions from your MSA unless you are receiving unemployment benefits, buying continuation coverage**

*required by federal law, or buying long-term care insurance.*

**Taxable distributions and penalty.** If you use the money from your MSA for any purpose besides qualified medical expenses, it will be taxable income that you must report on your tax return. In addition to the tax, you will be charged a 15 percent penalty for an early distribution. The penalty will not be charged if you are disabled or age 65.

## 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 in your income any welfare benefits obtained fraudulently.

**Alaska residents.** Payments the state of Alaska makes to its citizens who meet certain age and residency tests that are not based on need are not welfare benefits. Include them in gross income on line 21 of Form 1040.

**Persons with disabilities.** If you have a disability, you must include in income compensation you receive for services you perform unless the compensation is otherwise excluded. However, you do not include in income the value of goods, services, and cash that you receive, not in return for your services, but for your training and rehabilitation because you have a disability. Excludable amounts include payments for transportation and attendant care, such as interpreter services for the deaf, reader services for the blind, and services to help mentally retarded persons do their work.

**Disaster relief grants.** Grants made under the Disaster Relief Act of 1974 to help victims of natural disasters are not included in income. Do not deduct casualty losses or medical expenses that are specifically reimbursed by these disaster relief grants. Disaster unemployment assistance payments under the Act are unemployment benefits that are taxable. See *Unemployment compensation* in chapter 6.

**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.

## Scholarship and Fellowship Grants

If you receive a scholarship or fellowship grant, you may be able to exclude from income all or part of the amounts you receive.

**Scholarships and fellowships.** A candidate for a degree can exclude amounts received as a qualified scholarship or fellowship. A qualified scholarship or fellowship is any amount you receive that is for:

- 1) Tuition and fees to enroll at or attend an educational organization, or
- 2) Fees, books, supplies, and equipment required for courses at the educational institution.

Amounts used for room and board **do not** qualify. Get Publication 520 for more infor-

mation on qualified scholarships and fellowship grants.

**Payments for services.** Payments you receive for services required as a condition of receiving a scholarship or fellowship grant must be included in your income, even if the services are required of all candidates for the degree. This includes amounts received for teaching and research. Include these payments on line 7 of Form 1040 or Form 1040A, or on line 1 of Form 1040EZ.

For information about the exclusion for a qualified tuition reduction provided to em-

ployees and their families by an educational institution, see Publication 520.

**VA payments.** Allowances paid by the Department of Veterans Affairs are not included in your gross income. These allowances are not considered scholarship or fellowship grants.

**Prizes.** Scholarship prizes won in a contest are not scholarships or fellowships if you do not have to use the prizes for educational purposes. You must include these amounts in your gross income on line 21 of Form 1040, whether or not you use the amounts for educational purposes.



# Part Three.

## Gains and Losses

The four chapters in this part discuss investment gains and losses, including how to figure your basis in property. A gain from selling or trading stocks, bonds, or other investment property may be taxed or it may be tax free, at least in part. A loss may or may not be deductible. These chapters also discuss gains from selling property you personally use — including the special rules for selling your home. Nonbusiness casualty and theft losses are discussed in chapter 27 in Part Five.

### 14.

## Basis of Property

### Introduction

This chapter discusses how to figure your basis in property and covers the following topics.

- Cost basis of property you buy.
- Adjustments to basis after you receive property.
- Basis other than cost.

Basis is the amount of your investment in property for tax purposes. Use the basis of property to figure the amount of gain or loss on the sale, exchange, or other disposition of property. Also use it to figure the deduction for depreciation, amortization, depletion, and casualty losses. You must keep accurate records of all items that affect the basis of property so you can make these computations.

If you use property for both business and personal purposes, you must allocate the basis based on the use. Only the basis allocated to the business use of the property can be depreciated.

Your original basis in property is adjusted (increased or decreased) by certain events. If you make improvements to the property, increase your basis. If you take deductions for depreciation or casualty losses, reduce your basis.

Generally, the higher your basis for an asset, the less gain you will have to report on its sale. The higher your basis in a depreciable asset, the higher your depreciation deductions.

### Useful Items

You may want to see:

#### Publication

- 525** Taxable and Nontaxable Income
- 535** Business Expenses
- 537** Installment Sales
- 544** Sales and Other Dispositions of Assets
- 550** Investment Income and Expenses

- 551** Basis of Assets
- 564** Mutual Fund Distributions

### Cost Basis

The basis of property you buy is usually its cost. The cost is the amount you pay in cash, debt obligations, or other property. Your cost also includes, for example, amounts you pay for the following items.

- Sales tax charged on the purchase.
- Freight charges to obtain the property.
- Installation and testing charges.
- Excise taxes.
- Legal and accounting fees (when they must be capitalized).
- Revenue stamps.
- Recording fees.
- Real estate taxes (if assumed for the seller).

In addition, the cost basis of real estate and business assets may include other items.

**Loans with low or no interest.** If you buy property on any time-payment plan that charges little or no interest, the basis of your property is your stated purchase price minus any amount considered to be unstated interest. You generally have unstated interest if your interest rate is less than the applicable federal rate.

For more information, see *Unstated Interest and Original Issue Discount* in Publication 537.

### Real Property

Real property, also called real estate, is land and generally anything built on, growing on, or attached to land.

If you buy real property, certain fees and other expenses you pay are part of your cost basis in the property.

You must allocate your cost basis between land and improvements, such as buildings, to figure the basis for depreciation of the improvements. Allocate the costs according to the fair market values of the land and improvements at the time of purchase.

**Fair market value (FMV)** is the price at which the property would change hands between a buyer and a seller, neither having to buy or sell, and both having a reasonable knowledge of all necessary facts. Sales of similar property on or about the same date may be helpful in figuring the FMV of the property.

**Assumption of mortgage.** If you buy property and assume (or buy subject to) an existing mortgage on the property, your basis includes the amount you pay for the property plus the amount to be paid on the mortgage.

**Settlement costs.** You can include in the basis of property you buy the settlement fees and closing costs you pay for buying the property. You cannot include fees and costs for getting a loan on the property. (A fee for buying property is a cost that must be paid even if you buy the property for cash.)

The following are some of the settlement fees or closing costs you can include in the basis of your property.

- Abstract fees (abstract of title fees).
- Charges for installing utility services.
- Legal fees (including title search and preparation of the sales contract and deed).
- Recording fees.
- Surveys.
- Transfer taxes.
- Title insurance.
- Any amounts the seller owes that you agree to pay, such as back taxes or interest, recording or mortgage fees, charges for improvements or repairs, and sales commissions.

Settlement costs **do not include** amounts placed in escrow for the future payment of items such as taxes and insurance.

The following are some of the settlement fees and closing costs that you **cannot** include in the basis of property.

- 1) Fire insurance premiums.
- 2) Rent for occupancy of the property before closing.
- 3) Charges for utilities or other services related to occupancy of the property before closing.
- 4) Fees for refinancing a mortgage.
- 5) Charges connected with getting a loan. The following are examples of these charges.
  - a) Points (discount points, loan origination fees).
  - b) Mortgage insurance premiums.
  - c) Loan assumption fees.
  - d) Cost of a credit report.

- e) Fees for an appraisal required by a lender.

**Real estate taxes.** If you pay real estate taxes that the seller owed on real property you bought, and the seller did not reimburse you, treat those taxes as part of your basis. You cannot deduct them as taxes.

If you reimburse the seller for taxes the seller paid for you, you can usually deduct that amount. Do not include that amount in the basis of the property. If you did not reimburse the seller, you must reduce your basis by the amount of those taxes.

**Points.** If you pay points to get a loan (including a mortgage, second mortgage, line of credit, or a home equity loan), do not add the points to the basis of the related property. Generally, you deduct the points over the term of the loan. For more information on how to deduct points, see *Points* in chapter 8 of Publication 535.

**Points on home mortgage.** Special rules may apply to points you and the seller pay when you get a mortgage to buy your main home. If certain requirements are met, you can fully deduct the points for the year in which they are paid. Reduce the basis of your home by the amount of any seller-paid points. For more information, see *Points* in chapter 25.

## Adjusted Basis

Before figuring any gain or loss on a sale, exchange, or other disposition of property, or figuring allowable depreciation, depletion, or amortization, you must usually make certain adjustments (increases and decreases) to the basis of the property. The result of these adjustments to the basis is the adjusted basis.

## Increases to Basis

Increase the basis of any property by all items properly added to a capital account. These include the cost of any improvements having a useful life of more than 1 year and amounts spent after a casualty to restore the damaged property. Other items added to the basis of property include the cost of extending utility service lines to the property and legal fees, such as the cost of defending and perfecting title.

**Improvements.** Add the cost of improvements to your basis in the property if they increase the value of the property, lengthen its life, or adapt it to a different use. For example, improvements include putting a recreation room in your unfinished basement, adding another bathroom or bedroom, putting up a fence, putting in new plumbing or wiring, installing a new roof, or paving your driveway.

**Assessments for local improvements.** Add assessments for improvements, such as streets and sidewalks, to the basis of the property assessed if they increase the value of the property. Do not deduct them as taxes. However, you can deduct as taxes assessments you pay for maintenance, repair, or meeting interest charges on the improvements.

Table 14-1. Examples of Adjustments to Basis

Increases to Basis	Decreases to Basis
<b>Capital improvements:</b> Putting an addition on your home Replacing an entire roof Paving your driveway Installing central air conditioning Rewiring your home  <b>Assessments for local improvements:</b> Water connections Sidewalks Roads  <b>Casualty losses:</b> Restoring damaged property  <b>Legal fees:</b> Cost of defending and perfecting a title  Zoning costs	Exclusion from income of subsidies for energy conservation measures  Casualty or theft loss deductions and insurance reimbursements  Credit for qualified electric vehicles  Section 179 deduction  Deduction for clean-fuel vehicles and clean-fuel vehicle refueling property  Depreciation  Nontaxable corporate distributions

**Example.** Your city changes the street in front of your store into an enclosed pedestrian mall and assesses you and other affected property owners for the cost of the conversion. Add the assessment to your property's basis. In this example, the assessment is a depreciable asset.

## Decreases to Basis

Certain items that reduce the basis of your property are listed next.

- The section 179 deduction (an elected deduction in place of depreciation deductions).
- The deduction for clean-fuel vehicles and clean-fuel vehicle refueling property.
- Nontaxable corporate distributions (see chapter 9).
- Deductions previously allowed or allowable for amortization, depreciation, and depletion.
- Exclusion from income of subsidies for energy conservation measures (see *Energy conservation subsidies* in chapter 13).
- Credit for qualified electric vehicles.
- Gain from the sale of your home before May 7, 1997, on which tax was postponed.
- Deductible casualty and theft losses and insurance reimbursements.
- Certain canceled debt excluded from income.
- Rebates received from a manufacturer or seller.
- Easements.
- Gas-guzzler tax.

**Casualties and thefts.** If you have a casualty or theft loss, decrease the basis of your property by any insurance proceeds or other reimbursement. Also decrease it by any deductible loss not covered by insurance. However, increase your basis for your costs to restore the damaged property after a casualty. For information about figuring your casualty or theft loss, see chapter 27.

**Easements.** The amount you receive for granting an easement is generally considered to be from the sale of an interest in your real property. It reduces the basis of the affected part of the property. If the amount received is more than the basis of the part of the property affected by the easement, reduce your basis in that part to zero and treat the excess as a recognized gain.

If the recognized gain is on a capital asset, see chapter 17 for information about how to report it. If the recognized gain is on property used in a trade or business, see Publication 544 for information about how to report this gain.

**Depreciation and section 179 deduction.** Decrease the basis of your business property by any section 179 deduction you take and the depreciation you deducted, or could have deducted, on your tax returns under the method of depreciation you selected.

For more information about depreciation and the section 179 deduction, see Publication 946.

**Credit for qualified electric vehicles.** If you claim the credit for a qualified electric vehicle, you must reduce your basis in that vehicle by the lesser of the following amounts.

- \$4,000.
- 10% of the vehicle's cost.

This reduction amount applies even if the credit allowed is less than that amount. For more information on this credit, see chapter 15 in Publication 535.

**Deduction for clean-fuel vehicle and refueling property.** If you take the deduction for either clean-fuel vehicles or clean-fuel vehicle refueling property, decrease the basis of the property by the deduction. For more information about these deductions, see chapter 15 in Publication 535.

**Exclusion from income of subsidies for energy conservation measures.** You can exclude from gross income any subsidy you receive from a public utility company for the purchase or installation of an energy conservation measure for a dwelling unit. Reduce the basis of the property for which you

received the subsidy by the excluded amount. For more information about this subsidy, see chapter 13.

**Gain from sale of home on which tax was postponed.** If you postponed gain from the sale of your main home before May 7, 1997, you must reduce the basis of your new home by the amount of the postponed gain. For more information on the rules for the sale of a home, see Publication 523.

## Example

You owned a duplex used as rental property that cost you \$40,000, of which \$35,000 was allocated to the building and \$5,000 to the land. You added an improvement to the duplex that cost \$10,000. In February last year the duplex was damaged by fire. Up to that time you had been allowed depreciation of \$23,000. You sold some salvaged material for \$1,300 and collected \$19,700 from your insurance company. You deducted a casualty loss of \$1,000 on your income tax return for last year. You spent \$19,000 of the insurance proceeds for restoration of the duplex, which was completed this year. Figure the adjusted basis of the duplex after the restoration as follows:

Original cost of duplex .....	\$35,000
Addition to duplex .....	10,000
Total cost of duplex .....	\$45,000
Minus: Depreciation .....	23,000
Adjusted basis before casualty .....	\$22,000
Minus: Insurance proceeds .....	\$19,700
Deducted casualty loss .....	1,000
Salvage proceeds .....	1,300
Adjusted basis after casualty .....	\$-0-
Add: Cost of restoring duplex .....	19,000
<b>Adjusted basis after restoration .....</b>	<b>\$19,000</b>

Your basis in the land is its original cost of \$5,000.

## Other Basis

There are many times when you cannot use cost as a basis. In these cases, the fair market value or the adjusted basis of certain property may be used. Fair market value and adjusted basis were discussed earlier.

## Property Received for Services

If you receive property for your services, include the property's FMV in income. The amount you include in income becomes your basis. If the services were performed for a price agreed on beforehand, the price will be accepted as the FMV of the property if there is no evidence to the contrary.

**Restricted property.** If you receive property for your services and the property is subject to certain restrictions, your basis in the property is its FMV when it becomes substantially vested. However, this rule does not apply if you make an election to include in income the FMV of the property at the time it is transferred to you, less any amount you paid for it. Property becomes substantially vested when your rights in the property or the rights of any person to whom you transfer the property are not subject to a substantial risk of forfeiture. For more information, see *Restricted Property Received for Services* in Publication 525.

**Bargain purchases.** A bargain purchase is a purchase of an item for less than its FMV. If, as compensation for services, you buy goods or other property at less than FMV, include the difference between the purchase price and the property's FMV in your income. Your basis in the property is its FMV (your purchase price plus the amount you include in income).

If the difference between your purchase price and the FMV is a qualified employee discount, do not include the difference in income. However, your basis in the property is still its FMV. See *Qualified Employee Discount* in chapter 4 of Publication 535.

## Taxable Exchanges

A taxable exchange is one in which the gain is taxable or the loss is deductible. If you receive property in exchange for other property in a taxable exchange, the basis of the property you receive is usually its FMV at the time of the exchange.

## Involuntary Conversions

If you receive property as a result of an involuntary conversion, such as a casualty, theft, or condemnation, you may figure the basis of the replacement property you receive using the basis of the old property.

**Similar or related property.** If you receive property that is similar or related in service or use to the old property, the replacement property's basis is the same as the old property's basis on the date of the conversion. However, you must make certain adjustments as indicated next.

- 1) Decrease the basis by the following items.
  - a) Any loss you recognize on the conversion.
  - b) Any money you receive that you do not spend on similar property.
- 2) Increase the basis by the following items.
  - a) Any gain you recognize on the conversion.
  - b) Any cost of acquiring the replacement property.

**Money or property that is not similar or related.** If you receive money or property that is not similar or related in service or use to the old property and you buy replacement property that is similar or related in service or use to the old property, the basis of the replacement property is its cost decreased by the gain not recognized on the conversion.

**Example.** The state condemned your property. The adjusted basis of the property was \$26,000, and the state paid you \$31,000 for it. You realized a gain of \$5,000 (\$31,000 - \$26,000). You bought replacement property that is similar in use to the old property for \$29,000. You recognize a gain of \$2,000 (\$31,000 - \$29,000), the unspent part of the payment from the state. Your gain not recognized is \$3,000, the difference between the \$5,000 realized gain and the \$2,000 recognized gain. You figure the basis of the replacement property as follows:

Cost of replacement property .....	\$29,000
Minus: Gain not recognized .....	3,000
<b>Basis of replacement property .....</b>	<b>\$26,000</b>

**Allocating the basis.** If you buy more than one piece of replacement property, allocate your basis among the properties based on their respective costs.

## Nontaxable Exchanges

A nontaxable exchange is an exchange in which you are not taxed on any gain and you cannot deduct any loss. If you receive property in a nontaxable exchange, its basis is generally the same as the basis of the property you transferred. See *Nontaxable Trades* in chapter 15.

## Like-Kind Exchanges

The exchange of property for the same kind of property is the most common type of nontaxable exchange. To be a like-kind exchange, the property traded and the property received must be both of the following.

- 1) Qualifying property.
- 2) Like property.

The basis of the property you receive is generally the same as the basis of the property you gave up. If you trade property in a like-kind exchange and also pay money, the basis of the property received is the basis of the property you gave up increased by the money paid.

**Qualifying property.** In a like-kind exchange, you must hold for investment or for productive use in your trade or business both the property you give up and the property you receive.

**Like property.** There must be an exchange of like property. The exchange of real estate for real estate or personal property for similar personal property is an exchange of like property.

**Example.** You trade in an old truck used in your business, which has an adjusted basis of \$1,700, for a new one costing \$6,800. The dealer allows you \$2,000 on the old truck, and you pay \$4,800. This is a like-kind exchange. The basis of the new truck is \$6,500 (the adjusted basis of the old one, \$1,700, plus the amount you paid, \$4,800).

If you sell your old truck to a third party instead for \$2,000 and then buy the new one from the dealer, you have a taxable gain of \$300 on the sale (\$2,000 sale price minus \$1,700 basis). The basis of the new truck is the price you pay the dealer for it.

**Partially nontaxable exchange.** A partially nontaxable exchange is an exchange in which you receive unlike property or money in addition to like property. The basis of the property you receive is the basis of the property you gave up, with the following adjustments.

- 1) Decrease the basis by the following items.
  - a) Any money you receive in the exchange.

- b) Any loss you recognize on the exchange.
- 2) Increase the basis by the following items.
- a) Additional costs you incur for the exchange, such as brokerage commissions.
  - b) Any gain you recognize on the exchange.

Allocate the basis among the properties, other than money, you received in the exchange. In making this allocation, the basis of the unlike property is its FMV on the date of the exchange. The remainder is the basis of the like property.

**More information.** See *Like-Kind Exchanges* in chapter 1 of Publication 544, for more information.

## Property Transferred From a Spouse

The basis of property your spouse transferred to you or transferred in trust for your benefit is the same as your spouse's adjusted basis. The same rule applies to a transfer by your former spouse that is incident to divorce. However, adjust your basis for any gain recognized by the transferor on a property transferred in trust. This rule applies only to a transfer of property in trust in which the liabilities assumed, plus the liabilities to which the property is subject, are more than the adjusted basis of the property transferred.

If the property transferred to you is a series E, series EE, or series I United States savings bond, the transferor must include in income the interest accrued to the date of transfer. Your basis in the bond immediately after the transfer is equal to the transferor's basis plus the interest income includible in his or her income. For more information about these bonds, see chapter 8.

The transferor must give you the records needed to determine the adjusted basis and holding period of the property as of the date of the transfer.

For more information about the transfer of property from a spouse, see chapter 15.

## Property Received as a Gift

To figure the basis of property you receive as a gift, you must know its adjusted basis to the donor just before it was given to you. You also must know its FMV at the time it was given to you and any gift tax paid on it.

### FMV less than donor's adjusted basis.

If the FMV of the property is less than the donor's adjusted basis, your basis depends on whether you have a gain or a loss when you dispose of the property. Your basis for figuring gain is the same as the donor's adjusted basis plus or minus any required adjustment to basis while you held the property. Your basis for figuring loss is its FMV when you received the gift plus or minus any required adjustment to basis while you held the property. See *Adjusted Basis*, earlier.

**Example.** You received an acre of land as a gift. At the time of the gift, the land had an FMV of \$8,000. The donor's adjusted

basis was \$10,000. After you received the property, no events occurred to increase or decrease your basis in it. If you later sell the property for \$12,000, you will have a \$2,000 gain. You must use the donor's adjusted basis (\$10,000) at the time of the gift as your basis to figure gain. If you sell the property for \$7,000, you will have a \$1,000 loss because you must use the FMV (\$8,000) at the time of the gift to figure loss. If the sales price is between \$8,000 and \$10,000, you have neither gain nor loss.

**Business property.** If you hold the gift as business property, your basis for figuring any depreciation, depletion, or amortization deduction is the same as the donor's adjusted basis plus or minus any required adjustments to basis while you hold the property.

**FMV equal to or greater than donor's adjusted basis.** If the FMV of the property is equal to or greater than the donor's adjusted basis, your basis is the donor's adjusted basis at the time you received the gift. Increase your basis by all or part of any gift tax paid, depending on the date of the gift.

Also, for figuring gain or loss from a sale or other disposition or for figuring depreciation, depletion, or amortization deductions on business property, you must increase or decrease your basis (the donor's adjusted basis) by any required adjustments to basis while you held the property. See *Adjusted Basis*, earlier.

**Gift received before 1977.** If you received a gift before 1977, increase your basis in the gift (the donor's adjusted basis) by any gift tax paid on it. However, do not increase your basis above the FMV of the gift at the time it was given to you.

**Gift received after 1976.** If you received a gift after 1976, increase your basis in the gift (the donor's adjusted basis) by the part of any gift tax that is due to the net increase in value of the gift. Figure the increase by multiplying the gift tax paid by a fraction. The numerator of the fraction is the net increase in value of the gift and the denominator is the amount of the gift.

The net increase in value of the gift is the FMV of the gift minus the donor's adjusted basis. The amount of the gift is its value for gift tax purposes after reduction by any annual exclusion and marital or charitable deduction that applies to the gift. For information on the gift tax, see Publication 950, *Introduction to Estate and Gift Taxes*.

**Example.** In 1999, you received a gift of property from your mother that had an FMV of \$50,000. Her adjusted basis was \$20,000. The amount of the gift for gift tax purposes was \$40,000 (\$50,000 minus the \$10,000 annual exclusion). She paid a gift tax of \$9,000 on the property. Your basis is \$26,750, figured as follows:

Fair market value .....	\$50,000
Minus: Adjusted basis .....	<u>20,000</u>
Net increase in value .....	<u>\$30,000</u>
Gift tax paid .....	\$9,000
Multiplied by (\$30,000 ÷ \$40,000) .....	<u>× .75</u>
Gift tax due to net increase in value .....	\$6,750
Adjusted basis of property to your mother .....	<u>+20,000</u>
<b>Your basis in the property .....</b>	<b><u>\$26,750</u></b>

## Inherited Property

Your basis in property you inherit from a decedent is generally one of the following.

- 1) The FMV of the property at the date of the individual's death.
- 2) The FMV on the alternate valuation date, if the personal representative for the estate chooses to use alternate valuation.
- 3) The value under the special-use valuation method for real property used in farming or other closely held business, if chosen for estate tax purposes.
- 4) The decedent's adjusted basis in land to the extent of the value excluded from the decedent's taxable estate as a qualified conservation easement.

If a federal estate tax return does not have to be filed, your basis in the inherited property is its appraised value at the date of death for state inheritance or transmission taxes.

For more information about the basis of inherited property, see *Inherited Property* in Publication 551.

## Property Changed to Business or Rental Use

When you hold property for personal use and change it to business use or use it to produce rent, you must figure its basis for depreciation. An example of changing property held for personal use to business use would be renting out your former main home.

**Basis for depreciation.** The basis for depreciation is the lesser of the following amounts.

- 1) The FMV of the property on the date of the change.
- 2) Your adjusted basis on the date of the change.

**Example.** Several years ago, you paid \$160,000 to have your house built on a lot that cost \$25,000. Before changing the property to rental use last year, you paid \$20,000 for permanent improvements to the house and claimed a \$2,000 casualty loss deduction for damage to the house. Because land is not depreciable, you can only include the cost of the house when figuring the basis for depreciation.

Your adjusted basis in the house when you changed its use was \$178,000 (\$160,000 + \$20,000 - \$2,000). On the same date, your property had an FMV of \$180,000, of which \$15,000 was for the land and \$165,000 was for the house. The basis for figuring depreciation on the house is the FMV on the date of the change (\$165,000) because it is less than your adjusted basis (\$178,000).

**Sale of property.** If you later sell or dispose of the property, the basis you use will depend on whether you are figuring gain or loss.

**Gain.** The basis for figuring a gain is your adjusted basis when you sell the property.

**Example.** Assume the same facts as the previous example except that you sell the property at a gain after being allowed depreciation deductions of \$37,500. The basis for figuring gain is \$165,500 (\$178,000 + \$25,000 (land) – \$37,500).

**Loss.** Figure the basis for a loss starting with the smaller of your adjusted basis or the FMV of the property at the time of the change to business or rental use.

**Example.** Assume the same facts as in the previous example, except that you sell the property at a loss after being allowed depreciation deductions of \$37,500. In this case, you would start with the FMV (\$180,000) on the date of the change to rental use, because it is less than the adjusted basis of \$203,000 (\$178,000 + \$25,000) on that date. Reduce that amount (\$180,000) by the amount of depreciation deductions to arrive at a basis for loss of \$142,500 (\$180,000 – \$37,500).

## Stocks and Bonds

The basis of stocks or bonds you buy generally is the purchase price plus any costs of purchase, such as commissions and recording or transfer fees. If you get stocks or bonds other than by purchase, your basis is usually determined by the FMV or the previous owner's adjusted basis, as discussed earlier.

You must adjust the basis of stocks for certain events that occur after purchase. For example, if you receive additional stock from nontaxable stock dividends or stock splits, reduce the basis of your original stock. Also reduce your basis when you receive nontaxable distributions. They are a return of capital.

**Example.** In 1997 you bought 100 shares of XYZ stock for \$1,000 or \$10 a share. In 1998 you bought 100 shares of XYZ stock for \$1,600 or \$16 a share. In 1999 XYZ declared a 2-for-1 stock split. You now have 200 shares of stock with a basis of \$5 a share and 200 shares with a basis of \$8 a share.

**Other basis.** There are other ways to figure the basis of stocks or bonds depending on how you acquired them. For detailed information, see Publication 550.

**Identifying stocks or bonds sold.** If you can adequately identify the shares of stock or the bonds you sold, their basis is the cost or other basis of the particular shares of stocks or bonds. If you buy and sell securities at various times in varying quantities and you cannot adequately identify the shares you sell, the basis of the securities you sell is the basis of the securities you acquired first. For more information about identifying securities you sell, see *Stocks*

and *Bonds* under *Basis of Investment Property* in chapter 4 of Publication 550.

**Mutual fund shares.** If you sell mutual funds that you acquired at various times and prices, you can choose to use an average basis. For more information, see Publication 564.

**Bond premium.** If you buy a taxable bond at a premium and choose to amortize the premium, reduce the basis of the bond by the amortized premium you deduct each year. See *Bond Premium Amortization* in chapter 3 of Publication 550 for more information. Although you cannot deduct the premium on tax-exempt bonds, you must amortize the premium each year and reduce your basis in the bonds by the amortized amount.

**Original issue discount (OID) on debt instruments.** You must increase your basis in an OID debt instrument by the OID you include in income for that instrument. See *Original Issue Discount* in chapter 8.

**Tax-exempt bonds.** OID on tax-exempt bonds is generally not taxable. However, there are special rules for figuring basis on these bonds issued after September 3, 1982, and acquired after March 1, 1984. See chapter 4 of Publication 550.

## Sale of Property

### Important Reminder

**Foreign-source income.** If you are a U.S. citizen with investment income from sources outside the United States (foreign income), you must report all that income on your tax return unless it is exempt by U.S. law. This is true whether you reside inside or outside the United States and whether or not you receive a Form 1099 from the foreign payer.

### Introduction

This chapter discusses the tax consequences of selling or trading investment property. It explains:

- What is a sale or trade,
- When you have a nontaxable trade,
- What to do with a related party transaction,
- Whether the property you sell is a capital asset or a noncapital asset,
- Whether you have a capital or ordinary gain or loss from the sale of property,
- How to determine your holding period, and
- When you can make a tax-free rollover of a gain from selling certain securities.

**Sales not discussed in this publication.** Certain sales or trades of property are discussed in other publications. They include, for example, installment sales, covered in Publication 537, *Installment Sales*, and transfers of property at death, covered in Publication 559, *Survivors, Executors, and Administrators*.

Publication 544, *Sales and Other Dispositions of Assets*, provides information about various types of transactions involving business property.

Publication 550, *Investment Income and Expenses (Including Capital Gains and Losses)*, provides more detailed discussion about sales and trades of investment property. Publication 550 includes information about the rules covering nonbusiness bad debts, straddles, section 1256 contracts, puts and calls, commodity futures, short sales, and wash sales. It also discusses investment-related expenses.

Publication 925, *Passive Activity and At-Risk Rules*, discusses the rules that limit losses and credits from passive activities as well as the rules that apply to the disposition of an interest in a passive activity.

If you sell your home, different tax rules apply. These rules are discussed in chapter 16.

### Useful Items

You may want to see:

#### Publication

- 504** Divorced or Separated Individuals
- 550** Investment Income and Expenses
- 564** Mutual Fund Distributions

#### Form (and Instructions)

- Schedule D (Form 1040)** Capital Gains and Losses
- 8824** Like-Kind Exchanges

## Sales and Trades

If you sold property such as stocks, bonds, or certain commodities through a broker during the year, you should receive, for each sale, a **Form 1099-B, Proceeds From Broker and Barter Exchange Transactions**, or an equivalent statement from the broker. You should receive the statement by January 31 of the next year. It will show the gross proceeds from the sale. The IRS will also get a copy of Form 1099-B from the broker.

If you receive a Form 1099-B or equivalent statement, you must complete Schedule D of Form 1040.

### What is a Sale or Trade?

This section explains what a sale or trade is. It also explains certain transactions and events that are treated as sales or trades.

A sale is generally a transfer of property for money or a mortgage, note, or other promise to pay money. A trade is a transfer of property for other property or services and may be taxed in the same way as a sale.

**Sale and purchase.** Ordinarily, a transaction is not a trade when you voluntarily sell property for cash and immediately buy similar property to replace it. The sale and purchase are two separate transactions. But see *Like-kind exchanges* under *Non-taxable Trades*, later.

**Redemption of stock.** A redemption of stock is treated as a sale or trade and is subject to the capital gain or loss provisions unless the redemption is a dividend or other distribution on stock.

**Dividend vs. sale or trade.** Whether a redemption is treated as a sale, trade, dividend, or other distribution depends on the circumstances in each case. Both direct and indirect ownership of stock will be considered. The redemption is treated as a sale or trade of stock if:

- 1) The redemption is not essentially equivalent to a dividend (see chapter 9),
- 2) There is a substantially disproportionate redemption of stock,

- 3) There is a complete redemption of all the stock of the corporation owned by the shareholder, or
- 4) The redemption is a distribution in partial liquidation of a corporation.

**Redemption or retirement of bonds.** A redemption or retirement of bonds or notes at their maturity is generally treated as a sale or trade. You must report the transaction on Schedule D (Form 1040) whether or not you realize gain or loss.

**Surrender of stock.** A surrender of stock by a dominant shareholder who retains control of the corporation is treated as a contribution to capital rather than as an immediate loss deductible from taxable income. The surrendering shareholder must reallocate his or her basis in the surrendered shares to the shares he or she retains.

**Worthless securities.** Stocks, stock rights, and bonds (other than those held for sale by a securities dealer) that became worthless during the tax year are treated as though they were sold on the last day of the tax year. This affects whether your capital loss is long-term or short-term. See *Holding Period*, later.

If you are a cash basis taxpayer and make payments on a negotiable promissory note that you issued for stock that became worthless, you can deduct these payments as losses in the years you actually make the payments. Do not deduct them in the year the stock became worthless.

**How to report loss.** Report worthless securities on line 1 or line 8 of Schedule D (Form 1040), whichever applies. In columns (c) and (d), write "Worthless." Enter the amount of your loss in parentheses in column (f).

**Filing a claim for refund.** If you do not claim a loss for a worthless security on your original return for the year it becomes worthless, you can file a claim for a credit or refund due to the loss. You must use Form 1040X, *Amended U.S. Individual Income Tax Return*, to amend your return for the year the security became worthless. You must file it within 7 years from the date your original return for that year had to be filed, or 2 years from the date you paid the tax, whichever is later. For more information about filing a claim, see *Amended Returns and Claims for Refund* in chapter 1.

### How To Figure Gain or Loss

You figure gain or loss on a sale or trade of property by comparing the amount you realize with the adjusted basis of the property.

**Gain.** If the amount you realize from a sale or trade is more than the adjusted basis of the property you transfer, the difference is a gain.

**Loss.** If the adjusted basis of the property you transfer is more than the amount you realize, the difference is a loss.

**Adjusted basis.** The adjusted basis of property is your original cost or other original basis properly adjusted (increased or decreased) for certain items. See chapter

14 for more information about determining the adjusted basis of property.

**Amount realized.** The amount you realize from a sale or trade of property is everything you receive for the property. This includes the money you receive plus the fair market value of any property or services you receive.

If you finance the buyer's purchase of your property and the debt instrument does not provide for adequate stated interest, the unstated interest will reduce the amount realized. For more information, see Publication 537.

**Fair market value.** Fair market value is the price at which the property would change hands between a buyer and a seller, neither being forced to buy or sell and both having reasonable knowledge of all the relevant facts.

The fair market value of notes or other debt instruments you receive as a part of the sale price is usually the best amount you can get from selling them to, or discounting them with, a bank or other buyer of debt instruments.

**Example.** You trade A Company stock with an adjusted basis of \$7,000 for B Company stock with a fair market value of \$10,000, which is your amount realized. Your gain is \$3,000 (\$10,000 minus \$7,000). If you also receive a note for \$6,000 that has a discount value of \$4,000, your gain is \$7,000 (\$10,000 plus \$4,000 minus \$7,000).

**Debt paid off.** A debt against the property, or against you, that is paid off as a part of the transaction, or that is assumed by the buyer, must be included in the amount realized. This is true even if neither you nor the buyer is personally liable for the debt. For example, if you sell or trade property that is subject to a nonrecourse loan, the amount you realize generally includes the full amount of the note assumed by the buyer even if the amount of the note is more than the fair market value of the property.

**Example.** You sell stock that you had pledged as security for a bank loan of \$8,000. Your basis in the stock is \$6,000. The buyer pays off your bank loan and pays you \$20,000 in cash. The amount realized is \$28,000 (\$20,000 plus \$8,000). Your gain is \$22,000 (\$28,000 minus \$6,000).

**Payment of cash.** If you trade property for other property and in addition pay cash, the amount you realize is the fair market value of the property you receive. Determine your gain or loss by subtracting the cash you pay plus the adjusted basis of the property you traded in from the amount you realize. If the result is a positive number, it is a gain. If the result is a negative number, it is a loss.

**No gain or loss.** You may have to use a basis for figuring gain that is different from the basis used for figuring loss. In this case, you may have neither a gain nor a loss. See *Other Basis* in chapter 14.

## Nontaxable Trades

Certain trades or exchanges are nontaxable. This means that any gain from the exchange is not taxed, and any loss cannot be deducted. In other words, even though you may realize a gain or loss on the exchange, it will not be recognized for tax purposes. The property you get generally has the same basis as the adjusted basis of the property you gave up.

For more information on nontaxable trades, see chapter 1 of Publication 544.

**Like-kind exchanges.** If you trade business or investment property for other business or investment property of a like kind, you must postpone tax on the gain or postpone deducting the loss until you sell or dispose of the property you receive. To be nontaxable, a trade must meet all six of the following conditions.

- 1) The property must be business or investment property. You must hold both the property you trade and the property you receive for productive use in your trade or business or for investment. Neither property may be property used for personal purposes, such as your home or family car.
- 2) The property must not be held primarily for sale. The property you trade and the property you receive must not be property you sell to customers, such as merchandise.
- 3) The property must not be stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest, including partnership interests. However, you can have a nontaxable trade of corporate stocks under a different rule, as discussed later.
- 4) There must be a trade of like property. The trade of real estate for real estate, or personal property for similar personal property is a trade of like property. The trade of an apartment house for a store building, or a panel truck for a pickup truck, is a trade of like property. The trade of a piece of machinery for a store building is not a trade of like property. Real property located in the United States and real property located outside the United States are not like property. Also, personal property used predominantly within the United States and personal property used predominantly outside the United States are not like property.
- 5) The property to be received must be identified within 45 days after the date you transfer the property given up in the trade.
- 6) The property to be received must be received by the earlier of:
  - a) The 180th day after the date on which you transfer the property given up in the trade, or
  - b) The due date, including extensions, for your tax return for the year in which the transfer of the property given up occurs.

If you trade property with a related party in a like-kind exchange, a special rule may

apply. See *Related Party Transactions*, later in this chapter. Also, see chapter 1 of Publication 544 for more information on exchanges of business property and special rules for exchanges using qualified intermediaries or involving multiple properties.

**Partially nontaxable exchange.** If you receive cash or unlike property in addition to like property, and the above six conditions are met, you have a partially nontaxable trade. You are taxed on any gain you realize, but only to the extent of the cash and the fair market value of the unlike property you receive. You cannot deduct a loss.

**Like property and unlike property transferred.** If you give up unlike property in addition to the like property, you must recognize gain or loss on the unlike property you give up. The gain or loss is the difference between the adjusted basis of the unlike property and its fair market value.

**Like property and money transferred.** If the above six conditions are met, you have a nontaxable trade even if you pay money in addition to the like property.

**Basis of property received.** To figure the basis of the property received, see *Nontaxable Exchanges* in chapter 14.

**How to report.** You must report the trade of like property on **Form 8824, Like-Kind Exchanges**. If you figure a recognized gain or loss on Form 8824, report it on Schedule D of Form 1040 or on Form 4797, *Sales of Business Property*, whichever applies.

For information on using Form 4797, see chapter 4 of Publication 544.

**Corporate stocks.** The following trades of corporate stocks generally do not result in a taxable gain or a deductible loss.

**Stock for stock of the same corporation.** You can exchange common stock for common stock or preferred stock for preferred stock in the same corporation without having a recognized gain or loss. This is true for a trade between two stockholders as well as a trade between a stockholder and the corporation.

**Corporate reorganizations.** In some instances, you can trade common stock for preferred stock, preferred stock for common stock, or stock in one corporation for stock in another corporation without having a recognized gain or loss. These trades must be part of mergers, recapitalizations, transfers to controlled corporations, bankruptcies, corporate divisions, corporate acquisitions, or other corporate reorganizations.

**Convertible stocks and bonds.** You generally will not have a recognized gain or loss if you convert bonds into stock or preferred stock into common stock of the same corporation according to a conversion privilege in the terms of the bond or the preferred stock certificate.

**Property for stock of a controlled corporation.** If you transfer property to a corporation solely in exchange for stock in that corporation, and immediately after the trade you are in control of the corporation, you ordinarily will not recognize a gain or loss. This rule applies both to individuals and to groups who transfer property to a corporation. It does not apply if the corporation is an investment company.

For this purpose, to be in control of a corporation, you or your group of investors

must own, immediately after the exchange, at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the outstanding shares of each class of nonvoting stock of the corporation.

If this provision applies to you, you must attach to your return a complete statement of all facts pertinent to the exchange.

**Additional information.** For more information on trades of stock, see *Nontaxable Trades* in Publication 550.

**Insurance policies and annuities.** You will not have a recognized gain or loss if you trade:

- 1) A life insurance contract for another life insurance contract or for an endowment or annuity contract,
- 2) An endowment contract for an annuity contract or for another endowment contract that provides for regular payments beginning at a date not later than the beginning date under the old contract, or
- 3) An annuity contract for another annuity contract.

The insured or annuitant must be the same under both contracts. Exchanges of contracts not included in this list, such as an annuity contract for an endowment contract, or an annuity or endowment contract for a life insurance contract, are taxable.

**U.S. Treasury notes or bonds.** You can trade certain issues of U.S. Treasury obligations for other issues, designated by the Secretary of the Treasury, with no gain or loss recognized on the trade. See *U.S. Treasury Notes or Bonds* under *Nontaxable Trades* in Publication 550 for information about the tax treatment of income from these investments.

## Transfers Between Spouses

Generally, no gain or loss is recognized on a transfer of property from an individual to (or in trust for the benefit of) a spouse, or if incident to a divorce, a former spouse. This nonrecognition rule does not apply if the recipient spouse or former spouse is a nonresident alien. The rule also does not apply to a transfer in trust to the extent the adjusted basis of the property is less than the amount of the liabilities assumed plus any liabilities on the property.

Any transfer of property to a spouse or former spouse on which gain or loss is not recognized is treated by the recipient as a gift and is not considered a sale or exchange. The recipient's basis in the property will be the same as the adjusted basis of the giver immediately before the transfer. This carryover basis rule applies whether the adjusted basis of the transferred property is less than, equal to, or greater than either its fair market value at the time of transfer or any consideration paid by the recipient. This rule applies for purposes of determining loss as well as gain. Any gain recognized on a transfer in trust increases the basis.

A transfer of property is incident to a divorce if the transfer occurs within one year after the date on which the marriage ends, or if the transfer is related to the ending of the marriage.

For more information, see Publication 504.

## Related Party Transactions

Special rules apply to the sale or trade of property between related parties.

**Gain on sale or trade of depreciable property.** Your gain from the sale or trade of property to a related party may be ordinary income, rather than capital gain, if the property can be depreciated by the party receiving it. See chapter 2 in Publication 544 for more information.

**Like-kind exchanges.** Generally, if you trade business or investment property for other business or investment property of a like kind, no gain or loss is recognized. See *Like-kind exchanges* earlier under *Nontaxable Trades*.

This rule also applies to trades of property between related parties, defined next under *Losses on sales or trades of property*. However, if either you or the related party disposes of the like property within 2 years after the trade, you both must report any gain or loss not recognized on the original trade on your return filed for the year in which the later disposition occurs.

**Losses on sales or trades of property.** You cannot deduct a loss on the sale or trade of property, other than a distribution in complete liquidation of a corporation, if the transaction is directly or indirectly between you and the following *related parties*.

- 1) Members of your family. This includes only your brothers and sisters, half-brothers and half-sisters, spouse, ancestors (parents, grandparents, etc.), and lineal descendants (children, grandchildren, etc.).
- 2) A partnership in which you directly or indirectly own more than 50% of the capital interest or the profits interest.
- 3) A corporation in which you directly or indirectly own more than 50% in value of the outstanding stock (see *Constructive ownership of stock*, later).
- 4) A tax-exempt charitable or educational organization that is directly or indirectly controlled, in any manner or by any method, by you or by a member of your family, whether or not this control is legally enforceable.

In addition, a loss on the sale or trade of property is not deductible if the transaction is directly or indirectly between the following related parties.

- 1) A grantor and fiduciary, or the fiduciary and beneficiary, of any trust.
- 2) Fiduciaries of two different trusts, or the fiduciary and beneficiary of two different trusts, if the same person is the grantor of both trusts.
- 3) A trust fiduciary and a corporation of which more than 50% in value of the outstanding stock is directly or indirectly owned by or for the trust, or by or for the grantor of the trust.
- 4) A corporation and a partnership if the same persons own more than 50% in value of the outstanding stock of the

corporation and more than 50% of the capital interest, or the profits interest, in the partnership.

- 5) Two S corporations if the same persons own more than 50% in value of the outstanding stock of each corporation.
- 6) Two corporations, one of which is an S corporation, if the same persons own more than 50% in value of the outstanding stock of each corporation.
- 7) An executor and a beneficiary of an estate (except in the case of a sale or trade to satisfy a pecuniary bequest).
- 8) Two corporations that are members of the same controlled group. (Under certain conditions, however, these losses are not disallowed but must be deferred.)
- 9) Two partnerships if the same persons own, directly or indirectly, more than 50% of the capital interests or the profits interests in both partnerships.

**Multiple property sales or trades.** If you sell or trade to a related party a number of blocks of stock or pieces of property in a lump sum, you must figure the gain or loss separately for each block of stock or piece of property. The gain on each item may be taxable. However, you cannot deduct the loss on any item. Also, you cannot reduce gains from the sales of any of these items by losses on the sales of any of the other items.

**Indirect transactions.** You cannot deduct your loss on the sale of stock through your broker if, under a prearranged plan, a related party buys the same stock you had owned. This does not apply to a trade between related parties through an exchange that is purely coincidental and is not prearranged.

**Constructive ownership of stock.** In determining whether a person directly or indirectly owns any of the outstanding stock of a corporation, the following rules apply.

**Rule 1.** Stock directly or indirectly owned by or for a corporation, partnership, estate, or trust is considered owned proportionately by or for its shareholders, partners, or beneficiaries.

**Rule 2.** An individual is considered to own the stock that is directly or indirectly owned by or for his or her family. Family includes only brothers and sisters, half-brothers and half-sisters, spouse, ancestors, and lineal descendants.

**Rule 3.** An individual owning, other than by applying rule 2, any stock in a corporation is considered to own the stock that is directly or indirectly owned by or for his or her partner.

**Rule 4.** When applying rule 1, 2, or 3, stock constructively owned by a person under rule 1 is treated as actually owned by that person. But stock constructively owned by an individual under rule 2 or rule 3 is not treated as owned by that individual for again applying either rule 2 or rule 3 to make another person the constructive owner of the stock.

**Property received from a related party.** If you sell or trade at a gain property that you acquired from a related party, you recognize the gain only to the extent it is more than the loss previously disallowed to the



related party. This rule applies only if you are the original transferee and you acquired the property by purchase or exchange. This rule does not apply if the related party's loss was disallowed because of the wash sale rules, described in Publication 550 under *Wash Sales*.

**Example 1.** Your brother sells you stock for \$7,600. His cost basis is \$10,000. Your brother cannot deduct the loss of \$2,400. Later, you sell the same stock to an unrelated party for \$10,500, realizing a gain of \$2,900. Your reportable gain is \$500 — the \$2,900 gain minus the \$2,400 loss not allowed to your brother.

**Example 2.** If, in *Example 1*, you sold the stock for \$6,900 instead of \$10,500, your recognized loss is only \$700 (your \$7,600 basis minus \$6,900). You cannot deduct the loss that was not allowed to your brother.

## Capital Gains and Losses

This section discusses the tax treatment of gains and losses from different types of investment transactions. For information about the tax treatment of gains and losses on the sale or exchange of property used in a trade or business, see Publication 544.

**Character of gain or loss.** You need to classify your gains and losses as either ordinary or capital gains or losses. You then need to classify your capital gains and losses as either short-term or long-term. If you have long-term gains and losses, you must identify your 28% rate gains and losses.

The correct classification and identification helps you figure the limit on capital losses and the correct tax on capital gains. Reporting capital gains and losses is explained in chapter 17.

## Capital or Ordinary Gain or Loss

If you have a taxable gain or a deductible loss from a transaction, it may be either a capital gain or loss or an ordinary gain or loss, depending on the circumstances. Generally, a sale or trade of a capital asset (defined next) results in a capital gain or loss. A sale or trade of a noncapital asset generally results in ordinary gain or loss. Depending on the circumstances, a gain or loss on a sale or trade of property used in a trade or business may be treated as either capital or ordinary, as explained in Publication 544. In some situations, part of your gain or loss may be a capital gain or loss, and part may be an ordinary gain or loss.

## Capital Assets and Noncapital Assets

For the most part, everything you own and use for personal purposes, pleasure, or investment is a **capital asset**. Some examples are:

- Stocks or bonds held in your personal account,

- A house owned and used by you and your family,
- Household furnishings,
- A car used for pleasure or commuting,
- Coin or stamp collections,
- Gems and jewelry, and
- Gold, silver, or any other metal.

The following items are **noncapital assets**.

- 1) **Property held mainly for sale to customers** or property that will physically become a part of the merchandise that is for sale to customers.
- 2) **Depreciable property** used in your trade or business, even if fully depreciated.
- 3) **Real property** used in your trade or business.
- 4) **A copyright, a literary, musical, or artistic composition, a letter or memorandum**, or similar property:
  - a) Created by your personal efforts,
  - b) Prepared or produced for you as a letter, memorandum, or similar property, or
  - c) Acquired under circumstances (for example, by gift) entitling you to the basis of the person who created the property or for whom it was prepared or produced.
- 5) **Accounts or notes receivable** acquired in the ordinary course of a trade or business for services rendered or from the sale of any of the properties described in (1).
- 6) **U.S. Government publications** that you received from the government free or for less than the normal sales price, or that you acquired under circumstances entitling you to the basis of someone who received the publications free or for less than the normal sales price.

## Property Held for Personal Use

Property held for personal use is a capital asset. Gain from a sale or trade of that property is a capital gain. Loss from the sale or trade of that property is not deductible. You can deduct a loss relating to personal use property only if it results from a casualty, such as a fire or hurricane, or a theft, as discussed in chapter 27.

## Investment Property

Investment property is a capital asset. Any gain or loss you have from its sale or trade is generally a capital gain or loss.

**Gold, silver, stamps, coins, gems, etc.** These are capital assets except when they are held for sale by a dealer. Any gain or loss you have from their sale or trade generally is a capital gain or loss.

**Stocks, stock rights, and bonds.** All of these (including stock received as a dividend) are capital assets except when held for sale by a securities dealer. However, if you own small business stock, see *Losses on Section 1244 (Small Business) Stock*

and *Losses on Small Business Investment Company Stock* in chapter 4 of Publication 550.

**Personal use property.** Property held for personal use only, rather than for investment, is a capital asset, and you must report a gain from its sale as a capital gain. However, you cannot deduct a loss from selling personal use property.

**Discounted debt instruments.** Treat your gain or loss on the sale, redemption, or retirement of a bond or other debt instrument originally issued at a discount or bought at a discount as capital gain or loss, except as explained in the following discussions.

**Short-term government obligations.** Treat gains on short-term federal, state, or local government obligations (other than tax-exempt obligations) as ordinary income up to your ratable share of the acquisition discount. This treatment applies to obligations that have a fixed maturity date not more than 1 year from the date of issue. **Acquisition discount** is the stated redemption price at maturity minus your basis in the obligation.

However, do not treat these gains as income to the extent you previously included the discount in income. See *Discount on Short-Term Obligations* in chapter 1 of Publication 550 for more information.

**Short-term nongovernment obligations.** Treat gains on short-term nongovernment obligations as ordinary income up to your ratable share of original issue discount (OID). This treatment applies to obligations that have a fixed maturity date of not more than 1 year from the date of issue.

However, to the extent you previously included the discount in income, you do not have to include it in income again. See *Discount on Short-Term Obligations* in chapter 1 of Publication 550 for more information.

**Tax-exempt state and local government bonds.** If these bonds were originally issued at a discount before September 4, 1982, or you acquired them before March 2, 1984, treat your part of the OID as tax-exempt interest. To figure your gain or loss on the sale or trade of these bonds, reduce the amount realized by your part of the OID.

If the bonds were issued after September 3, 1982, and acquired after March 1, 1984, increase the adjusted basis by your part of the OID to figure gain or loss. For more information on the basis of these bonds, see *Discounted tax-exempt obligations* in chapter 4 of Publication 550.

Any gain from market discount is usually taxable on disposition or redemption of tax-exempt bonds. If you bought the bonds before May 1, 1993, the gain from market discount is capital gain. If you bought the bonds after April 30, 1993, the gain from market discount is ordinary income.

You figure the market discount by subtracting the price you paid for the bond from the sum of the original issue price of the bond and the amount of accumulated OID from the date of issue that represented interest to any earlier holders. For more information, see *Market Discount Bonds* in chapter 1 of Publication 550.

A loss on the sale or other disposition of a tax-exempt state or local government bond is deductible as a capital loss.

**Redeemed before maturity.** If a state or local bond that was issued **before June 9, 1980**, is redeemed before it matures, the OID is not taxable to you.

If a state or local bond issued **after June 8, 1980**, is redeemed before it matures, the part of the OID that is earned while you hold the bond is not taxable to you. However, you must report the unearned part of the OID as a capital gain.

**Example.** On July 1, 1988, the date of issue, you bought a 20-year, 6% municipal bond for \$800. The face amount of the bond was \$1,000. The \$200 discount was OID. At the time the bond was issued, the issuer had no intention of redeeming it before it matured. The bond was callable at its face amount beginning 10 years after the issue date.

The issuer redeemed the bond at the end of 11 years (July 1, 1999) for its face amount of \$1,000 plus accrued annual interest of \$60. The OID earned during the time you held the bond, \$73, is not taxable. The \$60 accrued annual interest also is not taxable. However, you must report the unearned part of the OID (\$127) as a capital gain.

**Long-term debt instruments issued after 1954 and before May 28, 1969 (or before July 2, 1982, if a government instrument).** If you sell, trade, or redeem for a gain one of these debt instruments, the part of your gain that is not more than your ratable share of the OID at the time of the sale or redemption is ordinary income. The rest of the gain is capital gain. If, however, there was an intention to call the debt instrument before maturity, all of your gain that is not more than the entire OID is treated as ordinary income at the time of the sale. This treatment of taxable gain also applies to corporate instruments issued after May 27, 1969, under a written commitment that was binding on May 27, 1969, and at all times thereafter.

See *Original Issue Discount (OID)* in chapter 8 for more information.

**Long-term debt instruments issued after May 27, 1969 (or after July 1, 1982, if a government instrument).** If you hold one of these debt instruments, you must include a part of the OID in your gross income each year that you own the instrument. Your basis in the instrument is increased by the amount of OID that you have included in your gross income. See *Original Issue Discount (OID)* in chapter 8 for information about the OID that you must report on your tax return.

If you sell or trade the debt instrument before maturity, your gain is a capital gain. However, if at the time the instrument was originally issued there was an intention to call it before its maturity, your gain generally is ordinary income to the extent of the entire OID reduced by any amounts of OID previously includible in your income. In this case, the rest of the gain is a capital gain.

**Market discount bonds.** If the debt instrument has market discount and you chose to include the discount in income as it accrued, increase your basis in the debt instrument by the accrued discount to figure capital gain or loss on its disposition. If you did not choose to include the discount in income as it accrued, you must report gain as ordinary interest income up to the in-

strument's accrued market discount. The rest of the gain is capital gain. See *Market Discount Bonds* in chapter 1 of Publication 550.

**Retirement of debt instrument.** Any amount that you receive on the retirement of a debt instrument is treated in the same way as if you had sold or traded that instrument.

**Notes of individuals.** If you hold an obligation of an individual that was issued with OID after March 1, 1984, you generally must include the OID in your income currently, and your gain or loss on its sale or retirement is generally capital gain or loss. An exception to this treatment applies if the obligation is a loan between individuals and all of the following requirements are met.

- 1) The lender is not in the business of lending money.
- 2) The amount of the loan, plus the amount of any outstanding prior loans, is \$10,000 or less.
- 3) Avoiding federal tax is not one of the principal purposes of the loan.

If the exception applies, or the obligation was issued before March 2, 1984, you do not include the OID in your income currently. When you sell or redeem the obligation, the part of your gain that is not more than your accrued share of the OID at that time is ordinary income. The rest of the gain, if any, is capital gain. Any loss on the sale or redemption is capital loss.

**Deposits in insolvent or bankrupt financial institution.** If you can reasonably estimate your loss on a deposit because of the bankruptcy or insolvency of a qualified financial institution, you can choose to treat the amount as either a casualty loss or an ordinary loss in the current year. Either way, you claim the loss as an itemized deduction. Otherwise, you can wait until the year of final determination of the actual loss and treat the amount as a nonbusiness bad debt (discussed later) in that year.

If you claim a casualty loss, attach **Form 4684, Casualties and Thefts**, to your return. Each loss must be reduced by \$100. Your total casualty losses for the year are reduced by 10% of your adjusted gross income.

If you claim an ordinary loss, report it as a miscellaneous itemized deduction on line 22 of Schedule A (Form 1040). The maximum amount you can claim is \$20,000 (\$10,000 if you are married filing separately) reduced by any expected state insurance proceeds. Your loss is subject to the 2%-of-adjusted-gross-income limit. You cannot choose to claim an ordinary loss if any of the deposit is federally insured.

You cannot choose either of these methods if:

- 1) You own at least 1% of the financial institution,
- 2) You are an officer of the institution, or
- 3) You are related to such an owner or officer. You are related if you and the owner or officer are "related parties," as defined earlier under *Related Party Transactions*, or if you are the owner's or officer's aunt, uncle, nephew, or niece.

If the actual loss that is finally determined is more than the amount deducted as an estimated loss, you can claim the excess loss as a bad debt. If the actual loss is less than the amount deducted as an estimated loss, you must include in income (in the final determination year) the excess loss claimed. See *Recoveries*, in Publication 525, *Taxable and Nontaxable Income*.

## Sale of Annuity

The part of any gain on the sale of an annuity contract before its maturity date that is based on interest accumulated on the contract is ordinary income.

## Nonbusiness Bad Debts

If someone owes you money that you cannot collect, you have a bad debt. You may be able to deduct the amount owed to you when you figure your tax for the year the debt becomes worthless. A debt must be genuine for you to deduct a loss. A debt is genuine if it arises from a debtor-creditor relationship based on a valid and enforceable obligation to repay a fixed or determinable sum of money.

Bad debts that you did not get in the course of operating your trade or business are nonbusiness bad debts. To be deductible, nonbusiness bad debts must be totally worthless. You cannot deduct a partially worthless nonbusiness debt.

**Basis in bad debt required.** To deduct a bad debt, you must have a basis in it — that is, you must have already included the amount in your income or loaned out your cash. For example, you cannot claim a bad debt deduction for court-ordered child support not paid to you by your former spouse. If you are a cash method taxpayer (most individuals are), you generally cannot take a bad debt deduction for unpaid salaries, wages, rents, fees, interest, dividends, and similar items.

**How to report bad debts.** Deduct nonbusiness bad debts as short-term capital losses on Schedule D (Form 1040).

In Part I, line 1 of Schedule D, enter the name of the debtor and "statement attached," in column (a). Enter the amount of the bad debt in parentheses in column (f). Use a separate line for each bad debt.

For each bad debt, attach a statement to your return that contains:

- 1) A description of the debt, including the amount, and the date it became due,
- 2) The name of the debtor, and any business or family relationship between you and the debtor,
- 3) The efforts you made to collect the debt, and
- 4) Why you decided the debt was worthless. For example, you could show that the borrower has declared bankruptcy, or that legal action to collect would probably not result in payment of any part of the debt.

**Filing a claim for refund.** If you do not deduct a bad debt on your original return for the year it becomes worthless, you can file a claim for a credit or refund due to the bad debt. You must use Form 1040X, *Amended U.S. Individual Income Tax Return*, to amend your return for the year the debt

became worthless. You must file it within 7 years from the date your original return for that year had to be filed, or 2 years from the date you paid the tax, whichever is later. For more information about filing a claim, see *Amended Returns and Claims for Refund* in chapter 1.

**Additional information.** For more information, see *Nonbusiness Bad Debts* in Publication 550.

For information on business bad debts, see chapter 14 of Publication 535, *Business Expenses*.

## Losses on Small Business Stock

You can deduct as an ordinary loss, rather than as a capital loss, your loss on the sale, trade, or worthlessness of section 1244 stock. Any gain on this stock is capital gain and is reported on Schedule D (Form 1040) if the stock is a capital asset in your hands. See *Losses on Section 1244 (Small Business) Stock and Losses on Small Business Investment Company Stock* in chapter 4 of Publication 550.

## Holding Period

If you sold or traded investment property, you must determine your holding period for the property. Your holding period determines whether any capital gain or loss was a short-term or long-term capital gain or loss.

**Long term or short term.** If you hold investment property *more than 1 year*, any capital gain or loss is a **long-term** capital gain or loss. If you hold the property **1 year or less**, any capital gain or loss is a **short-term** capital gain or loss.

To determine how long you held the investment property, begin counting on the date after the day you acquired the property. The day you disposed of the property is part of your holding period.

**Example.** If you bought investment property on February 5, 1998 and sold it on February 5, 1999, your holding period is not more than one year and you will have a short-term capital gain or loss. If you sold it on February 6, 1999, your holding period is more than 1 year and you will have a long-term capital gain or loss.

## Securities traded on established market.

For securities traded on an established securities market, your holding period begins the day after the trade date you bought the securities, and ends on the trade date you sold them.



**Do not confuse the trade date with the settlement date, which is the date by which the stock must be delivered and payment must be made.**

**Example.** You are a cash method, calendar year taxpayer. You sold stock at a gain on December 30, 1999. According to the rules of the stock exchange, the sale was closed by delivery of the stock 3 trading days after the sale, on January 5, 2000. You received payment of the sales price on that same day. Report your gain on your 1999 return, even though you received the payment in 2000. The gain is long term or short term depending on whether you held

the stock more than 1 year. Your holding period ended on December 30. If you had sold the stock at a loss, you would also report it on your 1999 return.

**Nontaxable trades.** If you acquire investment property in a trade for other investment property and your basis for the new property is determined, in whole or in part, by your basis in the old property, your holding period for the new property begins on the day following the date you acquired the old property. Chapter 14 discusses basis.

**Property received as a gift.** If you receive a gift of property and your basis is determined by the donor's basis, your holding period is considered to have started on the same day the donor's holding period started.

If your basis is determined by the fair market value of the property, your holding period starts on the day after the date of the gift.

**Inherited property.** If you inherit investment property and your basis for it is:

- 1) Determined by its fair market value at the date of the decedent's death,
- 2) Determined by its fair market value at the alternate valuation date, or
- 3) The decedent's adjusted basis (for appreciated property),

your capital gain or loss on any later disposition of that property is treated as a long-term capital gain or loss. This is true regardless of how long you actually held the property. See *Inherited Property* in chapter 14.

**Real property bought.** To figure how long you have held real property bought under an unconditional contract, begin counting on the day after you received title to it or on the day after you took possession of it and assumed the burdens and privileges of ownership, whichever happened first. However, taking delivery or possession of real property under an option agreement is not enough to start the holding period. The holding period cannot start until there is an actual contract of sale. The holding period of the seller cannot end before that time.

## Loss on mutual fund or REIT stock held 6 months or less.

If you hold stock in a mutual fund or real estate investment trust (REIT) for 6 months or less and then sell it at a loss, special rules may apply. See chapter 4 of Publication 550.

## Automatic investment service and dividend reinvestment plans.

If you take part in a plan to buy stock through a bank or other agent, the date the bank or other agent buys the stock is your purchase date for figuring the holding period of that stock. In determining your holding period for shares bought by the bank or other agent, full shares are considered bought first and any fractional shares are considered bought last. If a full share or a partial share was bought over a period of more than one purchase date, your holding period for that share is a split holding period. A part of the share is considered to have been bought on each date that stock was bought by the

bank or other agent with the proceeds of available funds.

**Stock dividends.** The holding period for stock you received as a taxable stock dividend begins on the date of distribution.

The holding period for new stock you received as a nontaxable stock dividend begins on the same day as the holding period of the old stock. This rule also applies to stock acquired in a "spin-off," which is a distribution of stock or securities in a controlled corporation.

**Nontaxable stock rights.** Your holding period for nontaxable stock rights begins on the same day as the holding period of the underlying stock. The holding period for stock acquired through the exercise of stock rights begins on the date the right was exercised.

## Rollover of Gain From Publicly Traded Securities

You may qualify for a tax-free rollover of certain gains from the sale of publicly traded securities. This means that if you buy certain replacement property and make the choice described in this section, you postpone part or all of your gain. You postpone the gain by adjusting the basis of the replacement property as described in *Basis of replacement property*, later. This postpones your gain until the year you dispose of the replacement property.

You qualify to make this choice if you meet all the following tests.

- 1) You sell publicly traded securities at a gain. Publicly traded securities are securities traded on an established securities market.
- 2) Your gain from the sale is a capital gain.
- 3) During the 60-day period beginning on the date of the sale, you buy replacement property. This replacement property must be either common stock or a partnership interest in a specialized small business investment company (SSBIC). This is any partnership or corporation licensed by the Small Business Administration under section 301(d) of the Small Business Investment Act of 1958, as in effect on May 13, 1993.

**Amount of gain recognized.** If you make the choice described in this section, you must recognize gain only up to the following amount:

- 1) The amount realized on the sale, minus
- 2) The cost of any common stock or partnership interest in an SSBIC that you bought during the 60-day period beginning on the date of sale (and did not previously take into account on an earlier sale of publicly traded securities).

If this amount is less than the amount of your gain, you can postpone the rest of your gain, subject to the limit described next. If this amount is equal to or more than the amount of your gain, you must recognize the full amount of your gain.

**Limit on gain postponed.** The amount of gain you can postpone each year is limited to the smaller of:

- 1) \$50,000 (\$25,000 if you are married and file a separate return), or
- 2) \$500,000 (\$250,000 if you are married and file a separate return), minus the amount of gain you postponed for all earlier years.

**Basis of replacement property.** You must subtract the amount of postponed gain from the basis of your replacement property.

**How to report gain.** See the Schedule D (Form 1040) instructions for details on how to report the gain.

# 16.

## Selling Your Home

### Important Reminders

**Change of address.** If you change your mailing address, be sure to notify the IRS using Form 8822, *Change of Address*. Mail it to the Internal Revenue Service Center for your old address (addresses for the Service Centers are on the back of the form).

**Home sold with undeducted points.** If you have not deducted all the points you paid to secure a mortgage on your old home, you may be able to deduct the remaining points in the year of the sale. See *Mortgage ending early* under *Points* in chapter 25.

### Introduction

This chapter explains the tax rules that apply when you sell your main home. Generally, your main home is the one in which you live most of the time.

**Gain.** If you have a gain from the sale of your main home, you may be able to exclude from income up to a limit of \$250,000 (\$500,000 on a joint return in most cases).

**Loss.** You cannot deduct a loss from the sale of your main home.

**Worksheets.** Publication 523, *Selling Your Home*, includes worksheets to help you figure the adjusted basis of the home you sold, the gain (or loss) on the sale, and the amount of the gain that you can exclude.

**Reporting the sale.** Do not report the sale of your main home on your tax return unless you have a gain and at least part of it is taxable. Report any taxable gain on Schedule D (Form 1040).

**Who may need to read chapter 3 in Publication 523.** Chapter 3 of Publication 523 explains the rules that applied to sales before May 7, 1997. Those rules may still apply to you if you are in either of the following situations.

- 1) You sold your main home at a gain before May 7, 1997, and either:
  - a) Bought a new home in 1999 within the replacement period, or
  - b) Did not buy a new home before your replacement period ended in 1999.
- 2) You sold your main home at a gain in 1999, and made the choice to use the rules that applied to sales of a main home before May 7, 1997.

If you are in either of these situations and

have questions, see Publication 523.

### Useful Items

You may want to see:

#### Publication

- 523** Selling Your Home
- 530** Tax Information for First-Time Homeowners

#### Form (and Instructions)

- Schedule D (Form 1040)** Capital Gains and Losses
- 8822** Change of Address
- 8828** Recapture of Federal Mortgage Subsidy

### Main Home

Usually, the home you live in most of the time is your main home and can be a:

- House,
- Houseboat,
- Mobile home,
- Cooperative apartment, or
- Condominium.

To exclude gain under the rules of this chapter, you generally must have owned and lived in the property as your main home for at least 2 years during the 5-year period ending on the date of sale.

**Land.** You may sell the land on which your main home is located, but not the house itself. In this case, you cannot postpone or exclude any gain you have from the sale of the land.

**Example.** On March 3, 1999, you sell the land on which your main home is located. You buy another piece of land and move your house to it. This sale is not considered a sale of your main home, and you cannot exclude tax on any gain on the sale.

**More than one home.** If you have more than one home, only the sale of your main home qualifies for postponing or excluding gain. 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 town. You also own a beach house, which you use in the summer months. The town house is your main home; the beach house is not.

**Example 2.** You own a house, but you live in another house that you rent. The rented home is your main home.

**Property used partly as your home.** If you use only part of the property as your main home, the rules discussed in this chapter apply only to the gain or loss on the sale of that part of the property. For details, see *Property used partly as your home and partly for business or rental during the year of sale* under *Business Use or Rental of Home*, later.

## How To Figure Gain or Loss On the Sale

To figure the gain or loss on the sale of your main home, you must know the selling price, the amount realized, and the adjusted basis.

**Selling price.** The selling price is the total amount you receive for your home. It includes money, all notes, mortgages, or other debts assumed by the buyer as part of the sale, and the fair market value of any other property or any services you receive.

**Payment by employer.** You may have to sell your home because of a job transfer. If your employer pays you for a loss on the sale or for your selling expenses, do **not** include the payment as part of the selling price. Your employer will include it in box 1 of your Form W-2 and you will include it in your gross income as wages on line 7 of Form 1040.

**Option to buy.** If you grant an option to buy your home and the option is exercised, add the amount you receive for the option to the selling price of your home. If the option is not exercised, you must report the amount as ordinary income in the year the option expires. Report this amount on line 21 of Form 1040.

**Form 1099-S.** If you received Form 1099-S, box 2 should show the total amount you received for your home.

However, box 2 will not include the fair market value of any property other than cash or notes, or any services, you received or will receive. Instead, box 4 will be checked.

If you can exclude the entire gain from a sale, the person responsible for closing the sale generally will not have to report it on Form 1099-S. You will use sale documents and other records to figure the total amount you received for your home.

**Amount realized.** The amount realized is the selling price minus selling expenses.

**Selling expenses.** Selling expenses include:

- Commissions,
- Advertising fees,
- Legal fees, and
- Loan charges paid by the seller, such as loan placement fees or "points."

**Amount of gain or loss.** When you know the amount realized and the home's adjusted basis, you can figure your gain or loss. If the amount realized is more than the adjusted basis, the difference is a gain and, except for any part you can exclude, generally is taxable.

To figure your home's adjusted basis, see *Basis*, later.

**Jointly owned home.** If you and your spouse sell your jointly owned home and file a joint return, you figure your gain or loss as one taxpayer.

**Separate returns.** If you file separate returns, each of you must figure and report your own gain or loss according to your ownership interest in the home. Your ownership interest is determined by state law.

**Joint owners not married.** If you and a joint owner other than your spouse sell your jointly owned home, each of you must figure and report your own gain or loss according to your ownership interest in the home. Each of you applies the rules discussed in this chapter on an individual basis.

**Trading homes.** If you trade your old home for another home, treat the trade as a sale and a purchase.

**Example.** You owned and lived in a home that had an adjusted basis of \$41,000. A real estate dealer accepted your old home as a trade-in and allowed you \$50,000 toward a new house priced at \$80,000. You are considered to have sold your old home for \$50,000 and to have had a gain of \$9,000 (\$50,000 – \$41,000).

If the dealer had allowed you \$27,000 and assumed your unpaid mortgage of \$23,000 on your old home, your sales price would still be \$50,000 (the \$27,000 trade-in allowed plus the \$23,000 mortgage assumed).

**Foreclosure or repossession.** If your home was foreclosed on or repossessed, you have a sale.

**Form 1099-A and Form 1099-C.** Generally, you will receive Form 1099-A, *Acquisition or Abandonment of Secured Property*, from your lender. This form will have the information you need to determine the amount of your gain or loss and whether you have any ordinary income from cancellation of debt. If your debt is canceled, you may receive Form 1099-C, *Cancellation of Debt*.

**Abandonment.** If you abandon your home, you may have ordinary income. If the abandoned home secures a debt for which you are personally liable and the debt is canceled, you have ordinary income equal to the amount of the canceled debt. If the home is foreclosed on or repossessed, you may also have a gain or loss. See *Foreclosure or repossession*, above. Get Publication 523 for more information.

**Transfer to spouse.** If you transfer your home to your spouse, or to your former spouse incident to your divorce, you generally have no gain or loss. This is true even if you receive cash or other consideration for the home. Therefore, the rules in this chapter do not apply.

**Exception.** These transfer rules do not apply if your spouse or former spouse is a nonresident alien.

**More information.** If you need more information, see *Transfer to spouse* in Publication 523 and *Property Settlements* in Publication 504, *Divorced or Separated Individuals*.

## Gain On Sale

You will generally exclude all or part of the gain on the sale of your main home under the rules in this chapter. If you sold your home before 1998 different rules could apply. For more information and the rules that could apply to you, get Publication 523.

## Loss on Sale

You **cannot** deduct a loss on the sale of your home. It is a personal loss.

## Basis

You will need to know your basis in your home as a starting point for determining any gain or loss when you sell it. Your basis in your home is determined by how you got the home. Your basis is its cost if you bought it or built it. If you got it in some other way, its basis is either its fair market value when you received it or the adjusted basis of the person you received it from.

While you owned your home, you may have made adjustments (increases or decreases) to the basis. This adjusted basis is used to figure gain or loss on the sale of your home.

You can find more information on basis and adjusted basis in chapter 14 of this publication and in Publication 523.

**Settlement fees or closing costs.** When buying your home, you may have to pay 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 had to pay even if you paid cash for the home.

Chapter 14 lists some of the settlement fees and closing costs that you can include in the basis of property, including your home. It also lists some settlement costs that cannot be included in basis.

In addition to the items listed in chapter 14, you **cannot** include in basis:

- 1) Any fee or cost that you deducted as a moving expense (allowed for certain fees and costs before 1994), and
- 2) VA funding fees.

## Adjusted Basis

Adjusted basis is your basis **increased** or **decreased** by certain amounts.

**Increases to basis.** These include any:

- 1) Improvements that have a useful life of more than 1 year,
- 2) Additions,
- 3) Special assessments for local improvements, and
- 4) Amounts you spent after a casualty to restore damaged property.

**Decreases 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 that you 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 certain 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 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 improvements to the basis of your property.

**Examples.** Putting a recreation room in your unfinished basement, adding another bathroom or bedroom, putting up a new fence, putting in new plumbing or wiring, putting on a new roof, or paving your unpaved driveway are improvements.

**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.

**Examples.** Repainting your house inside or outside, fixing your gutters or floors, repairing leaks or plastering, and replacing broken window panes are examples of repairs.

 **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 the basis of your old home affects the basis of your new one, such as when you sold your old home before May 7, 1997, and postponed tax on any gain, you should keep those records 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 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*

## 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 will have to pay tax on your entire gain, unless you choose to use the rules in chapter 3 of Publication 523.

## Maximum Amount of Exclusion

You can exclude the entire gain on the sale of your main home up to:

- 1) \$250,000, 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 (not counting any sales before May 7, 1997).

## Reduced Maximum Exclusion

You can claim an exclusion, but the maximum amount of gain you can exclude will be reduced, if any of the following are true.

- 1) You did not meet the ownership and use tests for a home you owned on August 5, 1997, and sold before August 5, 1999.
- 2) You did not meet the ownership and use tests for a home you sold due to a change in health or place of employment.
- 3) Your exclusion would have been disallowed because of the rule described in *More Than One Home Sold During 2-Year Period*, next, except that you sold the home due to a change in health or place of employment.

See Publication 523 for a worksheet to figure your reduced exclusion.

## 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. If you cannot exclude the gain, you must include it in your income.

However, if you sold the home due to a change in health or place of employment, you can still claim an exclusion. The maximum amount you can exclude is reduced. See *Reduced Maximum Exclusion*, earlier.

**Sales before May 7, 1997.** When counting the number of sales during a 2-year period, do not count sales before May 7, 1997.

## 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 may still be able to claim an exclusion in some cases. The maximum amount you can claim will be reduced. See *Reduced Maximum Exclusion*, earlier.

**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) do 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 × 2) during the 5-year period. 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. See *Ownership and use tests met at different times*, later.

**Example 1 – met use test but not ownership test.** From 1990 through August 1998 Amanda lived with her parents in a house that her parents owned. On September 2, 1998, she bought this house from her parents. She continued to live there until December 15, 1999, when she sold it at a gain. Although Amanda **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 health or place of employment, as explained under *Reduced Maximum Exclusion*, earlier.

**Example 2 – period of absence.** Professor Paul Beard, who is single, bought and moved into a house on August 30, 1996. He lived in it as his main home continuously until January 5, 1998, when 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 out. On January 5, 1999, he sold the house. Because his leave was not a short temporary absence, he cannot include the period of leave to meet the 2-year use test. However, even though he did not live in the house for the required 2-year period, he does qualify for an exclusion because he owned the home on August 5, 1997, and sold it before August 5, 1999. See *Reduced Maximum Exclusion*, earlier. The maximum amount of gain he

can exclude will be less than \$250,000. In addition, he cannot exclude the part of the gain equal to the depreciation he claimed. 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 1990, Helen Jones lived in a rented apartment. The apartment building was later changed to a condominium and she bought her apartment on December 1, 1996. In 1997, Helen became ill and on April 14 of that year she moved to her daughter's home. On July 10, 1999, while still living in her daughter's home, she sold her apartment.

Helen 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, 1994, to July 10, 1999, the date she sold the apartment. She owned her apartment from December 1, 1996, to July 10, 1999 (over 2 years). She lived in the apartment from July 11, 1994 (the beginning of the 5-year period), to April 14, 1997 (over 2 years).

**Cooperative apartment.** If you sold stock in a cooperative housing corporation, the ownership and use tests are that, during the 5-year period ending on the date of sale, you must have:

- 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.

**Exception 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.

**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 because of buying the home on which you wish to exclude gain.

In addition, if buying the previous home enabled you to postpone all or part of the gain on the sale of a home you owned earlier, you can also include the time you owned and lived in that earlier home.

**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 and your spouse file a joint return for the year of sale, you can exclude gain if either spouse meets the ownership and use tests. (But see *Maximum Amount of Exclusion*, earlier.)

**Example 1 – one spouse meets use test.** Emily sells her home in June 1999. She marries Jamie later in the year. She meets the ownership and use tests, but Jamie does not. She can exclude up to \$250,000 of gain on a separate or joint return for 1999.

**Example 2 – each spouse sells a home.** The facts are the same as in *Example 1* except that Jamie also sells a home. He meets the ownership and use tests on his home. Emily and Jamie 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 the ownership and use tests.

**Example.** On May 30, 1993, Amy bought a house. She moved in on that date and lived in it until May 31, 1995, when she moved out of the house and put it up for rent. The house was rented from July 1, 1995, to March 31, 1997. Amy moved back into the house on April 1, 1997, and lived there until she sold it on January 31, 1999. During the 5-year period ending on the date of the sale (February 1, 1994 – January 31, 1999), Amy owned and lived in the house for more than 2 years as shown in the table below.

Five Year Period	Used as Home	Used as Rental
2/1/94 – 5/31/95	16 months	
6/1/95 – 3/31/97		22 months
4/1/97 – 1/31/99	22 months 38 months	22 months

Amy can exclude gain up to \$250,000.

**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 by adequate records or other evidence that the depreciation deduction allowed was less than the amount allowable, the amount you cannot exclude is the smaller figure.

**Example.** Micah sold his main home in 1999 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 December 1998 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 is located,
- An apartment building in which you live in one unit and rent out the others,
- A store building with an upstairs apartment in which you live, or
- A home with a room used for business 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, *Sales of Business Property*. For more information, see *Property used partly as your home and partly for business or rental during the year of sale*, under *Business Use or Rental of Home*, in chapter 2 of Publication 523.

## Special Situations

This section explains certain situations that may affect your exclusion.

**Expatriates.** You cannot claim the exclusion if section 877(a)(1) of the Internal Revenue Code applies to you. That section 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.

In addition, you cannot make the choice described under *Who may need to read chapter 3 of Publication 523*, in the introduction to this chapter. (You could make that choice if you sold your home before August 6, 1997.)

**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 the rules explained in:

- Publication 547, *Casualties, Disasters, and Thefts (Business and Nonbusiness)*, in the case of a home that was destroyed, or
- Chapter 1 of Publication 544, *Sales and Other Dispositions of Assets*, in the case of a home that was condemned.

**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, as explained under *Related Party Transactions* in chapter 15.

## Reporting the Gain

Do not report the 1999 sale of your main home on your tax return unless:

- You have a gain and do not qualify to exclude all of it,
- You have a gain and choose not to exclude it, or
- You made the choice described earlier, under *Who may need to read chapter 3 in Publication 523*, and have a taxable gain.

If you have any taxable gain on the sale of your main home, report the entire gain realized on Schedule D (Form 1040), *Capital Gains and Losses*, with your return. 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 (in parentheses).

**Choice made to use prior law rules.** If you made the choice to use the rules for sales before May 7, 1997, and you sold your home in 1998, see chapter 3 of Publication 523.

**Tax rate on capital gains.** Your net capital gain is taxed at a tax rate of 10%, 15%, 20%, 25%, or 28%, depending on your situation. See Chapter 17.

**Installment sale.** Some sales are made under arrangements that provide for part or all of the 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 may have an installment sale. If the sale qualifies, you can report the part of the gain you cannot exclude on the installment basis.

Use Form 6252, *Installment Sale Income*, to report the sale.

**Seller-financed mortgage.** If you sell your home and hold a note, mortgage, or other financial agreement, the payments you receive generally consist of both interest and principal. You must report the interest you receive as part of each payment separately as interest income. If the buyer of your home uses the property as a main or second home, you must also report the name, address, and social security number (SSN) of the buyer on line 1 of either Schedule B (Form 1040) or Schedule 1 (Form 1040A). The buyer must give you his or her SSN and you must give the buyer your SSN. Failure to meet these requirements may result in a \$50 penalty for each failure. If you or the buyer does not have and is not eligible to get an SSN, see the next discussion.

**Individual taxpayer identification number (ITIN).** If either you or the buyer of your home is a nonresident or resident alien who does not have and is not eligible to get an SSN, the IRS will issue you (or the buyer) an ITIN. To apply for an ITIN, file Form W-7 with the IRS.

If you have to include the buyer's SSN on your return and the buyer does not have and cannot get an SSN, enter the buyer's ITIN. If you have to give an SSN to the buyer and you do not have and cannot get one, give the buyer your ITIN.

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.

**More information.** For more information on installment sales, see Publication 537, *Installment Sales*.

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## Recapture of Federal Subsidy

If you financed your home under a federally subsidized program (loans from tax-exempt qualified mortgage bonds or loans with mortgage credit certificates), you may have to recapture all or part of the benefit you received from that program when you sell or otherwise dispose of your home. You recapture the benefit by increasing your federal income tax for the year of the sale. The exclusion of gain provisions discussed earlier in this chapter do not apply to this recapture tax.

The recapture tax is figured on **Form 8828**. If you sell your home and your mortgage loan is subject to the recapture rules, you must file Form 8828 even if you do not owe a recapture tax.

**Loans subject to recapture rules.** The recapture of the subsidy applies to loans provided after 1990 that:

- 1) Came from the proceeds of qualified mortgage bonds issued after August 15, 1986, or
- 2) Were based on mortgage credit certificates issued after 1990.

The recapture also applies to assumptions of these loans.

If your mortgage loan is subject to this recapture rule, you should have received a notice containing information that you need to figure the recapture tax.

**When the recapture applies.** The recapture of the federal mortgage subsidy applies only if you meet **both** of the following conditions.

- 1) You sell or otherwise dispose of your home:
  - a) At a gain, and
  - b) During the first 9 years after the date you closed your mortgage loan.
- 2) Your income for the year of disposition is more than that year's adjusted qualifying income for your family size for that year (related to the income requirements a person must meet to qualify for the federally subsidized program).

**When recapture does not apply.** The recapture does **not** apply if any of the following situations apply to you:

- Your mortgage loan was a qualified home improvement loan of not more than \$15,000,
- The home is disposed of as a result of your death,
- You dispose of the home more than 9 years after the date you closed your mortgage loan,
- You transfer the home to your spouse, or to your former spouse incident to a divorce, where no gain is included in your income,
- You dispose of the home at a loss,
- Your home is destroyed by a casualty, and you repair it or replace it on its original site within 2 years after the end of the tax year when the destruction happened, or
- You refinance your mortgage loan (unless you later meet all of the conditions listed previously under *When the recapture applies*).

# 17.

## Reporting Gains and Losses

### Important Change

**Reporting capital gain distributions.** For 1999, if your only capital gains are capital gain distributions, such as from mutual funds, you may not need to file Schedule D. Instead, the gains generally can be reported directly on Form 1040, line 13. A worksheet in the Form 1040 instructions is used to figure the tax. For more information on this simpler method of reporting, see *Capital gain distributions only* under *Schedule D*, later.

### Introduction

This chapter discusses how to report capital gains and losses from sales, exchanges, and other dispositions of investment property on Schedule D of Form 1040. The discussion includes:

- How to report short-term gains and losses,
- How to report long-term gains and losses,
- How to figure capital loss carryovers,
- How to figure your tax using the maximum tax rates on a net capital gain, and
- An illustrated example of how to complete Schedule D.

If you sell or otherwise dispose of property used in a trade or business or for the production of income, see Publication 544, *Sales and Other Dispositions of Assets*, before completing Schedule D.

### Useful Items

You may want to see:

#### Publication

- 537** Installment Sales
- 544** Sales and Other Dispositions of Assets
- 550** Investment Income and Expenses

#### Form (and Instructions)

- Schedule D (Form 1040)** Capital Gains and Losses
- 4797** Sales of Business Property
- 6252** Installment Sale Income
- 8582** Passive Activity Loss Limitations

## Schedule D

Report capital gains and losses on Schedule D (Form 1040). Enter your sales and trades of stocks, bonds, etc., and real estate (if not required to be reported on another form) on line 1 of Part I or line 8 of Part II, as appropriate. Include all these transactions even if you did not receive a Form 1099-B, *Proceeds From Broker and Barter Exchange Transactions*, or Form 1099-S, *Proceeds From Real Estate Transactions* (or substitute statement). You can use Schedule D-1 as a continuation schedule to report more transactions.

**Installment sales.** If you will receive any of the proceeds from the sale of your investment property after the year of sale, you may have an installment sale. Generally, you report gain from an installment sale using the installment method. Under this method, you report part of the gain each year that you receive a payment. For information, see Form 6252 and Publication 537.

**Stock or securities.** You cannot use the installment method to report gain from the sale of stock or securities traded on an established securities market. You must report the entire gain for the year of sale (the year in which the trade date occurs).

**Passive activity gains and losses.** If you have gains or losses from a passive activity, you may also have to report them on **Form 8582**. In some cases, the loss may be limited under the passive activity rules. Refer to Form 8582 and its separate instructions for more information about reporting capital gains and losses from a passive activity.

**Form 1099-B transactions.** If you sold property, such as stocks, bonds, or certain commodities, through a broker, you should receive Form 1099-B or equivalent statement from the broker. Use the Form 1099-B or the equivalent statement to complete Schedule D.

Report the gross proceeds shown in box 2 of Form 1099-B as the **gross sales price** in column (d) of either line 1 or line 8 of Schedule D, whichever applies. However, if the broker advises you, in box 2 of Form 1099-B, that gross proceeds (gross sales price) less commissions and option premiums were reported to the IRS, enter that **net sales price** in column (d) of either line 1 or line 8 of Schedule D, whichever applies. If the net amount is entered in column (d), do not include the commissions and option premiums in column (e).

**Form 1099-S transactions.** If you sold or traded reportable real estate, you should receive from the real estate reporting person a Form 1099-S showing the gross proceeds.

"Reportable real estate" is defined as any present or future ownership interest in any of the following:

- 1) Improved or unimproved land, including air space,
- 2) Inherently permanent structures, including any residential, commercial, or industrial building,

- 3) A condominium unit and its accessory fixtures and common elements, including land, and
- 4) Stock in a cooperative housing corporation (as defined in section 216 of the Internal Revenue Code).

A "real estate reporting person" could include the buyer's attorney, your attorney, the title or escrow company, a mortgage lender, your broker, the buyer's broker, or the person acquiring the biggest interest in the property.

Your Form 1099-S will show the gross proceeds from the sale or exchange in box 2. Follow the instructions for Schedule D to report these transactions and include them on line 1 or 8 as appropriate.

**Reconciling Forms 1099 with Schedule D.** Add the following amounts reported to you for 1999 on Forms 1099-S and 1099-B (or on substitute statements):

- 1) Proceeds from transactions involving stocks, bonds, and other securities, and
- 2) Gross proceeds from real estate transactions not reported on another form or schedule.

If this total is more than the total of lines 3 and 10 of Schedule D, attach a statement to your return explaining the difference.

### Sale of property bought at various times.

If you sell a block of stock or other property that you bought at various times, report the short-term gain or loss from the sale on one line in Part I of Schedule D and the long-term gain or loss on one line in Part II. Write "Various" in column (b) for the "Date acquired." See the *Comprehensive Example* later in this chapter.

**Sale expenses.** Add to your cost or other basis any expense of sale such as brokers' fees, commissions, state and local transfer taxes, and option premiums. Enter this adjusted amount in column (e) of either Part I or Part II of Schedule D, whichever applies, unless you reported the net sales price amount in column (d).

For more information about adjustments to basis, see chapter 14.

**Property held for personal use.** Property held for personal use is a capital asset. Gain from a sale or trade of that property is a capital gain. Loss from the sale or trade of that property is not deductible. You can deduct a loss relating to personal use property only if it results from a casualty.

**Short-term gains and losses.** Capital gain or loss on the sale or trade of investment property held 1 year or less is a short-term capital gain or loss. You report it in Part I of Schedule D. If the amount you report in column (f) is a loss, show it in parentheses.

You combine your share of short-term capital gains or losses from partnerships, S corporations, and fiduciaries, and any short-term capital loss carryover, with your other short-term capital gains and losses to figure your net short-term capital gain or loss on line 7 of Schedule D.

**Long-term gains and losses.** A capital gain or loss on the sale or trade of property held more than 1 year is a long-term capital gain or loss. You report it in Part II of Schedule D. Report the amount of each gain or loss in column (f). If you have a loss, show it in parentheses.

You also report the following in Part II of Schedule D:

- 1) Undistributed long-term capital gains from a regulated investment company (mutual fund) or real estate investment trust (REIT),
- 2) Your share of long-term capital gains or losses from partnerships, S corporations, and fiduciaries,
- 3) All capital gain distributions from mutual funds and REITs not reported directly on line 13 of Form 1040, and
- 4) Long-term capital loss carryovers.

The result from combining these items with your other long-term capital gains and losses is your net long-term capital gain or loss (line 16 of Schedule D).

**28% rate gain or loss.** Enter in column (g) the amount, if any, from column (f) that is a 28% rate gain or loss. Enter any loss in parentheses.

A 28% rate gain or loss is:

- Any collectibles gain or loss, or
- The part of your gain on qualified small business stock that is equal to the section 1202 exclusion.

For more information, see *Capital Gain Tax Rates*, later.

**Capital gain distributions only.** You do not have to file Schedule D if all of the following are true.

- 1) The only amounts you would have to report on Schedule D are capital gain distributions from box 2a of Form 1099-DIV (or substitute statement).
- 2) You do not have an amount in box 2b, 2c, or 2d of any Form 1099-DIV (or substitute statement).
- 3) If you file Form 4952, the amount on line 4e of that form is not more than zero.

If all the above statements are true, report your capital gain distributions directly on line 13 of Form 1040 and check the box on that line. Also, use the *Capital Gain Tax Worksheet* in the Form 1040 instructions to figure your tax.

**Total net gain or loss.** To figure your total net gain or loss, combine your net short-term capital gain or loss (line 7) with your net long-term capital gain or loss (line 16). Enter the result on line 17, Part III of Schedule D. If your losses are more than your gains, see *Capital Losses*, next. If both lines 16 and 17 are gains and line 39 of Form 1040 is more than zero, see *Capital Gain Tax Rates*, later.

## Capital Losses

If your capital losses are more than your capital gains, you can claim a capital loss deduction. Report the deduction on line 13 of Form 1040, enclosed in parentheses.

**Limit on deduction.** Your allowable capital loss deduction, figured on Schedule D, is the lesser of:

- 1) \$3,000 (\$1,500 if you are married and file a separate return), or
- 2) Your total net loss as shown on line 17 of Schedule D.

You can use your total net loss to reduce your income dollar for dollar, up to the \$3,000 limit.

**Capital loss carryover.** If you have a total net loss on line 17 of Schedule D that is more than the yearly limit on capital loss deductions, you can carry over the unused part to the next year and treat it as if you had incurred it in that next year. If part of the loss is still unused, you can carry it over to later years until it is completely used up.

When you figure the amount of any capital loss carryover to the next year, you must take the current year's allowable deduction into account, whether or not you claimed it.

When you carry over a loss, it remains long term or short term. A long-term capital loss you carry over to the next tax year will reduce that year's long-term capital gains before it reduces that year's short-term capital gains.

**Figuring your carryover.** The amount of your capital loss carryover is the amount of your total net loss that is more than the lesser of:

- 1) Your allowable capital loss deduction for the year, or
- 2) Your taxable income increased by your allowable capital loss deduction for the year and your deduction for personal exemptions.

If your deductions are more than your gross income for the tax year, use your negative taxable income in computing the amount in item (2).

Complete the *Capital Loss Carryover Worksheet* in the Schedule D (Form 1040) instructions to determine the part of your capital loss for 1999 that you can carry over to 2000.

**Example.** Bob and Gloria sold securities in 1999. The sales resulted in a capital loss of \$7,000. They had no other capital transactions. Their taxable income was \$26,000. On their joint 1999 return, they can deduct \$3,000. The unused part of the loss, \$4,000 (\$7,000 – \$3,000), can be carried over to 2000.

If their capital loss had been \$2,000, their capital loss deduction would have been \$2,000. They would have no carryover to 2000.

**Use short-term losses first.** When you figure your capital loss carryover, use your short-term capital losses first, even if you incurred them after a long-term capital loss. If you have not reached the limit on the capital loss deduction after using short-term losses, use the long-term losses until you reach the limit.

**Decedent's capital loss.** A capital loss sustained by a decedent during his or her last tax year (or carried over to that year from an earlier year) can be deducted only on the final income tax return filed for the decedent. The capital loss limits discussed earlier still apply in this situation. The decedent's estate cannot deduct any of the loss or carry it over to following years.

**Joint and separate returns.** If you and your spouse once filed separate returns and are now filing a joint return, combine your separate capital loss carryovers. However, if you and your spouse once filed a joint return and are now filing separate returns, any capital loss carryover from the joint return can be deducted only on the return of the person who actually had the loss.

## Capital Gain Tax Rates

The 31%, 36%, and 39.6% income tax rates for individuals do not apply to a net capital gain. In most cases, the 15% and 28% rates do not apply either. Instead, your net capital gain is taxed at a lower capital gain rate.

The term "net capital gain" means the amount by which your net long-term capital gain for the year is more than your net short-term capital loss.

The capital gains rate may be 10%, 15%, 20%, 25%, or 28%, or a combination of those rates, as shown in Table 17-1.

**Investment interest deducted.** If you claim a deduction for investment interest, you may have to reduce the amount of your net capital gain that is eligible for the capital gain tax rates. Reduce it by the amount of the net capital gain you choose to include in investment income when figuring the limit on your investment interest deduction. This is done on lines 20–22 of Schedule D. For more information about the limit on investment interest, see chapter 3 of Publication 550.

**Collectibles gain or loss.** This is gain or loss from the sale or trade of a work of art, rug, antique, metal, gem, stamp, coin, or alcoholic beverage held more than 1 year.

**Gain on qualified small business stock.** If you realized a gain from qualified small business stock that you held more than 5 years, you exclude one-half of your gain from income. The taxable part of your gain equal to your section 1202 exclusion is a 28% rate gain. See *Gains on Qualified Small Business Stock*, in chapter 4 of Publication 550.

**Unrecaptured section 1250 gain.** Generally, this is any part of your capital gain from selling section 1250 property (real property) that is due to depreciation (but not more than your net section 1231 gain), reduced by any net loss in the 28% group. Use the worksheet in the Schedule D instructions to figure your unrecaptured section 1250 gain. For more information about section 1250 property and section 1231 gain, see chapter 3 of Publication 544.

**Using Schedule D.** You apply these rules by using Part IV of Schedule D (Form 1040) to figure your tax. You will need to use Part IV if both of the following are true.

- 1) You have a net capital gain. You have a net capital gain if both lines 16 and 17 of Schedule D are gains. (Line 16 is your net long-term capital gain or

Table 17-1. What Is Your Capital Gain Tax Rate?

IF your net capital gain is from ...	THEN your capital gain rate is ...
Collectibles gain	28% <sup>1</sup>
Gain on qualified small business stock equal to the section 1202 exclusion	28% <sup>1</sup>
Unrecaptured section 1250 gain	25% <sup>1</sup>
Other gain, and your regular tax rate is 28% or higher	20%
Other gain, and your regular tax rate is 15%	10% <sup>2</sup>

<sup>1</sup> 15%, if your regular tax rate is 15%.

<sup>2</sup> The 10% rate applies only to the part of your net capital gain that would be taxed at 15% if there were no capital gains rates.

loss. Line 17 is your net long-term capital gain or loss combined with any net short-term capital gain or loss.)

- Your taxable income on Form 1040, line 39, is more than zero.

See the *Comprehensive Example*, later, for an example of how to figure your tax on Schedule D using the capital gain rates.

**Using Capital Gain Tax Worksheet.** If you have capital gain distributions but do not have to file Schedule D, figure your tax using the *Capital Gain Tax Worksheet* in the Form 1040 instructions. For more information, see *Capital gain distributions only*, earlier.

**Changes for years after 2000.** Beginning in the year 2001, the 10% maximum capital gains rate will be lowered to 8% for “qualified 5-year gain.”

Beginning in the year 2006, the 20% maximum capital gain rate will be lowered to 18% for qualified 5-year gain from property with a holding period that begins after 2000.

## Comprehensive Example

Emily Jones is single and, in addition to wages from her job, she has income from some stocks and other securities. For the 1999 tax year, she had the following capital gains and losses, which she reports on Schedule D. All the Forms 1099 she re-

ceived showed net sales prices. Her filled-in Schedule D is shown in this chapter.

### Capital gains and losses — Schedule D.

Emily sold stock in two different companies that she held for less than a year. In June, she sold 100 shares of Trucking Co. stock that she had bought in February. She had an adjusted basis of \$650 in the stock and sold it for \$900, for a gain of \$250. In July, she sold 25 shares of Computer Co. stock that she bought in June. She had an adjusted basis in the stock of \$2,500 and she sold it for \$2,000, for a loss of \$500. She reports these short-term transactions on line 1 in Part I of Schedule D.

Emily had three other stock sales that she reports as long-term transactions on line 8 in Part II of Schedule D. In February, she sold 60 shares of Car Co. for \$2,100. She had inherited the Car Co. stock from her father. Its fair market value at the time of his death was \$2,500, which became her basis. Her loss on the sale is \$400. Because she had inherited the stock, her loss is a long-term loss, regardless of how long she and her father actually held the stock. She enters the loss in column (f) of line 8.

In June, she sold 500 shares of Furniture Co. stock for \$14,000. She had bought 100 of those shares in 1988, for \$1,000. She

had bought 100 more shares in 1990 for \$2,200, and an additional 300 shares in 1992 for \$1,500. Her total basis in the stock is \$4,700. She has a \$9,300 (\$14,000 – \$4,700) gain on this sale, which she enters in column (f) of line 8.

In December, she sold 20 shares of Toy Co. for \$4,100. This was qualified small business stock that she had bought in September 1994. Her basis is \$1,100, so she has a \$3,000 gain which she enters in column (f) of line 8. Because she held the stock more than 5 years, she has a \$1,500 section 1202 exclusion. She enters that amount in column (g) as a 28% rate gain and claims the exclusion on the line below by entering \$1,500 as a loss in column (f).

She received a Form 1099-B (not shown) from her broker for each of these transactions.

### Capital loss carryover from 1998.

Emily has a capital loss carryover to 1999 of \$800, of which \$300 is short-term capital loss, and \$500 is long-term capital loss. She enters these amounts on lines 6 and 14 of Schedule D.

She kept the completed *Capital Loss Carryover Worksheet* in her 1998 Schedule D instructions (not shown), so she could properly report her loss carryover for the 1999 tax year without refiguring it.

**Tax computation (Part IV).** Because Emily has gains on both lines 16 and 17 of Schedule D and has taxable income, she uses Part IV of Schedule D to figure her tax. She had already filled out her Form 1040 through line 39 and enters the amount from that line, \$30,000, on line 19 of Schedule D. After filling out the rest of Part IV, she finds that her tax is \$4,484. This is less than the tax she would have found using the Tax Table, \$5,060.

**Reconciliation of Forms 1099-B.** Emily makes sure that the total of the amounts reported in column (d) of lines 3 and 10 of Schedule D is not less than the total of the amounts shown on the Forms 1099-B she received from her broker. For 1999, the total of each is \$23,100.

**SCHEDULE D  
(Form 1040)**

Department of the Treasury  
Internal Revenue Service

**Capital Gains and Losses**

▶ Attach to Form 1040. ▶ See Instructions for Schedule D (Form 1040).  
▶ Use Schedule D-1 for more space to list transactions for lines 1 and 8.

OMB No. 1545-0074

**1999**

Attachment  
Sequence No. **12**

Name(s) shown on Form 1040

Emily Jones

Your social security number

111 00 1111

**Part I Short-Term Capital Gains and Losses—Assets Held One Year or Less**

(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-5)	(e) Cost or other basis (see page D-5)	(f) GAIN or (LOSS) Subtract (e) from (d)	
1 100 sh Trucking Co.	2-12-99	6-12-99	900	650	250	
25 sh Computer Co.	6-29-99	7-30-99	2,000	2,500	( 500 )	
2 Enter your short-term totals, if any, from Schedule D-1, line 2 . . . . .			2			
3 <b>Total short-term sales price amounts.</b> Add column (d) of lines 1 and 2 . . . . .			3	2,900		
4 Short-term gain from Form 6252 and short-term gain or (loss) from Forms 4684, 6781, and 8824 . . . . .					4	
5 Net short-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1 . . . . .					5	
6 Short-term capital loss carryover. Enter the amount, if any, from line 8 of your 1998 Capital Loss Carryover Worksheet . . . . .					6	( 300 )
7 <b>Net short-term capital gain or (loss).</b> Combine lines 1 through 6 in column (f) ▶					7	( 550 )

**Part II Long-Term Capital Gains and Losses—Assets Held More Than One Year**

(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-5)	(e) Cost or other basis (see page D-5)	(f) GAIN or (LOSS) Subtract (e) from (d)	(g) 28% RATE GAIN or (LOSS) * (see instr. below)
8 60 sh Car Co.	Inherited	2-3-99	2,100	2,500	( 400 )	
500 sh Furniture Co.	Various	6-27-99	14,000	4,700	9,300	
20 sh Toy Co.	9-20-94	12-15-99	4,100	1,100	3,000	1,500
Section 1202 exclusion					( 1,500 )	
9 Enter your long-term totals, if any, from Schedule D-1, line 9 . . . . .			9			
10 <b>Total long-term sales price amounts.</b> Add column (d) of lines 8 and 9 . . . . .			10	20,200		
11 Gain from Form 4797, Part I; long-term gain from Forms 2439 and 6252; and long-term gain or (loss) from Forms 4684, 6781, and 8824 . . . . .					11	
12 Net long-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1 . . . . .					12	
13 Capital gain distributions. See page D-1 . . . . .					13	
14 Long-term capital loss carryover. Enter in both columns (f) and (g) the amount, if any, from line 13 of your 1998 Capital Loss Carryover Worksheet . . . . .					14	( 500 ) ( 500 )
15 Combine lines 8 through 14 in column (g) . . . . .					15	1,000
16 <b>Net long-term capital gain or (loss).</b> Combine lines 8 through 14 in column (f) ▶ <b>Next:</b> Go to Part III on the back.					16	9,900

\* 28% Rate Gain or Loss includes all "collectibles gains and losses" (as defined on page D-5) and up to 50% of the eligible gain on qualified small business stock (see page D-4).

**Part III Summary of Parts I and II**

<p><b>17</b> Combine lines 7 and 16. If a loss, go to line 18. If a gain, enter the gain on Form 1040, line 13  <b>Next:</b> Complete Form 1040 through line 39. Then, go to <b>Part IV</b> to figure your tax if:</p> <ul style="list-style-type: none"> <li>• Both lines 16 and 17 are gains, <b>and</b></li> <li>• Form 1040, line 39, is more than zero.</li> </ul>	<b>17</b>	9,350	
<p><b>18</b> If line 17 is a loss, enter here and as a (loss) on Form 1040, line 13, the <b>smaller</b> of these losses:</p> <ul style="list-style-type: none"> <li>• The loss on line 17, <b>or</b></li> <li>• (\$3,000) or, if married filing separately, (\$1,500)</li> </ul> <p><b>Next:</b> Skip <b>Part IV</b> below. Instead, complete Form 1040 through line 37. Then, complete the <b>Capital Loss Carryover Worksheet</b> on page D-6 if:</p> <ul style="list-style-type: none"> <li>• The loss on line 17 exceeds the loss on line 18, <b>or</b></li> <li>• Form 1040, line 37, is a loss.</li> </ul>	<b>18</b>	( )	

**Part IV Tax Computation Using Maximum Capital Gains Rates**

<p><b>19</b> Enter your taxable income from Form 1040, line 39</p>	<b>19</b>	30,000	
<p><b>20</b> Enter the <b>smaller</b> of line 16 or line 17 of Schedule D</p>	<b>20</b>	9,350	
<p><b>21</b> If you are filing Form 4952, enter the amount from Form 4952, line 4e</p>	<b>21</b>		
<p><b>22</b> Subtract line 21 from line 20. If zero or less, enter -0-</p>	<b>22</b>	9,350	
<p><b>23</b> Combine lines 7 and 15. If zero or less, enter -0-</p>	<b>23</b>	450	
<p><b>24</b> Enter the <b>smaller</b> of line 15 or line 23, but not less than zero</p>	<b>24</b>	450	
<p><b>25</b> Enter your unrecaptured section 1250 gain, if any, from line 16 of the worksheet on page D-7</p>	<b>25</b>		
<p><b>26</b> Add lines 24 and 25</p>	<b>26</b>	450	
<p><b>27</b> Subtract line 26 from line 22. If zero or less, enter -0-</p>	<b>27</b>	8,900	
<p><b>28</b> Subtract line 27 from line 19. If zero or less, enter -0-</p>	<b>28</b>	21,100	
<p><b>29</b> Enter the <b>smaller</b> of:</p> <ul style="list-style-type: none"> <li>• The amount on line 19, <b>or</b></li> <li>• \$25,750 if single; \$43,050 if married filing jointly or qualifying widow(er); \$21,525 if married filing separately; or \$34,550 if head of household</li> </ul>	<b>29</b>	25,750	
<p><b>30</b> Enter the <b>smaller</b> of line 28 or line 29</p>	<b>30</b>	21,100	
<p><b>31</b> Subtract line 22 from line 19. If zero or less, enter -0-</p>	<b>31</b>	20,650	
<p><b>32</b> Enter the <b>larger</b> of line 30 or line 31</p>	<b>32</b>	21,100	
<p><b>33</b> Figure the tax on the amount on line 32. Use the Tax Table or Tax Rate Schedules, whichever applies  <b>Note.</b> If line 29 is less than line 28, go to line 38.</p>	<b>33</b>	3,169	
<p><b>34</b> Enter the amount from line 29</p>	<b>34</b>	25,750	
<p><b>35</b> Enter the amount from line 28</p>	<b>35</b>	21,100	
<p><b>36</b> Subtract line 35 from line 34. If zero or less, enter -0-</p>	<b>36</b>	4,650	
<p><b>37</b> Multiply line 36 by 10% (.10)  <b>Note.</b> If line 27 is more than zero <b>and</b> equal to line 36, go to line 52.</p>	<b>37</b>	465	
<p><b>38</b> Enter the <b>smaller</b> of line 19 or line 27</p>	<b>38</b>	8,900	
<p><b>39</b> Enter the amount from line 36</p>	<b>39</b>	4,650	
<p><b>40</b> Subtract line 39 from line 38</p>	<b>40</b>	4,250	
<p><b>41</b> Multiply line 40 by 20% (.20)  <b>Note.</b> If line 25 is zero or blank, skip lines 42 through 47 and read the note above line 48.</p>	<b>41</b>	850	
<p><b>42</b> Enter the <b>smaller</b> of line 22 or line 25</p>	<b>42</b>		
<p><b>43</b> Add lines 22 and 32</p>	<b>43</b>		
<p><b>44</b> Enter the amount from line 19</p>	<b>44</b>		
<p><b>45</b> Subtract line 44 from line 43. If zero or less, enter -0-</p>	<b>45</b>		
<p><b>46</b> Subtract line 45 from line 42. If zero or less, enter -0-</p>	<b>46</b>		
<p><b>47</b> Multiply line 46 by 25% (.25)  <b>Note.</b> If line 24 is zero or blank, go to line 52.</p>	<b>47</b>		
<p><b>48</b> Enter the amount from line 19</p>	<b>48</b>	30,000	
<p><b>49</b> Add lines 32, 36, 40, and 46</p>	<b>49</b>	30,000	
<p><b>50</b> Subtract line 49 from line 48</p>	<b>50</b>	-0-	
<p><b>51</b> Multiply line 50 by 28% (.28)</p>	<b>51</b>	-0-	
<p><b>52</b> Add lines 33, 37, 41, 47, and 51</p>	<b>52</b>	4,484	
<p><b>53</b> Figure the tax on the amount on line 19. Use the Tax Table or Tax Rate Schedules, whichever applies</p>	<b>53</b>	5,060	
<p><b>54</b> <b>Tax on all taxable income (including capital gains).</b> Enter the <b>smaller</b> of line 52 or line 53 here and on Form 1040, line 40.</p>	<b>54</b>	4,484	

# Part Four.

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## Adjustments to Income

*The three chapters in this part discuss three of the adjustments to income that you can deduct in figuring your adjusted gross income. These chapters cover:*

- *Contributions you make to traditional individual retirement arrangements (IRAs) — chapter 18,*
- *Moving expenses you pay — chapter 19, and*
- *Alimony you pay — chapter 20.*

*Other adjustments to income are discussed in other parts of this publication or in other publications and instructions. They are deductions for:*

- *Interest paid on student loans — instructions for Form 1040, line 24, or Form 1040A, line 16,*
  - *Contributions to a medical savings account — chapter 23,*
  - *Self-employment tax — chapter 24,*
  - *Self-employed health insurance — chapter 23,*
  - *Payments to a Keogh retirement plan or self-employed SEP or SIMPLE plan — Publication 560, Retirement Plans for Small Business,*
  - *Penalty on early withdrawal of savings — chapter 8.*
  - *Amortization of the costs of reforestation — chapter 12 of Publication 535, Business Expenses,*
  - *Contributions to Internal Revenue Code section 501(c)(18) pension plans — instructions for Form 1040, line 32,*
  - *Expenses from the rental of personal property — chapter 13,*
  - *Expenses of fee-basis officials or certain performing artists — chapter 28,*
  - *Certain required repayments of supplemental unemployment benefits (sub-pay) — chapter 6,*
  - *Foreign housing deduction — chapter 4 of Publication 54, Tax Guide for U.S. Citizens and Resident Aliens Abroad,*
  - *Jury duty pay given to your employer — chapter 13, and*
  - *Part of the cost of qualified clean-fuel vehicle property — chapter 15 of Publication 535, Business Expenses.*
-

# 18.

## Individual Retirement Arrangements (IRAs)

### Important Change

**Modified AGI limit increased.** For 1999, if you are covered by a retirement plan at work, your deduction for contributions to a traditional IRA will not be reduced (phased out) unless your modified adjusted gross income (AGI) is between:

- \$51,000 and \$61,000 for a married couple or a qualifying widow(er) filing a joint return,
- \$31,000 and \$41,000 for a single individual or head of household, or
- \$-0- (no increase) and \$10,000 for a married individual filing a separate return.

See *How Much Can I Deduct?*, later.

### Important Reminders

**Traditional IRA defined.** A traditional IRA is any IRA that is not a Roth, SIMPLE, or education IRA.

**Interest earned.** Although interest earned from your IRA is generally not taxed in the year earned, it is **not tax-exempt** interest. **Do not** report this interest on your tax return as tax-exempt interest.

**Penalty for failure to file Form 8606.** If you make nondeductible contributions to a traditional IRA and you do not file Form 8606, *Nondeductible IRAs*, with your tax return, you may have to pay a \$50 penalty.

**Contributions to spousal IRAs.** In the case of a married couple filing a joint return, up to \$2,000 can be contributed to IRAs (other than SIMPLE and education IRAs) on behalf of each spouse, even if one spouse has little or no compensation. This means that the total combined contributions that can be made on behalf of a married couple can be as much as \$4,000 for the year. See *Spousal IRA limit*, under *How Much Can Be Contributed?* and under *Can I contribute to a Roth IRA for my spouse?* under *Roth IRAs*, later.



**Employer contributions under a SEP plan are not counted when figuring the limits just discussed. SEP plans are discussed in Publication 590.**

**Spouse covered by employer plan.** If you are not covered by an employer retirement plan, you may be able to deduct all of your

contributions to a traditional IRA, even if your spouse is covered by a plan  
See *How Much Can I Deduct?*, later.

**No additional tax on early withdrawals for higher education expenses.** You can take distributions from your traditional IRA for qualified higher education expenses without having to pay the 10% additional tax on early withdrawals.

For more information, see Publication 590, *Individual Retirement Arrangements (IRAs) (Including Roth IRAs and Education IRAs)*.

**No additional tax on early withdrawals for first home.** You can take distributions of up to \$10,000 from your traditional or Roth IRA to buy, build, or rebuild a first home without having to pay the 10% additional tax on early withdrawals.

**Roth IRA.** You may be able to establish and contribute to a nondeductible tax-free individual retirement plan called a Roth IRA. You cannot claim a deduction for any contributions to a Roth IRA. But, if you satisfy the requirements, all earnings are tax free and neither your nondeductible contributions nor any earnings on them are taxable when you withdraw them. See *Roth IRAs*, later.

**Education IRA.** You may be able to make nondeductible contributions of up to \$500 annually to an education IRA for a child under age 18. Earnings in the IRA accumulate free of income tax. See *Education IRAs*, later.

### Introduction

An individual retirement arrangement (IRA) is a personal savings plan that offers you tax advantages to set aside money for your retirement or, in some plans, for certain education expenses. Two advantages of an IRA are:

- 1) You may be able to deduct your contributions in whole or in part, depending on the type of IRA and your circumstances, and
- 2) Generally, amounts in your IRA, including earnings and gains are not taxed until distributed, or, in some cases, are not taxed at all if distributed according to the rules.

This chapter discusses:

- 1) The rules for a **traditional IRA** (those that are not Roth, SIMPLE, or education IRAs),
- 2) The **Roth IRA**, which features nondeductible contributions and tax-free withdrawals, and
- 3) The **education IRA**, which can be set up to finance higher education expenses.

Simplified Employee Pensions (SEPs) and Savings Incentive Match Plans for Employees (SIMPLE) are not discussed in this chapter. For more information on these plans and employees' SEP-IRAs and SIMPLE IRAs that are part of these plans,

see Publication 590.

### Useful Items

You may want to see:

#### Publication

- 590** Individual Retirement Arrangements (IRAs) (Including Roth IRAs and Education IRAs)

#### Form (and Instructions)

- 5329** Additional Taxes Attributable to IRAs, Other Qualified Retirement Plans, Annuities, Modified Endowment Contracts, and MSAs
- 8606** Nondeductible IRAs

## Traditional IRAs

In this chapter the original IRA (sometimes called an ordinary or regular IRA) is referred to as the "traditional IRA." Two advantages of a traditional IRA are that you may be able to deduct some or all of your contributions to it, depending on your circumstances, and, generally, amounts in your IRA, including earnings and gains, are not taxed until they are distributed.

### What Is a Traditional IRA?

A traditional IRA is any IRA that is not a Roth IRA, a SIMPLE IRA, or an education IRA.

### Who Can Set Up a Traditional IRA?

You can set up and make contributions to a traditional IRA if you (or if you file a joint return, your spouse) received taxable **compensation** during the year and you were not age 70½ by the end of the year.

**What is compensation?** Compensation includes wages, salaries, tips, professional fees, bonuses, and other amounts you receive for providing personal services. The IRS treats as compensation any amount properly shown in box 1 (Wages, tips, other compensation) of Form W-2, provided that amount is reduced by any amount properly shown in box 11 (Nonqualified plans). Compensation also includes commissions and taxable alimony and separate maintenance payments.

**Self-employment income.** If you are self-employed (a sole proprietor or a partner), compensation is the net earnings from your trade or business (provided your personal services are a material income-producing factor) reduced by the deduction for contributions made on your behalf to retirement plans and the deduction allowed for one-half of your self-employment taxes.

Compensation includes earnings from self-employment even if they are not subject to self-employment tax because of your religious beliefs. See Publication 533, *Self-Employment Tax*, for more information.

**What is not compensation?** Compensation does **not** include any of the following items.



- Earnings and profits from property, such as rental income, interest income, and dividend income.
- Pension or annuity income.
- Deferred compensation received (compensation payments postponed from a past year).
- Income from a partnership for which you do not provide services that are a material income-producing factor.
- Any amounts you exclude from income, such as foreign earned income and housing costs.

## When and How Can a Traditional IRA Be Set Up?

You can set up a traditional IRA at any time. However, the time for making contributions for any year is limited. See *When Can Contributions Be Made?*, later.

You can set up different kinds of IRAs with a variety of organizations. You can set up an IRA at a bank or other financial institution or with a mutual fund or life insurance company. You can also set up an IRA through your stockbroker. Any IRA must meet Internal Revenue Code requirements.

Your traditional IRA can be an individual retirement account or annuity. It can be either a part of a simplified employee pension (SEP) or a part of an employer or employee association trust account.

**Inherited IRAs.** If you inherit a traditional IRA, that IRA becomes subject to special rules.

If you are a surviving spouse, you can elect to treat a traditional IRA inherited from your spouse as your own.

For more information, see the discussions of inherited IRAs under *How Much Can Be Contributed?* and under *Rollover From One IRA Into Another*, later.

## How Much Can Be Contributed?

Contributions to a traditional IRA must be in the form of money (cash, check, or money order). Property cannot be contributed.

There are limits and other rules that affect the amount that can be contributed and the amount you can deduct. These rules are explained next.

**General limit.** The most that can be contributed for any year to your traditional IRA is the smaller of the following amounts:

- 1) Your compensation (defined earlier) that you must include in income for the year, or
- 2) \$2,000.

This is the most that can be contributed regardless of whether the contributions are to one or more traditional IRAs or whether all or part of the contributions are nondeductible. (See *Nondeductible Contributions*, later.)

**Example 1.** Betty, who is single, earns \$24,000 in 1999. Her IRA contributions for 1999 are limited to \$2,000.

**Example 2.** John, a college student working part time, earns \$1,500 in 1999. His IRA contributions for 1999 are limited to \$1,500, the amount of his compensation.

**Spousal IRA limit.** If you file a joint return and your taxable compensation is less than that of your spouse, the most that can be contributed for the year to your IRA is the smaller of the following amounts:

- 1) \$2,000, or
- 2) The total compensation includible in the gross income of both you and your spouse for the year, reduced by the following amounts:
  - a) Your spouse's IRA contribution for the year.
  - b) Any contribution for the year to a Roth IRA on behalf of your spouse.

This means that the total combined contributions that can be made for the year to your IRA and your spouse's IRA can be as much as \$4,000.



*Contributions to your traditional IRAs reduce the limit for contributions to Roth IRAs (see Roth IRAs, later).*

**Age 70½ rule.** Contributions cannot be made to your traditional IRA for the year in which you reach age 70½ or any later year.

**Community property laws.** Except as just discussed, each spouse figures his or her limit separately, using his or her own compensation.

**Contributions not required.** You do not have to contribute to your traditional IRA for every tax year, even if you can.

**Inherited IRAs.** If you inherit a traditional IRA from your spouse, you can choose to treat it as your own by making contributions to it.

If, however, you inherit a traditional IRA and you are not the decedent's spouse, you cannot contribute to that IRA, because you cannot treat it as your own.

**Trustees' fees.** Trustees' administrative fees are not subject to the contribution limit. A trustee's administrative fees that are billed separately and paid in connection with your traditional IRA are deductible. They are deductible (if they are ordinary and necessary) as a miscellaneous itemized deduction on Schedule A (Form 1040). The deduction is subject to the 2%-of-adjusted-gross-income limit (see chapter 30).

**Brokers' commissions.** Brokers' commissions paid in connection with your traditional IRA are subject to the contribution limit. They are not deductible as a miscellaneous itemized deduction on Schedule A (Form 1040).

## When Can Contributions Be Made?

Contributions can be made to your traditional IRA for a year at any time during the year or by the due date for filing your return for that year, **not** including extensions. For

most people, this means that contributions for 1999 must be made by April 17, 2000.

**Designating year for which contribution is made.** If an amount is contributed to your traditional IRA between January 1 and April 17, tell the sponsor (the trustee or issuer) to which year (the current year or the previous year) the contribution applies. If you do not tell the sponsor which year it is for, the sponsor can assume, for reporting to IRS, that the contribution is for the current year (the year the sponsor received it).

**Filing before a contribution is made.** You can file your return claiming a traditional IRA contribution before the contribution is actually made. However, the contribution must be made by the due date of your return, **not** including extensions.

## How Much Can I Deduct?

Generally, you can deduct the lesser of the contributions to your traditional IRA for the year or the general limit (or the spousal IRA limit, if it applies). However, **if you or your spouse were covered by an employer retirement plan** at any time during the year for which contributions were made, you may not be able to deduct all the contributions. Your deduction may be reduced or eliminated, depending on your filing status and the amount of your income, as discussed later under *Deduction Limits*. Any limit on the amount you can deduct does not affect the amount that can be contributed. See *Nondeductible Contributions*, later.

## Are You Covered by an Employer Plan?

The Form W-2, *Wage and Tax Statement*, you receive from your employer has a box used to indicate whether you were covered for the year. The "Pension Plan" box should have a mark in it if you were covered.

If you are not certain whether you were covered by your employer's retirement plan, you should ask your employer.

**Employer plans.** An employer retirement plan is one that an employer sets up for the benefit of its employees. For purposes of the traditional IRA deduction rules, an employer retirement plan is any of the following plans.

- A qualified pension, profit-sharing, stock bonus, money purchase pension, etc., plan (including Keogh plan).
- A 401(k) plan (generally an arrangement included in a profit-sharing or stock bonus plan that allows you to choose to either take part of your compensation from your employer in cash or have your employer pay it into the plan).
- A union plan (a qualified stock bonus, pension, or profit-sharing plan created by a collective bargaining agreement).
- A qualified annuity plan.
- A plan established for its employees by the United States, a state or political subdivision thereof, or by an agency or instrumentality of any of the foregoing (other than an eligible state deferred compensation plan (section 457(b) plan)).

**Table 18–1. Can I Take A Traditional IRA Deduction?**

This chart sums up whether you can take a full deduction, a partial deduction, or no deduction as discussed in this chapter.

If Your Modified AGI <sup>1</sup> is:	If You Are Covered by a Retirement Plan at Work and Your Filing Status is:			If You Are Not Covered by a Retirement Plan at Work and Your Filing Status is:			
	• Single • Head of Household	• Married Filing Jointly (even if your spouse is <u>not</u> covered by a plan at work) • Qualifying Widow(er)	Married Filing Separately <sup>2</sup>	Married Filing Jointly (and your spouse is covered by a plan at work)	• Single • Head of Household	• Married Filing Jointly or Separately (and your spouse is <u>not</u> covered by a plan at work) • Qualifying Widow(er)	Married Filing Separately (and your spouse is covered by a plan at work) <sup>3</sup>
At Least      But Less Than	You Can Take	You Can Take	You Can Take	You Can Take	You Can Take	You Can Take	You Can Take
\$0.01      \$10,000.00	Full deduction	Full deduction	Partial deduction	Full deduction	Full Deduction	Full Deduction	Partial deduction
\$10,000.00      \$31,000.00	Full deduction	Full deduction	No deduction	Full deduction			No deduction
\$31,000.00      \$41,000.00	Partial deduction	Full deduction	No deduction	Full deduction	Full Deduction	Full Deduction	No deduction
\$41,000.00      \$51,000.00	No deduction	Full deduction	No deduction	Full deduction			No deduction
\$51,000.00      \$61,000.00	No deduction	Partial deduction	No deduction	Full deduction	Full Deduction	Full Deduction	No deduction
\$61,000.00      \$150,000.00	No deduction	No deduction	No deduction	Full deduction			No deduction
\$150,000.00      \$160,000.00	No deduction	No deduction	No deduction	Partial deduction	Full Deduction	Full Deduction	No deduction
\$160,000.00 or over	No deduction	No deduction	No deduction	No deduction			No deduction

<sup>1</sup>**Modified AGI** (adjusted gross income). For Form 1040A it is the amount on line 14 increased by any excluded qualified bond interest shown on Form 8815, *Exclusion of Interest from Series EE and I U.S. Savings Bonds Issued after 1989*, and certain tax-exempt income amounts. (See *Modified adjusted gross income*, later.) For Form 1040 it is the amount on line 33, figured without taking into account any IRA deduction, any foreign earned income exclusion and foreign housing exclusion (deduction), any student loan interest deduction, any qualified bond interest exclusion from Form 8815, and certain tax-exempt income amounts. (See *Modified adjusted gross income*, later.)

<sup>2</sup>If you did not live with your spouse at any time during the year, your filing status is considered, for this purpose, as Single (therefore your IRA deduction is determined under the “Single” column).

<sup>3</sup>You are entitled to the full deduction if you did not live with your spouse at any time during the year.

- A tax-sheltered annuity plan for employees of public schools and certain tax-exempt organizations (403(b) plan).
- A simplified employee pension (SEP) plan.
- A 501(c)(18) trust (a certain type of tax-exempt trust created before June 25, 1959, that is funded only by employee contributions) if you made deductible contributions during the year.
- A SIMPLE plan.

A **qualified plan** is one that meets the requirements of the Internal Revenue Code.

**When Are You Covered?**

Special rules apply to determine whether you are considered covered by a plan for a tax year. These rules differ depending on whether the plan is a defined contribution plan or a defined benefit plan.

**Defined contribution plan.** A defined contribution plan is a plan that provides for a separate account for each person covered by the plan. Types of defined contribution plans include profit-sharing plans, stock bonus plans, and money purchase pension plans.

Generally, you are considered covered by a defined contribution plan if amounts are contributed or allocated to your account for the plan year that ends within your tax year.

**Defined benefit plan.** A defined benefit plan is any plan that is not a defined contribution plan which includes pension plans and annuity plans.

If you are eligible (meet minimum age and years of service requirements) to participate in your employer's defined benefit plan for the plan year that ends within your tax year, you are considered covered by the plan. This rule applies even if you declined to be covered by the plan, you did not make a required contribution, or you did not perform the minimum service required to accrue a benefit for the year.

**No vested interest.** If an amount is allocated to your account, or if you accrue a benefit for a plan year, you are covered by that plan even if you have no vested interest in (legal right to) the account or the accrual.

**When Are You Not Covered?**

You are not covered by an employer plan in the following situations.

**Social security or railroad retirement.** Coverage under social security or railroad retirement (Tier I and Tier II) does not count as coverage under an employer retirement plan.

**Benefits from a previous employer's plan.** If you receive retirement benefits from a previous employer's plan and you are not covered under your current employer's plan, you are not considered covered.

**Reservists.** If the only reason you participate in a plan is because you are a member of a reserve unit of the armed forces, you may not be considered covered by the plan. You are not considered covered by the plan if **both** of the following conditions are met.

- 1) The plan you participate in is established for its employees by:
  - a) The United States,
  - b) A state or political subdivision of a state, or
  - c) An instrumentality of either (a) or (b) above.
- 2) You did not serve more than 90 days on active duty during the year (not counting duty for training).

**Volunteer firefighters.** If the only reason you participate in a plan is because you are a volunteer firefighter, you may not be considered covered by the plan. You are not considered covered by the plan if both of the following conditions are met.

- 1) The plan you participate in is established for its employees by:
  - a) The United States,
  - b) A state or political subdivision of a state, or
  - c) An instrumentality of either (a) or (b) above.

- 2) Your accrued retirement benefits at the beginning of the year will not provide more than \$1,800 per year at retirement.

## Social Security Recipients

Complete the worksheets in *Appendix B* of Publication 590 if, for the year, **all** of the following apply.

- You received social security benefits.
- You received taxable compensation.
- Contributions were made to your traditional IRA.
- You or your spouse were covered by an employer retirement plan.

Use those worksheets to figure your IRA deduction and the taxable portion, if any, of your social security benefits.

## Deduction Limits

As discussed under *How Much Can I Deduct?* earlier, the deduction you can take for contributions made to your traditional IRA depends on whether you or your spouse was covered for any part of the year by an employer retirement plan. Your deduction is also affected by how much income you had and by your filing status, as explained later under *Reduced or no deduction*.

**Full deduction.** If neither you nor your spouse was covered for any part of the year by an employer retirement plan, you can take a deduction for total contributions to one or more traditional IRAs of up to \$2,000, or 100% of your compensation, whichever is less. This limit is reduced by any contributions made to a 501(c)(18) plan on your behalf.

**Spousal IRA.** In the case of a married couple with unequal compensation who file a joint return, the deduction for contributions to the traditional IRA of the spouse with less compensation is limited to the **smaller** of the following two amounts:

- 1) \$2,000, or
- 2) The total compensation includible in the gross income of both you and your spouse for the year reduced by the following two amounts.
  - a) Any deduction allowed for contributions to the traditional IRAs of the spouse with more compensation, and
  - b) Any contributions for the year to a Roth IRA on behalf of your spouse.

This limit is reduced by any contributions to a section 501(c)(18) plan on behalf of the spouse with less compensation.

**Reduced or no deduction.** If either you or your spouse were covered by an employer retirement plan, you may be entitled to only a partial (reduced) deduction or no deduction at all, depending on your income and your filing status. Your deduction begins to decrease (phase out) when your income rises above a certain amount, and is eliminated altogether when it reaches a higher amount. The amounts vary depending on your filing status. See *Table 18-1, Can I Take A Traditional IRA Deduction?*, earlier.

To determine if your deduction is limited, you must determine your modified adjusted gross income (AGI) and your filing status as explained next.

## Deduction Phaseout

If you are covered by an employer retirement plan, your IRA deduction is reduced or eliminated depending on your filing status and modified AGI as shown in *Table 1*.

If your filing status is:	Your deduction is reduced if your <b>modified AGI</b> is between:	Your deduction is eliminated if your <b>modified AGI</b> is:
Single, or Head of household	\$31,000 and \$41,000	\$41,000 or more
Married—joint return, or Qualifying widow(er)	\$51,000 and \$61,000	\$61,000 or more
Married—separate return	\$-0- and \$10,000	\$10,000 or more

See *Married filing separately exception*, under *Filing status*, later.

**TIP** For 2000, if you are covered by a retirement plan at work, your IRA deduction will not be reduced (phased out) unless your modified AGI is between:

- \$32,000 (a \$1,000 increase) and \$42,000 for a single individual (or head of household),
- \$52,000 (a \$1,000 increase) and \$62,000 for a married couple (or a qualifying widow(er)) filing a joint return, or
- \$-0- (no increase) and \$10,000 for a married individual filing a separate return.

**If you are not covered, but your spouse is.** If you are not covered by an employer retirement plan, but your spouse is, your IRA deduction is reduced or eliminated depending on your filing status and modified AGI as shown in *Table 2*.

If your filing status is:	Your deduction is reduced if your <b>modified AGI</b> is between:	Your deduction is eliminated if your <b>modified AGI</b> is:
Married—joint return, or Qualifying widow(er)	\$150,000 and \$160,000	\$160,000 or more
Married—separate return	\$-0- and \$10,000	\$10,000 or more

See *Married filing separately exception*, under *Filing status*, next. Also, see *Table 18-1* earlier.

**Filing status.** Your filing status depends primarily on your marital status. For this purpose, you need to know if your filing status is single or head of household, married filing jointly or qualifying widow(er), or married filing separately. If you need more information on filing status, see chapter 2.

**Married filing separately exception.** If you did not live with your spouse at any time during the year and you file a separate return, you are not treated as married and your filing status is considered, for this purpose, as single.

**Modified adjusted gross income (AGI).** How you figure your modified AGI depends on whether you are filing Form 1040 or Form 1040A.

**Form 1040.** If you file Form 1040, figure the amount on page 1 "adjusted gross income" line without taking into account any:

- IRA deduction,
- Student loan interest deduction,
- Foreign earned income exclusion,
- Foreign housing exclusion or deduction,
- Exclusion of qualified bond interest shown on Form 8815, *Exclusion of Interest From Series EE and I U.S. Savings Bonds Issued After 1989 (For Filers With Qualified Higher Education Expenses)*, or
- Exclusion of employer-paid adoption expenses shown on Form 8839, *Qualified Adoption Expenses*.

This is your modified AGI.

**Form 1040A.** If you file Form 1040A, figure the amount on page 1 "adjusted gross income" line without taking into account any:

- IRA deduction,
- Student loan interest deduction,
- Exclusion of qualified bond interest shown on Form 8815, or
- Exclusion of employer-paid adoption expenses shown on Form 8839.

This is your modified AGI.

**CAUTION** Do not assume modified AGI is the same as your compensation. You will find that your modified AGI may include income in addition to your taxable compensation (discussed earlier), such as interest, dividends, and taxable IRA distributions.

**How to figure your reduced IRA deduction.** You can figure your reduced IRA deduction for either Form 1040 or Form 1040A by using the worksheets in chapter 1 of Publication 590. Also, the instructions for these tax forms include similar worksheets.

**Note.** If you were divorced or legally separated (and did not remarry) before the end of the year, you cannot deduct any contributions to your spouse's IRA. After a divorce or legal separation you can deduct only contributions to your own IRA, and your deductions are subject to the rules for single individuals.

## Reporting Deductible Contributions

You do not have to itemize deductions to claim your deduction for IRA contributions. If you file **Form 1040**, deduct IRA contributions for 1999 on line 23. If you file **Form 1040A**, deduct contributions on line 15. **Form 1040EZ** does not provide for IRA deductions.

**Form 5498.** You should receive by June 1, 2000, Form 5498, *Individual Retirement Arrangement Information*, or similar statement from plan sponsors, showing all the contributions made to your IRA for 1999.

## Nondeductible Contributions

Although your deduction for IRA contributions may be reduced or eliminated (see *Deduction Limits*, earlier), a contribution can be made to your IRA of up to \$2,000 or 100% of compensation, whichever is less. For a spousal IRA, see *Spousal IRA limit*, under *How Much Can Be Contributed?*, earlier. The difference between your total permitted contributions and your total deductible contributions, if any, is your nondeductible contribution.

**Example.** Sonny Jones is single. In 1999, he is covered by a retirement plan at work. His salary is \$52,312. His modified AGI is \$55,000. Sonny makes a \$2,000 IRA contribution for that year. Because he is covered by a retirement plan and his modified AGI is over \$41,000, he cannot deduct his \$2,000 IRA contribution. However, he can choose to either:

- 1) Designate this contribution as a nondeductible contribution by reporting it on his tax return, as explained later under *Reporting Nondeductible Contributions*, or
- 2) Withdraw the contribution as explained under *Tax-free withdrawal of contributions* under *When Can I Withdraw or Use IRA Assets?*, later.

As long as contributions are within the contribution limits, none of the earnings or gains on those contributions (deductible or nondeductible) will be taxed until they are distributed. See *When Can I Withdraw or Use IRA Assets?*, later.

**Cost basis.** You will have a cost basis in your IRA if there are nondeductible contributions. Your basis is the sum of the nondeductible contributions to your IRA less any distributions of those amounts. When you withdraw (or receive distributions of) these amounts, as discussed later under *Are Distributions Taxable?*, you can do so tax free.

## Reporting Nondeductible Contributions

You must report nondeductible contributions, but you do not have to designate a contribution as nondeductible until you file your tax return. When you file, you can even designate otherwise deductible contributions as nondeductible.

**Designating nondeductible contributions.** To designate contributions as nondeductible, you must file Form 8606. You must file Form 8606 to report nondeductible contributions even if you do not have to file a tax return for the year.

**Form 8606.** You must file Form 8606 if *either* of the following applies.

- You made nondeductible contributions to your traditional IRA for 1999, or
- You received IRA distributions in 1999 and you have ever made nondeductible

contributions to any of your traditional IRAs.

Also, see *Roth IRAs*, later.

**Contribution and distribution in the same year.** If you receive a distribution from an IRA in the same year that you make an IRA contribution that may be partly nondeductible, use the worksheet in chapter 1 of Publication 590 to figure the taxable portion of the distribution. Then you can figure the amount of nondeductible contributions to report on Form 8606.

**Failure to report nondeductible contributions.** If you do not report nondeductible contributions, all of the contributions to your traditional IRA will be treated as deductible. When you make withdrawals from your IRA, the amounts you withdraw will be taxed unless you can show, with satisfactory evidence, that nondeductible contributions were made.

**Penalty for overstatement.** If you overstate the amount of nondeductible contributions on your Form 8606 for any tax year, you must pay a penalty of \$100 for each overstatement, unless it was due to reasonable cause.

**Penalty for failure to file Form 8606.** You will have to pay a \$50 penalty if you do not file a required Form 8606, unless you can prove that the failure was due to reasonable cause.

## Can I Move Retirement Plan Assets?

Traditional IRA rules permit you to transfer, tax free, assets (money or property) from other retirement plans (including traditional IRAs) to a traditional IRA. The rules permit the following kinds of transfers.

- Transfers from one trustee to another.
- Rollovers.
- Transfers incident to a divorce.

**Transfers to Roth IRAs.** Under certain conditions, you can move assets from a traditional IRA to a Roth IRA. See *Can I Move Amounts Into a Roth IRA?*, under *Roth IRAs*, later.

## Trustee-to-Trustee Transfer

A transfer of funds in your traditional IRA from one trustee directly to another, either at your request or at the trustee's request, is **not a rollover**. Because there is no distribution to you, the transfer is tax free. Because it is not a rollover, it is not affected by the 1-year waiting period that is required between rollovers, discussed later under *Rollover From One IRA Into Another*. For information about direct transfers to IRAs from retirement plans other than IRAs, see Publication 590.

## Rollovers

Generally, a rollover is a tax-free distribution to you of cash or other assets from one retirement plan that you contribute (roll over) to another retirement plan. The amount you roll over tax free, however, is generally taxable later when the new plan pays that amount to you or your beneficiary.

**Kinds of rollovers to an IRA.** There are two kinds of rollover contributions to a traditional IRA. In one, you put amounts you receive from one traditional IRA into another traditional IRA. In the other, you put amounts you receive from an employer's qualified retirement plan for its employees into a traditional IRA.

**Treatment of rollovers.** You cannot deduct a rollover contribution, but you must report the rollover distribution on your tax return as discussed later under *Reporting rollovers from IRAs*, and under *Reporting rollovers from employer plans*.

**Time limit for making a rollover contribution.** You must make the rollover contribution by the 60th day after the day you receive the distribution from your traditional IRA or your employer's plan.

**Extension of rollover period.** If an amount distributed to you from a traditional IRA or a qualified employer retirement plan becomes a frozen deposit in a financial institution during the 60-day period allowed for a rollover, a special rule extends the rollover period. For more information, get Publication 590.

## Rollover From One IRA Into Another

You can withdraw, tax free, all or part of the assets from one traditional IRA if you reinvest them within 60 days in another traditional IRA. Because this is a rollover, you cannot deduct the amount that you reinvest in the new IRA.

**Waiting period between rollovers.** You can take (receive) a distribution from a traditional IRA and make a rollover contribution (of all or part of the amount received) to another traditional IRA only once in any 1-year period. The 1-year period begins on the date you receive the IRA distribution, not on the date you roll it over into another IRA. This rule applies separately to each IRA you own.

**Example.** If you have two traditional IRAs, IRA-1 and IRA-2, and you roll over assets of IRA-1 into a new traditional IRA (IRA-3), you may also make a rollover from IRA-2 into IRA-3, or into any other traditional IRA, within 1 year after the rollover distribution from IRA-1. These are both allowable rollovers because you have not received more than one distribution from either IRA within 1 year. However, you cannot, within the 1-year period, again roll over the assets you rolled over into IRA-3 into any other traditional IRA.

**Exception.** There is an exception to this 1-year waiting period rule for distributions from certain failed financial institutions. Get Publication 590 for more information.

**Partial rollovers.** If you withdraw assets from a traditional IRA, you can roll over part of the withdrawal tax free into another traditional IRA and keep the rest of it. The amount you keep generally will be taxable (except for the part that is a return of nondeductible contributions) and may be subject to the 10% additional tax on premature distributions, discussed later under *Premature Distributions (Early Withdrawals)*.

**Required distributions.** Amounts that must be distributed during a particular year under the required distribution rules (discussed later) **are not eligible for rollover** treatment.

**Inherited IRAs.** If you inherit a traditional IRA from your spouse, you generally can roll it over into a traditional IRA established for you.

**Not inherited from spouse.** If you inherit a traditional IRA from someone other than your spouse, you cannot roll it over or allow it to receive a rollover contribution. You must withdraw the IRA assets within a certain period. For more information, see Publication 590.

**Reporting rollovers from IRAs.** Report any rollover from one traditional IRA to another traditional IRA on lines 15a and 15b, Form 1040, or lines 10a and 10b, Form 1040A. Enter the total amount of the distribution on line 15a, Form 1040, or line 10a, Form 1040A. If the total amount on line 15a, Form 1040, or line 10a, Form 1040A, was rolled over, enter zero on line 15b, Form 1040, or line 10b, Form 1040A. Otherwise, enter the taxable portion of the part that was not rolled over on line 15b, Form 1040, or line 10b, Form 1040A.

## Rollover From Employer's Plan Into an IRA

Special rules apply to distributions made from qualified employer plans that are rolled over or transferred to traditional IRAs. The rules primarily relate to requirements affecting rollovers, income tax withholding, and notices to recipients. See Publication 590 for more information.

Generally, if you receive an **eligible rollover distribution** from your (or your deceased spouse's) employer's qualified pension, profit-sharing or stock bonus plan, annuity plan, or tax-sheltered annuity plan (403(b) plan), you can roll over all or part of it into a traditional IRA.

**Eligible rollover distribution.** Generally, an eligible rollover distribution is the taxable part of any distribution of all or part of the balance to your credit in a qualified retirement plan **except:**

- 1) A required minimum distribution,
- 2) Hardship distributions from 401(k) plans and 403(b) plans, or
- 3) Any of a series of substantially equal periodic distributions paid at least once a year over:
  - a) Your lifetime or life expectancy,
  - b) The lifetimes or life expectancies of you and your beneficiary, or
  - c) A period of 10 years or more.

The taxable parts of most other distributions are eligible rollover distributions. See Publication 575, *Pension and Annuity Income*, for additional exceptions.

**Maximum rollover.** The most that you can roll over is the taxable part of any eligible rollover distribution from your employer's qualified plan. The distribution you receive generally will be all taxable unless you have made nondeductible employee contributions to the plan.

**Reporting rollovers from employer plans.** To report a rollover from an employer retirement plan to a traditional IRA, use lines 16a and 16b, Form 1040, or lines 11a and 11b, Form 1040A. Do not use lines 15a or 15b, Form 1040, or lines 10a or 10b, Form 1040A.

**For more information on rollovers,** get Publication 590.

## Transfers Incident to Divorce

If an interest in a traditional IRA is transferred from your spouse or former spouse to you by a divorce or separate maintenance decree or a written document related to such a decree, the interest in the IRA, starting from the date of the transfer, is treated as your IRA. **The transfer is tax free.** For detailed information, see Publication 590.

## When Can I Withdraw or Use IRA Assets?

There are rules limiting the withdrawal and use of your IRA assets. Violation of the rules generally results in additional taxes in the year of violation. See *Prohibited Transactions, Premature Distributions (Early Withdrawals), and Excess Accumulations (Insufficient Distributions)*, later.

**Distributions (withdrawals)—general rule.** If during a year you receive distributions from a traditional IRA, you must generally **include them in your gross income** for the year.

**Age 59½ rule.** Generally, if you are under age 59½ and you withdraw assets (money or other property) from your traditional IRA, you must pay a 10% additional tax. Withdrawals before you are age 59½ are called premature distributions or early withdrawals. This tax is 10% of the part of the distribution that you have to include in gross income. It is in addition to any regular income tax on the amount you have to include in gross income. However, there are a number of exceptions to that rule.

**Exceptions.** There are several exceptions to the age 59½ rule. You may qualify for an exception if you are in one of the following situations.

- You have **unreimbursed medical expenses** that are more than 7.5% of your adjusted gross income.
- The distributions are not more than the cost of your **medical insurance**.
- You are **disabled**.
- You are the **beneficiary** of a deceased IRA owner.
- You are receiving distributions in the form of an **annuity**.
- The distributions are not more than your qualified **higher education expenses**.
- You use the distributions to buy, build, or rebuild a **first home**.
- The distribution is of **contributions returned before the due date** of your tax return.
- The distribution is due to an **IRS levy** of the qualified plan.

Most of these exceptions are explained in Publication 590.

**Note.** Distributions that are timely and properly rolled over, as discussed earlier, are not subject to either regular income tax or the 10% additional tax. Certain withdrawals of excess contributions after the due date of your return are also tax free and not subject to the 10% additional tax (see *Contributions returned before the due date*, next).

**Contributions returned before the due date.** If you made IRA contributions for 1999, you can withdraw them tax free by the due date of your return. If you have an extension of time to file your return, you can withdraw them tax free by the extended due date. You can do this if **both** the following apply.

- You did not take a deduction for the contributions you withdraw.
- You also withdraw any interest or other income earned on the contributions.

You must include in income any earnings on the contributions you withdraw. Include the earnings in income for the year in which you made the withdrawn contributions.



Generally, except for any part of a withdrawal that is a return of non-deductible contributions (basis), any withdrawal of your contributions after the due date (or extended due date) of your return will be treated as a taxable distribution. Another exception is the return of an excess contribution as discussed under *What Acts Result in Penalties?*, later.

**Premature distributions tax.** The 10% additional tax on withdrawals made before you reach age 59½ does not apply to these tax-free withdrawals of your contributions. However, your early withdrawal of interest or other income must be reported on Form 5329 and, unless the withdrawal qualifies as an exception to the age 59½ rule, it will be subject to this tax.

**Excess contributions tax.** If any part of these contributions is an excess contribution for 1998, it is subject to a 6% excise tax. You will not have to pay the 6% tax if any 1998 excess contribution was withdrawn by April 15, 1999 (plus extensions), and if any 1999 excess contribution is withdrawn by April 17, 2000 (plus extensions). See *Excess Contributions under What Acts Result in Penalties?*, later.

## When Must I Withdraw IRA Assets? (Required Distributions)

You cannot keep funds in your traditional IRA indefinitely. Eventually you **must** withdraw them. If you do not make any withdrawals, or if you do not withdraw enough, you may have to pay a 50% excise tax on the amount not withdrawn as required. See *Excess Accumulations (Insufficient Distributions)*, later. The requirements for withdrawing IRA funds differ depending on whether you are the IRA owner or the beneficiary of a decedent's IRA.

**IRA owners.** If you are the owner of a traditional IRA, you must withdraw the entire balance in your IRA or start receiving periodic distributions from your IRA by April 1 of the year following the year in which you reach age 70½. This date is referred to as the **required beginning date**.

**Periodic distributions.** If you choose to receive periodic distributions, you must receive at least a minimum amount for each year starting with the year you reach age 70½ (your 70½ year). If you do not (or did not) receive the minimum amount in your 70½ year, then you must receive distributions for your 70½ year that reach the minimum amount by April 1 of the next year.

**Distributions after the required beginning date.** The required minimum distribution for any year after your 70½ year must be made by December 31 of that later year.

**Beneficiaries.** If you are the beneficiary of a decedent's traditional IRA, the requirements for withdrawals from that IRA depend on whether distributions that satisfy the minimum distributions requirement have begun.

**More information.** For more information, including how to figure your required minimum distribution each year and how to figure your required distribution if you are a beneficiary of a decedent's IRA, see Publication 590.

## Are Distributions Taxable?

In general, include distributions from a traditional IRA in your gross income in the year you receive them.

**Exceptions.** Exceptions to this general rule are rollovers and tax-free withdrawals of contributions, discussed earlier, and the return of nondeductible contributions, discussed later under *Distributions Fully or Partly Taxable*.

**Ordinary income.** Distributions from traditional IRAs that you include in income are taxed as ordinary income.

**No special treatment.** In figuring your tax, you cannot use the special averaging or capital gain treatment that applies to lump-sum distributions from qualified employer plans.

## Distributions Fully or Partly Taxable

Distributions from your traditional IRA may be fully or partly taxable, depending on whether your IRA includes any nondeductible contributions.

**Fully taxable.** If only deductible contributions were made to your traditional IRA (or IRAs, if you have more than one) since it was set up, you have **no basis** in your IRA. Because you have no basis in your IRA, any distributions are fully taxable when received. See *Reporting taxable distributions on your return*, later.

**Partly taxable.** If you made nondeductible contributions to any of your traditional IRAs, you have a **cost basis** (investment in the contract) equal to the amount of those con-

tributions. These nondeductible contributions are not taxed when they are distributed to you. They are a return of your investment in your IRA.

Only the part of the distribution that represents nondeductible contributions (your cost basis) is tax free. If nondeductible contributions have been made, distributions consist partly of nondeductible contributions (basis) and partly of deductible contributions, earnings, and gains (if there are any). Until all of your basis has been distributed, each distribution is partly nontaxable and partly taxable.

**Form 8606.** You must complete Form 8606 and attach it to your return if you receive a distribution from a traditional IRA and have ever made nondeductible contributions to any of your traditional IRAs. Using the form, you will figure the nontaxable distributions for 1999, and your total IRA basis for 1999 and earlier years.

**Note.** If you are required to file Form 8606, but you are not required to file an income tax return, you still **must** file Form 8606. Send it to the IRS at the time and place you would otherwise file an income tax return.

## Distributions reported on Form 1099-R.

If you receive a distribution from your traditional IRA, you will receive Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, Etc.*, or a similar statement. IRA distributions are shown in boxes 1 and 2 of Form 1099-R. A number or letter code in box 7 tells you what type of distribution you received from your IRA.

**Withholding.** Federal income tax is withheld from distributions from traditional IRAs unless you choose not to have tax withheld. See chapter 5.

**IRA distributions delivered outside the United States.** In general, if you are a U.S. citizen or resident alien and your home address is outside the United States or its possessions, you cannot choose exemption from withholding on distributions from your traditional IRA.

**Reporting taxable distributions on your return.** Report fully taxable distributions, including taxable premature distributions, on line 15b, Form 1040 (no entry is required on line 15a), or line 10b, Form 1040A. If only part of the distribution is taxable, enter the total amount on line 15a, Form 1040, or line 10a, Form 1040A, and the taxable part on line 15b, Form 1040, or line 10b, Form 1040A. You cannot report distributions on Form 1040EZ.

## What Acts Result in Penalties?

The tax advantages of using traditional IRAs for retirement savings can be offset by additional taxes and penalties if you do not follow the rules. For example, there are additions to the regular tax for using your IRA funds in prohibited transactions. There are also additional taxes for the following activities.

- Investing in collectibles.
- Making excess contributions.

- Making early withdrawals (taking premature distributions).
- Allowing excess amounts to accumulate (failing to make required withdrawals).

There are penalties for overstating the amount of nondeductible contributions and for failure to file a required Form 8606. See *Reporting Nondeductible Contributions*, earlier.

## Prohibited Transactions

Generally, a prohibited transaction is any improper use of your traditional IRA by you, your beneficiary, or any disqualified person.

Examples of disqualified persons include your fiduciary, and members of your family (spouse, ancestor, lineal descendant, and any spouse of a lineal descendant).

The following are examples of prohibited transactions with a traditional IRA.

- Borrowing money from it.
- Buying property for personal use (present or future) with IRA funds.
- Selling property to it.
- Receiving unreasonable compensation for managing it.
- Using it as collateral for a loan.

**Effect on an IRA account.** Generally, if you or your beneficiary engage in a prohibited transaction at any time during the year with your IRA account, the account stops being an IRA as of the first day of the year.

**Effect on you or your beneficiary.** If you or your beneficiary engage in a prohibited transaction with your traditional IRA account at any time during the year, you or your beneficiary must include the fair market value of all (or part, in certain cases) of the IRA assets in your gross income for that year. The fair market value is the price at which the IRA assets would change hands between a willing buyer and a willing seller, when neither has any need to buy or sell, and both have reasonable knowledge of the relevant facts.

You must use the fair market value of the assets as of the first day of the year you engaged in the prohibited transaction. You may have to pay the 10% additional tax on premature distributions, discussed later.

**Taxes on prohibited transactions.** If someone other than the owner or beneficiary of a traditional IRA engages in a prohibited transaction, that person may be liable for certain taxes. In general, there is a 15% tax on the amount of the prohibited transaction and a 100% additional tax if the transaction is not corrected.

**More information.** For more information on prohibited transactions, get Publication 590.

## Investment in Collectibles

If your traditional IRA invests in collectibles, the amount invested is considered distributed to you in the year invested. You may have to pay the 10% additional tax on premature distributions, discussed later.

**Collectibles.** These include art works, rugs, antiques, metals, gems, stamps, coins, alcoholic beverages, and other tan-

gible personal property if specified by the IRS.

**Exception.** Your IRA can invest in one, one-half, one-quarter, or one-tenth ounce U.S. gold coins, or one ounce silver coins minted by the Treasury Department. It can also invest in certain platinum coins and certain gold, silver, palladium, and platinum bullion.

## Excess Contributions

Generally, an excess contribution is the amount contributed to your traditional IRA(s) for the year that is more than the smaller of:

- Your taxable compensation for the year, or
- \$2,000.

**Tax on excess contributions.** In general, if the excess contribution for a year and any earnings on it are not withdrawn by the date your return for the year is due (including extensions), you are subject to a 6% tax. You must pay the 6% tax each year on excess amounts that remain in your traditional IRA at the end of your tax year. The tax cannot be more than 6% of the value of your IRA as of the end of your tax year.

**Excess contributions withdrawn by due date of return.** You will not have to pay the 6% tax if you withdraw an excess contribution made during a tax year *and* you also withdraw interest or other income earned on the excess contribution by the date your return for that year is due, including extensions.

**How to treat withdrawn contributions.** Do not include in your gross income an excess contribution that you withdraw from your traditional IRA before your tax return is due if *both* the following conditions are met.

- 1) No deduction was allowed for the excess contribution.
- 2) You withdraw the interest or other income earned on the excess contribution.

**How to treat withdrawn interest or other income.** You must include in your gross income the interest or other income that was earned on the excess contribution. Report it on your return for the year in which the excess contribution was made. Your withdrawal of interest or other income may be subject to an additional 10% tax on early withdrawals, discussed later.

**Excess contributions withdrawn after due date of return.** In general, you must include all withdrawals from your traditional IRA in your gross income. However, if the total contributions (other than rollover contributions) for the year to your IRA are \$2,000 or less and there were no employer contributions for the year, you can withdraw any excess contribution after the due date for filing your tax return for that year, including extensions. You do not include the withdrawn contribution in your gross income. This exclusion from income applies only to the part of the withdrawn excess contribution for which you did not take a deduction.

## Premature Distributions (Early Withdrawals)

You must include premature distributions of taxable amounts from your traditional IRA in your gross income. Premature distributions (sometimes called early withdrawals or early distributions) are also subject to an **additional 10% tax**. See the discussion of Form 5329 under *Reporting Additional Taxes*, later, to figure and report the tax.

**Premature distributions defined.** Premature distributions are amounts you withdraw from your traditional IRA account or annuity before you are age 59½.

**Exceptions.** There are several exceptions to the age 59½ rule. You may qualify for an exception if you are in one of the following situations.

- You have **unreimbursed medical expenses** that are more than 7.5% of your adjusted gross income.
- The distributions are not more than the cost of your **medical insurance**.
- You are **disabled**.
- You are the **beneficiary** of a deceased IRA owner.
- You are receiving distributions in the form of an **annuity**.
- The distributions are not more than your qualified **higher education expenses**.
- You use the distributions to buy, build, or rebuild a **first home**.
- The distribution is of **contributions returned before the due date** of your tax return.
- The distribution is due to an **IRS levy** of the qualified plan.

**Note.** Distributions that are timely and properly rolled over, as discussed earlier, are not subject to either regular income tax or the 10% additional tax. Certain withdrawals of excess contributions after the due date of your return are also tax free and not subject to the 10% additional tax (see *Excess contributions withdrawn after due date of return*, earlier).

**Additional tax.** The additional tax on premature distributions is 10% of the amount of the premature distribution that you must include in your gross income. This tax is in addition to any regular income tax resulting from including the distribution in income.

**Nondeductible contributions.** The tax on premature distributions does not apply to the part of a distribution that represents a return of your nondeductible contributions (basis).

**More information.** For more information on premature distributions, see Publication 590.

## Excess Accumulations (Insufficient Distributions)

You cannot keep amounts in your traditional IRA indefinitely. Generally, you must begin receiving distributions by April 1 of the year following the year in which you reach age 70½ (your 70½ year). The required minimum distribution for any year after your

70½ year must be made by December 31 of that later year.

**Tax on excess.** If distributions are less than the required minimum distribution for the year, you may have to pay a 50% excise tax for that year on the amount not distributed as required.

**Request to excuse the tax.** If the excess accumulation is due to reasonable error and you have taken, or are taking, steps to remedy the insufficient distribution, you can request that the tax be excused by filing Form 5329.

**Exemption from tax.** If you are unable to make required distributions because you have a traditional IRA invested in a contract issued by an insurance company that is in state insurer delinquency proceedings, the 50% excise tax does not apply if the conditions and requirements of Revenue Procedure 92-10 are satisfied.

**More information.** For more information on excess accumulations, see Publication 590.

## Reporting Additional Taxes

Generally, you must use Form 5329 to report the tax on excess contributions, premature (early) distributions, and excess accumulations.

**Filing Form 1040.** If you file Form 1040, complete Form 5329 and attach it to your Form 1040. Enter the total amount of IRA tax due on line 53, Form 1040.

**Note.** If you have to file an individual income tax return and Form 5329, you must use Form 1040.

**Not filing Form 1040.** If you do not have to file a Form 1040 but do have to pay one of the IRA taxes mentioned earlier, file the completed Form 5329 with IRS at the time and place you would have filed your Form 1040. Be sure to include your address on page 1 and your signature on page 2. Enclose, but do not attach, a check or money order payable to the United States Treasury for the tax you owe, as shown on Form 5329. Write your social security number and "1999 Form 5329" on your check or money order.

**Form 5329 not required.** You do not have to use Form 5329 if any of the following conditions exist.

- Distribution code 1 (early distribution) is shown in box 7 of Form 1099-R. Instead, multiply the taxable part of the distribution by 10% and enter the result on line 53 of Form 1040. Write "No" next to line 53 to indicate that you do not have to file Form 5329. However, if you owe this tax and also owe any other additional tax on a distribution, do not enter this 10% additional tax directly on your Form 1040. You must file Form 5329 to report your additional taxes.
- You qualify for an exception to the additional tax on early distributions. You need not report the exception if distribution code 2, 3, or 4 is shown in box 7 of Form 1099-R. However, if one of those codes is not shown, or the code

shown is incorrect, you must file Form 5329 to report the exception.

- You properly rolled over all distributions you received during the year.

## Roth IRAs

Regardless of your age, you may be able to establish and make nondeductible contributions to a retirement plan called a Roth IRA.

**TIP** You can make contributions for 1999 by the due date (not including extensions) for filing your 2000 tax return. This means that most people can make contributions for 1999 by April 17, 2000.

### What Is a Roth IRA?

A Roth IRA is an individual retirement plan that, except as explained in this chapter, is subject to the rules that apply to a traditional IRA (defined below). It can be either an account or an annuity. Individual retirement accounts and annuities are described in Publication 590.

To be a Roth IRA, the account or annuity must be designated as a Roth IRA when it is set up. Neither a SEP-IRA nor a SIMPLE IRA can be designated as a Roth IRA.

Unlike a traditional IRA, you cannot deduct contributions to a Roth IRA. But, if you satisfy the requirements, qualified distributions (discussed later) are tax free. Contributions can be made to your Roth IRA after you reach age 70½ and you can leave amounts in your Roth IRA as long as you live.

**Traditional IRA.** A traditional IRA is any IRA that is not a Roth IRA, SIMPLE IRA, or education IRA.

### Can I Contribute to a Roth IRA?

Generally, you can contribute to a Roth IRA if you have taxable **compensation** and your **modified AGI** (defined later) is less than the amount shown for your filing status in *Table 18-2*.

**Is there an age limit for contributions?** Contributions can be made to your Roth IRA regardless of your age.

**Can I contribute to a Roth IRA for my spouse?** You can contribute to a Roth IRA for your spouse provided the contributions satisfy the spousal IRA limit discussed earlier under *Traditional IRAs* and your modified AGI (defined later) is less than the amount shown for your filing status in *Table 18-2*.

**Compensation.** Compensation includes wages, salaries, tips, professional fees, bonuses, and other amounts received for providing personal services. It also includes commissions, self-employment income, and taxable alimony and separate maintenance payments.

**Modified AGI.** Your modified AGI is your adjusted gross income (AGI) as shown on your return modified as follows.

Table 18-2. You Can Contribute to a Roth IRA

IF you have taxable compensation and your filing status is ...	AND your modified AGI is less than ...
Married filing jointly	\$160,000
Married filing separately—and you lived with your spouse during the year	\$ 10,000
Single, head of household, or married filing separately—and you did not live with your spouse at any time during the year	\$110,000

- 1) **Subtract** any income resulting from the conversion (rollover) of an IRA (other than a Roth IRA) to a Roth IRA (conversion income).
- 2) **Add** the following deductions and exclusions:
  - a) Traditional IRA deduction,
  - b) Student loan interest deduction,
  - c) Foreign earned income exclusion,
  - d) Foreign housing exclusion or deduction,
  - e) Exclusion of qualified bond interest shown on Form 8815, and
  - f) Exclusion of employer-paid adoption expenses shown on Form 8839.

### How Much Can Be Contributed?

The contribution limit for Roth IRAs depends on whether a contribution is made only to Roth IRAs or to both traditional IRAs and Roth IRAs.

**Roth IRAs only.** If a contribution is made only to Roth IRAs, the maximum contribution limit is the lesser of \$2,000 or your taxable compensation. If your modified AGI is above a certain amount, your contribution limit may be reduced, as explained later in *Contribution limit reduced*.

**Roth IRAs and traditional IRAs.** If you contribute to both Roth IRAs and traditional IRAs established for your benefit, your contribution limit for Roth IRAs must be reduced by all contributions (other than employer contributions under a SEP or SIMPLE IRA plan) for the year to all IRAs other than Roth IRAs. If your modified AGI is above a certain amount, you also may have to reduce the contribution limit as explained next.

**Contribution limit reduced.** If your modified AGI is above a certain amount, your maximum contribution limit is gradually reduced. Use *Table 18-3* to determine if this reduction applies to you.

**Figuring the reduction.** If your modified AGI is within the range shown in *Table 18-3* for your filing status, see Publication 590.

### When Can I Make Contributions?

You can make contributions to a Roth IRA for a year at any time during the year or by the due date of your return for that year (not including extensions).

### What If I Contribute Too Much?

A 6% excise tax applies to any **excess contribution** to a Roth IRA.

**Excess contributions.** These are the contributions to your Roth IRAs for a year that equal the **total** of:

- 1) Amounts contributed for the tax year to your Roth IRAs (other than amounts properly and timely rolled over from a Roth IRA or properly converted from a traditional IRA, as described later) that are more than your contribution limit for the year, plus
- 2) Any excess contributions for the preceding year, reduced by the total of:
  - a) Any distributions out of your Roth IRAs for the year, plus
  - b) Your contribution limit for the year minus your contributions to all your IRAs (other than education IRAs) for the year.

**Withdrawal of excess contributions.** For purposes of determining excess contributions, any contribution that is withdrawn on or before the due date (including extensions) for filing your tax return for the year is treated as an amount not contributed. This treatment applies only if any earnings on the contributions are also withdrawn and are reported as income earned and receivable in the year the contribution was made.

**Applying excess contributions.** If contributions to your Roth IRA for a year were more than the limit, you can apply the excess contribution in one year to a later year if the contributions for that later year are less than the maximum allowed for that year.

### Can I Move Amounts Into a Roth IRA?

You may be able to convert amounts from either a traditional (including SEP-IRA) or SIMPLE IRA into a Roth IRA. You may be able to recharacterize contributions made to one IRA as having been made directly to a different IRA. You can roll amounts over from one Roth IRA to another Roth IRA.

### Conversions

You can convert a traditional IRA to a Roth IRA. The conversion is treated as a rollover, regardless of the conversion method used. Most of the rules for rollovers, described under *Rollover From One IRA Into Another*, under *Traditional IRAs*, earlier, apply to these rollovers. However, the 1-year waiting period does not apply.



Table 18–3 Your Contribution Limit is Reduced

IF your filing status is ...	AND your modified AGI is between ...
Married filing a joint return	\$150,000 and \$160,000
Married filing separately—and you lived with your spouse during the year	\$0 and \$10,000
Single, head of household, or married filing separately—and you did not live with your spouse at any time during the year	\$95,000 and \$110,000

**Conversion methods.** You can convert amounts from a traditional IRA to a Roth IRA in *any* of the following three ways.

- 1) **Rollover.** You can receive a distribution from a traditional IRA and roll it over (contribute it) to a Roth IRA within 60 days after the distribution.
- 2) **Trustee-to-trustee transfer.** You can direct the trustee of the traditional IRA to transfer an amount from the traditional IRA to the trustee of the Roth IRA.
- 3) **Same trustee transfer.** If the trustee of the traditional IRA also maintains the Roth IRA, you can direct the trustee to transfer an amount from the traditional IRA to the Roth IRA.

**Same trustee.** Conversions made with the same trustee can be made by redesignating the traditional IRA as a Roth IRA, rather than opening a new account or issuing a new contract.

**Converting from any traditional IRA.** You can convert amounts from a traditional IRA into a Roth IRA if, for the tax year you make the withdrawal from the traditional IRA, *both* of the following requirements are met.

- 1) Your modified AGI (explained earlier) is not more than \$100,000.
- 2) You are not a married individual filing a separate return. (See *Married filing separately exception*, under *Filing status*, earlier.)

**Required distributions.** Amounts that must be distributed from your traditional IRA for a particular year (including the calendar year in which you reach age 70½) under the required distribution rules (discussed under *Traditional IRAs*, earlier) cannot be converted.

**Inherited IRAs.** If you inherited a traditional IRA from someone other than your spouse, you cannot convert it to a Roth IRA.

**Income.** You must include in your gross income amounts that you withdraw from a traditional IRA that you would have to include in income if you had not converted them into a Roth IRA. You do not include in gross income any part of a withdrawal from a traditional IRA that is a return of your basis, as discussed earlier under *Traditional IRAs*.

**Conversion of 1998 withdrawal from a traditional IRA.** If you withdrew an amount from a traditional IRA in 1998 and converted

it to a Roth IRA, any amount you had to include in income as a result of the withdrawal is generally included ratably over a 4-year period, beginning with 1998. This means you included one-quarter of the amount in income in 1998, and must include one-quarter in 1999, one-quarter in 2000, and one-quarter in 2001. However, see *Later withdrawals from Roth IRA*, next.

**Later withdrawals from Roth IRA.** If you are including the taxable part of a 1998 conversion ratably over the 4-year period and in 1999 or 2000 you withdraw from the Roth IRA any amount allocable to the taxable part of the conversion, you will generally have to include in income both the ratable (one-quarter) portion for the year and the part of the withdrawal made during the year that is allocable to the taxable part of the conversion. See *Ordering rules for withdrawals*, later for information on how to determine the amount allocable to the taxable part of the conversion.

**Death of IRA owner during 4-year period.** If a Roth IRA owner who is including amounts ratably over the 4-year period dies before including all of the amounts in income, any amounts not included must generally be included in the owner's gross income for the year of death. However, if the owner's surviving spouse receives the entire interest in all the owner's Roth IRAs, that spouse can elect to continue to ratably include the amounts in income over the remaining years in the 4-year period. See Publication 590 for more information on making this election.

**Converting from a SIMPLE IRA.** Generally, you can convert an amount in your SIMPLE IRA to a Roth IRA under the same rules explained earlier under *Converting from any traditional IRA*.

However, you cannot convert any amount distributed from the SIMPLE IRA during the 2-year period beginning on the date, you first participated in any SIMPLE IRA plan maintained by your employer.

**More information.** For more detailed information on conversions, see Publication 590.

### Rollover From a Roth IRA

You can withdraw, tax free, all or part of the assets from one Roth IRA if you contribute them within 60 days to another Roth IRA. The rules for rollovers explained under *Rollover From One IRA Into Another*, under *Traditional IRAs*, earlier, apply to this rollover.

### Failed Conversions

If, when you converted amounts from a traditional IRA or SIMPLE IRA (including a transfer by redesignation) into a Roth IRA, you expected to have modified AGI of less than \$100,000 and a filing status other than married filing separately, but events changed these facts, you have made a failed conversion.

**Adverse consequences.** If the converted amount (contribution) is not recharacterized (explained later), the contribution will be treated as a regular contribution to the Roth IRA and subject to the following tax consequences.

- 1) A 6% excise tax per year will apply to any excess contribution not withdrawn from the Roth IRA.
- 2) The distributions from the traditional IRA must be included in your gross income.
- 3) The 10% additional tax on early withdrawals may apply to any distribution.

**How to avoid.** You must move the amount converted (including all earnings from the date of conversion) into a traditional IRA by the due date (including extensions) for your tax return for the year during which you made the conversion to the Roth IRA. You do not have to include this withdrawal in income. See *Recharacterizations*, next for more information.

### Recharacterizations

You may be able to treat a contribution made to one type of IRA as having been made to a different type of IRA. This is called recharacterizing the contribution. More detailed information is in Publication 590.

To recharacterize a contribution, you generally must have the contribution transferred from the first IRA (the one to which it was made) to the second IRA in a trustee-to-trustee transfer. If the transfer is made by the due date (including extensions) for your tax return for the year during which the contribution was made, you can elect to treat the contribution as having been originally made to the second IRA instead of to the first IRA. It will be treated as having been made to the second IRA on the same date that it was actually made to the first IRA.

**No deduction allowed.** No deduction is allowed for the contribution to the first IRA and any net earnings transferred with the recharacterized contribution are treated as earned in the second IRA.

**Effect of previous tax-free transfers.** If a contribution has been moved from one IRA to another in a tax-free transfer, such as a rollover, the contribution to the second IRA generally cannot be recharacterized.

### How do I recharacterize a contribution?

To recharacterize a contribution, you must notify both the trustee of the first IRA (the one to which the contribution was initially made) and the trustee of the second IRA that you have elected to treat, for federal tax purposes, the contribution as having been made to the second IRA rather than the first. You must make the notifications by the date

of the transfer. Only one notification is required if both IRAs are maintained by the same trustee.

**Reporting a recharacterization.** If you elect to recharacterize a contribution to one IRA as a contribution to another IRA, you must report the recharacterization on your tax return as directed by the tax form and its instructions. You must treat the contribution as having been made to the second IRA.

## Are Distributions From My Roth IRA Taxable?

You do not include in your gross income **qualified distributions** or distributions that are a return of your regular contributions from your Roth IRA(s). You also do not include distributions from your Roth IRA that you roll over tax free into another Roth IRA. You may have to include part of other distributions in your income. See *Ordering rules for withdrawals*, later.

**What are qualified distributions?** A qualified distribution is, generally, any payment or distribution from your Roth IRA made after the 5-taxable-year period beginning with the first taxable year for which a contribution was made to a Roth IRA set up for your benefit if the payment or distribution is:

- 1) Made on or after the date you reach age 59½,
- 2) Made because you are disabled,
- 3) Made to a beneficiary or to your estate after your death, or
- 4) To pay certain qualified first-time homebuyer amounts discussed in Publication 590.

**Distributions that are not qualified distributions.** A distribution is not a qualified distribution if either of the following rules applies.

- 1) **5-year rule.** Any distribution made within the 5-taxable-year period beginning with the first tax year for which either a regular contribution or a conversion contribution was made to a Roth IRA set up for your benefit is not a qualified distribution.
- 2) **Excess contributions rule.** Withdrawals of excess contributions and the earnings on them before the due date of your return (including extensions) are not qualified distributions. The returned contributions are not taxable, but the distributed earnings are taxable in the year the contribution to which they relate was made and may be subject to the 10% additional tax on premature distributions.

**Additional tax on withdrawals of conversion contributions within 5-year period.** If within the 5-year period starting with the year of a conversion contribution, any part of a withdrawal from a Roth IRA is from the taxable part of an amount converted, the 10% additional tax on premature distributions applies. It applies only to the portion

of a conversion contribution that is includible in income because of the conversion. And it applies as though the amount is includible in gross income in the year of the withdrawal, even if no conversion income is includible.

**Additional tax on other withdrawals.** The taxable part of other withdrawals from your Roth IRA(s) that are not qualified distributions is subject to the additional tax on premature distributions. See Publication 590 for more information.

**Ordering rules for withdrawals.** If you make a withdrawal from your Roth IRA that is **not** a qualified distribution, part of the withdrawal may be taxable. For purposes of determining the correct tax treatment of withdrawals (other than the withdrawal of excess contributions and the earnings on them, discussed earlier), there is an order in which contributions (including conversion contributions) and earnings are considered to be withdrawn from your Roth IRA. Regular contributions are withdrawn first. See Publication 590 for more information.

**Am I required to take distributions when I reach age 70½?** You are not required to take distributions from your Roth IRA at any age. The minimum distribution rules that apply to traditional IRAs do not apply to Roth IRAs while the owner is alive. However, after the death of a Roth IRA owner, certain of the minimum distribution rules that apply to traditional IRAs also apply to Roth IRAs.

**More information.** For more detailed information on Roth IRAs, see Publication 590.

## Education IRAs

You may be able to contribute up to \$500 each year to an education individual retirement account (education IRA or Ed IRA) for a child under age 18. Contributions to an education IRA are not deductible.

Any individual (including the child) can contribute to a child's education IRA if the individual's **modified adjusted gross income** (defined later) is less than \$110,000 (\$160,000 on a joint return). The \$500 maximum contribution for each contributor is gradually reduced if the individual's modified adjusted gross income is between \$95,000 and \$110,000 (between \$150,000 and \$160,000 on a joint return). See *Who Can Contribute to an Education IRA?*, later.

There is no limit on the number of education IRAs that can be established designating the same child as the beneficiary. However, **total** contributions for the child during any tax year cannot be more than \$500.

Amounts deposited in the accounts grow tax free until distributed (withdrawn).

If, for a year, withdrawals from an account are not more than a child's **qualified higher education expenses** (defined later) at an **eligible educational institution** (defined later), the withdrawals are not taxable. See *Distributions*, later, for more information.

## What Is an Education IRA?

An education IRA is not a retirement arrangement. It is a trust or custodial account created only for the purpose of paying the **qualified higher education expenses** (defined later) of the designated beneficiary of the account. To be treated as an education IRA, the account must be designated as an education IRA when it is created. It must be created or organized in the United States.

**Account requirements.** The document creating and governing the account must be in writing and must satisfy certain requirements. See Publication 590.

**Designated beneficiary.** The designated beneficiary is the individual on whose behalf the trust or custodial account has been established.

**Qualified higher education expenses.** These are expenses required for the enrollment or attendance of the designated beneficiary at an **eligible educational institution**. The following are qualified higher education expenses.

- 1) Tuition.
- 2) Fees.
- 3) Books.
- 4) Supplies.
- 5) Equipment.
- 6) Amounts contributed to a qualified state tuition program. State tuition programs are discussed in Publication 970, *Tax Benefits for Higher Education*.
- 7) Room and board if the designated beneficiary is at least a half-time student at an eligible educational institution. A student is enrolled at least half-time if he or she is enrolled for at least half the full-time academic workload for the course of study the student is pursuing as determined under the standards of the institution where the student is enrolled. Room and board is limited to:
  - a) The school's posted room and board charge for students living on-campus, or
  - b) \$2,500 each year for students living off-campus and not at home.

**Eligible educational institution.** This is any college, university, vocational school, or other postsecondary educational institution eligible to participate in the student aid programs administered by the Department of Education. It includes virtually any accredited public, nonprofit, or proprietary (privately owned profit-making) postsecondary institution.

## Who Can Contribute to an Education IRA?

Any individual (including the designated beneficiary) can contribute to a child's education IRA if the individual's modified adjusted gross income (discussed later) for the tax year is less than \$110,000 (\$160,000 for married taxpayers filing jointly).

Contributions can be made to one or several education IRAs for the same child provided that the total contributions are not more than the **contribution limit** (defined later) for a tax year.

**Qualified state tuition program.** No contributions can be made to an education IRA on behalf of a beneficiary if any amount is contributed during the tax year to a qualified state tuition program on behalf of the same beneficiary. For more information on state tuition programs see Publication 970.

### Contribution Limits

There are two yearly limits, one on the total amount that can be contributed for each designated beneficiary (child) and one on the amount that any individual can contribute for any one child for a year.

**Limit for each child.** The total of all contributions to all education IRAs set up for the benefit of any one designated beneficiary (child) cannot be more than \$500 for a tax year. This includes contributions (other than rollovers) to all the child's education IRAs from all sources. Rollovers are discussed at *Can Education IRA Assets Be Moved?*, later.

**Limit for each contributor.** You can contribute up to \$500 for each child for any tax year. This is the most you can contribute for the benefit of any one child for any year, regardless of the number of education IRAs set up for the child. This limit may be reduced as explained next.

**Reduced limit for certain contributors.** If your **modified adjusted gross income** (defined later) is between \$95,000 and \$110,000 (between \$150,000 and \$160,000 if filing a joint return), your \$500 limit for each child is gradually reduced. If your modified adjusted income is \$110,000 or more (\$160,000 or more if filing a joint return), you cannot contribute to anyone's education IRA. See Publication 590 for more information.

**Modified adjusted gross income.** Your modified adjusted gross income for the purpose of determining the contribution limit is the adjusted gross income shown on your return, increased by the following exclusions from your income.

- 1) Foreign earned income of U.S. citizens or residents living abroad.
- 2) Housing costs of U.S. citizens or residents living abroad.
- 3) Income from sources within:
  - a) Puerto Rico,
  - b) Guam,
  - c) American Samoa, or
  - d) The Northern Mariana Islands.

**Additional tax on excess contributions.** A 6% excise tax applies each year to excess contributions that are in an education IRA at the end of the year. Excess contributions are the **total** of the following three amounts.

- 1) Contributions to any child's education IRAs for the year that are more than

\$500 (or, if less, the total of each contributor's limit for the year, as discussed earlier).

- 2) All contributions to a child's education IRA for the year if any amount is also contributed during the year to a qualified state tuition program on behalf of the same child. However, amounts withdrawn from the education IRA to be contributed to the qualified state tuition program are not excess contributions.
- 3) Excess contributions for the preceding year, reduced by the total of the following:
  - a) Withdrawals (other than those rolled over as discussed later) made during the year, and
  - b) The contribution limit for the current year minus the amount contributed for the current year.

**When contributions can be made.** You can make contributions to an education IRA for a year at any time during the year. The last day you can make a contribution for 1999 is December 31, 1999.

**Other contribution rules.** You can contribute only cash to an education IRA. You cannot contribute to an education IRA after the beneficiary reaches age 18.

### Can Education IRA Assets Be Moved?

You can roll over assets from one education IRA to another. You can also change the designated beneficiary or transfer the beneficiary's interest to a spouse or former spouse.

### Rollovers

Any amount withdrawn from an education IRA and rolled over to another education IRA for the benefit of the same designated beneficiary or member of the designated beneficiary's family is not taxable. This rule applies only if the beneficiary of the new IRA is under age 30 on the date of the rollover contribution to the new IRA.

An amount is rolled over if it is paid to another education IRA within 60 days after the date of the withdrawal.

**Members of the beneficiary's family.** The beneficiary's spouse and the following individuals (and their spouses) are members of the designated beneficiary's family.

- 1) The beneficiary's child, grandchild, or stepchild.
- 2) A brother, sister, stepbrother or stepsister of the beneficiary.
- 3) A son or daughter of the beneficiary's brother or sister.
- 4) The father, mother, grandfather, grandmother, stepfather or stepmother of the beneficiary.
- 5) A brother or sister of the beneficiary's father or mother.
- 6) The beneficiary's son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law or sister-in-law.



*Only one rollover per education IRA is allowed during the 12-month period ending on the date of the payment or distribution.*

### Changing the Designated Beneficiary

The designated beneficiary can be changed to certain members of the beneficiary's family (listed earlier). There are no tax consequences if, at the time of the change, the new beneficiary is under age 30.

### Transfer Because of Divorce

The transfer of a designated beneficiary's interest in an education IRA to his or her spouse or former spouse under a divorce or separation instrument is not a taxable transfer. After the transfer, the interest will be treated as an education IRA in which the spouse or former spouse is the designated beneficiary.

### Are Withdrawals Taxable?

Withdrawals that are not more than the designated beneficiary's qualified higher education expenses during the year are generally tax free. The portion of any withdrawal that is more than the education expenses may be taxable.

### What Determines the Tax Treatment of Withdrawals?

The tax treatment of distributions (withdrawals) from an education IRA depends, in part, on the qualified higher education expenses that a designated beneficiary has in a tax year.

### Distribution not more than expenses.

Generally, a withdrawal is tax free if it is not more than the designated beneficiary's qualified higher education expenses in a tax year.



*You cannot take a tax deduction or credit for educational expenses you use as the basis for a tax-free withdrawal from an education IRA.*

**Waiver of tax-free treatment.** If you are the designated beneficiary, you can waive the tax-free treatment of the education IRA distribution and elect to pay any tax that would otherwise be owed on the distribution. You or your parents may then be eligible to claim a Hope credit or lifetime learning credit for qualified higher education expenses paid with the distribution in that tax year.

**Distributions more than expenses.** Generally, if the total withdrawals for a tax year are more than the qualified higher education expenses, a portion of the amount withdrawn is taxable and the beneficiary must include it in income. For more information, see Publication 590.

**Additional tax.** Generally, if you receive a taxable distribution, you must pay a **10%** additional tax on the amount you must include in income.

**Exceptions.** There are exceptions to the 10% additional tax for special situations such as the death or disability of the designated beneficiary. For more information, see Publication 590.

### **When Must Education IRA Assets Be Distributed?**

Generally, any assets remaining in an education IRA **must** be withdrawn when either one of the following two events occurs.

- 1) The designated beneficiary reaches age 30. In this case, the designated beneficiary must withdraw the remaining assets within 30 days after he or she reaches age 30.
- 2) The designated beneficiary dies before reaching age 30. In this case, the remaining assets must generally be distributed within 30 days after the date of death.

The withdrawn earnings that accumulated tax free in the account, generally, must be included in taxable income.

**Exception for transfer to surviving spouse or family member.** If an education IRA is transferred to a surviving spouse or other family member (defined earlier) under age 30 as a result of the death of the designated beneficiary, the education IRA retains its status. This means that the spouse or other family member is treated as the designated beneficiary of the education IRA. There are no income tax consequences as a result of the transfer.

# 19.

## Moving Expenses

### Important Reminder

**Change of address.** If you change your mailing address, be sure to notify the IRS using Form 8822, *Change of Address*. Mail it to the Internal Revenue Service Center for your old address. Addresses for the Service Centers are on the back of the form.

### Introduction

This chapter discusses what expenses you can deduct for a job-related move. The following topics are covered.

- When moving expenses qualify for a deduction.
- Which moving expenses can be claimed.
- How to report moving expenses on Form 3903, *Moving Expenses*.

You may be able to deduct some of your expenses for moving to a new home because you changed job locations or started a new job. You can qualify for the deduction whether you are self-employed or an employee. However, the *Requirements*, explained later, must be met.

This chapter contains three charts that may help you determine whether your move qualifies for a deduction, and if so, how much you can deduct. The charts are:

- Figure 19–A, *Illustration of Distance Test*, which covers the minimum distance you must move before you qualify to deduct moving expenses,
- Table 19–1, *Satisfying the Time Test for Employees and Self-Employed Persons*, which covers the time test you must meet, and
- Figure 19–B, *Qualifying Moves Within the United States (Non-Military)*, which covers general qualifications.

**Moves to the United States.** You may be able to deduct the expenses of moving to the United States or its possessions even if the move is not related to a new job. You must have worked outside the United States or be a survivor of someone who did. See *Retirees or Survivors Who Move to the United States*, later.

**Moves outside the United States.** This chapter does not discuss moves outside the United States. If you are a United States citizen or resident alien who moved outside the United States or its possessions because of your job or business, see Publication 521, *Moving Expenses*, for special rules

that apply to your move.

### Useful Items

You may want to see:

#### Publication

- 521** Moving Expenses

#### Form (and Instructions)

- 3903** Moving Expenses
- 8822** Change of Address

### Requirements

You can deduct your allowable moving expenses if your move is closely related to the start of work. You also must meet the distance test and the time test. These two tests are discussed later.

#### Related to Start of Work

Your move must be closely related, both in time and in place, to the start of work at your new job location.

**Closely related in time.** You can generally consider moving expenses incurred within one year from the date you first reported to work at the new location as closely related in time to the start of work. It is not necessary that you arrange to work before moving to a new location, as long as you actually do go to work.

If you do not move within one year, you ordinarily cannot deduct the expenses unless you can show that circumstances existed that prevented the move within that time.

**Example.** Your family moved more than a year after you started work at a new location. You delayed the move for 18 months to allow your child to complete high school. You can deduct your allowable moving expenses.

**Closely related in place.** You can generally consider your move closely related in place to the start of work if the distance from your new home to the new job location is not more than the distance from your former home to the new job location. A move that does not meet this requirement can qualify if you can show that:

- 1) A condition of employment requires you to live at your new home, or
- 2) You will spend less time or money commuting from your new home to your new job.

**Home defined.** Your *home* means your main home (residence). It can be a house, apartment, condominium, houseboat, house trailer, or similar dwelling. It does not include other homes owned or kept up by you or members of your family. It also does not include a seasonal home, such as a summer beach cottage. Your *former home* means your home before you left for your new job location. Your *new home* means

your home within the area of your new job location.

### Distance Test

Your move will meet the distance test if your new main job location is **at least 50 miles** farther from your former home than your old main job location was from your former home. For example, if your old job was 3 miles from your former home, your new job must be at least 53 miles from that former home.

The distance between a job location and your home is the shortest of the more commonly traveled routes between them. The distance test considers only the location of your former home. It does not take into account the location of your new home. See *Figure 19–A*.

**Example.** You moved to a new home less than 50 miles from your former home because you changed job locations. Your old job was 3 miles from your former home. Your new job is 60 miles from that home. Because your new job is 57 miles farther from your former home than the distance from your former home to your old job, you meet the 50-mile distance test.

**First job or return to full-time work.** If you go to work full time for the first time, your place of work must be at least 50 miles from your former home to meet the distance test.

If you go back to full-time work after a substantial period of part-time work or unemployment, your place of work must also be at least 50 miles from your former home.

**TIP** **Exception for Armed Forces.** If you are in the Armed Forces and you moved because of a permanent change of station, you do not have to meet the distance test. See *Members of the Armed Forces*, later.

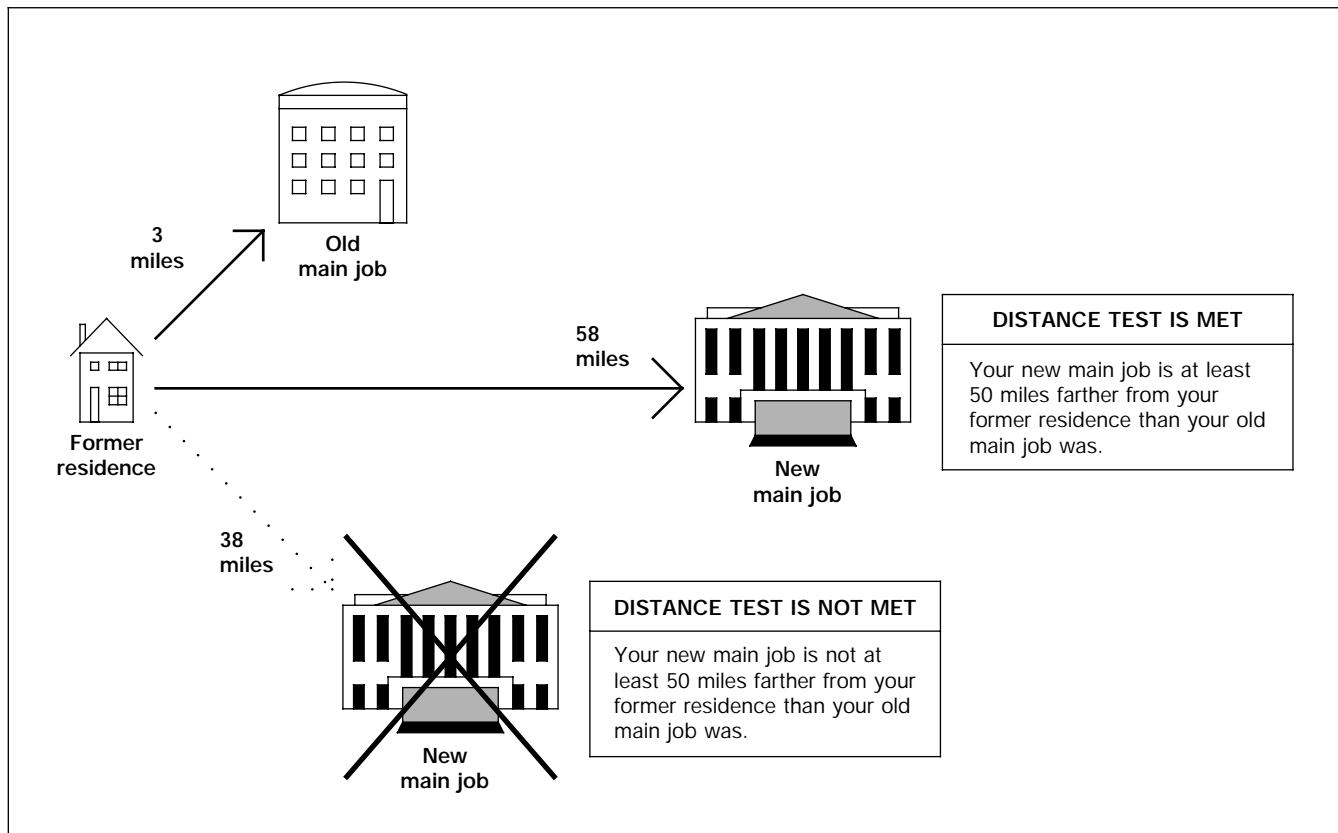
**Main job location.** Your main job location is usually the place where you spend most of your working time. A new job location is a new place where you will work permanently or indefinitely rather than temporarily. If there is no one place where you spend most of your working time, your main job location is the place where your work is centered. For example, your main job location is where you report for work or are otherwise required to “base” your work.

**Union members.** If you work for several employers on a short-term basis and you get work under a union hall system (such as a construction or building trades worker), your main job location is the union hall.

**More than one job.** If you have more than one job at anytime, your main job location depends on the facts in each case. The more important factors to be considered are:

- The total time you spend at each place,
- The amount of work you do at each place, and
- The money you earn at each place.

Figure 19-A. Illustration of Distance Test



## Time Test

To deduct your moving expenses, you also must meet one of the following time tests. See *Table 19-1*, for a summary of these tests.

**Time test for employees.** If you are an employee, you must work full time for at least **39 weeks during the first 12 months** after you arrive in the general area of your new job location. For this time test, count only your full-time work as an employee; do not count any work you do as a self-employed person. You do not have to work for the same employer for the 39 weeks. You do not have to work 39 weeks in a row. However, you must work full time within the same general commuting area. Full-time employment depends on what is usual for your type of work in your area.

**Temporary absence from work.** You are considered working full time during any week you are temporarily absent from work because of illness, strikes, lockouts, layoffs, natural disasters, or similar causes. You are also considered a full-time employee during any week you are absent from work for leave or vacation provided for in your work contract or agreement.

**Seasonal work.** If your work is seasonal, you are considered working full time during the off-season only if your work contract or agreement covers an off-season period and that period is less than 6 months. For example, a school teacher on a 12-month contract who teaches on a full-time basis for more than 6 months is considered a full-time employee for 12 months.

**Time test for self-employed persons.** If you are self-employed, you must work full time for at least **39 weeks during the first**

**12 months AND** for a total of at least **78 weeks during the first 24 months** after you arrive in your new job location. For this time test, count any full-time work you do as an employee or as a self-employed person. You do not have to work for the same employer or be self-employed in the same trade or business for the 78 weeks. If you were both an employee and self-employed, see *Table 19-1* for the requirements.

**Self-employment.** You are self-employed if you work as the sole owner of an unincorporated business or as a partner in a partnership carrying on a business. You are not considered self-employed if you are semiretired, are a part-time student, or work only a few hours each week.

**Full-time work.** Whether you work full time during any week depends on what is usual for your type of work in your area.

For more information, see *Time test for self-employed persons* in Publication 521.

**TIP** **Joint return.** If you are married and file a joint return and both you and your spouse work full time, either of you can satisfy the full-time work test. However, you cannot combine the weeks your spouse worked with the weeks you worked to satisfy that test.

**Time test not yet met.** You can deduct your moving expenses on your 1999 tax return even if you have not yet met the time test by the date your 1999 return is due. You can do this if you expect to meet the 39-week test in 2000, or the 78-week test in 2000 or 2001. If you deduct moving expenses but do not meet the time test by 2000 or 2001, you must either:

- 1) Report your moving expense deduction as other income on your Form 1040 for the year you cannot meet the test, or
- 2) Amend your 1999 return.

Use Form 1040X, *Amended U.S. Individual Income Tax Return*, to amend your return.

If you do not deduct your moving expenses on your 1999 return and you later meet the time test, you can file an amended return for 1999 to take the deduction.

## Exceptions to the Time Test

You do not have to meet the time test if one of the following applies.

- 1) You are in the Armed Forces and you moved because of a permanent change of station. See *Members of the Armed Forces*, later.
- 2) You moved to the United States because you retired. See *Retirees or Survivors Who Move to the United States*, later.
- 3) You are the survivor of a person whose main job location at the time of death was outside the United States. See *Retirees or Survivors Who Move to the United States*, later.
- 4) Your job at the new location ends because of death or disability.
- 5) You are transferred for your employer's benefit or laid off for a reason other than willful misconduct. For this exception, you must have obtained full-time employment, and you must have expected to meet the test at the time you started the job.

Table 19-1. **Satisfying the Time Test for Employees and Self-Employed Persons**

IF you are...	THEN you satisfy the time test by meeting...
An employee and become self-employed before satisfying the 39-week test for employees	The 78-week test for self-employed persons.
Self-employed and become an employee before satisfying the 78-week test for self-employed persons	The 39-week test for employees, or using the time spent as a full-time employee to satisfy the 78-week test.
Both self-employed and an employee at the same time	The 78-week test for a self-employed person or the 39-week test for an employee based on your principal place of work.

### Members of the Armed Forces

If you are a member of the Armed Forces on active duty and you move because of a permanent change of station, you do not have to meet the **distance and time tests**, discussed earlier. You can deduct your unreimbursed allowable moving expenses.

A permanent change of station includes:

- 1) A move from your home to the first post of active duty,
- 2) A move from one permanent post of duty to another, and
- 3) A move from your last post of duty to your home or to a nearer point in the United States. The move must occur within one year of ending your active duty or within the period allowed under the Joint Travel Regulations.

**Spouse and dependents.** If a member of the Armed Forces deserts, is imprisoned, or dies, a permanent change of station for the spouse or dependent includes a move to:

- The place of enlistment,
- The member's, spouse's, or dependent's home of record, or
- A nearer point in the United States.

If the military moves you and your spouse and dependents to or from separate locations, the moves are treated as a single move to your new main job location.

**More information.** For more information on moving expenses for members of the Armed Forces, and instructions for completing Form 3903, see *Members of the Armed Forces* in Publication 521.

### Retirees or Survivors Who Move to the United States

You can deduct your allowable moving expenses if you move to the United States or to a possession of the United States. You do not have to meet the **time test**, discussed earlier, but you must meet the requirements discussed next.

**Retirees.** You can deduct moving expenses for a move to a new home in the United States when you permanently retire. However, both your former main job location and your former home must have been outside the United States.

**Permanently retired.** You are considered permanently retired when you cease gainful full-time employment or self-employment. If, at the time you retire, you intend your retirement to be permanent, you will be considered retired though you later return to work. Your intention to retire permanently will be determined by:

- 1) Your age and health,
- 2) The customary retirement age for people who do similar work,
- 3) Whether you are receiving retirement payments from a pension or retirement fund, and
- 4) The length of time before you return to full-time work.

**Survivors.** You can deduct moving expenses for a move to a home in the United States if you are the spouse or the dependent of a person whose main job location at the time of death was outside the United States. The move must begin within 6 months after the decedent's death. It must be from the decedent's former home outside the United States. That home must also have been your home.

**When a move begins.** A move begins when one of the following events occurs.

- 1) You contract for your household goods and personal effects to be moved to your home in the United States, but only if the move is completed within a reasonable time.
- 2) Your household goods and personal effects are packed and on the way to your home in the United States.
- 3) You leave your former home to travel to your new home in the United States.

## Deductible Moving Expenses

If you meet the *Requirements* discussed earlier, you can deduct the reasonable expenses of:

- 1) Moving your household goods and personal effects (including in-transit storage expenses), and
- 2) Traveling (including lodging but not meals) to your new home.

However, you cannot deduct any expenses for meals.

**Reasonable expenses.** You can deduct only those expenses that are reasonable for the circumstances of your move. For example, the cost of traveling from your former home to your new one should be by the shortest, most direct route available by conventional transportation. If, during your trip to your new home, you make side trips for sightseeing, the additional expenses for your side trips are not deductible as moving expenses.

**Travel by car.** If you use your car to take yourself, members of your household, or your personal effects to your new home, you can figure your expenses by deducting either:

- 1) Your **actual expenses**, such as gas and oil for your car, if you keep an accurate record of each expense, or
- 2) **10 cents a mile.**

You can deduct parking fees and tolls you paid in moving. You cannot deduct any part of general repairs, general maintenance, insurance, or depreciation for your car.

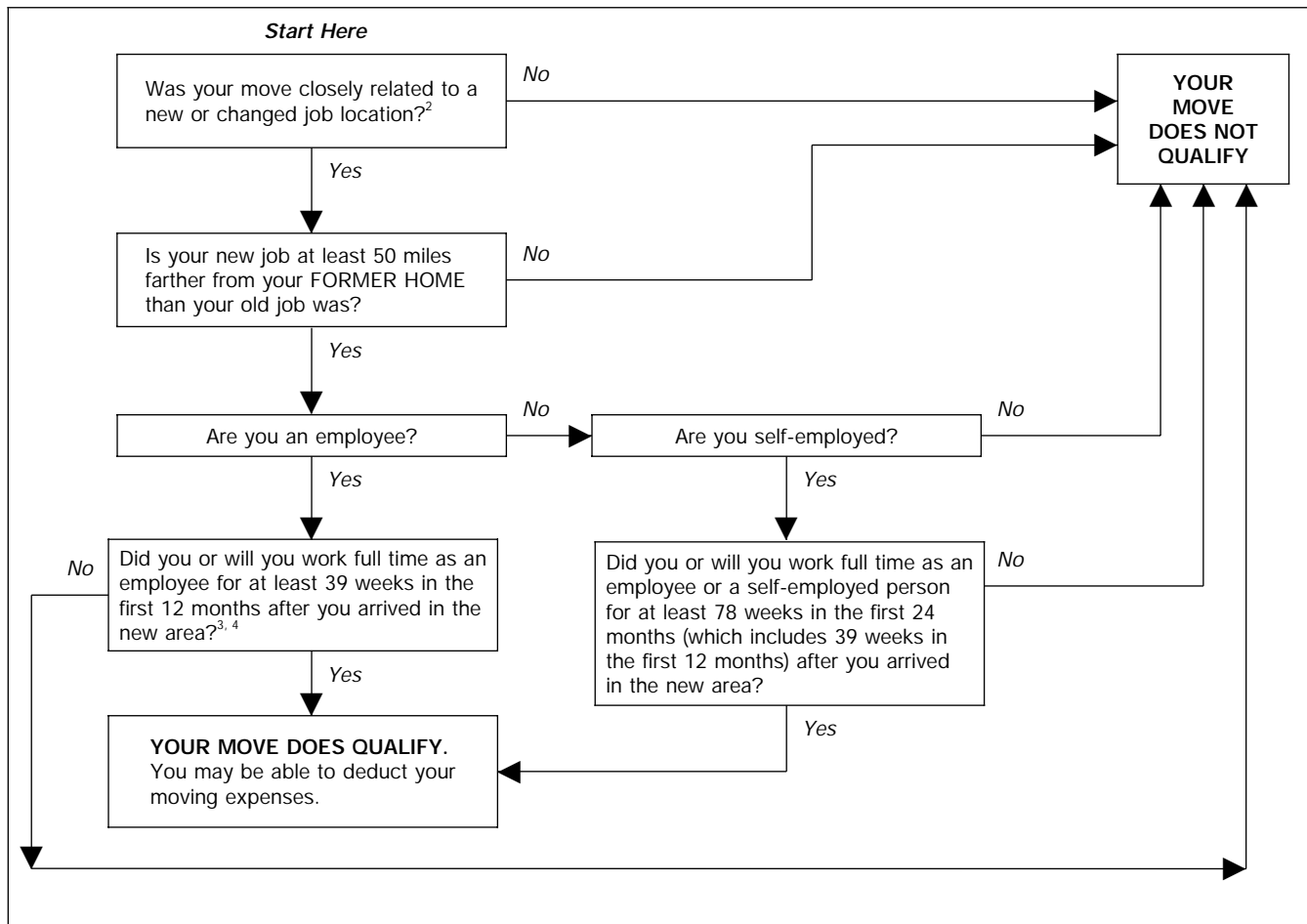
**Member of household.** You can deduct moving expenses you pay for yourself and members of your household. A member of your household is anyone who has both your former and new home as his or her home. It does not include a tenant or employee, unless you can claim that person as a dependent.

**Location of move.** There are different rules for moving within or to the United States than for moving outside the United States. This chapter only discusses moves within or to the United States. The rules for moves outside the United States can be found in Publication 521.

## Household Goods and Personal Effects

You can deduct the cost of packing, crating, and transporting your household goods and personal effects and those of the members of your household from your former home to your new home. If you use your own car to move your things, see *Travel by car*, earlier. You can include the cost of storing and insuring household goods and personal effects within **any period of 30 consecutive days** after the day your things are moved from your former home and before they are delivered to your new home.

Figure 19–B. Qualifying Moves Within the United States (Non-Military)<sup>1</sup>



<sup>1</sup>Military persons should see *Members of the Armed Forces* for special rules that apply to them.

<sup>2</sup>Your move must be closely related to the start of work at your new job location. See *Related to Start of Work*.

<sup>3</sup>If you deduct expenses and do not meet this test later, you must either file an amended tax return or report your moving expense deduction as other income. See *Time test not yet met*.

<sup>4</sup>If you become self-employed during the first 12 months, answer YES if your combined time as a full-time employee and self-employed person equals or will equal at least 78 weeks in the first 24 months (including 39 weeks in the first twelve months) after you arrived in the new area.

You can deduct any costs of connecting or disconnecting utilities required because you are moving your household goods, appliances, or personal effects.

You can deduct the cost of shipping your car and household pets to your new home.

You can deduct the cost of moving your household goods and personal effects from a place other than your former home. Your deduction is limited to the amount it would have cost to move them from your former home.



You cannot deduct the cost of moving furniture you buy on the way to your new home.

## Travel Expenses

You can deduct the cost of transportation and lodging for yourself and members of your household while traveling from your former home to your new home. This includes expenses for the day you arrive. You can include any lodging expenses you had in the area of your former home within one day after you could not live in your former home because your furniture had been moved. You can deduct expenses for only one trip to your new home for yourself and

members of your household. However, all of you do not have to travel together. If you use your own car, see *Travel by car*, earlier.

## Nondeductible Expenses

You cannot deduct the following items as moving expenses.

- Any part of the purchase price of your new home.
- Car tags.
- Driver's license.
- Expenses of buying or selling a home.
- Expenses of getting or breaking a lease.
- Home improvements to help sell your home.
- Loss on the sale of your home.
- Losses from disposing of memberships in clubs.
- Meal expenses.

- Mortgage penalties.
- Pre-move househunting expenses.
- Real estate taxes.
- Refitting carpets and draperies.
- Security deposits (including any given up due to the move).
- Storage charges except those incurred in transit.
- Temporary living expenses.

**Temporary employment.** You cannot take a moving expense deduction and a business expense deduction for the same expenses. You must decide if your expenses are deductible as moving expenses or as business expenses. For example, expenses you have for travel, meals, and lodging while temporarily working at a place away from your regular place of work may be deductible as business expenses if you are considered away from home on business. Generally, your work at a single location is considered temporary if it is realistically expected to last (and does in fact last) for one year or less. See *Temporary Assignment or Job* in chapter 28 for information on deducting your expenses.



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## How To Report

The following discussions explain how to report your moving expenses and any reimbursements or allowances you received for your move.

**Form 3903.** Use Form 3903 to report your moving expenses.

**Where to deduct.** Deduct your moving expenses on line 26 of Form 1040. The amount of moving expenses you can deduct is shown on line 5 of Form 3903.



*You cannot deduct moving expenses on Form 1040EZ or Form 1040A.*

**Reimbursements.** If you received a reimbursement for your allowable moving expenses, how you report this amount and your expenses depends on whether the reimbursement was paid to you under an accountable plan or a nonaccountable plan.

For more information on reimbursements, see Publication 521.

## When To Deduct Expenses

If you were not reimbursed, deduct your allowable moving expenses either in the year you had them or in the year you paid them.

**Example.** In December 1999, your employer transferred you to another city in the United States, where you still work. You are single and were not reimbursed for your moving expenses. In 1999 you paid for moving your furniture. You deducted these expenses in 1999. In January 2000, you paid for travel to the new city. You can deduct these additional expenses in 2000.

**Reimbursed expenses.** If you are reimbursed for your expenses, you can also deduct your allowable expenses in the year you had them or paid them. If you use the cash method of accounting, you can choose to deduct the expenses in the year you are reimbursed even though you paid the expenses in a different year. For more information, see Publication 521.

**Choosing when to deduct.** If you use the cash method of accounting, which is used by most individuals, you can choose to deduct moving expenses in the year your employer reimburses you if:

- 1) You paid the expenses in a year before the year of reimbursement, or
- 2) You paid the expenses in the year immediately after the year of reimbursement but by the due date, including extensions, for filing your return for the reimbursement year.

**How to make the choice.** You can choose to deduct moving expenses in the year you received reimbursement by taking the deduction on your return, or amended return, for that year.



*You cannot deduct any moving expenses for which you received a reimbursement that was excluded from your income. (Reimbursements are discussed in Publication 521.)*

# Alimony

## Introduction

This chapter discusses the rules that apply if you pay or receive alimony. It covers the following topics:

- What payments are alimony,
- What payments are not alimony, such as child support,
- How to deduct alimony you paid,
- How to report alimony income you received, and
- Whether you must recapture the tax benefits of alimony. Recapture means adding back in your income all or part of a deduction you took in a prior year.

Alimony is a payment to or for a spouse or former spouse under a divorce or separation instrument. It does not include voluntary payments that are not made under a divorce or separation instrument.

Alimony is deductible by the payer and must be included by the spouse or former spouse in his or her income. Although this chapter is generally written for the payer of the alimony, the recipient can use the information to determine whether an amount received is alimony.

To be alimony, a payment must meet certain requirements. Different requirements apply to payments under instruments executed after 1984 and to payments under instruments executed before 1985. This chapter discusses the rules for payments under instruments executed after 1984. For the rules for payments under pre-1985 instruments, see Publication 504, *Divorced or Separated Individuals*.

Use *Table 20-1* in this chapter as a guide to determine whether certain payments are considered alimony.

**Definitions.** The following definitions apply throughout this chapter.

**Spouse or former spouse.** Unless otherwise stated in the following discussions about alimony, the term “spouse” includes former spouse.

**Divorce or separation instrument.** The term “divorce or separation instrument” means:

- 1) A decree of divorce or separate maintenance or a written instrument incident to that decree,
- 2) A written separation agreement, or
- 3) A decree or any type of court order requiring a spouse to make payments for the support or maintenance of the other spouse. This includes a temporary decree, an interlocutory (not final) decree, and a decree of alimony *pendente lite* (while awaiting action on the final decree or agreement).

## Useful Items

You may want to see:

### Publication

- 504** Divorced or Separated Individuals

## General Rules

The following rules apply to alimony regardless of when the divorce or separation instrument was executed.

**Payments not alimony.** Not all payments under a divorce or separation instrument are alimony. Alimony does not include any of the following.

- 1) Child support.
- 2) Noncash property settlements.
- 3) Payments that are your spouse's part of community income. (See *Community Property* in Publication 504.)
- 4) Payments to keep up the payer's property.
- 5) Use of property.

**Payments to a third party.** Cash payments (including checks and money orders) to a third party on behalf of your spouse under the terms of your divorce or separation instrument may be alimony if they otherwise qualify. These include payments for your spouse's medical expenses, housing costs (rent, utilities, etc.), taxes, tuition, etc. The payments are treated as received by your spouse and then paid to the third party.

**Life insurance premiums.** Alimony includes premiums you must pay under your divorce or separation instrument for insurance on your life to the extent your spouse owns the policy.

**Payments for jointly-owned home.** If your divorce or separation instrument states that you must pay expenses for a home owned by you and your spouse or former spouse, some of your payments may be alimony.

**Mortgage payments.** If you must pay all the mortgage payments (principal and interest) on a jointly-owned home, and they otherwise qualify, you can deduct one-half of the total payments as alimony. If you itemize deductions and the home is a qualified home, you can claim the other half of the interest in figuring your deductible interest. Your spouse must report one-half of the payments as alimony received. If your spouse itemizes deductions and the home is a qualified home, he or she can claim one-half of the interest on the mortgage in figuring deductible interest.

**Taxes and insurance.** If you must pay all the real estate taxes or insurance on a home held as **tenants in common**, you can deduct one-half of these payments as alimony. Your spouse must report one-half of these payments as alimony received. If you and your spouse itemize deductions, you can each claim one-half of the real estate taxes and none of the home insurance.

If your home is held as **tenants by the entirety** or **joint tenants**, none of your

payments for taxes or insurance are alimony. But if you itemize deductions, you can claim all of the real estate taxes and none of the home insurance.

**Other payments to a third party.** If you made other third-party payments, see Publication 504 to see whether any part of the payments qualify as alimony.

## Instruments Executed After 1984

The following rules for alimony apply to payments under divorce or separation instruments executed after 1984. They also apply to alimony payments under earlier instruments that were modified after 1984 to:

- 1) Specify that these rules will apply,
- 2) Change the amount or period of payment, or
- 3) Add or delete any contingency or condition.

The rules in this section do not apply to divorce or separation instruments executed after 1984 if the terms for alimony are unchanged from an instrument executed before 1985.

**Example 1.** In November 1984, you and your former spouse executed a written separation agreement. In February 1985, a decree of divorce was substituted for the written separation agreement. The decree of divorce did not change the terms for the alimony you pay your former spouse. The decree of divorce is treated as executed before 1985. Alimony payments under this decree are not subject to the rules for payments under instruments executed after 1984.

**Example 2.** Assume the same facts as in Example 1 except that the decree of divorce changed the amount of the alimony. In this example, the decree of divorce is not treated as executed before 1985. The alimony payments are subject to the rules for payments under instruments executed after 1984.

**Alimony requirements.** A payment to or for a spouse under a divorce or separation instrument is alimony if the spouses do not file a joint return with each other and **all** the following requirements are met.

- 1) The payment is in cash.
- 2) The instrument does not designate the payment as not alimony.
- 3) The spouses are not members of the same household at the time the payments are made. This requirement applies only if the spouses are legally separated under a decree of divorce or separate maintenance.
- 4) There is no liability to make any payment (in cash or property) after the death of the recipient spouse.
- 5) The payment is not treated as child support.

Each of these requirements is discussed below.

**Payment must be in cash.** Only cash payments, including checks and money orders, qualify as alimony. The following do not qualify as alimony.

- Transfers of services or property (including a debt instrument of a third party or an annuity contract).
- Execution of a debt instrument by the payer.
- The use of property.

**Payments to a third party.** Cash payments to a third party under the terms of your divorce or separation instrument can qualify as a cash payment to your spouse. See *Payments to a third party* under *General Rules*, earlier.

Also, cash payments made to a third party at the written request of your spouse qualify as alimony if **all** the following requirements are met.

- 1) The payments are in lieu of payments of alimony directly to your spouse.
- 2) The written request states that both spouses intend the payments to be treated as alimony.
- 3) You receive the written request from your spouse before you file your return for the year you made the payments.

**Payments designated as not alimony.**

You and your spouse can designate that otherwise qualifying payments are not alimony. You do this by including a provision in your divorce or separation instrument that states the payments are not deductible by you and are excludable from your spouse's income. For this purpose, any instrument (written statement) signed by both of you that makes this designation and that refers to a previous written separation agreement is treated as a written separation agreement. If you are subject to temporary support orders, the designation must be made in the original or a later temporary support order.

Your spouse can exclude the payments from income only if he or she attaches a copy of the instrument designating them as not alimony to his or her return. The copy must be attached each year the designation applies.

**Spouses cannot be members of the same household.**

Payments to your spouse while you are members of the same household are not alimony if you are legally separated under a decree of divorce or separate maintenance. A home you formerly shared is considered one household, even if you physically separate yourselves in the home.

You are not treated as members of the same household if one of you is preparing to leave the household and does leave no later than one month after the date of the payment.

**Exception.** If you are not legally separated under a decree of divorce or separate maintenance, a payment under a written separation agreement, support decree, or other court order may qualify as alimony even if you are members of the same household when the payment is made.

**Liability for payments after death of recipient spouse.** If you must continue to make payments for any period after your

Table 20-1. **Alimony Requirements (Instruments executed after 1984)**

<p><b>Payments ARE alimony if <u>all</u> of the following are true:</b></p> <p>Payments are required by a divorce or separation instrument.</p> <p>Payer and recipient spouse do not file a joint return.</p> <p>Payment is in cash (including checks or money orders).</p> <p>Payment is not designated in the instrument as not alimony.</p> <p>Spouses legally separated under a decree of divorce or separate maintenance are not members of the same household.</p> <p>Payments are not required after death of the recipient spouse.</p> <p>Payment is not designated as child support.</p>	<p><b>Payments are NOT alimony if <u>any</u> of the following are true:</b></p> <p>Payment is designated as child support.</p> <p>Payment is a noncash property settlement.</p> <p>Payments are spouse's part of community income.</p> <p>Payments are to keep up the payer's property.</p> <p>Payments are not required by a divorce or separation instrument.</p>
<p><i>These payments are deductible by the payer and includible in income by the recipient.</i></p>	<p><i>These payments are neither deductible by the payer nor includible in income by the recipient.</i></p>

spouse's death, none of the payments made before or after the death are alimony.

The divorce or separation instrument does not have to expressly state that the payments cease upon the death of your spouse if, for example, the liability for continued payments would end under state law.

**Example.** You must pay your former spouse \$10,000 in cash each year for 10 years. Your divorce decree states that the payments will end upon your former spouse's death. You must also pay your former spouse or your former spouse's estate \$20,000 in cash each year for 10 years. The death of your spouse would not terminate these payments under state law.

The \$10,000 annual payments are alimony. But because the \$20,000 annual payments will not end upon your former spouse's death, they are not alimony.

**Substitute payments.** If you must make any payments in cash or property after your spouse's death as a substitute for continuing otherwise qualifying payments, the otherwise qualifying payments are not alimony. To the extent that your payments begin, accelerate, or increase because of the death of your spouse, otherwise qualifying payments you made may be treated as payments that were not alimony. Whether or not such payments will be treated as not alimony depends on all the facts and circumstances.

**Example 1.** Under your divorce decree, you must pay your former spouse \$30,000 annually. The payments will stop at the end of 6 years or upon your former spouse's death, if earlier.

Your former spouse has custody of your minor children. The decree provides that if any child is still a minor at your spouse's death, you must pay \$10,000 annually to a trust until the youngest child reaches the age of majority. The trust income and cor-

pus (principal) are to be used for your children's benefit.

These facts indicate that the payments to be made after your former spouse's death are a substitute for \$10,000 of the \$30,000 annual payments. \$10,000 of each of the \$30,000 annual payments is not alimony.

**Example 2.** Under your divorce decree, you must pay your former spouse \$30,000 annually. The payments will stop at the end of 15 years or upon your former spouse's death, if earlier. The decree provides that if your former spouse dies before the end of the 15-year period, you must pay the estate the difference between \$450,000 (\$30,000 × 15) and the total amount paid up to that time. For example, if your spouse dies at the end of the tenth year, you must pay the estate \$150,000 (\$450,000 – \$300,000).

These facts indicate that the lump-sum payment to be made after your former spouse's death is a substitute for the full amount of the \$30,000 annual payments. None of the annual payments are alimony. The result would be the same if the payment required at death were to be discounted by an appropriate interest factor to account for the prepayment.

**Child support.** A payment that is specifically designated as child support or treated as specifically designated as child support under your divorce or separation instrument is not alimony. The designated amount or part may vary from time to time. Child support payments are neither deductible by the payer nor taxable to the payee.

**Specifically designated as child support.** A payment will be treated as specifically designated as child support to the extent that the payment is reduced either:

- 1) On the happening of a contingency relating to your child, or

- 2) At a time that can be clearly associated with a contingency.

A payment may be treated as specifically designated as child support even if other separate payments are specifically designated as child support.

**Contingency relating to your child.**

A contingency relates to your child if it depends on any event relating to that child. It does not matter whether the event is certain or likely to occur. Events relating to your child include the child's:

- Becoming employed,
- Dying,
- Leaving the household,
- Leaving school,
- Marrying, or
- Reaching a specified age or income level.

**Clearly associated with a contingency.** Payments are presumed to be reduced at a time clearly associated with the happening of a contingency relating to your child only in the following situations.

- 1) The payments are to be reduced not more than 6 months before or after the date the child will reach 18, 21, or the local age of majority.
- 2) The payments are to be reduced on two or more occasions that occur not more than one year before or after a different one of your children reaches a certain age from 18 to 24. This certain age must be the same for each child, but need not be a whole number of years.

In all other situations, reductions in payments are not treated as clearly associated with the happening of a contingency relating to your child.

Either you or the IRS can overcome the presumption in the two situations above. This is done by showing that the time at which the payments are to be reduced was determined independently of any contingencies relating to your children. For example, if you can show that the period of alimony payments is customary in the local jurisdiction, such as a period equal to one-half of the duration of the marriage, you can treat the amount as alimony.

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## How To Deduct Alimony Paid

You can deduct alimony you paid, whether or not you itemize deductions on your return. You must file Form 1040; you cannot use Form 1040A or Form 1040EZ.

Enter the amount of alimony you paid on line 31a of Form 1040. In the space provided on line 31b, enter your spouse's or former spouse's social security number.

If you paid alimony to more than one person, enter the social security number of one of the recipients. Show the social security number and amount paid to each other recipient on an attached statement. Enter your total payments on line 31a.



*If you do not provide your spouse's or former spouse's social security number, you may have to pay a \$50 penalty and your deduction may be disallowed.*

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## How To Report Alimony Received

Report alimony you received on line 11 of Form 1040; you cannot use Form 1040A or Form 1040EZ.



*You must give the person who paid the alimony your social security number. If you do not, you may have to pay a \$50 penalty.*

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## Recapture Rule

If your alimony payments decrease or terminate during the first 3 calendar years, you may be subject to the recapture rule. If you are subject to this rule, you have to include in income in the third year part of the alimony payments you previously deducted. Your spouse can deduct in the third year part of the alimony payments he or she previously included in income.

The 3-year period starts with the first calendar year you make a payment qualifying as alimony under a decree of divorce or separate maintenance or a written separation agreement. Do not include any time in which payments were being made under temporary support orders. The second and third years are the next 2 calendar years, whether or not payments are made during those years.

The reasons for a reduction or termination of alimony payments that can require a recapture include:

- A change in your divorce or separation instrument,
- A failure to make timely payments,
- A reduction in your ability to provide support, or
- A reduction in your spouse's support needs.

**When to apply the recapture rule.** You are subject to the recapture rule in the third year if the alimony you pay in either the second year or the third year decreases by more than \$15,000 from the prior year.

When you figure a decrease in alimony, do not include the following amounts.

- 1) Payments made under a temporary support order.
- 2) Payments required over a period of at least 3 calendar years of a fixed part of your income from a business or property, or from compensation for employment or self-employment.
- 3) Payments that decrease because of the death of either spouse or the remarriage of the spouse receiving the payments.

**Figuring the recapture.** There is a blank worksheet for your use to figure recaptured alimony in Publication 504.

**Including the recapture in income.** If you must include a recapture amount in income, show it on Form 1040, line 11 ("Alimony received"). Cross out "received" and write "recapture." On the dotted line next to the amount, enter your spouse's last name and social security number.

**Deducting the recapture.** If you can deduct a recapture amount, show it on Form 1040, line 31a ("Alimony paid"). Cross out "paid" and write "recapture." In the space provided, enter your spouse's social security number.

# Part Five.

## Standard Deduction and Itemized Deductions

After you have figured your adjusted gross income, you are ready to subtract the deductions used to figure taxable income. You can subtract either the standard deduction or itemized deductions. Itemized deductions are deductions for certain expenses that are listed on Schedule A (Form 1040). The ten chapters in this part discuss the standard deduction, each itemized deduction, and the limit on some of your itemized deductions if your adjusted gross income exceeds certain amounts. See chapter 21 for the factors to consider when deciding whether to subtract the standard deduction or itemized deductions.

### 21.

## Standard Deduction

### Important Changes

**Increase in standard deduction.** The standard deduction for taxpayers who do not itemize deductions on Schedule A of Form 1040 is higher in 1999 than it was in 1998. The amount depends upon your filing status. *1999 Standard Deduction Tables* are shown at the end of this chapter.

**Itemized deductions.** The amount you can deduct for itemized deductions is limited if your adjusted gross income is more than \$126,600 (\$63,300 if you are married filing separately). See chapter 22 for more information.

### Introduction

This chapter discusses:

- How to figure the amount of your standard deduction,
- The standard deduction for dependents, and
- Whether to take the standard deduction or to itemize your deductions.

The standard deduction is a dollar amount that reduces the amount of income on which you are taxed.

The standard deduction is a benefit that eliminates the need for many taxpayers to itemize actual deductions, such as medical expenses, charitable contributions, or taxes. The benefit is higher for taxpayers who are 65 or older or blind. If you have a choice, you should use the method that gives you the lower tax.

You benefit from the standard deduction if your standard deduction is more than the total of your allowable itemized deductions.

### Figuring the Amount

Most taxpayers have a choice of either taking a standard deduction or itemizing their deductions.

**Persons not eligible to take the standard deduction.** Your standard deduction is **zero** and you should itemize any deductions you have if:

- 1) You are married and filing a separate return, and your spouse itemizes deductions,
- 2) You are filing a tax return for a short tax year because of a change in your annual accounting period, or
- 3) You are a nonresident or dual-status alien during the year. You are considered a dual-status alien if you were both a nonresident and resident alien during the year.

**Note.** If you are a nonresident alien who is married to a U.S. citizen or resident at the end of the year, you can choose to be treated as a U.S. resident. (See Publication 519, *U.S. Tax Guide for Aliens*.) If you make this choice, you can take the standard deduction.



If an exemption for you can be claimed on another person's return (such as your parents' return), your standard deduction may be limited. See Standard Deduction for Dependents, later.

### Standard Deduction Amount

The standard deduction amounts for most taxpayers are shown in *Table 21-1*.

The amount of the standard deduction for a decedent's final return is the same as it would have been had the decedent continued to live. However, if the decedent was not 65 or older at the time of death, the higher standard deduction for age cannot be claimed.

### Higher Standard Deduction for Age (65 or Older)

If you do not itemize deductions, you are entitled to a higher standard deduction if you are age 65 or older at the end of the year. You are considered 65 on the day before your 65th birthday. Therefore, you can take

a higher standard deduction for 1999 if your 65th birthday was on or before January 1, 2000.

Use *Table 21-2* to figure the standard deduction amount.

### Higher Standard Deduction for Blindness

If you are blind on the last day of the year and you do not itemize deductions, you are entitled to a higher standard deduction as shown in *Table 21-2*. You qualify for this benefit if you are totally or partly blind.

**Partly blind.** If you are partly blind, you must get a certified statement from an eye physician or registered optometrist that:

- 1) You cannot see better than 20/200 in the better eye with glasses or contact lenses, or
- 2) Your field of vision is not more than 20 degrees.

If your eye condition will never improve beyond these limits, the examining eye physician must include this fact in the certification. You should keep the certification in your records.

If your vision can be corrected beyond these limits only by contact lenses that you can wear only briefly because of pain, infection, or ulcers, you can take the higher standard deduction for blindness if you otherwise qualify.

### Spouse 65 or Older or Blind

You can take the higher standard deduction if your spouse is age 65 or older or blind and:

- 1) You file a joint return, or
- 2) You file a separate return, your spouse had no gross income, and an exemption for your spouse could not be claimed by another taxpayer.



You cannot claim the higher standard deduction for an individual, other than your spouse, for whom you can claim an exemption.

### Examples

The following examples illustrate how to determine your standard deduction using *Tables 21-1* and *21-2*.

**Example 1.** Larry, 46, and Donna, 33, are filing a joint return for 1999. Neither is blind. They decide not to itemize their de-

ductions. They use *Table 21-1*. Their standard deduction is \$7,200.

**Example 2.** Assume the same facts as in Example 1, except that Larry is blind at the end of 1999. Larry and Donna use *Table 21-2*. Their standard deduction is \$8,050.

**Example 3.** Bill and Terry are filing a joint return for 1999. Both are over age 65. Neither is blind. If they do not itemize deductions, they use *Table 21-2*. Their standard deduction is \$8,900.

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## Standard Deduction for Dependents

The standard deduction for an individual for whom an exemption can be claimed on another person's tax return is generally limited to the greater of (a) \$700, or (b) the individual's earned income for the year plus \$250 (but not more than the regular standard deduction amount, generally \$4,300).

However, if you are 65 or older or blind, your standard deduction may be higher.

If an exemption for you can be claimed on someone else's return, use *Table 21-3* to determine your standard deduction.

**Earned income defined.** Earned income is salaries, wages, tips, professional fees, and other amounts received as pay for work you actually perform.

For purposes of the standard deduction, earned income also includes any part of a **scholarship or fellowship grant** that you must include in your gross income. See *Scholarship and Fellowship Grants* in chapter 13 for more information on what qualifies as a scholarship or fellowship grant.

**Example 1.** Michael is single. His parents claim an exemption for him on their 1999 tax return. He has interest income of \$780 and wages of \$150. He has no itemized deductions. Michael uses *Table 21-3* to find his standard deduction. He enters \$150 (his earned income) on line 1, \$400 (\$150 plus \$250) on line 3, \$700 (the larger of \$400 and \$700) on line 5, and \$4,300 on line 6. The amount of his standard deduction, on line 7a, is \$700 (the smaller of \$700 and \$4,300).

**Example 2.** Joe, a 22-year-old full-time college student, is claimed on his parents' 1999 tax return. Joe is married and files a separate return. His wife does not itemize deductions on her separate return.

Joe has \$1,500 in interest income and wages of \$3,600. He has no itemized deductions. Joe finds his standard deduction by using *Table 21-3*. He enters his earned income, \$3,600, on line 1. He adds lines 1 and 2 and enters \$3,850 on line 3. On line 5 he enters \$3,850, the larger of lines 3 and 4. Since Joe is married filing a separate return, he enters \$3,600 on line 6. On line 7a he enters \$3,600 as his standard deduction because it is smaller than \$3,850, the amount on line 5.

**Example 3.** Amy, who is single, is claimed on her parents' 1999 tax return. She is 18 years old and blind. She has interest income of \$1,300 and wages of \$2,900. She has no itemized deductions. Amy uses *Table 21-3* to find her standard deduction. She enters her wages of \$2,900 on line 1. She adds lines 1 and 2 and enters \$3,150 on line 3. On line 5 she enters \$3,150, the larger of lines 3 and 4. Since she is single, Amy enters \$4,300 on line 6. She enters \$3,150 on line 7a. This is the smaller of the amounts on lines 5 and 6. Because she checked one box in the top part of the worksheet, she enters \$1,050 on line 7b. She then adds the amounts on lines 7a and 7b and enters her standard deduction of \$4,200 on line 7c.

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## Who Should Itemize

You should itemize deductions if your total deductions are more than the standard deduction amount. Also, you should itemize if you do not qualify for the standard deduction, as discussed earlier under *Persons not eligible for the standard deduction*.

You should first figure your itemized deductions and compare that amount to your standard deduction to make sure you are using the method that gives you the greater benefit.



*You may be subject to a limit on some of your itemized deductions if your adjusted gross income (AGI) is more than \$126,600 (\$63,300 if you are married filing separately). See chapter 22 and the instructions for Schedule A (Form 1040), line 28, for more information on figuring the correct amount of your itemized deductions.*

**When to itemize.** You may benefit from itemizing your deductions on Schedule A (Form 1040) if you:

- 1) Do not qualify for the standard deduction, or the amount you can claim is limited,
- 2) Had large uninsured medical and dental expenses during the year,
- 3) Paid interest and taxes on your home,
- 4) Had large unreimbursed employee business expenses or other miscellaneous deductions,
- 5) Had large uninsured casualty or theft losses,
- 6) Made large contributions to qualified charities, or
- 7) Have total itemized deductions that are more than the highest standard deduction to which you otherwise are entitled.

These deductions are explained in chapters 23-30.

If you decide to itemize your deductions, complete Schedule A and attach it to your Form 1040. Enter the amount from Schedule A, line 28, on Form 1040, line 36.

### Itemizing for state tax or other purposes.

If you choose to itemize even though your itemized deductions are less than the amount of your standard deduction, write "IE" (itemized elected) next to line 36 (Form 1040).

**Changing your mind.** If you do not itemize your deductions and later find that you should have itemized — or if you itemize your deductions and later find you should not have — you can change your return by filing Form 1040X, *Amended U.S. Individual Income Tax Return*. See *Amended Returns and Claims for Refund* in chapter 1 for more information on amended returns.

**Married persons who filed separate returns.** You can change methods of taking deductions only if you and your spouse both make the same changes. Both of you must file a consent to assessment for any additional tax either one may owe as a result of the change.

You and your spouse can use the method that gives you the lower total tax, even though one of you may pay more tax than you would have paid by using the other method. You both must use the same method of claiming deductions. If one itemizes deductions, the other should itemize because he or she will not qualify for the standard deduction (see *Persons not eligible for the standard deduction*, earlier).

**1999 Standard Deduction Tables**

**Table 21-1. Standard Deduction Chart for Most People\***

IF Your Filing Status is ...	Your Standard Deduction is:
Single	\$4,300
Married filing joint return or Qualifying widow(er) with dependent child	7,200
Married filing separate return	3,600
Head of household	6,350

\*DO NOT use this chart if you were 65 or older or blind, OR if someone else can claim an exemption for you (or your spouse if married filing jointly). Use Table 21-2 or 21-3 instead.

**Table 21-2. Standard Deduction Chart for People Age 65 or Older or Blind\***

Check the correct number of boxes below. Then go to the chart. You 65 or older <input type="checkbox"/> Blind <input type="checkbox"/> Your spouse, if claiming spouse's exemption 65 or older <input type="checkbox"/> Blind <input type="checkbox"/> Total number of boxes you checked <input type="checkbox"/>		
IF Your Filing Status is ...	AND the Number in the Box Above is ...	THEN your Standard Deduction is:
Single	1	\$5,350
	2	6,400
Married filing joint return or Qualifying widow(er) with dependent child	1	8,050
	2	8,900
	3	9,750
	4	10,600
Married filing separate return	1	4,450
	2	5,300
	3	6,150
	4	7,000
Head of household	1	7,400
	2	8,450

\*If someone else can claim an exemption for you (or your spouse if married filing jointly), use Table 21-3, instead.

**Caution: If you are married filing a separate return and your spouse itemizes deductions, or if you are a dual-status alien, you cannot take the standard deduction even if you were 65 or older or blind.**

**Table 21-3. Standard Deduction Worksheet for Dependents\***

If you were 65 or older or blind, check the correct number of boxes below. Then go to the worksheet. You 65 or older <input type="checkbox"/> Blind <input type="checkbox"/> Your spouse, if claiming spouse's exemption 65 or older <input type="checkbox"/> Blind <input type="checkbox"/> Total number of boxes you checked <input type="checkbox"/>	
1. Enter your <b>earned income</b> (defined below). If none, enter -0-.	1. _____
2. Additional amount	2. <u>\$250</u>
3. Add lines 1 and 2	3. _____
4. Minimum amount	4. <u>\$700</u>
5. Enter the <b>larger</b> of line 3 or line 4.	5. _____
6. Enter the amount shown below for your filing status. <ul style="list-style-type: none"> <li>• Single, enter \$4,300</li> <li>• Married filing separate return, enter \$3,600</li> <li>• Married filing jointly or Qualifying widow(er) with dependent child, enter \$7,200</li> <li>• Head of household, enter \$6,350</li> </ul>	6. _____
7. <b>Standard deduction.</b> <ul style="list-style-type: none"> <li>a. Enter the <b>smaller</b> of line 5 or line 6. If under 65 and not blind, stop here. This is your standard deduction. Otherwise, go on to line 7b.</li> <li>b. If 65 or older or blind, multiply \$1,050 (\$850 if married or qualifying widow(er) with dependent child) by the number in the box above.</li> <li>c. Add lines 7a and 7b. This is your standard deduction for 1999.</li> </ul>	7a. _____  7b. _____  7c. _____
<b>Earned income includes wages, salaries, tips, professional fees, and other compensation received for personal services you performed. It also includes any amount received as a scholarship that you must include in your income.</b>	

\*Use this worksheet ONLY if someone else can claim an exemption for you (or your spouse if married filing jointly).

## 22.

# Limit on Itemized Deductions

## Introduction

This chapter discusses an overall limit on itemized deductions. The topics include:

- Who is subject to the limit,
- Which itemized deductions are limited, and
- How to figure the limit.

## Useful Items

You may want to see:

### Form (and Instructions)

- Schedule A (Form 1040) Itemized Deductions**

## Are You Subject to the Limit?

You are subject to the limit on certain itemized deductions if your adjusted gross income (AGI) is more than \$126,600 (\$63,300 if you are married filing separately). Your AGI is the amount on line 34 of your Form 1040.

This limit does not apply to estates or trusts.

## Which Deductions Are Limited?

Schedule A (Form 1040) deductions subject to the overall limit are:

- Taxes — line 9,
- Interest — lines 10, 11, and 12,
- Gifts to charity — line 18,
- Job expenses and most other miscellaneous deductions — line 26, and
- Other miscellaneous deductions — line 27 less gambling losses.

## Which Deductions Are Not Limited?

The Schedule A (Form 1040) deductions listed next are not subject to the overall limit on itemized deductions. However, they are still subject to other applicable limits.

- Medical and dental expenses—line 4.
- Investment interest expense—line 13.
- Nonbusiness casualty and theft losses—line 19.
- Gambling losses—line 27.

## How Do You Figure the Limit?

If your itemized deductions are subject to the limit, the total of all your itemized deductions is reduced by the smaller of:

- 1) 3% of the amount by which your AGI exceeds \$126,600 (\$63,300 if married filing separately), or
- 2) 80% of your itemized deductions that are affected by the limit. See *Which Deductions Are Limited?*, earlier.

Before you figure the overall limit on itemized deductions, you must first complete lines 1 through 27 of Schedule A (Form 1040), including any appropriate forms (such as Form 2106, Form 4684, etc.).

The overall limit on itemized deductions is figured after you have applied any other limit on the allowance of any itemized deduction. These other limits include charitable contribution limits (chapter 26), the limit on certain meals and entertainment (chapter 28), and the 2%-of-adjusted-gross-income limit on certain miscellaneous deductions (chapter 30).

**Itemized Deductions Worksheet.** After you have completed Schedule A (Form 1040) through line 27, you can use the *Itemized Deductions Worksheet* in the Instructions for Form 1040 to figure your limit. Enter the result on line 28 of Schedule A (Form 1040). Keep the worksheet for your records.



*You should compare the amount of your standard deduction to the amount of your itemized deductions after applying the limit. Use the greater amount when completing line 36 of your Form 1040. See chapter 21 for information on how to figure your standard deduction.*

## Example

For tax year 1999, Bill and Terry Willow are filing a joint return on Form 1040 and have adjusted gross income of \$255,250. Their Schedule A itemized deductions consist of the following:

State income and real estate taxes .....	\$17,900
Home mortgage interest .....	45,000
Charitable contributions .....	21,000
Investment interest expense .....	41,000
Miscellaneous deductions .....	17,240
<b>Total .....</b>	<b>\$142,140</b>

The Willows' investment interest expense is not subject to the overall limit on itemized deductions. Their deduction for miscellaneous deductions is the total after applying the 2%-of-adjusted-gross-income limit and does not include any gambling losses.

The Willows figure their overall limit as follows:

### Itemized Deductions Worksheet Line 28 (Schedule A) (Keep for your records)

1. Add the amounts on Schedule A, lines 4, 9, 14, 18, 19, 26, and 27 .. **\$142,140**
2. Add the amounts on Schedule A, lines 4, 13, and 19, plus any gambling losses included on line 27 .... **41,000**
3. Is the amount on line 2 less than the amount on line 1?  
  
No. Stop. Enter the amount from line 1 above on Schedule A.  
  
Yes. Subtract line 2 from line 1. .... **101,140**
4. Multiply the amount on line 3 by 80% (.80) ..... **80,912**
5. Enter the amount from Form 1040, line 34 ..... **255,250**
6. Enter \$126,600 (\$63,300 if married filing separately) ..... **126,600**
7. Is the amount on line 6 less than the amount on line 5?  
  
No. **Stop.** Enter the amount from line 1 above on Schedule A, line 28.  
  
Yes. Subtract line 6 from line 5 ..... **\$128,650**
8. Multiply the amount on line 7 by 3% (.03) ..... **3,860**
9. Enter the smaller of line 4 or line 8 ..... **3,860**
10. **Total itemized deductions.** Subtract line 9 from line 1. Enter the result here and on Schedule A, line 28 ..... **\$138,280**

Of their \$142,140 total itemized deductions, the Willows can deduct only \$138,280. They enter \$138,280 on Schedule A, line 28.



# Medical and Dental Expenses

## Important Changes

**Self-employed health insurance deduction.** For 1999, the amount you can deduct increased from 45% to 60% of the amount you paid.

**Stop-smoking programs.** You can now include in medical expenses amounts you pay for a program to stop smoking. If you paid for a stop-smoking program in 1996, 1997, or 1998, you may be able to file an amended return on Form 1040X, *Amended U.S. Individual Income Tax Return*, to include in medical expenses the amounts you paid for that stop-smoking program. However, you cannot include in medical expenses amounts you pay for drugs that do not require a prescription, such as nicotine gum or patches, that are designed to help stop smoking.

## Important Reminder

**Medical savings account.** You may be able to make deductible contributions to a medical savings account (MSA). If you are an employee of a small business (fewer than 50 employees), or self-employed and covered only by a high deductible health plan, you may be eligible to have an MSA. You deduct MSA contributions on Form 1040, line 25, not on Schedule A (Form 1040) as a qualified medical expense. See Publication 969, *Medical Savings Accounts (MSAs)*, for more information.

## Introduction

This chapter explains how to claim a deduction for your medical and dental expenses. It contains a 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.

It will help you determine:

- Whose expenses you can include,
- What expenses you can include,
- How to claim expenses of a decedent, and
- How to figure your deduction.

You figure your medical expense deduction on **Schedule A** (Form 1040). You cannot claim medical expenses on Form 1040A or Form 1040EZ. You must reduce your total medical expenses by all reimbursement for medical expenses that you receive from insurance or other sources during the year. This includes payments from Medicare.

You can deduct only the amount of your medical and dental expenses that is **more than 7.5%** of your adjusted gross income shown on line 34, Form 1040. See *How To Figure Your Deduction*, later.

### Useful Items

You may want to see:

#### Publication

- 502** Medical and Dental Expenses

#### Form (and Instructions)

- Schedule A (Form 1040)** Itemized Deductions

## Whose Expenses Can You Include?

You can include medical expenses you pay for yourself and for the individuals discussed in this section.

**Spouse.** You can include medical expenses you paid for your spouse. To claim these expenses, you must have been married either at the time your spouse received the medical services or at the time you paid the medical expenses.

**Example 1.** Mary received medical treatment before she married Bill. Bill paid for the treatment after they married. Bill can include these expenses in figuring his medical expense deduction even if Bill and Mary file separate returns.

If Mary had paid the expenses before she and Bill married, Bill could not include Mary's medical expenses in his separate return. Mary would include the amounts she paid during the year in her separate return. If they filed a joint return, the medical expenses both paid during the year would be used to figure their medical expense deduction.

**Example 2.** This year, John paid medical expenses for his wife Louise who died last year. John married Belle this year and they file a joint return. Because John was married to Louise when she incurred the medical expenses, he can include those expenses in figuring his medical deduction for this year.

**Dependents.** You can include medical expenses you paid for your dependent. To claim these expenses, the person must have been your dependent either at the time the medical services were provided or at the time you paid the expenses. A person generally qualifies as your dependent for purposes of the medical expense deduction if:

- 1) That person lived with you for the entire year as a member of your household or is related to you,
- 2) That person was a U.S. citizen or resident, or a resident of Canada or Mexico for some part of the calendar year in which your tax year began, and
- 3) You provided over half of that person's total support for the calendar year.


You can include the medical expenses of any person who is your dependent even

if you cannot claim an exemption for him or her on your return.

**Example 1.** Last year your son was your dependent. This year he no longer qualifies as your dependent. However, you paid \$800 this year for medical expenses your son incurred last year when he was your dependent. You can include the \$800 in figuring this year's medical expense deduction. You cannot include this amount on last year's return.

**Example 2.** You provided more than half of your married daughter's support, including medical expenses of \$1,200. She and her husband file a joint return. Although you may not be able to claim an exemption for your daughter, she is still your dependent, and you can include in your medical expenses the \$1,200 you paid.

**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 expenses were provided or when the expenses were paid. 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 provided you clearly substantiate that the payment is directly attributable to the medical care of the child. But if you pay back medical expenses incurred and paid before adoption negotiations began, you cannot include them as medical expenses.

 **TIP** You may be able to take a credit for other expenses related to adoption. See Publication 968, *Tax Benefits for Adoption*, for more information.

**Child of divorced or separated parents.** If either parent can claim a child as a dependent under the rules for divorced or separated parents, each parent can include the medical expenses he or she pays for the child even if an exemption for the child is claimed by the other parent.

**Support claimed under a multiple support agreement.** A multiple support agreement is used when two or more people provide more than half of a person's support, but no one alone provides more than half. If you are considered to have provided more than half of a person's support under such an agreement, you can include medical expenses you pay for that person, even if you cannot claim the person because he or she had gross income of more than the standard deduction amount or filed a joint return.

Any medical expenses paid by others who joined you in the agreement cannot be included as medical expenses by anyone. However, you can include the entire unreimbursed amount you paid for medical expenses.

**Example.** You and your three brothers each provide one-fourth of your mother's total support. Under a multiple support agreement, you claim your mother as a dependent. You paid all of her medical expenses. Your brothers repaid you for three-fourths of these expenses. In figuring your medical expense deduction, you can include only one-fourth of your mother's medical expenses. Your brothers cannot include any part of the expenses. However, if you and

your brothers share the nonmedical support items and you separately pay all of your mother's medical expenses, you can include the amount you paid for her medical expenses in your medical expenses.

## Medical Care

Medical care expenses include amounts paid for the diagnosis, cure, mitigation, treatment, or prevention of disease, and for treatments affecting any part or function of the body. The expenses must be primarily to alleviate or prevent a physical or mental 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.

Use *Table 23-1* in this chapter as a guide to determine which medical and dental expenses you can include on Schedule A (Form 1040). See Publication 502 for information about other expenses you can include.

## Medical Insurance Premiums

You can include in medical expenses insurance premiums you pay 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,
- Membership in an association that gives cooperative or so-called "free-choice" medical service, or group hospitalization and clinical care, or
- Qualified long-term care insurance contracts (subject to additional limitations). See *Long-term Care Contracts, Qualified* in Publication 502.

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.

**Cafeteria plans.** Do not include in your medical and dental expenses insurance premiums paid by an employer-sponsored health insurance plan (cafeteria plan) unless the premiums are included in box 1 of your Form(s) W-2. Also, do not include any other medical and dental expenses paid by the plan unless the amount paid is included in box 1 of your Form(s) W-2.

**Medicare A.** If you are covered under social security (or if you are a government employee who paid Medicare tax), you are enrolled in Medicare A. The payroll tax paid for Medicare A is not a medical expense. If you are not covered under social security (or were not a government employee who paid Medicare tax), you can voluntarily enroll in Medicare A. In this situation the pre-

miums paid for Medicare A can be included as a medical expense on your tax return.

**Medicare B.** Medicare B is a supplemental medical insurance. Premiums you pay for Medicare B are a medical expense. If you applied for it at age 65 or after you became disabled, you can deduct the monthly premiums you paid. If you were over age 65 or disabled when you first enrolled, check the information you received from the Social Security Administration to find out your premium.

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

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

**Unused sick leave used to pay premiums.** You must include in gross income cash payments you receive at the time of retirement for unused sick leave. You must also include in gross income the value of unused sick leave that, at your option, your employer applies to the cost of your continuing participation in your employer's health plan after you retire. You can include this cost of continuing participation in the health plan as a medical expense.

If you participate in a health plan where your employer automatically applies the value of unused sick leave to the cost of your continuing participation in the health plan (and you do not have the option to receive cash), you do not include the value of the unused sick leave in gross income. You cannot include this cost of continuing participation in that health plan as a medical expense.

## Health Insurance Costs for Self-Employed Persons

If you were self-employed and had a net profit for the year, you may be able to deduct up to 60% of the amount paid for health insurance on behalf of yourself, your spouse, and dependents. If you itemize your deductions, include the remaining premiums with all other medical care expenses on Schedule A (Form 1040), subject to the 7.5% limit. See Publication 535, *Business Expenses*, for more information.

## Meals and Lodging

You can include in medical expenses the cost of meals and lodging at a hospital or similar institution if your main reason for being there is to receive medical care. See *Nursing home*, later.

You may be able to include in medical expenses the cost of lodging not provided in a hospital or similar institution. You can include the cost of such lodging while away from home if you meet all of the following requirements.

- 1) The lodging is primarily for and essential to medical care.
- 2) The 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 for lodging cannot be more than \$50 for each night for each person. You can include lodging for a person 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.)

**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.

## Transportation

You can include in medical expenses amounts paid for transportation primarily for, and essential to, medical care.

**You can include:**

- Bus, taxi, train, or plane fares, or ambulance service,
- 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, and
- Transportation expenses for regular visits to see a mentally ill dependent, if these visits are recommended as a part of treatment.

**You cannot include:**

- Transportation expenses to and from work even if your condition requires an unusual means of transportation, or
- Transportation expenses if, for non-medical 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.

**Car expenses.** You can include out-of-pocket expenses for your car, such as gas and oil when you use your car for medical reasons. You cannot include depreciation, insurance, general repair, or maintenance expenses.

If you do not want to use your actual expenses, you can use a standard rate of **10 cents a mile** for use of your car for medical reasons.

You can also include the cost of parking fees and tolls. You can add these fees and tolls to your medical expenses whether you

Table 23–1. Medical and Dental Expenses Checklist

You can include:		You cannot include:	
<ul style="list-style-type: none"> <li>• Birth control pills prescribed by your doctor</li> <li>• Capital expenses for equipment or improvements to your home needed for medical care (see Publication 502)</li> <li>• Cost and care of guide dogs or other animals aiding the blind, deaf, and disabled</li> <li>• Cost of lead-based paint removal (see Publication 502)</li> <li>• Expenses of an organ donor</li> <li>• Hospital services fees (lab work, therapy, nursing services, surgery, etc.)</li> <li>• Legal abortion</li> <li>• Legal operation to prevent having children</li> <li>• Long-term care contracts, qualified</li> <li>• Meals and lodging provided by a hospital during medical treatment</li> <li>• Medical and hospital insurance premiums</li> <li>• Medical services fees (from doctors, dentists, surgeons, specialists, and other medical practitioners)</li> </ul>	<ul style="list-style-type: none"> <li>• Oxygen equipment and oxygen</li> <li>• Part of life-care fee paid to retirement home designated for medical care</li> <li>• Prescription medicines (prescribed by a doctor) and insulin</li> <li>• Psychiatric care at a specially equipped medical center (includes meals and lodging)</li> <li>• Social Security tax, Medicare tax, FUTA, and state employment tax for worker providing medical care (see <i>Wages for nursing services</i>, later).</li> <li>• Special items (artificial limbs, false teeth, eye-glasses, contact lenses, hearing aids, crutches, wheelchair, etc.)</li> <li>• Special school or home for mentally or physically disabled persons (see Publication 502)</li> <li>• Stop-smoking programs</li> <li>• Transportation for needed medical care</li> <li>• Treatment at a drug or alcohol center (includes meals and lodging provided by the center)</li> <li>• Wages for nursing services (see Publication 502)</li> </ul>	<ul style="list-style-type: none"> <li>• Bottled water</li> <li>• Diaper service</li> <li>• Expenses for your general health (even if following your doctor's advice) such as— <ul style="list-style-type: none"> <li>—Health club dues</li> <li>—Household help (even if recommended by a doctor)</li> <li>—Social activities, such as dancing or swimming lessons</li> <li>—Trip for general health improvement</li> <li>—Weight loss program</li> </ul> </li> <li>• Funeral, burial, or cremation expenses</li> </ul>	<ul style="list-style-type: none"> <li>• Illegal operation or treatment</li> <li>• Life insurance or income protection policies, or policies providing payment for loss of life, limb, sight, etc.</li> <li>• Maternity clothes</li> <li>• Medical insurance included in a car insurance policy covering all persons injured in or by your car</li> <li>• Medicine you buy without a prescription</li> <li>• Nursing care for a healthy baby</li> <li>• Surgery for purely cosmetic reasons</li> <li>• Toothpaste, toiletries, cosmetics, etc.</li> </ul>

use actual expenses or use the standard mileage rate.

**Example.** Bill Jones drove 2,800 miles for medical reasons during the year. He spent \$200 for gas, \$5 for oil, and \$50 for tolls and parking. He wants to figure the amount he can include in medical expenses both ways to see which gives him the greater deduction.

He figures the actual expenses first. He adds the \$200 for gas, the \$5 for oil, and the \$50 for tolls and parking for a total of \$255.

He then figures the standard mileage amount. He multiplies the 2,800 miles by 10 cents a mile for a total of \$280. He then adds the \$50 tolls and parking for a total of \$330.

Bill includes the \$330 of car expenses with his other medical expenses for the year because the \$330 is more than the \$255 he figured using actual expenses.

## Disabled Dependent Care Expenses

Some disabled dependent care expenses may qualify as medical expenses or as work-related expenses for purposes of taking a credit for dependent care. (See chapter 33.) You can choose to apply them either way as long as you do not use the same expenses to claim both a credit and a medical expense deduction.

## Impairment-Related Work Expenses (Business or Medical)

Certain unreimbursed expenses may appear to be deductible as either medical or business expenses. Deduct them as business deductions if they are:

- Necessary for you to do your work satisfactorily,

- For goods or services not required or used, other than incidentally, in your personal activities, and
- Not specifically covered under other income tax laws.

**Example.** You are blind. You must use a reader to do your work. You use the reader both during your regular working hours at your place of work and outside your regular working hours away from your place of work. The reader's services are only for your work. You can deduct your expenses for the reader as business expenses.

## 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 the decedent's amended return, Form 1040X), saying that the expenses have not been and will not be claimed on the estate tax return.

Amended returns and claims for refund are discussed in chapter 1.

**Expenses for deceased spouse or dependent.** 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. The expenses can be included if the person was your spouse or dependent either at the time the medical services were provided or at the time you paid the expenses.

## How To Figure Your Deduction

To figure your medical expense deduction, complete lines 1–4 of Schedule A (Form 1040). If you need more information on itemized deductions or you are not sure whether you can itemize, see chapters 21 and 22.

Write in the amounts you paid for medical and dental care expenses after reducing the amount by payments you received from insurance and other sources. You can deduct only the amount of your medical and dental expenses that is more than 7.5% of your adjusted gross income shown on line 34, Form 1040.

Write the amount of your unreimbursed medical expenses on line 1, Schedule A (Form 1040). For an example, see Publication 502.

**Separate returns.** If you and your spouse live in a noncommunity property state and file separate returns, each of you can include only the medical expenses each actually paid. Any medical expenses paid out of a joint checking account in which you and your spouse have the same interest are considered to have been paid equally by each of you, unless you can show otherwise.

**Community property states.** If you and your spouse live in a community property state and file separate returns, any medical expenses paid out of community funds are divided equally. Each of you should include half the expenses. If medical expenses are paid out of the separate funds of one spouse, only the spouse who paid the medical expenses can include them. If you live in a community property state, are married, and file a separate return, see Publication 555, *Community Property*.

### What expenses can you include in 1999?

You can include only the medical and dental expenses you paid this year, regardless of when the services were provided. (But see *Decedents*, earlier.) If you pay medical expenses by check, the day you mail or deliver the check generally is the date of payment. If you use a "pay-by-phone" or "on-line" account to pay your medical expenses, the date reported on the statement of the fi-

nancial 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.

## 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 reduce medical expenses by payments you receive for loss of earnings or damages for personal injury or sickness.

**Excess reimbursement.** You do not have a medical deduction if you are reimbursed for all of your medical expenses for the year.

**Premiums paid by you.** If you pay the entire premium for your medical insurance or all of the costs of a plan similar to medical insurance, generally do not include an 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 an 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 annual cost of the policy (\$600 ÷ \$2,000) .....	30%

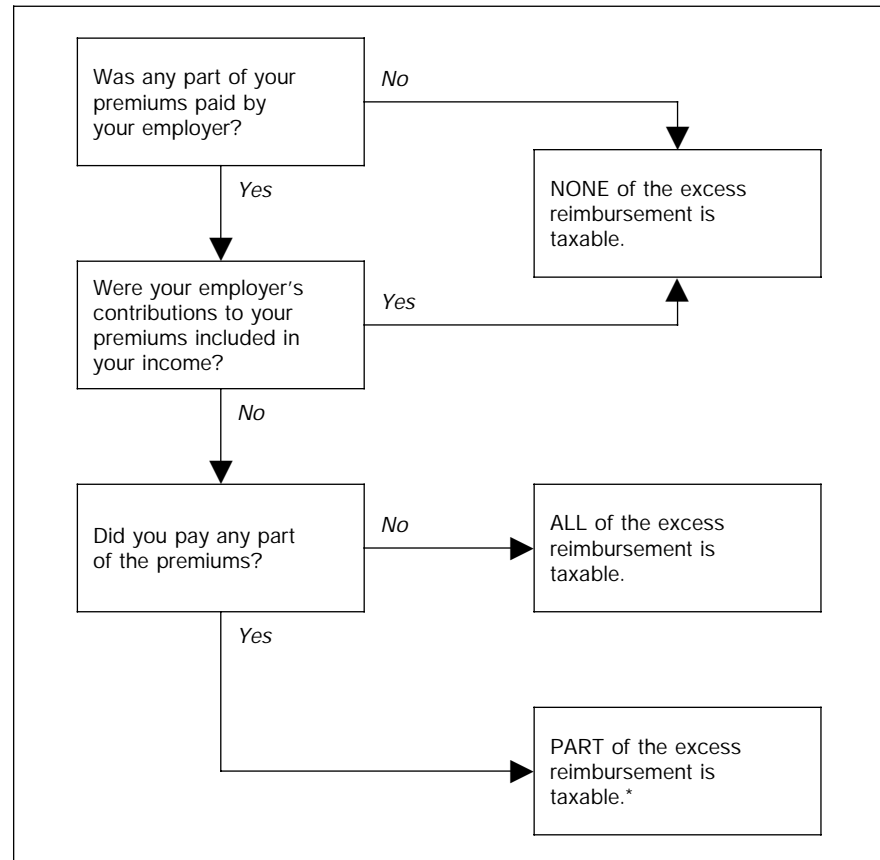
You must include in your gross income 30% of any excess reimbursement you received for medical expenses under the policy.

**Premiums paid by your employer.** If your employer or your former employer pays the total cost of your medical insurance plan and your employer's contributions are not included in your income, you must report all of your excess reimbursement as other income.

**More than one policy.** If you are covered under more than one policy, the costs of which are paid by both you and your employer, you must first divide the medical expense among the policies to figure the excess reimbursement from each policy. Then divide the policy costs to figure the part of any excess reimbursement that is from your employer's contribution.

**Example.** You are covered by your employer's health insurance policy. The annual premium is \$1,200. Your employer pays \$300, and the balance of \$900 is deducted from your wages. You also paid the entire premium (\$250) for a personal health insurance policy.

### Figure 23–A. Is Your Excess Medical Reimbursement Taxable?



\*See *Premiums paid by you and your employer* in this chapter.

During the year, you paid medical expenses of \$3,600. In the same year, you were reimbursed \$2,500 under your employer's policy and \$1,500 under your personal policy.

You figure the part of any excess reimbursement you receive that is from your employer's contribution like this:

**Step 1.**

Reimbursement from employer's policy ...	\$2,500
Reimbursement from your policy .....	<u>1,500</u>
<b>Total reimbursement</b> .....	<u>\$4,000</u>
Amount of medical expenses from your policy (\$1,500 ÷ \$4,000) × \$3,600 total medical expenses .....	\$1,350
Amount of medical expenses from your employer's policy (\$2,500 ÷ \$4,000) × \$3,600 total medical expenses .....	<u>2,250</u>
<b>Total medical expenses</b> .....	<u>\$3,600</u>
<b>Excess reimbursement from your employer's policy</b> (\$2,500 – \$2,250) ....	<u>\$250</u>

**Step 2.**

Because both you and your employer contribute to the cost of this policy, you must divide the cost to determine the excess reimbursement from your employer's contribution.

Employer's contribution in relation to the annual cost of the policy (\$300 ÷ \$1,200) .....	25%
<b>Amount to report as other income</b> (25% × \$250) .....	\$62.50

**Reimbursement in a later year.** If you are reimbursed in a later year for medical expenses you deducted in an earlier year, you must report as income the amount you received from insurance or other sources that is equal to, or less than, the amount you previously deducted as medical expenses. However, do not report as income the reimbursement you received up to the amount of your medical deductions that did not reduce your tax for the earlier year. For more information about the recovery of an amount that you claimed as an itemized deduction in an earlier year, see *Itemized Deduction Recoveries* in chapter 13.

**Medical expenses not deducted.** If you did not deduct a medical expense in the year you paid it because your medical expenses were not more than 7.5% of your adjusted gross income, or because you did not itemize deductions, do not include in

income the reimbursement for this expense that you receive in a later year. However, if the reimbursement is more than the expense, see *Excess reimbursement*, earlier.

**Example.** In 1999, you had medical expenses of \$500. You cannot deduct the \$500 because it is less than 7.5% of your adjusted gross income. If, in a later year, you are reimbursed for any of the \$500 medical expenses, you do not include that amount in your gross income.

**Settlement of damages suit.** If you receive an amount in settlement of a personal injury suit, the part that is for medical expenses deducted in an earlier year is included in income in the later year if your medical deduction in the earlier year reduced your income tax in that year. See *Reimbursement in a later year*, earlier.

**Future medical expenses.** If you receive an amount in settlement of a damage suit for personal injuries that is properly allocable or determined to be for future medical expenses, you must reduce any medical expenses for these injuries until the amount you received has been completely used.

## Important Reminder

**Limit on itemized deductions.** If your adjusted gross income is more than \$126,600 (\$63,300 if you are married filing separately), the overall amount of your itemized deductions may be limited. See chapter 22 for more information about this limit.

## Introduction

This chapter discusses which taxes you can deduct if you itemize deductions on Schedule A (Form 1040). It also explains which taxes you can deduct on other schedules or forms and which taxes you cannot deduct.

The chapter covers:

- Income taxes (state, local, or foreign),
- Real estate taxes (state, local, or foreign),
- Personal property taxes (state or local), and
- Taxes and fees you cannot deduct.

At the end of the chapter is a section that explains which form you use to deduct the different types of taxes.

**Table.** Use *Table 24-1* as a guide to determine which taxes you can deduct.

**Business taxes.** You can deduct certain taxes only if they are ordinary and necessary expenses of your trade or business or of producing income. For information on these taxes, see Publication 535, *Business Expenses*.

**State or local taxes.** These are taxes imposed by the 50 states, U.S. possessions, or any of their political subdivisions (such as a county or city), or by the District of Columbia.

**Indian tribal government.** An Indian tribal government that is recognized by the Secretary of the Treasury as performing substantial government functions will be treated as a state for this purpose. Income taxes, real estate taxes, and personal property taxes imposed by that Indian tribal

government (or by any of its subdivisions that are treated as political subdivisions of a state) are deductible.

**Foreign taxes.** These are taxes imposed by a foreign country or any of its political subdivisions.

### Useful Items

You may want to see:

#### Publication

- 514** Foreign Tax Credit for Individuals
- 530** Tax Information for First-Time Homeowners

#### Form (and Instructions)

- Schedule A (Form 1040)** Itemized Deductions
- Schedule E (Form 1040)** Supplemental Income and Loss
- Form 1116** Foreign Tax Credit

## Tests to Deduct Any Tax

The following two tests must be met for any tax to be deductible by you.

- 1) The tax must be imposed on you.
- 2) The tax must be paid during your tax year.

**The tax must be imposed on you.** Generally, you can deduct only taxes that are imposed on you.

Generally, you can deduct property taxes only if you are the property owner. If your spouse owns property and pays real estate taxes on it, the taxes are deductible on your spouse's separate return or on your joint return.

**The tax must be paid during your tax year.** If you are a cash basis taxpayer, you can deduct only those taxes paid during the calendar year for which you file a return. If you pay your taxes by check, the day you mail or deliver the check is generally the date of payment. If you use a pay-by-phone account, the date reported on the statement of the financial institution showing when payment was made is the date of payment. If you contest a tax liability and use the cash method of accounting, you can deduct the tax only in the year it is actually paid.

If you use an accrual method of accounting, see Publication 538, *Accounting Periods and Methods*, for more information.

## Income Taxes

This section discusses the deductibility of state and local income taxes (including employee contributions to state benefit funds) and foreign income taxes.

### State and Local Income Taxes

You can deduct state and local income taxes.

**Exception.** You cannot deduct state and local income taxes you pay on income that is exempt from federal income tax, unless the exempt income is interest income. For example, you cannot deduct the part of a state's income tax that is on a cost-of-living allowance that is exempt from federal income tax.

### What To Deduct

Your deduction may be for withheld taxes, estimated tax payments, or other tax payments as follows.

**Withheld taxes.** Deduct state and local income taxes withheld from your salary in the year they are withheld. For 1999, these taxes will be shown in boxes 18 and 21 of your Form W-2. You may also have state or local income tax withheld on Form W-2G (box 14), Form 1099-MISC (box 11), or Form 1099-R (boxes 10 and 13).

**Estimated tax payments.** Deduct estimated tax payments you made during the year under a pay-as-you-go plan of a state or local government. However, you must have a reasonable basis for making the estimated tax payments. Any estimated state or local tax payments you make that are not reasonably determined in good faith at the time of payment are not deductible. For example, you made an estimated state income tax payment. However, the estimate of your state tax liability shows that you will get a refund of the full amount of your estimated payment. You had no reasonable basis to believe you had any additional liability for state income taxes and you cannot deduct the estimated tax payment.

**Refund applied to taxes.** Deduct any part of a refund of prior-year state or local income taxes that you chose to have credited to your 1999 estimated state or local income taxes.

**Do not** reduce your deduction by either of the following items.

- Any state or local income tax refund (or credit) you expect to receive for 1999.
- Any refund of (or credit for) prior year state and local income taxes you actually received in 1999.

See *Refund (or Credit) of State or Local Income Taxes*, later.

**Separate federal returns.** If you and your spouse file separate state, local, and federal income tax returns, you each can deduct on your federal return only the amount of your own state and local income tax.

**Joint state and local returns.** If you and your spouse file joint state and local returns and separate federal returns, each of you can deduct on your separate federal return part of the state and local income taxes. You can deduct only the amount of the total taxes that is proportionate to your gross income compared to the combined gross income of you and your spouse. However, you cannot deduct more than the amount you actually paid during the year. If you and your spouse are jointly and individually liable for the full amount of the state and local income taxes, you and your spouse can deduct on your separate federal returns the amount you each actually paid.

**Joint federal return.** If you file a joint federal return, you can deduct on your joint federal return the total of the state and local income taxes both of you paid.

**Contributions to state benefit funds.** As an employee, you can deduct mandatory contributions to state benefit funds that provide protection against loss of wages. Mandatory payments made to the following state benefit funds are deductible as state income taxes on line 5 of Schedule A (Form 1040).

- California.
- New Jersey.
- New York Nonoccupational Disability Benefit Fund.
- Rhode Island Temporary Disability Benefit Fund.
- Washington State Supplemental Workmen's Compensation Fund.



*Employee contributions to private or voluntary disability plans are not deductible.*

## Refund (or Credit) of State or Local Income Taxes

If you receive a refund of (or credit for) state or local income taxes in a year after the year in which you paid them, you may have to include the refund in income on line 10 of Form 1040, in the year you receive it. This includes refunds resulting from taxes that were overwithheld, applied from a prior year return, not figured correctly, or figured again because of an amended return. If you did not itemize your deductions in the previous year, you do not have to include the refund in income. If you did deduct the taxes in the previous year, include all or part of the refund on line 10, Form 1040, in the year you receive the refund. For a discussion of how much to include, see *Recoveries* in chapter 13.

## Foreign Income Taxes

Generally, you can take either a deduction or a credit for income taxes imposed on you by a foreign country or a U.S. possession. However, you cannot take a deduction or credit for foreign income taxes paid on income that is exempt from U.S. tax under the foreign earned income exclusion or the foreign housing exclusion. For information on these exclusions, get Publication 54, *Tax Guide for U.S. Citizens and Resident Aliens Abroad*. For information on the foreign tax credit, get Publication 514.

## Real Estate Taxes

Deductible real estate taxes are any state, local, or foreign taxes on real property levied for the general public welfare. The taxes must be based on the assessed value of the real property and must be charged uniformly against all property under the jurisdiction of the taxing authority.

Deductible real estate taxes generally do not include taxes charged for local benefits and improvements that increase the value of the property. They also do not include itemized charges for services (such as trash collection) to specific property or people, even if the charge is paid to the taxing authority. For more information about taxes and charges that are not deductible, see *Real Estate-Related Items You Cannot Deduct*, later.

**Tenant-shareholders in a cooperative housing corporation.** Generally, you can deduct your share of the real estate taxes the corporation paid or incurred on the property. The corporation should provide you with a statement showing you your share of the taxes. For more information, see *Special Rules for Cooperatives* in Publication 530.

**Buyers and sellers of real estate.** If you bought or sold real estate during the year, the real estate taxes must be divided between the buyer and the seller.

The buyer and the seller must divide the real estate taxes according to the number of days in the **real property tax year** (the period to which the tax imposed relates) that each owned the property. The seller is treated as paying the taxes up to, but not including, the date of sale. The buyer is treated as paying the taxes beginning with the date of sale. This applies regardless of the lien dates under local law. Generally, this information is included on the settlement statement provided at the closing.

If you (the seller) cannot deduct taxes until they are paid because you use the cash method of accounting, and the buyer of your property is personally liable for the tax, **you are considered to have paid your part of the tax at the time of the sale.** This lets you deduct the part of the tax to the date of sale even though you did not actually pay it. However, you must also include the amount of that tax in the selling price of the property. The buyer must include the same amount in his or her cost of the property.

You figure your deduction for taxes on each property bought or sold during the real property tax year as follows.

1. Enter the total real estate taxes for the real property tax year .....
2. Enter the number of days in the real property tax year that you owned the property .....
3. Divide line 2 by 365 .....
4. Multiply line 1 by line 3. This is your deduction. Enter it on line 6 of Schedule A (Form 1040) .....

**Note.** Repeat steps 1 through 4 for each property you bought or sold during the real property tax year.

**Delinquent taxes.** Do not divide delinquent taxes between the buyer and seller if the taxes are for any real property tax year

before the one in which the property is sold. Even if the buyer agrees to pay the delinquent taxes, the buyer cannot deduct them. The buyer must add them to the cost of the property. The seller can deduct these taxes paid by the buyer. However, the seller must include them in the selling price.

**Examples.** The following examples illustrate how real estate taxes are divided between buyer and seller.

**Example 1.** Dennis and Beth White's real property tax year for both their old home and their new home is the calendar year, with payment due August 1. The tax on their old home, sold on May 6, was \$620. The tax on their new home, bought on May 3, was \$732. Dennis and Beth are considered to have paid a proportionate share of the real estate taxes on the old home even though they did not actually pay them to the taxing authority. On the other hand, they can claim only a proportionate share of the taxes they paid on their new property even though they paid the entire amount.

Dennis and Beth owned their old home during the real property tax year for 125 days (January 1 to May 5, the day before the sale). They figure their deduction for taxes on their old home as follows.

### TAXES ON OLD HOME

1. Enter the total real estate 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 ..... 125
3. Divide line 2 by 365 ..... .342
4. Multiply line 1 by line 3. This is your deduction. Enter it on line 6 of Schedule A (Form 1040) ..... \$212

Since the buyers of their old home paid all of the taxes, Dennis and Beth also include the \$212 in the selling price of the old home. (The buyers add the \$212 to their cost of the home.)

Dennis and Beth owned their new home during the real property tax year for 243 days (May 3 to December 31, including their date of purchase). They figure their deduction for taxes on their new home as follows.

### TAXES ON NEW HOME

1. Enter the total real estate taxes for the real property tax year ..... \$732
2. Enter the number of days in the real property tax year that you owned the property ..... 243
3. Divide line 2 by 365 ..... .666
4. Multiply line 1 by line 3. This is your deduction. Enter it on line 6 of Schedule A (Form 1040) ..... \$488

Since Dennis and Beth paid all of the taxes on the new home, they add \$244 (\$732 paid less \$488 deduction) to their cost of the new home. (The sellers add this \$244 to their selling price and deduct the \$244 as a real estate tax.)

Dennis and Beth's real estate tax deduction for their old and new homes is the sum of \$212 and \$488, or \$700. They will enter this amount on line 6 of Schedule A (Form 1040).

**Example 2.** George and Helen Brown bought a home on May 3, 1999. Their real property tax year is the calendar year. Real estate taxes for 1998 were assessed in their state on January 1, 1999. The taxes became due on May 31, 1999, and October 31, 1999.

Table 24-1. Which Taxes Can You Deduct?

	You Can Deduct	You Cannot Deduct
<b>Income Taxes</b>	State and local income taxes. Foreign income taxes. Employee contributions to state funds listed under <i>Contributions to state benefit funds</i> .	Federal income taxes. Employee contributions to private or voluntary disability plans.
<b>Real Estate Taxes</b>	State and local real estate taxes. Foreign real estate taxes. Tenant's share of real estate taxes paid by cooperative housing corporation.	Taxes for local benefits. Trash and garbage pickup fees. Rent increase due to higher real estate taxes. Homeowners association charges.
<b>Personal Property Taxes</b>	State and local personal property taxes.	
<b>Other Taxes</b>	Taxes that are expenses of your trade or business or producing income. One-half of self-employment tax paid. Taxes on property producing rent or royalty income. Occupational taxes.	Many taxes, such as state and local sales taxes and federal excise taxes, generally are not deductible. See <i>Taxes and Fees You Cannot Deduct</i> .
<b>Fees and Charges</b>		Fees and charges, such as fees for driver's licenses or charges for water bills, generally are not deductible. See <i>Taxes and Fees You Cannot Deduct</i> .

The Browns agreed to pay all taxes due after the date of purchase. Real estate taxes for 1998 were \$680. They paid \$340 on May 31, 1999, and \$340 on October 31, 1999. These taxes were for the 1998 real property tax year. The Browns cannot deduct them since they did not own the property until 1999. Instead, they must add \$680 to the cost of their home.

In January 2000, the Browns receive their 1999 property tax statement for \$752, which they will pay in 2000. The Browns owned their new home during the 1999 real property tax year for 243 days (May 3 to December 31). They will figure their 2000 deduction for taxes as follows.

1. Enter the total real estate taxes for the real property tax year ..... \$752
2. Enter the number of days in the real property tax year that you owned the property ..... 243
3. Divide line 2 by 365 ..... .666
4. Multiply line 1 by line 3. This is your deduction. Claim it on line 6 of Schedule A (Form 1040) ..... \$501

The remaining \$251 (\$752 paid less \$501 deduction) of taxes paid in 2000, along with the \$680 paid in 1999, is added to the cost of their home.

Because the taxes up to the date of sale are considered paid by the seller on the date of sale, the seller is entitled to a 1999 tax deduction of \$931. This is the sum of the \$680 for 1998 and the \$251 for the 122 days the seller owned the home in 1999. The seller must also include the \$930 in the selling price when he or she figures the gain or loss on the sale. The seller should contact the Browns in January 2000 to find out how much real estate tax is due for 1999.

**Form 1099-S.** For certain sales or exchanges of real estate, the person responsible for closing the sale (generally the settlement agent) prepares Form 1099-S, *Proceeds From Real Estate Transactions*, to report certain information to the IRS and to the seller of the property. Box 2 of the form should include the portion of the seller's real estate tax liability that the buyer

will pay after the date of sale. The buyer includes these taxes in the cost basis of the property, and the seller both deducts this amount as a tax paid and includes it in the sales price of the property.

For a real estate transaction that involves a home, any real estate tax the seller paid in advance but that is the liability of the buyer appears in box 5 of Form 1099-S. The buyer deducts this amount as a real estate tax, and the seller reduces his or her real estate tax deduction by the same amount. See *Refund (or rebate)*, later.

**Taxes placed in escrow.** If your monthly mortgage payment includes an amount placed in escrow (put in the care of a third party) for real estate taxes, you may not be able to deduct the total amount placed in escrow. You can deduct only the real estate tax that the third party actually paid to the taxing authority. If the third party does not notify you of the amount of real estate tax that was paid for you, contact the third party or the taxing authority to find the proper amount to show on your return.

**Tenants by the entirety.** If you and your spouse held property as tenants by the entirety and you file separate returns, each of you can deduct only the taxes each of you paid on the property.

**Divorced individuals.** If your divorce or separation agreement states that you must pay the real estate taxes for a home owned by you and your spouse, part of your payments may be deductible as alimony and part as real estate taxes. See Publication 504, *Divorced or Separated Individuals*, for information.

**Minister's and military personnel housing allowances.** If you are a minister or a member of the uniformed services and receive a housing allowance that you can exclude from income, you still can deduct all of the real estate taxes you pay on your home.

**Refund (or rebate).** If you receive a refund or rebate in 1999 of real estate taxes you paid in 1999, you must reduce your deduction by the amount refunded to you. If you receive a refund or rebate in 1999 of real estate taxes you deducted in an earlier year, you generally must include the refund or rebate in income in the year you receive it. However, you only need to include the amount of the deduction that reduced your tax in the earlier year. For more information, see *Recoveries* in chapter 13.

**TIP** If you did not itemize deductions in the year you paid the tax, do not report the refund as income.

## Real Estate-Related Items You Cannot Deduct

Payments for the following items generally are not deductible as real estate taxes.

- Taxes for local benefits.
- Itemized charges for services (such as trash and garbage pickup fees).
- Transfer taxes (or stamp taxes).
- Rent increases due to higher real estate taxes.
- Homeowners association charges.

**Taxes for local benefits.** Deductible real estate taxes generally do not include taxes charged for local benefits and improvements that increase the value of your property. These include assessments for streets, sidewalks, water mains, sewer lines, public parking facilities, and similar improvements. You should increase the basis of your property by the amount of the assessment.

Local benefit taxes are deductible only if they are for maintenance, repair, or interest charges related to those benefits. If only a part of the taxes is for maintenance, repair, or interest, you must be able to show the amount of that part to claim the deduction. If you cannot determine what part of the tax is for maintenance, repair, or interest, none of it is deductible.



Taxes for local benefits may be included in your real estate tax bill. If your taxing authority (or mortgage lender) does not furnish you a copy of your real estate tax bill, ask for it. You should use the rules above to determine if the local benefit tax is deductible.

**Itemized charges for services.** An itemized charge for services to specific property or people is not a tax, even if the charge is paid to the taxing authority. For example, you cannot deduct the charge as a real estate tax if it is:

- A unit fee for the delivery of a service (such as a \$5 fee charged for every 1,000 gallons of water you use),
- A periodic charge for a residential service (such as a \$20 per month or \$240 annual fee charged to each homeowner for trash collection), or
- A flat fee charged for a single service provided by your government (such as a \$30 charge for mowing your lawn because it was allowed to grow higher than permitted under your local ordinance).



You must look at your real estate tax bill to determine if any nondeductible itemized charges, such as those just listed, are included in the bill. If your taxing authority (or mortgage lender) does not furnish you a copy of your real estate tax bill, ask for it.

**Exception.** Service charges used to maintain or improve services (such as trash collection or police and fire protection) are deductible as real estate taxes if:

- 1) The fees or charges are imposed at a like rate against all property in the taxing jurisdiction,
- 2) The funds collected are not earmarked; instead, they are commingled with general revenue funds, and
- 3) Funds used to maintain or improve services are not limited to or determined by the amount of these fees or charges collected.

**Transfer taxes (or stamp taxes).** Transfer taxes and similar taxes and charges on the sale of a personal home are not deductible. If they are paid by the seller, they are expenses of the sale and reduce the amount realized on the sale. If paid by the buyer, they are included in the cost basis of the property.

**Rent increase due to higher real estate taxes.** If your landlord increases your rent in the form of a tax surcharge because of increased real estate taxes, you cannot deduct the increase as taxes.

**Homeowners association charges.** These charges are not deductible because they are imposed by the homeowners as-

sociation, rather than the state or local government.

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## Personal Property Taxes

Personal property tax is deductible if it is a state or local tax that is:

- 1) Charged on personal property,
- 2) Based **only** on the value of the personal property, and
- 3) Charged on a yearly basis, even if it is collected more than once a year, or less than once a year.

A tax that meets the above requirements can be considered charged on personal property even if it is for the exercise of a privilege. For example, a yearly tax based on value qualifies as a personal property tax even if it is called a registration fee and is for the privilege of registering motor vehicles or using them on the highways.

**Example.** Your state charges a yearly motor vehicle registration tax of 1% of value plus 50 cents per hundredweight. You paid \$32 based on the value (\$1,500) and weight (3,400 lbs.) of your car. You can deduct \$15 (1% × \$1,500) as a personal property tax, since it is based on the value. The remaining \$17 (\$.50 × 34), based on the weight, is not deductible.

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## Taxes and Fees You Cannot Deduct

Many federal, state, and local government taxes are not deductible because they do not fall within the categories discussed earlier. Other taxes and fees, such as federal income taxes, are not deductible because the tax law specifically prohibits a deduction for them.

Taxes and fees that are generally not deductible include the following items.

- **Estate, inheritance, legacy, or succession taxes.** These taxes are generally not deductible. However, you can deduct the estate tax attributable to income in respect of a decedent if you must include that income in gross income. In that case, deduct the estate tax as a miscellaneous deduction that is not subject to the 2%-of-adjusted-gross-income limit. For more information, see *Estate Tax Deduction* in Publication 559, *Survivors, Executors, and Administrators*.
- **Federal income taxes.** This includes taxes withheld from your pay.
- **Fines.** You cannot deduct penalties for violation of any law, including forfeiture of related collateral deposits.

- **Gift taxes.**
- **License fees.** You cannot deduct license fees for personal purposes (such as marriage, driver's, and dog license fees).
- **Social security.** This includes social security, Medicare, or railroad retirement taxes withheld from your pay.
- **Social security and other employment taxes for household workers.** You generally cannot deduct the social security or other employment taxes you pay on the wages of a household worker. However, you may be able to include them in medical or child care expenses. For more information, see chapters 23 and 33.

Many taxes and fees other than those listed above are also nondeductible, unless they are ordinary and necessary expenses of a business or income-producing activity. For other nondeductible items, see *Real Estate-Related Items You Cannot Deduct*, earlier.

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## Where To Deduct

You deduct taxes on the following schedules.

**State and local income taxes.** These taxes are deducted on line 5 of Schedule A (Form 1040), even if your only source of income is from business, rents, or royalties.

**Foreign income taxes.** Generally, income taxes you pay to a foreign country or U.S. possession can be claimed as an itemized deduction on line 8 of Schedule A (Form 1040), or as a credit against your U.S. income tax on line 46 of Form 1040. To claim the credit, you may have to complete and attach Form 1116. For more information, see the instructions for Form 1040 or get Publication 514.

**Real estate taxes and personal property taxes.** These taxes are deducted on lines 6 and 7 of Schedule A (Form 1040), unless they are paid on property used in your business or on property that produces rent or royalty income. See *Taxes on property producing rent or royalty income*, later.

**Self-employment tax.** Deduct one-half of your self-employment tax on line 27, Form 1040.

**Taxes on property producing rent or royalty income.** These taxes generally are deducted on Schedule E (Form 1040).

**Other taxes.** All other deductible taxes are deducted on line 8 of Schedule A (Form 1040).

# Interest Expense

## Important Reminders

**Personal interest.** Personal interest is not deductible. Examples of personal interest include interest on a loan to purchase an automobile for personal use and credit card and installment interest incurred for personal expenses. But you may be able to deduct interest you pay on a qualified student loan. For details, see Publication 970, *Tax Benefits for Higher Education*.

**Limit on itemized deductions.** Certain itemized deductions (including home mortgage interest) are limited if your adjusted gross income is more than \$126,600 (\$63,300 if you are married filing a separate return). For more information, see chapter 22.

## Introduction

This chapter discusses interest. Interest is the amount you pay for the use of borrowed money.

The types of interest you can deduct as itemized deductions on Schedule A (Form 1040) are:

- Home mortgage interest, including certain points, and
- Investment interest.

This chapter explains the deduction for home mortgage interest. It also explains where to deduct other types of interest and lists some types of interest you cannot deduct.

Use *Table 25-1* to find out where to get more information on various types of interest, including investment interest.

### Useful Items

You may want to see:

#### Publication

- 936** Home Mortgage Interest Deduction

## Home Mortgage Interest

Generally, home mortgage interest is any interest you pay on a loan secured by your home (main home or a second home). The loan may be a mortgage to buy your home, a second mortgage, a line of credit, or a home equity loan.

You can deduct home mortgage interest only if you meet all the following conditions.

- You must file Form 1040 and itemize deductions on Schedule A (Form 1040).
- You must be legally liable for the loan. You cannot deduct payments you make for someone else if you are not legally liable to make them. Both you and the lender must intend that the loan be repaid. In addition, there must be a true debtor-creditor relationship between you and the lender.
- The mortgage must be a secured debt on a qualified home. (Generally, your mortgage is a secured debt if you put your home up as collateral to protect the interests of the lender. The term "qualified home" means your main home or second home. For details, see Publication 936.)

## Deductible Mortgage Interest

In most cases, you will be able to deduct all of your home mortgage interest. Whether you can deduct all of it depends on the date you took out the mortgage, the amount of the mortgage, and your use of its proceeds.

**Fully deductible interest.** If all of your mortgages fit into one or more of the following three categories at all times during the year, you can deduct all of the interest on those mortgages. (If any one mortgage fits into more than one category, add the debt that fits in each category to your other debt in the same category.)

The three categories are:

- 1) Mortgages you took out on or before October 13, 1987 (called **grandfathered debt**).
- 2) Mortgages you took out after October 13, 1987, to buy, build, or improve your home (called **home acquisition debt**), but only if throughout 1999 these mortgages plus any grandfathered debt totaled \$1 million or less (\$500,000 or less if married filing separately).
- 3) Mortgages you took out after October 13, 1987, other than to buy, build, or improve your home (called **home equity debt**), but only if throughout 1999 these mortgages totaled \$100,000 or less (\$50,000 or less if married filing separately) **and** totaled no more than the fair market value of your home reduced by (1) and (2).

The dollar limits for the second and third categories apply to the combined mortgages on your main home and second home.

See *Part II* of Publication 936 for more detailed definitions of grandfathered, home acquisition, and home equity debt.

You can use *Figure 25-A* to check whether your home mortgage interest is fully deductible.

**Limits on deduction.** You cannot fully deduct interest on a mortgage that does not fit into any of the three categories listed above. If this applies to you, see *Part II* of Publication 936 to figure the amount of interest you can deduct.

## Special Situations

This section describes certain items that can be included as home mortgage interest and others that cannot. It also describes certain special situations that may affect your deduction.

**Late payment charge on mortgage payment.** You can deduct as home mortgage interest a late payment charge if it was not for a specific service performed in connection with your mortgage loan.

**Mortgage prepayment penalty.** If you pay off your home mortgage early, you may have to pay a penalty. You can deduct that penalty as home mortgage interest provided the penalty is not for a specific service performed or cost incurred in connection with your mortgage loan.

**Sale of home.** If you sell your home, you can deduct your home mortgage interest (subject to any limits that apply) paid up to, but not including, the date of sale.

**Example.** John and Peggy Harris sold their home on May 7. Through April 30, they made home mortgage interest payments of \$1,220. The settlement sheet for the sale of the home showed \$50 interest for the 6-day period in May up to, but not including, the date of sale. Their mortgage interest deduction is \$1,270 (\$1,220 + \$50).

**Prepaid interest.** If you pay interest in advance for a period that goes beyond the end of the tax year, you must spread this interest over the tax years to which it applies. You can deduct in each year only the interest that qualifies as home mortgage interest for that year. However, see *Points*, later.

**Mortgage interest credit.** You may be able to claim a mortgage interest credit if you were issued a mortgage credit certificate (MCC) by a state or local government. Figure the credit on **Form 8396, Mortgage Interest Credit**. If you take this credit, you must reduce your mortgage interest deduction by the amount of the credit.

For more information on the credit, see chapter 38.

**Ministers' and military housing allowance.** If you are a minister or a member of the uniformed services and receive a housing allowance that is not taxable, you can still deduct your home mortgage interest.

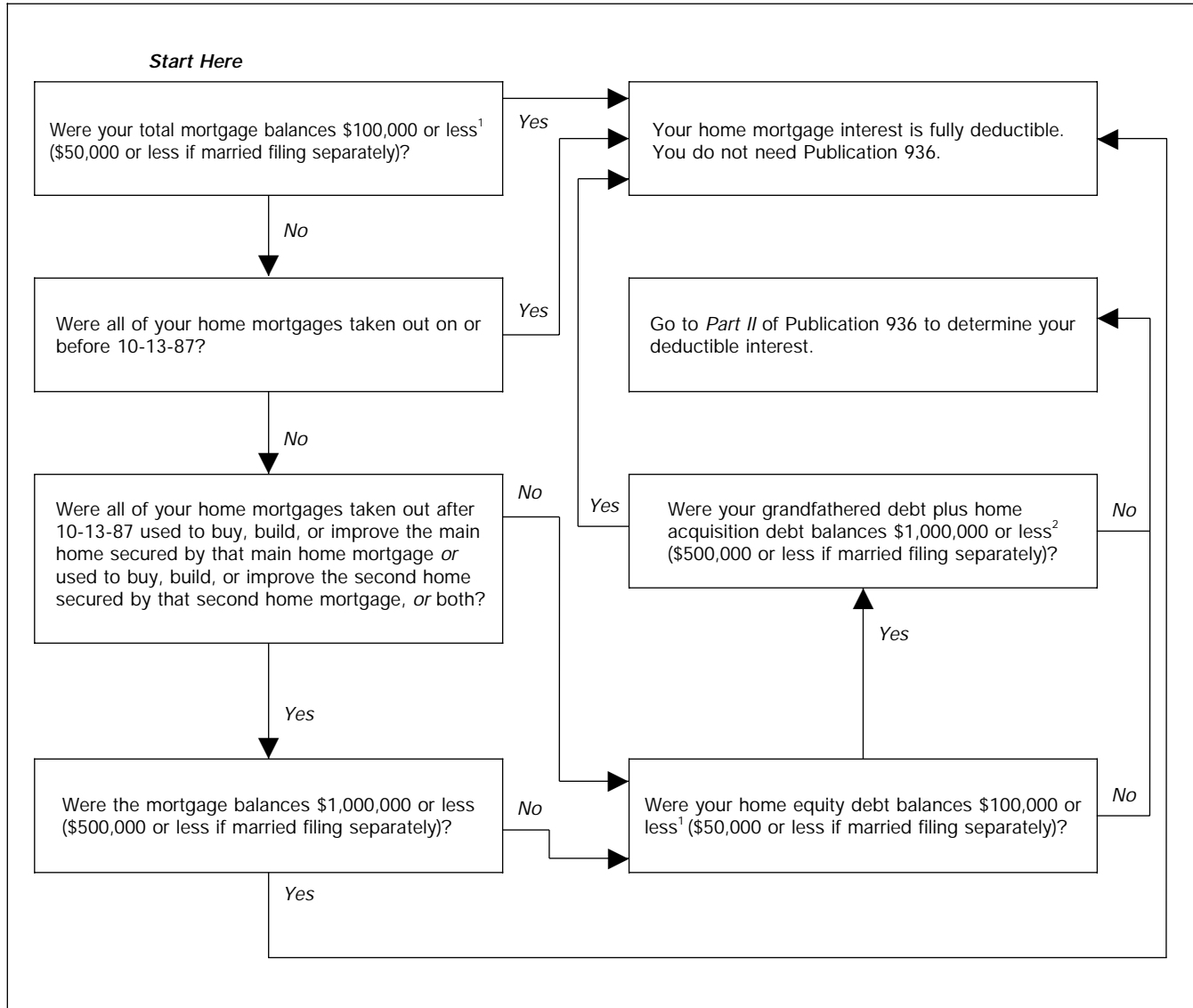
**Mortgage assistance payments.** If you qualify for mortgage assistance payments under section 235 of the National Housing Act, part or all of the interest on your mortgage may be paid for you. You cannot deduct the interest that is paid for you.

**No other effect on taxes.** Do not include these mortgage assistance payments in your income. Also, do not use these payments to reduce other deductions, such as real estate taxes.

**Divorced or separated individuals.** If a divorce or separation agreement requires you or your spouse or former spouse to pay home mortgage interest on a home owned by both of you, the payment of interest may be alimony. See the discussion of *Payments for jointly-owned home* in chapter 20.

## Figure 25–A. Is My Home Mortgage Interest Fully Deductible?

(Instructions: Include balances of ALL mortgages secured by your main home and second home. Answer YES only if the answer is true at ALL times during the year.)



<sup>1</sup>If all mortgages on your main or second home exceed the home's fair market value, a lower limit may apply. See *Home equity debt limit* under *Home Equity Debt* in Part II of Publication 936.

<sup>2</sup>Amounts over the \$1,000,000 limit (\$500,000 if married filing separately) qualify as home equity debt if they are not more than the total home equity debt limit. See Publication 936 for more information about grandfathered debt, home acquisition debt, and home equity debt.

**Redeemable ground rent.** If you make annual or periodic rental payments on a redeemable ground rent, you can deduct them as mortgage interest.

Payments made to end the lease and to buy the lessor's entire interest in the land are not ground rents. You cannot deduct them. For more information, see Publication 936.

**Nonredeemable ground rent.** Payments on a nonredeemable ground rent are not mortgage interest. You can deduct them as rent if they are a business expense or if they are for rental property.

**Rental payments.** If you live in a house before final settlement on the purchase, any payments you make for that period are rent and not interest. This is true even if the settlement papers call them interest. You cannot deduct these payments as home mortgage interest.

**Mortgage proceeds invested in tax-exempt securities.** You cannot deduct the home mortgage interest on grandfathered debt or home equity debt if you used the proceeds of the mortgage to buy securities or certificates that produce tax-free income. Grandfathered debt and home equity debt are defined earlier under *Deductible Mortgage Interest*.

**Refunds of interest.** If you receive a refund of interest in the same tax year you paid it, you must reduce your interest expense by the amount refunded to you. If you receive a refund of interest you deducted in an earlier year, you generally must include the refund in income in the year you receive it. However, you need to include it only up to the amount of the deduction that reduced your tax in the earlier year. This is true whether the interest overcharge was refunded to you or was used to reduce the outstanding principal on your mortgage.

If you received a refund of interest you overpaid in an earlier year, you generally will receive a Form 1098, *Mortgage Interest Statement*, showing the refund in box 3. For information about Form 1098, see *Mortgage Interest Statement*, later.

For more information on how to treat refunds of interest deducted in earlier years, see *Recoveries* in chapter 13.

## Points

The term "points" is used to describe certain charges paid, or treated as paid, by a borrower to obtain a home mortgage. Points may also be called loan origination fees, maximum loan charges, loan discount, or discount points.

A borrower is treated as paying any points that a home seller pays for the borrower's mortgage. See *Points paid by the seller*, later.

**General rule.** You generally cannot deduct the full amount of points in the year paid. Because they are prepaid interest, you generally must deduct them over the life (term) of the mortgage.

**Exception.** You can fully deduct points in the year paid if you meet all the following tests.

- 1) Your loan is secured by your main home. (Your main home is the one you live in most of the time.)
- 2) Paying points is an established business practice in the area where the loan was made.
- 3) The points paid were not more than the points generally charged in that area.
- 4) You use the cash method of accounting. This means you report income in the year you receive it and deduct expenses in the year you pay them. (If you want more information about this method, see *Accounting Methods* in chapter 1.)
- 5) The points were not paid in place of amounts that ordinarily are stated separately on the settlement statement, such as appraisal fees, inspection fees, title fees, attorney fees, and property taxes.
- 6) You use your loan to buy or build your main home.
- 7) The points were computed as a percentage of the principal amount of the mortgage.
- 8) The amount is clearly shown on the settlement statement (such as the Uniform Settlement Statement, Form HUD-1) as points charged for the mortgage. The points may be shown as paid from either your funds or the seller's.
- 9) The funds you provided at or before closing, plus any points the seller paid, were at least as much as the points charged. The funds you provided do not have to have been applied to the points. They can include a down payment, an escrow deposit, earnest money, and other funds you paid at or before closing for any purpose. You cannot have borrowed these funds from your lender or mortgage broker.

**Home improvement loan.** You can also fully deduct in the year paid points paid on a loan to improve your main home, if statements (1) through (5) are true.

**Figure 25-B.** You can use *Figure 25-B* as a quick guide to see whether your points are fully deductible in the year paid. If you do not qualify under the exception to deduct the full amount of points in the year paid, see *Points* in chapter 8 of Publication 535, *Business Expenses*, for the rules on when and how much you can deduct. However, if the points relate to refinancing a home mortgage, see *Refinancing*, later.

**Amounts charged for services.** Amounts charged by the lender for specific services connected to the loan are not interest. Examples of these charges are:

- 1) Appraisal fees,
- 2) Notary fees,

- 3) Preparation costs for the mortgage note or deed of trust,
- 4) Mortgage insurance premiums, and
- 5) VA funding fees.

You cannot deduct these amounts as points either in the year paid or over the life of the mortgage. For information about the tax treatment of these amounts and other settlement fees and closing costs, get Publication 530.

**Points paid by the seller.** The term "points" includes loan placement fees that the seller pays to the lender to arrange financing for the buyer.

**Treatment by seller.** The seller *cannot* deduct these fees as interest. But they are a selling expense that reduces the amount realized by the seller. See chapter 16 for information on the sale of your home.

**Treatment by buyer.** The buyer reduces the basis of the home by the amount of the seller-paid points and treats the points as if he or she had paid them. If all the tests under the *Exception*, earlier, are met, the buyer can deduct the points in the year paid. If any of those tests is not met, the buyer deducts the points over the life of the loan.

For information about basis, see chapter 14.

**Funds provided are less than points.** If you meet all the tests in the *Exception*, earlier, except that the funds you provided were less than the points charged to you (test 9), you can deduct the points in the year paid, up to the amount of funds you provided. In addition, you can deduct any points paid by the seller.

**Example 1.** When you took out a \$100,000 mortgage loan to buy your home in December, you were charged one point (\$1,000). You meet all the nine tests for deducting points in the year paid, except the only funds you provided were a \$750 down payment. Of the \$1,000 charged for points, you can deduct \$750 in the year paid. You spread the remaining \$250 over the life of the mortgage.

**Example 2.** The facts are the same as in *Example 1*, except that the person who sold you your home also paid one point (\$1,000) to help you get your mortgage. In the year paid, you can deduct \$1,750 (\$750 of the amount you were charged plus the \$1,000 paid by the seller). You must reduce the basis of your home by the \$1,000 paid by the seller.

**Excess points.** If you meet all the tests in the *Exception*, earlier, except that the points paid were more than are generally paid in your area (test 3), you deduct in the year paid only the points that are generally charged. You must spread any additional points over the life of the mortgage.



**Second home.** The *Exception, earlier, does not apply to points you pay on loans secured by your second home. You can deduct these points only over the life of the loan.*

**Mortgage ending early.** If you spread your deduction for points over the life of the mortgage, you can deduct any remaining

balance in the year the mortgage ends. However, if you refinance the mortgage with the same lender, you cannot deduct any remaining balance of spread points. Instead, deduct the remaining balance over the term of the new loan.

A mortgage may end early due to a prepayment, refinancing, foreclosure, or similar event.

**Example.** Dan paid \$3,000 in points in 1993 that he had to spread out over the 15-year life of the mortgage. He had deducted \$1,200 of these points through 1998.

Dan prepaid his mortgage in full in 1999. He can deduct the remaining \$1,800 of points in 1999.

**Refinancing.** Generally, points you pay to refinance a mortgage are not deductible in full in the year you pay them. This is true even if the new mortgage is secured by your main home.

However, if you use part of the refinanced mortgage proceeds to *improve your main home* and you meet the first five tests listed under the *Exception*, earlier, you can fully deduct the part of the points related to the improvement in the year paid. You can deduct the rest of the points over the life of the loan.

For more information on refinancing, see Publication 936.

**Limits on deduction.** You cannot fully deduct points on a mortgage unless the mortgage fits into one of the categories listed earlier under *Fully deductible interest*. See Publication 936 for details.

## Mortgage Interest Statement

If you paid \$600 or more of mortgage interest (including certain points) during the year on any one mortgage, you generally will receive a **Form 1098, Mortgage Interest Statement**, or a similar statement from the mortgage holder. You will receive the statement if you pay interest to a person (including a financial institution or a cooperative housing corporation) in the course of that person's trade or business. A governmental unit is a person for purposes of furnishing the statement.

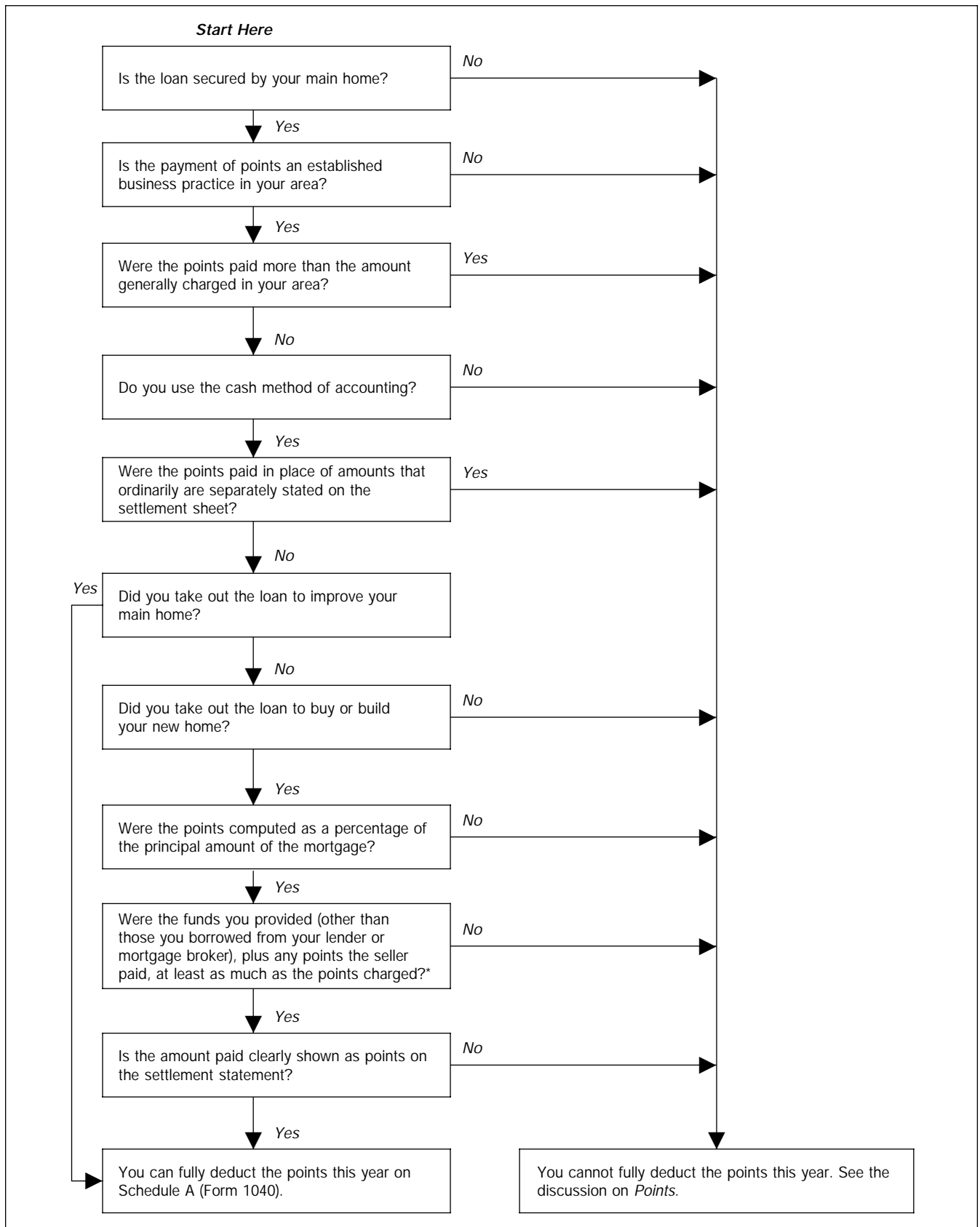
You should receive the statement for each year by January 31 of the following year. A copy of this form will also be sent to the IRS.

The statement will show the total interest you paid during the year. If you purchased a main home during the year, it will also show the deductible points paid during the year, including seller-paid points. However, it should not show any interest that was paid for you by a government agency.

As a general rule, Form 1098 will include only points that you can fully deduct in the year paid. However, certain points not included on Form 1098 also may be deductible, either in the year paid or over the life of the loan. See *Points*, earlier, to determine whether you can deduct points not shown on Form 1098.

**Prepaid interest on Form 1098.** If you prepaid interest in 1999 that accrued in full by January 15, 2000, this prepaid interest may be included in box 1 of Form 1098. However, you cannot deduct the prepaid amount for January 2000 in 1999. (See

Figure 25–B. Are My Points Fully Deductible This Year?



\*The funds you provided do not have to have been applied to the points. They can include a down payment, an escrow deposit, earnest money, and other funds you paid at or before closing for any purpose.

Table 25–1. Where To Deduct Your Interest

Type of interest	Where to deduct	Where to find information
Student loan interest	Form 1040, line 24 or Form 1040A, line 16	Publication 970
Deductible home mortgage interest and points reported on Form 1098	Schedule A (Form 1040), line 10	Publication 936
Deductible home mortgage interest <i>not</i> reported on Form 1098	Schedule A (Form 1040), line 11	Publication 936
Points <i>not</i> reported on Form 1098	Schedule A (Form 1040), line 12	Publication 936
Investment interest (other than interest incurred to produce rents or royalties)	Schedule A (Form 1040), line 13	Publication 550
Business interest (non-farm)	Schedule C or C-EZ (Form 1040)	Publication 535
Farm business interest	Schedule F (Form 1040)	Publications 225 and 535
Interest incurred to produce rents or royalties	Schedule E (Form 1040)	Publications 527 and 535
Personal interest	Not Deductible	

*Prepaid interest, earlier.*) You will have to figure the interest that accrued for 2000 and subtract it from the amount in box 1. You will include the interest for January 2000 with the other interest you pay for 2000. See *How To Report*, later.

**Refunded interest.** If you received a refund of mortgage interest you overpaid in an earlier year, you generally will receive a Form 1098 showing the refund in box 3. See *Refunds of interest, earlier.*

## Items You Cannot Deduct

Some interest payments are not deductible. Certain expenses similar to interest also are not deductible. Nondeductible expenses include the following items.

- Personal interest (discussed later).
- Service charges (however, see *Other Expenses* in chapter 30).
- Annual fees for credit cards.
- Loan fees.
- Credit investigation fees.
- FHA mortgage insurance premiums and VA funding fees.
- Interest to purchase or carry tax-exempt securities.

**Penalties.** You cannot deduct fines and penalties for violations of law, regardless of their nature.

## Personal Interest

Personal interest is not deductible. Personal interest is any interest that is not home mortgage interest, investment interest, business interest, or other deductible interest. It includes the following items.

- Interest on car loans (unless you use the car for business).
- Interest on federal, state, or local income tax.
- Finance charges on credit cards, retail installment contracts, and revolving charge accounts incurred for personal expenses.
- Late payment charges by a public utility.

**TIP** You may be able to deduct interest you pay on a qualified student loan. For details, see the instructions for line 24 of Form 1040 or line 16 of Form 1040A.

## Allocation of Interest

If you use the proceeds of a loan for more than one purpose (for example, personal and business), you must allocate the interest on the loan to each use. However, you do not have to allocate home mortgage interest if it is fully deductible, regardless of how the funds are used.

You allocate interest (other than fully deductible home mortgage interest) on a

loan in the same way as the loan itself is allocated. You do this by tracing disbursements of the debt proceeds to specific uses. For details on how to do this, see chapter 8 of Publication 535.

## How To Report

You must file Form 1040 to deduct any home mortgage interest expense on your tax return. Where you deduct your interest expense generally depends on how you use the loan proceeds. See Table 25–1 for a summary of where to deduct your interest expense.

**Home mortgage interest and points.** Deduct the home mortgage interest and points reported to you on Form 1098 on line 10 of Schedule A (Form 1040). If you paid more deductible interest to the financial institution than the amount shown on Form 1098, show the larger deductible amount on line 10. Attach a statement explaining the difference and print “See attached” next to line 10.

Deduct home mortgage interest that was *not* reported to you on Form 1098 on line 11 of Schedule A (Form 1040). If you paid home mortgage interest to the person from whom you bought your home, show that person’s name, address, and taxpayer identification number (TIN) on the dotted lines next to line 11. The seller must give you this number and you must give the seller your TIN. A Form W–9 can be used for this purpose. Failure to meet any of these requirements may result in a \$50 penalty for each failure. The TIN can be either a social security number, an individual taxpayer identification number (issued by the Internal Revenue Service), or an employer identification number. See *Social Security Number* in chapter 1 for more information about TINs.

If you can take a deduction for points that were *not* reported to you on Form 1098, deduct those points on line 12 of Schedule A (Form 1040).

**More than one borrower.** If you and at least one other person (other than your spouse if you file a joint return) were liable for and paid interest on a mortgage that was for your home, and the other person received a Form 1098 showing the interest that was paid during the year, attach a statement to your return explaining this. Show how much of the interest each of you paid, and give the name and address of the person who received the form. Deduct your share of the interest on line 11 of Schedule A (Form 1040), and print “See attached” next to the line.

If you are the payer of record on a mortgage on which there are other borrowers entitled to a deduction for the interest shown on the Form 1098 you received, deduct only your share of the interest on line 10 of Schedule A (Form 1040). You should let each of the other borrowers know what his or her share is.

**Mortgage proceeds used for business or investment.** If your home mortgage interest deduction is limited but all or part of the mortgage proceeds were used for business, investment, or other deductible activities, see Table 25–1. It shows where to deduct the part of your excess interest that is for those activities.

**Investment interest.** Deduct investment interest, subject to certain limits discussed in Publication 550, on line 13 of Schedule A (Form 1040).

**Amortization of bond premium.** There are various ways to treat the premium you pay to buy taxable bonds. See *Bond Premium Amortization* in Publication 550.

**Income-producing rental or royalty interest.** Deduct interest on a loan for income-producing rental or royalty property that is not used in your business in Part I of Schedule E (Form 1040).

**Example.** You rent out part of your home and borrow money to make repairs. You can deduct only the interest payment

for the rented part in Part I of Schedule E (Form 1040). Deduct the rest of the interest

payment on Schedule A (Form 1040) if it is deductible home mortgage interest.

# Contributions

## Important Reminders

**Disaster relief.** You can deduct contributions earmarked for flood relief, hurricane relief or other disaster relief to a qualified organization (defined later under *Organizations That Qualify To Receive Deductible Contributions*). However, you cannot deduct contributions earmarked for relief of a particular individual or family.

**Written acknowledgment required.** You can claim a deduction for a contribution of \$250 or more only if you have a written acknowledgment of your contribution from the qualified organization or certain payroll deductions. For more information, see *Records To Keep*, later in this chapter.

**Payment partly for goods or services.** A qualified organization that receives a payment from you must give you a written statement if the payment is more than \$75 and is partly a contribution and partly for goods or services. The statement must tell you that you can deduct only the amount of your payment that is more than the value of the goods or services you received. See *Contributions From Which You Benefit*, later in this chapter, for more information.

## Introduction

This chapter discusses:

- Organizations that are qualified to receive deductible charitable contributions,
- The types of contributions you can deduct,
- How much you can deduct,
- What records to keep, and
- How to report your charitable contributions.

A **charitable contribution** is a donation or gift to, or for the use of, a qualified organization. It is voluntary and is made without getting, or expecting to get, anything of equal value.

**Form 1040 required.** To deduct a charitable contribution, you must file Form 1040 and itemize deductions on Schedule A. The amount of your deduction may be limited if certain rules and limits explained in this chapter apply to you.

### Useful Items

You may want to see:

#### Publication

- 526** Charitable Contributions
- 561** Determining the Value of Donated Property

### Form (and Instructions)

- Schedule A (Form 1040)** Itemized Deductions
- 8283** Noncash Charitable Contributions

## Organizations That Qualify To Receive Deductible Contributions

You can deduct your contributions only if you make them to a **qualified organization**. To become a qualified organization, most organizations other than churches and governments, as described below, must apply to the IRS.

**TIP** If you do not know whether you may deduct what you gave to an organization, check with that organization or with the IRS.

### Types of Qualified Organizations

Generally, only the five following types 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:
  - a) Charitable,
  - b) Religious,
  - c) Scientific,
  - d) Literary,
  - e) Educational purposes, or
  - f) For the prevention of cruelty to children or animals.

Certain organizations that foster national or international 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.

**Examples.** Qualified organizations include:

- Churches, a convention or association of churches, temples, synagogues, mosques, and other religious organizations.
- Most nonprofit charitable organizations such as the Red Cross and the United Way.
- Most nonprofit educational organizations, including the Girl (and Boy) Scouts of America, colleges, museums, and day care centers if substantially all the child care provided is to enable individuals (the parents) to be gainfully employed and the services are available to the general public. However, if your contribution is a substitute for tuition or other enrollment fee, it is not deductible as a charitable contribution, as explained later under *Contributions You Cannot Deduct*.
- Nonprofit hospitals and medical research organizations.
- Utility company emergency energy programs, if the utility company is an agent for a charitable organization that assists individuals with emergency energy needs.
- Nonprofit volunteer fire companies.
- Public parks and recreation facilities.
- Civil defense organizations.

### Certain foreign charitable organizations.

Under income tax treaties with Canada, Israel, and Mexico, you may be able to deduct contributions to certain Canadian, Israeli, or Mexican charitable organizations. The organization must meet tests that are essentially the same as the tests that qualify U.S. organizations to receive deductible contributions. For additional information on the deduction of contributions to Canadian charities, see Publication 597, *Information on the United States–Canada Income Tax Treaty*. See the United States–Israel income tax treaty for information on the deduction of contributions to Israeli charities. If you need more information on how to figure your contribution to Mexican charities, see Publication 526.

## Contributions You Can Deduct

Generally, you can deduct your contributions of money or property that you make to, or for the use of, a qualified organization. A gift or contribution is "for the use of" a qualified organization when it is held in a legally enforceable trust for the qualified organization or in a similar legal arrangement.



If you give property to a qualified organization, you generally can deduct the fair market value of the property at the time of the contribution. See *Contributions of Property*, later in this chapter.

Your deduction for charitable contributions is generally limited to 50% of your adjusted gross income, but in some cases 20% and 30% limits may apply. See *Limit on Deductions*, later.

Table 26–1 lists some examples of contributions you can deduct and some that you cannot deduct.

## Contributions From Which You Benefit

If you receive a benefit as a result of making a contribution to a qualified organization, you can deduct only the amount of your contribution 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 can be a charitable contribution. For the excess amount to qualify, you must pay it with the intent to make a charitable contribution.

**Example 1.** You pay \$65 for a ticket to a dinner-dance at a church. All of the proceeds of the function go to the church. The ticket to the dinner-dance has a fair market value of \$25. When you buy your ticket you know that its value is less than your payment. To figure the amount of your charitable contribution, you subtract the value of the benefit you received (\$25) from your total payment (\$65). You can deduct \$40 as a contribution to the church.

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

**Athletic events.** If you make a payment to, or for the benefit of, a college or university and, as a result, you receive the right to buy tickets to an athletic event in the athletic stadium of the college or university, you can deduct 80% of the payment as a charitable contribution.

If any part of your payment is for tickets (rather than the right to buy tickets), that part is not deductible. In that case, subtract the price of the tickets from your payment. 80% of the remaining amount is a charitable contribution.

**Example 1.** You pay \$300 a year for membership in an athletic scholarship program maintained by a university (a qualified organization). The only benefit of membership is that you have the right to buy one season ticket for a seat in a designated area of the stadium at the university's home football games. You can deduct \$240 (80% of \$300) as a charitable contribution.

**Example 2.** The facts are the same as in Example 1 except that your \$300 payment included the purchase of one season ticket for the stated ticket price of \$120. You must subtract the usual price of a ticket (\$120) from your \$300 payment. The result is \$180. Your deductible charitable contribution is \$144 (80% of \$180).

Table 26–1. Examples of Charitable Contributions—A Quick Check

Use the following lists for a <b>quick check</b> of contributions you can or cannot deduct. See the rest of this chapter for more information and additional rules and limits that may apply.	
Deductible As Charitable Contributions	Not Deductible As Charitable Contributions
<p>Money or property you give to:</p> <ul style="list-style-type: none"> <li>● Churches, synagogues, temples, mosques, and other religious organizations</li> <li>● Federal, state, and local governments, if your contribution is solely for public purposes (for example, a gift to reduce the public debt)</li> <li>● Nonprofit schools and hospitals</li> <li>● Public parks and recreation facilities</li> <li>● Salvation Army, Red Cross, CARE, Goodwill Industries, United Way, Boy Scouts, Girl Scouts, Boys and Girls Clubs of America, etc.</li> <li>● War veterans' groups</li> </ul> <p>Costs you pay for a student living with you, sponsored by a qualified organization</p> <p>Out-of-pocket expenses when you serve a qualified organization as a volunteer</p>	<p>Money or property you give to:</p> <ul style="list-style-type: none"> <li>● Civic leagues, social and sports clubs, labor unions, and chambers of commerce</li> <li>● Foreign organizations (except certain Canadian, Israeli, and Mexican charities)</li> <li>● Groups that are run for personal profit</li> <li>● Groups whose purpose is to lobby for law changes</li> <li>● Homeowners' associations</li> <li>● Individuals</li> <li>● Political groups or candidates for public office</li> </ul> <p>Cost of raffle, bingo, or lottery tickets</p> <p>Dues, fees, or bills paid to country clubs, lodges, fraternal orders, or similar groups</p> <p>Tuition</p> <p>Value of your time or services</p> <p>Value of blood given to a blood bank</p>

**Charity benefit events.** If you pay a qualified organization more than fair market value for the right to attend a charity ball, banquet, show, sporting event, or other benefit event, you can deduct only the amount that is more than the value of the privileges or other benefits you receive.

If there is an established charge for the event, that charge is the value of your benefit. If there is no established charge, your contribution is that part of your payment that is more than the reasonable value of the right to attend the event. Whether you use the tickets or other privileges has no effect on the amount you can deduct. However, if you return the ticket to the qualified organization for resale, you can deduct the entire amount you paid for the ticket.

Even if the ticket or other evidence of payment indicates that the payment is a "contribution," this does not mean you can deduct the entire amount. If the ticket shows the price of admission and the amount of the contribution, you can deduct the contribution amount.

**Example.** You pay \$40 to see a special showing of a movie for the benefit of a qualified organization. Printed on the ticket is "Contribution—\$40." If the regular price for the movie is \$8, your contribution is \$32 (\$40 payment – \$8 regular price).

**Membership fees or dues.** You may be able to deduct membership fees or dues you pay to a qualified organization. However, you can deduct only the amount that

is more than the value of the benefits you receive. You cannot deduct dues, fees, or assessments paid to country clubs and other social organizations. They are not qualified organizations.

**Certain membership benefits can be disregarded.** Both you and the organization can disregard certain membership benefits you get in return for an annual payment of \$75 or less to the qualified organization. You can pay more than \$75 to the organization, if the organization does not require a larger payment for you to get the benefits. The following benefits are covered under this rule.

- 1) Any rights or privileges, other than those discussed under *Athletic events* earlier, that you can use frequently while you are a member, such as:
  - a) Free or discounted admission to the organization's facilities or events,
  - b) Free or discounted parking,
  - c) Preferred access to goods or services, and
  - d) Discounts on the purchase of goods and services.
- 2) Admission, while you are a member, to events that are open only to members of the organization, if the organization reasonably projects that the cost per person (excluding any allocated overhead) is not more than

\$7.20. This amount may be adjusted annually for inflation.

**Token items.** You can deduct your entire payment to a qualified organization as a charitable contribution if both of the following are true.

- 1) You get a small item or other benefit of token value.
- 2) The qualified organization correctly determines that the value of the item or benefit you received is not substantial and informs you that you can deduct your payment in full.

**Written statement.** A qualified organization must give you a written statement if you make a payment to it that is more than \$75 and is partly a contribution and partly for goods or services. The statement must tell you that you can deduct only the amount of your payment that is more than the value of the goods or services you received. It must also give you a good faith estimate of the value of those goods or services.

The organization can give you the statement either when it solicits or when it receives the payment from you.

**Exception.** An organization will not have to give you this statement if one of the following is true.

- 1) The organization is:
  - a) The type of organization described in (5) under *Types of Qualified Organizations*, earlier, or
  - b) Formed only for religious purposes, and the only benefit you receive is an intangible religious benefit (such as admission to a religious ceremony) that generally is not sold in commercial transactions outside the donative context.
- 2) You receive only items whose value is not substantial, as described under *Token items*, earlier.
- 3) You receive only membership benefits that can be disregarded, as described earlier.

## 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 expenses** for a foreign or American student who:

- 1) Lives in your home under a written agreement between you and a **qualified organization** 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 days or more counts as a full month.*

**Mutual exchange program.** You cannot deduct the costs of a foreign student living in your home under a mutual exchange program through which your child will live with a family in a foreign country.

For additional information, see *Expenses Paid for Student Living With You* in Publication 526.

## Out-of-Pocket Expenses in Giving Services

You may be able to deduct some amounts you pay in giving services to a qualified organization. The amounts must be:

- Unreimbursed,
- Directly connected with the services,
- Expenses you had only because of the services you gave, and
- Not personal, living, or family expenses.

Table 26–2 contains questions and answers that apply to some individuals who volunteer their services.

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

You cannot deduct personal expenses 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 can deduct the cost and upkeep of uniforms that are not suitable for everyday use and that you must wear while performing donated services for a charitable organization.

**Foster parents.** You can deduct as a charitable contribution some of the costs of being a foster parent (foster care provider) if you have no profit motive in providing the foster care and are not, in fact, making a profit. A qualified organization must designate the individuals you take into your home for foster care.

You can deduct expenses that are:

- 1) Greater than any nontaxable payments you receive from the organization, and
- 2) Spent to provide support for those individuals.

For more information, see *Foster-care providers* under *Income Not Taxed* in chapter 13.

**Car expenses.** You can deduct unreimbursed out-of-pocket expenses, such as the cost of gas and oil, that are directly related to the use of your car in giving services to a charitable organization. You cannot deduct any part of general repair and maintenance expenses, depreciation, registration fees, or the costs of tires or insurance.

If you do not want to deduct your actual expenses, you can use a standard mileage rate of **14 cents a mile** to figure your contribution.

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

You must keep reliable written records of your car expenses. For more information, see *Car expenses* under *Records To Keep*, later.

**Travel.** Generally, you can claim a charitable contribution deduction for travel expenses necessarily incurred 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 the travel. This applies whether you pay the expenses directly or indirectly. You are paying the expenses indirectly if you make a payment to the charitable organization and the organization pays for your travel expenses.

The deduction for travel expenses will not be denied simply because you enjoy providing services to the charitable organization. Even if you enjoy the trip, you can take a charitable contribution deduction for your travel expenses if you are on duty in a genuine and substantial sense throughout the trip. However, if you have only nominal duties, or if for significant portions of the trip you do not have any duties, you cannot deduct your travel expenses.

**Example 1.** You are a troop leader for a tax-exempt youth group and take the group on a camping trip. You are responsible for overseeing the setup of the camp and for providing the adult supervision for the other activities during the entire trip. You participate in the activities of the group and really enjoy your time with them. You oversee the breaking of camp and you transport the group home. You can deduct your travel expenses.

**Example 2.** 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, you cannot deduct your expenses.

**Example 3.** You work for several hours each morning on an archaeological excavation sponsored by a charitable organization. The rest of the day is free for recreation and sightseeing. You cannot take a charitable contribution deduction even though you work very hard during those few hours.

**Example 4.** You spend the entire day attending a charitable organization's regional meeting as a chosen representative. In the evening you go to the theater. You can claim your travel expenses as charitable contributions, but you cannot claim the cost of your evening at the theater.

**Daily allowance (per diem).** If you provide services for a charitable organization and receive a daily allowance to cover

Table 26–2. **Volunteers' Questions and Answers**

Question	Answer
<p>I do volunteer work 6 hours a week in the office of a qualified organization. The receptionist is paid \$6 an hour to do the same work I do. Can I deduct \$36 a week for my time?</p> <p>The office is 30 miles from my home. Can I deduct any of my car expenses for these trips?</p>	<p>No, you cannot deduct the value of your time or services.</p> <p>Yes, you can deduct the costs of gas and oil that are directly related to getting to the qualified organization where you are a volunteer. If you don't want to figure your actual costs, you can deduct 14 cents for each mile.</p>
<p>I am a Red Cross nurse's aide at a hospital. Can I deduct the cost of uniforms that I must wear?</p>	<p>Yes, you can deduct the cost of buying and cleaning your uniforms if the hospital is a qualified organization, the uniforms are not suitable for everyday use, and you must wear them when working.</p>
<p>I pay a babysitter to watch my children while I do volunteer work for a qualified organization. Can I deduct these costs?</p>	<p>No, you cannot deduct payments for child care expenses as a charitable contribution, even if they are necessary so you can do volunteer work for a qualified organization. (If you have child care expenses so you can work for pay, see Chapter 33.)</p>

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 can deduct your necessary travel expenses that are more than the allowance.

**Deductible travel expenses.** These include:

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

Because these travel expenses are not business-related, they are not subject to the same limits business-related expenses are. For information on business travel expenses, see *Travel Expenses* in chapter 28.

## Contributions You Cannot Deduct

There are some contributions that you cannot deduct, such as those made to individuals and those made to nonqualified organizations. (See *Contributions to Individuals*, and *Contributions to Nonqualified Organizations*, next). There are others that you can deduct only part of as discussed later under *Contributions From Which You Benefit*.

### Contributions To Individuals

You cannot deduct contributions to specific individuals, including the following.

- Contributions to fraternal societies made for the purpose of paying medical or burial expenses of **deceased members**.
- Contributions to **individuals who are needy or worthy**. This includes contri-

butions to a qualified organization if you indicate that your contribution is for a specific person. **But** you can deduct a contribution that you give to a qualified organization that in turn helps needy or worthy individuals if you do not indicate that your contribution is for a specific person.

- Payments to **a member of the clergy** that can be spent as he or she wishes, such as for personal expenses.
- Expenses you paid **for another person** who provided services to a qualified organization.
 

**Example.** Your son does missionary work. You pay his expenses. You cannot claim a deduction for your son's unreimbursed expenses related to his contribution of services.
- Payments to a hospital that are for services for **a specific patient** or for a specific patient's care. You cannot deduct these payments even if the hospital is operated by a city, a state, or other qualified organization.

### Contributions To Nonqualified Organizations

You cannot deduct contributions to organizations that are not qualified to receive tax-deductible contributions, including:

- 1) **Certain state bar associations**, if:
  - a) The state bar is not a political subdivision of a state,
  - b) The bar has private, as well as public, purposes, such as promoting the professional interests of members, and
  - c) Your contribution is unrestricted and can be used for private purposes,
- 2) **Chambers of commerce** and other business leagues or organizations,
- 3) **Civic leagues and associations**,
- 4) **Communist organizations**,
- 5) **Country clubs** and other social clubs,

6) **Foreign organizations**— But you can deduct contributions you make to:

- a) A U.S. organization that transfers funds to a charitable foreign organization if the U.S. organization controls the use of the funds, or if the foreign organization is only an administrative arm of the U.S. organization, or
- b) Certain Canadian, Israeli, or Mexican charitable organizations. See *Certain foreign charitable organizations* under *Organizations That Qualify To Receive Deductible Contributions*, earlier,

7) **Homeowners' associations**,

8) **Labor unions**— But you may be able to deduct union dues as a miscellaneous itemized deduction, subject to the 2%-of-adjusted-gross-income limit, on Schedule A (Form 1040). See chapter 30, or

9) **Political organizations and candidates**.

### Contributions From Which You Benefit

If you receive or expect to receive a financial or economic benefit as a result of making a contribution to a qualified organization, you cannot deduct the part of the contribution that represents the value of the benefit you receive. These contributions include the following.

- Contributions for **lobbying**. This includes amounts that you earmark for use in or in connection with influencing specific legislation.
- Contributions to a **retirement home** that are clearly for room, board, maintenance, or admittance. Also, if the amount of your contribution depends on the type or size of apartment you will occupy, it is not a charitable contribution.
- Costs of **raffles, bingo, lottery, etc.** You cannot deduct as a charitable contribution amounts you pay to buy

raffle or lottery tickets or to play bingo or other games of chance. For more information on how to report gambling winnings and losses, see *Gambling Losses Up To the Amount of Gambling Winnings* in chapter 30.

- Dues to **fraternal orders** and similar groups. However, see *Membership fees or dues* earlier under *Contributions You Can Deduct*.
- **Tuition**, or amounts you pay instead of tuition, even if you pay them for children to attend parochial schools or qualifying nonprofit day care centers. You also cannot deduct any fixed amount you may be required to pay in addition to the tuition fee to enroll in a private school, even if it is designated as a “donation.”

## Value of Time or Services

You cannot deduct the value of your time or services, including:

- **Blood donations** to the Red Cross or to blood banks, or
- **The value of income lost** while you work as an unpaid volunteer for a qualified organization.

## Personal Expenses

You cannot deduct personal, living, or family expenses, such as:

- **The cost of meals** you eat while you perform services for a qualified organization, unless it is necessary for you to be away from home overnight while performing the services, or
- **Adoption expenses**, including fees paid to an adoption agency and the costs of keeping a child in your home before adoption is final. However, you may be able to claim a tax credit for these expenses, and/or exclude from your gross income adoption expenses paid or reimbursed by your employer. See *Adoption Credit* in chapter 38 and Publication 968, *Tax Benefits for Adoption*.  
You also may be able to claim an exemption for the child. See *Adoption* in chapter 3.

## Appraisal Fees

Fees that you pay to find the fair market value of donated property are not deductible as contributions. You can claim them, subject to the 2%-of-adjusted-gross-income limit, as miscellaneous deductions on Schedule A (Form 1040). See chapter 30.

# Contributions of Property

If you contribute property to a qualified organization, the amount of your charitable contribution is generally 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 to the amount of your deduction. See *Giving Property That Has Increased in Value*, later.

For information about the records you must keep and the information you must furnish with your return if you donate property, see *Records To Keep and How To Report*, later.

**Partial interest in property.** Generally, you cannot deduct a charitable contribution (not made by a transfer in trust) 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. For exceptions and more information, see *Partial Interest in Property Not in Trust* in Publication 561.

**Future interests 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.

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

## Determining Fair Market Value

This section discusses general guidelines for determining the fair market value of various types of donated property. 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 all the relevant facts. Publication 561 contains a more complete discussion.

**Used clothing and household goods.** Generally, the fair market value of used clothing and household goods is far less than its original cost.

For used clothing, 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.

See *Household Goods* in Publication 561 for information on the valuation of household goods, such as furniture, appliances, and linens.

**Cars, boats, and aircraft.** If you contribute a car, boat, or aircraft to a charitable organization, you must determine its fair market value.

Certain commercial firms and trade organizations publish guides, commonly called “blue books,” containing complete dealer sale prices or dealer average prices for recent model years. The guides may be published monthly or seasonally, and for different regions of the country. These guides also provide estimates for adjusting for unusual equipment, unusual mileage, and physical condition. The prices are not “official” and these publications are not considered an appraisal of any specific donated property. But they do provide clues for making an appraisal and suggest relative prices for comparison with current sales and offerings in your area.

**Example.** You donate your car to a local high school for use by their students studying automobile repair. Your credit union told you that the “blue book” value of the car is \$1,600. However, your car needs extensive repairs and, after some checking, you find that you could sell it for \$750. You can deduct \$750, the **true** fair market value of the car, as a charitable contribution.

**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.

## Giving Property That Has Decreased in Value

If you contribute property with a fair market value that is less than your basis in it, your deduction is limited to fair market value. You cannot claim a deduction for the difference between the property's basis and its fair market value.

## Giving Property That Has Increased in Value

If you contribute 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.

Your “basis” in property is generally what you paid for it. See chapter 14 if you need more information about basis.

Different rules apply to figuring your deduction, depending on whether the property is:

- 1) Ordinary income property, or
- 2) 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. Examples of ordinary income property are inventory, works of art created by the donor, manuscripts prepared by the donor, and capital assets held one year or less.

The amount you can deduct for a contribution of ordinary income property is its fair market value less the amount that would be ordinary income or short-term capital gain if you sold the property for 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 fair market value of the stock on the day you donate it 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).

**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.

**Amount of deduction — general rule**  
When figuring your deduction for a gift of capital gain property, you usually can use the **fair market value** of the gift.

**Exceptions.** However, in certain situations, you must reduce the fair market value by any amount that would have been long-term capital gain if you had sold the property for its fair market value. Generally, this means reducing the fair market value to the property's cost or other basis.

**Bargain sales.** A bargain sale of property to a qualified organization (a sale or exchange for less than the property's fair market value) is partly a charitable contribution and partly a sale or exchange. A bargain sale may result in a taxable gain.

**For more information** on donated appreciated property, see *Giving Property That Has Increased in Value* in Publication 526.

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## When To Deduct

You can deduct your contributions only in the year you actually make them in cash or other property (or in a later carryover year, as explained later under *Carryovers*). This applies whether you use the cash or an 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 properly endorsed stock certificate is completed on the date of mailing or other delivery to the charity or to 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.

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## Limit on Deductions

If your total contributions for the year are 20% or less of your adjusted gross income, you do not need to read this section. The limits discussed here do not apply to you.

The amount of your deduction may be limited to either **20%, 30%, or 50%** of your

adjusted gross income, depending on the type of property you give and the type of organization you give it to. These limits are described below.

If your contributions are more than any of the limits that apply, see *How To Figure Your Deduction When Limits Apply*, in Publication 526.

### 50% Limit

This limit applies to the total of all charitable contributions you make during the year. This means that your deduction for charitable contributions cannot be more than 50% of your adjusted gross income for the year.

The 50% limit is the only limit that applies to gifts to organizations listed below under *50% limit organizations*. But there is one **exception**. The 30% limit also applies to such gifts if they are gifts of capital gain property for which you figure your deduction using fair market value without reduction for appreciation. (See *30% Limit*, later.)

**50% limit organizations.** You can ask any organization whether it is a 50% limit organization and most will be able to tell you. The following is a partial list of the types of organizations that are 50% limit organizations:

- 1) Churches, and conventions or associations of churches,
- 2) Educational organizations with a regular faculty and curriculum that normally have a regularly enrolled student body attending classes on site,
- 3) Hospitals and certain medical research organizations associated with these hospitals,
- 4) Publicly supported charities,
- 5) Private operating foundations,
- 6) Private nonoperating foundations that make qualifying distributions of 100% of contributions within 2½ months following the year they receive the contribution, and
- 7) Certain private foundations whose contributions are pooled in a common fund, the income and principal of which are paid to public charities.

### 30% Limit

This limit applies to the following contributions.

- Gifts of capital gain property to 50% limit organizations. (For other gifts of capital gain property, see *20% Limit*, later.) However, the 30% limit does not apply when you choose to reduce the fair market value of the property by the amount that would have been long-term capital gain if you had sold the property. Instead, only the 50% limit applies. For more information, see the rules for electing the 50% limit for capital gain property under *How To Figure Your Deduction When Limits Apply* in Publication 526.
- Gifts (other than gifts of capital gain property — see *20% Limit*, later) **for the use of** any organization.

- Gifts (other than capital gain property — see *20% Limit*, later) to all qualified organizations other than 50% limit organizations. This includes gifts to veterans' organizations, fraternal societies, nonprofit cemeteries, and certain private nonoperating foundations.

### 20% Limit

This limit applies to all gifts of capital gain property to or for the use of qualified organizations other than gifts of capital gain property to 50% limit organizations.

### Carryovers

You can carry over your contributions that you are not able to deduct in the current year because they exceed your adjusted gross income limits. You can deduct the excess in each of the next 5 years until it is used up, but not beyond that time. For more information, see *Carryovers* in Publication 526.

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## Records To Keep

You must keep records to prove the amount of the cash and noncash contributions you make during the year. The kind of records you must keep depends on the amount of your contributions 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. (See *Contributions From Which You Benefit* under *Contributions You Can Deduct*, earlier.) 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, or payroll deduction. They also include your out-of-pocket expenses when donating your services.

For a contribution made in cash, the records you must keep depend on whether the contribution is:

- 1) Less than \$250, or
- 2) \$250 or more.

**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.

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

If you made a payment that is partly for goods and services, as described earlier under *Contributions From Which You Benefit*, your contribution is the amount of the payment that is more than the value of the goods and services.

## Contributions of Less Than \$250

For each cash contribution that is less than \$250, you must keep one of the following items.

- 1) A canceled check, **or** a legible and readable account statement that shows:
  - a) If payment was by check – the check number, amount, date posted, and to whom paid.
  - b) If payment was by electronic funds transfer – the amount, date posted, and to whom paid.
  - c) If payment was charged to a credit card – the amount, transaction date, and to whom paid.
- 2) A receipt (or a letter or other written communication) from the charitable organization showing the name of the organization, the date of the contribution, and the amount of the contribution.
- 3) Other reliable written records that include the information described in (2). Records may be considered reliable if they were made at or near the time of the contribution, were regularly kept by you, or if, in the case of small donations, you have emblems, buttons, or other tokens that are regularly given to persons making small cash contributions.

**Car expenses.** If you claim expenses directly related to use of your car in giving services to a qualified organization, you must keep reliable written records of your expenses. Whether your records are considered reliable depends on all the facts and circumstances. Generally, they may be considered reliable if you made them regularly and at or near the time you had the expenses.

Your records must show the name of the organization you were serving and the date each time you used your car for a charitable purpose. If you use the standard mileage rate of 14 cents a mile, your records must show the miles you drove your car for the charitable purpose. If you deduct your actual expenses, your records must show the costs of operating the car that are directly related to a charitable purpose.

See *Car expenses*, earlier under *Out-of-Pocket Expenses in Giving Services*, for the expenses you can deduct.

## Contributions of \$250 or More

You can claim a deduction for a contribution of \$250 or more only if you have an acknowledgment of your contribution from the qualified organization or certain payroll deduction records.

If you made more than one contribution of \$250 or more, you can have either a separate acknowledgment for each or one acknowledgment that shows your total contributions.

**Acknowledgment.** The acknowledgment 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 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). 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 context, the acknowledgment 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 deductions.** If you make a contribution by payroll deduction, you do not need an acknowledgment 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 document furnished by your employer that proves the amount withheld, and
- 2) A pledge card or other document 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.

**Out-of-pocket expenses.** If you render services to a qualified organization and have unreimbursed out-of-pocket expenses related to those services, you can satisfy the written acknowledgment requirement just discussed if:

- 1) You have adequate records to prove the amount of the expenses, and
- 2) By the required date, you get an acknowledgment from the qualified organization that contains:
  - a) A description of the services you provided,
  - b) A statement of whether or not the organization provided you any goods or services to reimburse you for the expenses you incurred,
  - c) A description and a good faith estimate of the value of any goods or services (other than intangible religious benefits) provided to reimburse you, and
  - d) A statement of any intangible religious benefits provided to you.

## 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 contribution.** In figuring whether your contribution is \$250 or more, do not combine separate contributions. If you received goods or services in return, as described earlier in *Contributions From Which You Benefit*, reduce your contribution by the value of those goods or services. If you figure your deduction by reducing the fair market value of the donated property by its appreciation, as described earlier in *Giving Property That Has Increased in Value*, your contribution is the reduced amount.

## 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.



*A 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 a 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. For a security, keep the name of the issuer, the type of security, and whether it is regularly traded on a stock exchange or in an over-the-counter market.
- 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, 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. Your records should also include the amount of the reduction and how you figured it. If you choose the 50% limit instead of the special 30% limit on certain capital gain property, you must keep a record showing the years for which you made the choice, contributions for the current year to which the choice applies, and carryovers from preceding years to which the choice applies. See *How To Figure Your Deduction When Limits*

Apply in Publication 526 for information on how to make the capital gain property election.

- 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. Your records must include the amount you claimed as a deduction in any earlier years for contributions of other interests in this property. They must also include the name and address of each organization to which you contributed the other interests, the place where any such tangible property is located or kept, and the name of any person in possession of the property, other than the organization to which you contributed.
- 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 acknowledgment of your contribution from the qualified organization. If you made more than one contribution of \$250 or more, you can have either a separate acknowledgment for each or one acknowledgment that shows your total contribution.

The acknowledgment 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 acknowledgment 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). 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 context, the acknowledgment must say so and does not need to describe or estimate the value of the benefit.
- 3) You must get the acknowledgment 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**

You are required to give additional information if you claim a deduction over \$500 for noncash charitable contributions. See *Records To Keep* in Publication 526 for more information.

### **Qualified conservation contribution**

If the gift was a "qualified conservation contribution," your records must also include the fair market value of the underlying property before and after the gift and the conservation purpose furthered by the gift. See *Qualified conservation contribution* in Publication 561 for more information.

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## **How To Report**

Enter your cash contributions (including out-of-pocket expenses) on line 15, Schedule A (Form 1040).

Enter your noncash contributions on line 16 of Schedule A (Form 1040).

If your total deduction for all noncash contributions for the year is over \$500, you must also file **Form 8283**. See *How To Report* in Publication 526 for more information.

# Nonbusiness Casualty and Theft Losses

## Important Reminder

**Interest abatement in federally declared disaster areas.** For individuals located in an area declared a disaster area by the President after 1997, the IRS will abate interest on income tax for the length of any extension granted for filing income tax returns and paying income tax for 1997 and 1998.

For other taxpayers located in an area declared a disaster area by the President after 1997, the IRS will abate interest on income tax for the length of any extension granted for filing income tax returns and paying income tax for tax years beginning after 1997. See *Disaster area loss* under *When To Report Gain or Loss*, later.

## Introduction

This chapter explains the tax treatment of personal (not business related) casualty losses, theft losses, and losses on deposits.

The chapter also explains the following topics.

- How to figure the amount of your loss.
- How to treat insurance and other reimbursements you receive.
- The deduction limits.
- When and how to report a casualty or theft.

**Forms to file.** When you have a casualty or theft, you have to file Form 4684, *Casualties and Thefts*. You will also have to file one or more of the following forms.

- Schedule A (Form 1040), *Itemized Deductions*
- Schedule D (Form 1040), *Capital Gains and Losses*

**Condemnations.** For information on condemnations of property, see *Involuntary Conversions* in chapter 1 of Publication 544, *Sales and Other Dispositions of Assets*. Also see Publication 523, *Selling Your Home*.

**Workbook for casualties and thefts.** Publication 584 is available to help you make a list of your stolen or damaged personal-use property and figure your loss. It includes schedules to help you figure the loss on your home and its contents, and your motor vehicles.

**Other sources of information.** For information on a casualty or theft loss of business or income-producing property, see Publication 547.

For information on a condemnation of your home, see *Involuntary Conversions* in chapter 1 of Publication 544.

## Useful Items

You may want to see:

### Publication

- 544** Sales and Other Dispositions of Assets
- 547** Casualties, Disasters, and Thefts (Business and Nonbusiness)
- 584** Casualty, Disaster, and Theft Loss Workbook (Personal-Use Property)

### Form (and Instructions)

- 4684** Casualties and Thefts

## Casualty

A casualty is the damage, destruction, or loss of property resulting from an identifiable event that is sudden, unexpected, or unusual.

- A **sudden** event is one that is swift, not gradual or progressive.
- An **unexpected** event is one that is ordinarily unanticipated and unintended.
- An **unusual** event is one that is not a day-to-day occurrence and that is not typical of the activity in which you were engaged.

**Deductible losses.** Deductible casualty losses can result from a number of different causes, including the following.

- Car accidents (but see *Nondeductible losses*, next, for exceptions).
- Earthquakes.
- Fires (but see *Nondeductible losses*, next, for exceptions).
- Floods.
- Government-ordered demolition or relocation of a home that is unsafe to use because of a disaster as discussed under *Disaster Area Losses* in Publication 547.
- Hurricanes.
- Mine cave-ins.
- Shipwrecks.
- Sonic booms.
- Storms.
- Tornadoes.
- Vandalism.
- Volcanic eruptions.

**Nondeductible losses.** A casualty loss is not deductible if the damage or destruction is caused by the following.

- Accidentally breaking articles such as glassware or china under normal conditions.
- A family pet.

- A fire if you willfully set it, or pay someone else to set it.
- A car accident if your willful negligence or willful act caused it. The same is true if the willful act or willful negligence of someone acting for you caused the accident.
- Progressive deterioration (explained next).

**Progressive deterioration.** Loss of property due to progressive deterioration is not deductible as a casualty loss. This is because the damage results from a steadily operating cause or a normal process, rather than from a sudden event. The following are examples of damage due to progressive deterioration.

- The steady weakening of a building due to normal wind and weather conditions.
- The deterioration and damage to a water heater that bursts. But the rust and water damage to rugs and drapes caused by the bursting of a water heater does qualify as a casualty.
- Most losses of property caused by droughts. To be deductible, a drought-related loss generally must be incurred in a trade or business or in a transaction entered into for profit.
- Termite or moth damage.
- The damage or destruction of trees, shrubs, or other plants by a fungus, disease, insects, worms, or similar pests. But a sudden destruction due to an unexpected or unusual infestation by beetles or other insects may result in a casualty loss.

## Theft

A theft is the taking and removing of money or property with the intent to deprive the owner of it. The taking of your property must be illegal under the laws of the state where it occurred and it must have been done with criminal intent.

Theft includes the taking of money or property by the following means.

- Blackmail
- Burglary
- Embezzlement
- Extortion
- Kidnapping for ransom
- Larceny
- Robbery
- Threats

**Mislaid or lost property.** The simple disappearance of money or property is not a theft. However, an accidental loss or disappearance of property can qualify as a casualty if it results from an identifiable event that is sudden, unexpected, or unusual.

**Example.** A car door is accidentally slammed on your hand, breaking the setting of your diamond ring. The diamond falls from the ring and is never found. The loss of the diamond is a casualty.



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## Loss on Deposits

A loss on deposits can occur when a bank, credit union, or other financial institution becomes insolvent or bankrupt. If you incurred this type of loss, you have three choices of how to deduct the loss.

- 1) As a casualty loss.
- 2) As an ordinary loss.
- 3) As a nonbusiness bad debt.

**Casualty loss or ordinary loss.** You can choose to deduct a loss on deposits as a casualty loss or as an ordinary loss for any year in which you can reasonably estimate how much of your deposits you have lost in an insolvent or bankrupt financial institution. The choice is generally made on the return you file for that year and applies to all your losses on deposits for the year in that particular financial institution. Once you treat the loss as a casualty or ordinary loss, you cannot treat the same amount of the loss as a nonbusiness bad debt when it actually becomes worthless.

**Nonbusiness bad debt.** If you do not choose to deduct the loss as a casualty loss or as an ordinary loss, you must wait until the actual loss is determined before you can deduct the loss as a nonbusiness bad debt. Once you make this choice, you cannot change it without permission from the Internal Revenue Service.

**How to report.** The kind of deduction you choose for your loss on deposits determines how you report your loss. If you choose:

- Casualty loss — report it on Form 4684 first and then on Schedule A (Form 1040).
- Ordinary loss — report it on Schedule A (Form 1040).
- Nonbusiness bad debt — report it on Schedule D (Form 1040).

**More information.** For more information, see *Special Treatment for Losses on Deposits in Insolvent or Bankrupt Financial Institutions* in the instructions for Form 4684.

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## Proof of Loss

To deduct a casualty or theft loss, you must be able to prove that you had a casualty or theft. You must be able to support the amount you claim for the loss as discussed next.

**Casualty losses.** For a casualty loss, your records should show all of the following.

- 1) The type of casualty (car accident, fire, storm, etc.) and when it occurred.
- 2) That the loss was a direct result of the casualty.
- 3) That you were the owner of the property or, if you leased the property from someone else, that you were contractually liable to the owner for the damage.

**Theft loss.** For a theft loss, your records should show all of the following.

- 1) When you discovered that your property was missing.
- 2) That your property was stolen.
- 3) That you were the owner of the property.

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## Amount of Loss

You figure the amount of your loss using the following steps.

- 1) Determine your adjusted basis in the property before the casualty or theft.
- 2) Determine the decrease in fair market value of the property as a result of the casualty or theft.
- 3) From the smaller of the amounts you determined in (1) and (2), subtract any insurance or other reimbursement you received or expect to receive.

For personal-use property and property used in performing services as an employee, apply the deduction limits, discussed later, to determine the amount of your deductible loss.

**Leased property.** If you are liable for casualty damage to property you lease, your loss is the amount you must pay to repair the property minus any insurance or the reimbursement you receive or expect to receive.

### Adjusted Basis

Adjusted basis is your basis (usually cost) increased or decreased by various events, such as improvements and casualty losses. For more information, see chapter 14.

### Decrease in Fair Market Value

Fair market value (FMV) is the price for which you could sell your property to a willing buyer when neither of you have to sell or buy and both of you know all the relevant facts.

The decrease in FMV is the difference between the property's *fair market value* immediately before and immediately after the casualty or theft.

**FMV of stolen property.** The FMV of property immediately after a theft is considered to be zero, since you no longer have the property.

**Recovered property.** Recovered property is your property that was stolen and later returned to you. If you recover property after you had already taken a theft loss deduction, you must refigure your loss using the smaller of the property's adjusted basis (explained earlier) or the decrease in FMV from the time it was stolen until the time it was recovered. Use this amount to refigure your total loss for the year in which the loss was deducted.

If your refigured loss is less than the loss you deducted, you generally have to report

the difference as income in the recovery year. But report the difference only up to the amount of the loss that reduced your tax. For more information on the amount to report, see *Recoveries* in chapter 13.

### Figuring Decrease in FMV—Items To Consider

To figure the decrease in FMV because of a casualty or theft, you generally need a competent appraisal. But, other measures can also be used to establish certain decreases.

**Appraisal.** The appraisal to determine the difference between the FMV of the property immediately before a casualty or theft and immediately afterward should be made by a competent appraiser. The appraiser must recognize the effects of any general market decline that may occur along with the casualty. This information is needed to limit any deduction to the actual loss resulting from damage to the property.

Several factors are important in evaluating the accuracy of an appraisal, including the following.

- The appraiser's familiarity with your property before and after the casualty or theft.
- The appraiser's knowledge of sales of comparable property in the area.
- The appraiser's knowledge of conditions in the area of the casualty.
- The appraiser's method of appraisal.

**Appraisal fee.** The appraisal fee is not a part of the casualty or theft loss. It is an expense in determining your tax liability. You can deduct it as a miscellaneous deduction subject to the 2%-of-adjusted-gross-income limit on Schedule A (Form 1040). For information about miscellaneous deductions, see chapter 30.

### Cost of cleaning up or making repairs.

The cost of repairing damaged property is not part of a casualty loss. Neither is the cost of cleaning up after a casualty. But, you can use the cost of cleaning up or making repairs as a measure of the decrease in FMV if you meet all the following conditions.

- 1) The repairs are necessary to bring the property back to its condition before the casualty.
- 2) The amount spent for repairs is not excessive.
- 3) The repairs take care of the damage only.
- 4) The value of the property after the repairs is not, due to the repairs, more than the value of the property before the casualty.

**Landscaping.** The cost of restoring landscaping to its original condition after a casualty may indicate the decrease in FMV. You may be able to measure your loss by what you spend on the following.

- 1) Removing destroyed or damaged trees and shrubs minus any salvage you receive.
- 2) Pruning and other measures taken to preserve damaged trees and shrubs.

- 3) Replanting necessary to restore the property to its approximate value before the casualty.

**Car values.** Books issued by various automobile organizations that list your car may be useful in figuring the value of your car. You can modify the book's retail value by such factors as mileage and the condition of your car to figure its value. The prices are not "official," but they may be useful in determining value and suggesting relative prices for comparison with current sales and offerings in your area. If your car is not listed in the books, determine its value from other sources. A dealer's offer for your car as a trade-in on a new car is not usually a measure of its true value.

### Figuring Decrease in FMV— Items Not To Consider

The following items are generally not considered when establishing the decrease in the FMV of your property.

**Replacement cost.** The cost of replacing stolen or destroyed property is not part of a casualty or theft loss.

**Cost of protection.** The cost of protecting your property against a casualty or theft is not part of a casualty or theft loss. For example, you cannot deduct the amount you spend on insurance or to board up your house against a storm.

If you make permanent improvements to your property to protect it against a casualty or theft, add the cost of these improvements to your basis in the property. An example would be the cost of a dike to prevent flooding.

**Related expenses.** Any incidental expenses you have due to a casualty or theft, such as expenses for the treatment of personal injuries, for temporary housing, or for a rental car, are not part of your casualty or theft loss.

**Sentimental value.** Do not consider sentimental value when determining your loss. If a family portrait, heirloom, or keepsake is damaged, destroyed, or stolen, you must base your loss only on its fair market value.

**Decline in market value of property.** A decrease in the value of your property because it is in or near an area that suffered a casualty, or that might again suffer a casualty, is not to be taken into consideration. You have a loss only for actual casualty damage to your property. However, if your home is in a federally declared disaster area, see *Disaster Area Losses* in Publication 547.

**Photographs.** Photographs taken after a casualty will be helpful in establishing the condition and value of the property after it was damaged. Photographs showing the condition of the property after it was repaired, restored, or replaced may also be helpful.

The cost of photographs obtained for this purpose is not a part of the loss. You can claim this cost as a miscellaneous itemized deduction subject to the 2%-of-adjusted-gross-income limit on Schedule A (Form 1040). For information about miscellaneous deductions, see chapter 30.

## Insurance and Other Reimbursements

If you receive an insurance or other type of reimbursement, you must subtract the reimbursement when you figure your loss. You do not have a casualty or theft loss to the extent you are reimbursed.

If you expect to be reimbursed for part or all of your loss, you must subtract the expected reimbursement when you figure your loss. You must reduce your loss even if you do not receive payment until a later tax year. See *Reimbursement Received After Deducting Loss*, later.

**Failure to file claim for reimbursement.** If your property is covered by insurance, you should file a timely insurance claim for reimbursement of your loss. Otherwise, you cannot deduct this loss as a casualty or theft loss. However, this rule does not apply to the portion of the loss not covered by insurance (for example, a deductible).

**Example.** You have a car insurance policy with a \$500 deductible. Because your insurance did not cover the first \$500 of an auto collision, the \$500 would be deductible (subject to the deduction limits discussed later). This is true even if you do not file an insurance claim, since your insurance policy would never have reimbursed you for it.

**Gain from reimbursement.** If your reimbursement is more than your adjusted basis in the property, you have a gain. This is true even if the decrease in the FMV of the property is more than your adjusted basis. If you have a gain, you may have to pay tax on it, or you may be able to postpone reporting the gain. See Publication 547 for more information on how to treat a gain from the reimbursement for a casualty or theft.

### Types of Reimbursements

The most common type of reimbursement is an insurance payment for your stolen or damaged property. Other types of reimbursements are discussed next. Also see the *Instructions for Form 4684*.

**Employer's emergency disaster fund.** If you receive money from your employer's emergency disaster fund, and you must use that money to rehabilitate or replace property on which you are claiming a casualty loss deduction, then you must take that money into consideration in computing the casualty loss deduction. Take into consideration only the amount you used to replace your destroyed or damaged property.

**Example.** Your home was extensively damaged by a tornado. Your loss after reimbursement from your insurance company was \$10,000. Your employer set up a disaster relief fund for its employees. Employees receiving money from the fund had to use it to rehabilitate or replace their damaged or destroyed property. You received \$5,000 from the fund and spent the entire amount on repairs to your home. In figuring your casualty loss, you must reduce your unreimbursed loss (\$10,000) by the \$5,000 you received from your employer's fund. Your casualty loss before applying the deduction limits discussed later is \$5,000.

**Cash gifts.** If you receive excludable cash gifts as a disaster victim, and there are no limits on how you can use the money, you do not reduce your casualty loss by the amount of these excludable gifts. This applies even if you use the money to pay for repairs to property damaged in the disaster.

**Example.** Your home was damaged by a hurricane. Relatives and neighbors made cash gifts to you which were excludable from your income. You applied part of the cash gifts to the cost of repairing your home. There were no limits or restrictions on how you could use the cash gifts. The money you received as excludable gifts and used to pay for repairs to your home does not reduce the amount of your casualty loss on the damaged home.

**Insurance payments for living expenses.** You do not reduce your casualty loss by insurance payments you receive to cover living expenses in either of the following situations.

- You lose the use of your main home because of a casualty.
- Government authorities do not allow you access to your main home because of a casualty or threat of a casualty.

**Inclusion in income.** If these insurance payments are more than the temporary increase in your living expenses, you must include the excess in your income. Report this amount on line 21 of Form 1040.

A temporary increase in your living expenses is the difference between the actual living expenses you and your family incurred during the period you could not use your home and your normal living expenses for that period. Actual living expenses are the reasonable and necessary expenses incurred because of the loss of your main home. Generally, these expenses include the amounts you pay for the following.

- Rent for suitable housing
- Transportation
- Food
- Utilities
- Miscellaneous services

Normal living expenses consist of these same expenses that you would have incurred but did not because of the casualty.

**Example.** As a result of a fire, you vacated your apartment for a month and moved to a motel. You normally pay \$525 a month rent. None was charged for the month the apartment was vacated. Your motel rent for this month was \$1,200. You normally pay \$200 a month for food. Your food expenses for the month you lived in the motel were \$400. You received \$1,100 from your insurance company to cover your living expenses. You determine the amount of the payment you must include in income as follows.

- 1) Insurance payment for living expenses ..... \$1,100
- 2) Actual expenses during the month you are unable to use your home because of the fire . \$1,600
- 3) Normal living expenses ..... 725

- 4) Temporary increase in living expenses: Subtract line 3 from line 2 ..... 875  
 5) Amount of payment includible in income: Subtract line 4 from line 1 ..... \$225

**Tax year of inclusion.** You include the taxable part of the insurance payment in income for the year you regain the use of your main home or, if later, for the year you receive the taxable part of the insurance payment.

**Example.** Your main home was destroyed by a tornado in August 1997. You regained use of your home in November 1998. The insurance payments you received in 1997 and 1998 were \$1,500 more than the temporary increase in your living expenses during those years. You include this amount in income on your 1998 Form 1040. If, in 1999, you receive further payments to cover the living expenses you had in 1997 and 1998, you must include those payments in income on your 1999 Form 1040.

**Disaster relief.** Food, medical supplies, and other forms of assistance you receive do not reduce your casualty loss unless they are replacements for lost or destroyed property. These items are not taxable income to you.

### Reimbursement Received After Deducting Loss

If you figured your casualty or theft loss using your expected reimbursement, you may have to adjust the tax return for the tax year in which you get your actual reimbursement. This section explains the adjustment you may have to make.

**Actual reimbursement less than expected.** If you later receive less reimbursement than you expected, you include that difference as a loss with your other losses (if any) on your return for the year in which you can reasonably expect no more reimbursement.

**Example.** Your personal car had an FMV of \$2,000 when it was destroyed in a collision with another car last year. The accident was due to the negligence of the other driver. At the end of the year, there was a reasonable prospect that the owner of the other car would reimburse you in full. You subtracted the expected reimbursement when you figured your loss. You did not have a deductible loss last year.

This January, the court awarded you a judgment of \$2,000. However, in July it became apparent that you will be unable to collect any amount from the other driver. You can claim this as a casualty loss, subject to the deduction limits discussed later.

**Actual reimbursement more than expected.** If you receive more reimbursement than you expected after you claimed a deduction for the loss, you may have to include the extra reimbursement in your income for the year you receive it. However, if any part of your original deduction did not reduce your tax for the earlier year, do not include that part of the reimbursement in your income. You do not refigure your tax for the year you claimed the deduction. For

more information, see *Recoveries* in chapter 13.

**Actual reimbursement same as expected.** If you receive exactly the reimbursement you expected to receive, you do not have any amount to include in your income or any loss to deduct.

**Example.** Last December, you had a collision while driving your personal car. Repairs to the car cost \$950. You had \$100 deductible collision insurance. Your insurance company agreed to reimburse you for the rest of the damage. As a result of your expected reimbursement from the insurance company, you did not have a casualty loss deduction last year.

Due to the \$100 rule (discussed later under *Deduction Limits*), you cannot deduct the \$100 you paid. When you receive the \$850 from the insurance company this year, you do not have to report it as income.

### Examples

**Personal property.** If a single casualty or theft involves more than one item of personal property, you must figure the loss on each item separately. Then combine the losses to determine your total loss from that casualty or theft. Personal property is any property that is not real property.

**Example.** A fire in your home destroyed an upholstered chair, an oriental rug, and an antique table. You did not have fire insurance to cover your loss. (This was the only casualty or theft you had during the year.) You paid \$750 for the chair, and you established that it had an FMV of \$500 just before the fire. The rug cost \$3,000 and had an FMV of \$2,500 just before the fire. You bought the table at an auction for \$100, before discovering it was an antique. It had been appraised at \$900 before the fire. You figure your loss on each of these items as follows:

	Chair	Rug	Table
1) Basis (cost) .....	<u>\$750</u>	<u>\$3,000</u>	<u>\$100</u>
2) FMV before fire .....	\$500	\$2,500	\$900
3) FMV after fire .....	<u>0</u>	<u>0</u>	<u>0</u>
4) Decrease in FMV .....	<u>\$500</u>	<u>\$2,500</u>	<u>\$900</u>
5) Loss (smaller of (1) or (4)) .....	<u>\$500</u>	<u>\$2,500</u>	<u>\$100</u>
6) <b>Total loss</b> .....			<b><u>\$3,100</u></b>

**Real property.** In figuring a casualty loss on personal-use real property, treat the entire property (including any improvements, such as buildings, trees, and shrubs) as one item. Figure the loss using the smaller of the adjusted basis or the decrease in FMV of the entire property.

**Example.** You bought your home a few years ago. You paid \$50,000 (\$10,000 for the land and \$40,000 for the house). You also spent \$2,000 for landscaping. This year a fire destroyed your home. The fire also damaged the shrubbery and trees in your yard. The fire was your only casualty or theft loss this year. Competent appraisers valued the property as a whole at \$75,000 before the fire, but only \$15,000 after the fire. (The loss to your household furnishings is not shown in this example. It would be figured

separately, as explained earlier under *Personal property*.) Shortly after the fire, the insurance company paid you \$45,000 for the loss. Your adjusted gross income is \$48,000. You figure your casualty loss as follows:

1) Adjusted basis of the entire property (cost of land, building, and landscaping) .....	<u>\$52,000</u>
2) FMV of entire property before fire .	\$75,000
3) FMV of entire property after fire ....	<u>15,000</u>
4) Decrease in FMV of entire property	<u>\$60,000</u>
5) Loss (smaller of (1) or (4)) .....	\$52,000
6) Subtract insurance .....	<u>45,000</u>
7) <b>Amount of loss</b> .....	<b><u>\$7,000</u></b>

### Deduction Limits

After you have figured the amount of your loss, as discussed earlier, you must figure how much of the loss you can deduct. If the loss was to property for your personal use or your family's, there are **two limits** on the amount you can deduct for your casualty or theft loss.

- 1) You must reduce each casualty or theft loss by \$100 (\$100 rule).
- 2) You must further reduce the total of all your losses by 10% of your adjusted gross income (10% rule).

You make these reductions on Form 4684.

These rules are explained next, and *Table 27-1* summarizes how to apply the \$100 rule and the 10% rule in various situations. For more detailed explanations and examples, see Publication 547.

**Property used partly for business and partly for personal purposes.** When property is used partly for personal purposes and partly for business or income-producing purposes, the casualty or theft loss deduction must be figured separately for the personal-use portion and for the business or income-producing portion. You must figure each loss separately because the \$100 rule and the 10% rule apply only to the loss on the personal-use portion of the property.

### \$100 Rule

After you have figured the amount of your casualty or theft loss, as discussed earlier, you must reduce that loss by \$100. This reduction applies to each casualty or theft loss. It does not matter how many pieces of property are involved in an event; only a single \$100 reduction applies.

**Example.** A hailstorm damages your home and your car. Determine the amount of loss, as discussed earlier, for each of these items. Since the losses are due to a single event, you combine the losses and reduce the combined amount by \$100.

**Single event.** Generally, events closely related in origin cause a single casualty. It is a single casualty when the damage is from two or more closely related causes, such as wind and flood damage caused by the same storm.

Table 27-1. How To Apply the Deduction Limits

		\$100 Rule	10% Rule
<b>General Application</b>		You must reduce each casualty or theft loss by \$100 when figuring your deduction. Apply this rule after you have figured the amount of your loss.	You must reduce your total casualty or theft loss by 10% of your adjusted gross income. Apply this rule after you reduce each loss by \$100 (the \$100 rule).
<b>Single Event</b>		Apply this rule only once, even if many pieces of property are affected.	Apply this rule only once, even if many pieces of property are affected.
<b>More Than One Event</b>		Apply to the loss from each event.	Apply to the total of all your losses from all events.
<b>More Than One Person— With Losses From the Same Event (other than a married couple filing jointly)</b>		Apply separately to each person.	Apply separately to each person.
<b>Married Couple— With Loss From the Same Event</b>	Filing jointly	Apply as if you were one person.	Apply as if you were one person.
	Filing separately	Apply separately to each spouse.	Apply separately to each spouse.
<b>More Than One Owner (other than a married couple filing jointly)</b>		Apply separately to each owner of jointly owned property.	Apply separately to each owner of jointly owned property.

**10% Rule**

You must reduce the total of all your casualty or theft losses by 10% of your adjusted gross income. Apply this rule after you reduce each loss by \$100. If you have both gains and losses from casualties or thefts, see *Gains and losses*, later in this discussion.

**Example 1.** In June, you discovered that your house had been burglarized. Your loss after insurance reimbursement was \$2,000. Your adjusted gross income is \$29,500. You first apply the \$100 rule and then the 10% rule. Figure your theft loss deduction as follows.

1. Loss after insurance .....	\$2,000
2. Subtract \$100 .....	<u>100</u>
3. Loss after \$100 rule .....	\$1,900
4. Subtract 10% of \$29,500 AGI .....	<u>2,950</u>
<b>5. Theft loss deduction .....</b>	<b><u>0</u></b>

You do not have a theft loss deduction because your loss (\$1,900) is less than 10% of your adjusted gross income (\$2,950).

**Example 2.** In March, you had a car accident that totally destroyed your car. You did not have collision insurance on your car, so you did not receive any insurance reimbursement. Your loss on the car was \$1,200. In November, you had a fire that damaged your basement and totally destroyed the furniture, washer, dryer, and other items you had stored there. Your loss on the basement items after reimbursement was \$1,700. Your adjusted gross income is \$25,000. You figure your casualty loss deduction as follows.

	Car	Basement
1. Loss .....	\$1,200	\$1,700
2. Subtract \$100 .....	<u>100</u>	<u>100</u>
3. Loss after \$100 rule .....	<u>\$1,100</u>	<u>\$1,600</u>
4. Total loss .....		\$2,700

5. Subtract 10% of \$25,000 AGI .....	<u>2,500</u>
<b>6. Casualty loss deduction .....</b>	<b><u>\$200</u></b>

**Gains and losses.** If you had both gains and losses from casualties or thefts to personal-use property, you must compare your total gains to your total losses. Do this after you have reduced each loss by \$100.

**Losses more than gains.** If your losses are more than your recognized gains, subtract your gains from your losses and reduce the result by 10% of your adjusted gross income. The rest is your deductible loss.

**Gains more than losses.** If your recognized gains are more than your losses, subtract your losses from your gains. The difference is treated as capital gain and must be reported on Schedule D (Form 1040). The 10% rule does not apply to your losses.

**When To Report Gain or Loss**

If you receive an insurance or other reimbursement that is more than your adjusted basis in the destroyed or stolen property, you have a **gain** from the casualty or theft. You must include this gain in your income in the year you receive the reimbursement, unless you choose to postpone the gain as explained in Publication 547.

If you have a **loss**, see Table 27-2.

**Loss on deposits.** If your loss is a loss on deposits in an insolvent or bankrupt financial institution, see *Loss on Deposits*, earlier.

**Casualty loss.** Generally, you can deduct a casualty loss only in the tax year in which the casualty occurred. This is true even if

Table 27-2. When To Deduct a Loss

Type of Loss	Tax Year Deducted
<b>Loss on deposits</b>	
<ul style="list-style-type: none"> <li>Casualty loss</li> <li>Bad debt</li> <li>Ordinary loss</li> </ul>	Year a reasonable estimate can be made Year deposits are totally worthless Year a reasonable estimate can be made
<b>Casualty losses</b>	Year loss occurred
<b>Federal disaster area losses</b>	Year the disaster occurred or the year immediately before the disaster
<b>Thefts</b>	Year of discovery of the theft

you do not repair or replace the damaged property until a later year.

**Disaster area loss.** If you have a casualty loss in a Presidentially declared disaster area, you can choose to deduct the loss on your tax return for either of the following years.

- 1) The year the casualty occurred.
- 2) The year immediately preceding the year the casualty occurred.

**Interest abatement on underpayments in disaster areas.** The IRS will abate interest for the length of the extension period granted to all taxpayers who meet both of the following requirements.

- 1) They were located in an area declared a disaster area by the President.
- 2) They were granted extensions to file income tax returns and pay income tax.

**More information.** For more information, see *Disaster Area Losses* in Publication 547.

**Theft loss.** You can generally deduct a theft loss only in the year you discover your property was stolen. You must be able to show that there was a theft, but you do not have to know when the theft occurred. However, you should show when you discovered that your property was missing.

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## How To Report Gains and Losses

Use Form 4684 to report a gain or a deductible loss from a casualty or theft. If you have more than one casualty or theft, use a separate Form 4684 to determine your gain or loss for each event. Combine the gains and losses on one Form 4684. Follow the form instructions as to which lines to fill out.

**If you have a: Report it on:**

Gain .....	Schedule D (Form 1040)
Loss .....	Schedule A (Form 1040)

**Adjustments to basis.** If you have a casualty or theft loss, you must reduce your adjusted basis in the property by any deductible loss and any insurance or other reimbursements. Amounts you spend to restore your property after a casualty increase your adjusted basis. See *Adjusted Basis* in chapter 14 for more information.

**Net operating loss.** If your casualty or theft loss deduction is more than your income, you may have a net operating loss (NOL). You can use an NOL to lower your taxes in an earlier year, allowing you to get a refund for taxes you have already paid. Or, you can use it to lower your taxes in a later year. You do not have to be in business to have an NOL from a casualty or theft loss. For more information, see Publication 536, *Net Operating Losses*.

# Car Expenses and Other Employee Business Expenses

## Important Changes

**Standard mileage rate.** The standard mileage rate for the cost of operating your car in 1999 is 32½ cents a mile for all business miles driven before April 1. The rate is 31 cents a mile for miles driven after March 31.

Car expenses and use of the standard mileage rate are explained under *Local Transportation Expenses*, later.

**Temporary work location.** The IRS has reconsidered its definition of **temporary** for purposes of determining whether travel expenses to a temporary work location are deductible. In general, employment at a work location is temporary if it is realistically expected to last (and does in fact last) for one year or less. See *Temporary work location* under *Local Transportation Expenses*, later.

## Important Reminders

**Standard meal allowance.** The standard meal allowance for most areas in the United States is \$30. However, the standard meal allowance is higher for many areas as shown in *Appendix A* of Publication 463. Use of the standard meal allowance is explained under *Deductible Travel Expenses*, later.

**Days you depart and return.** For the days you depart for and return from a business trip, you can claim ¾ of the standard meal allowance amount. For more information, see *Travel for days you depart and return* under *Standard Meal Allowance*, later.

**Limits that apply to employee deductions.** If you are an employee, deduct your work-related expenses discussed in this chapter as a miscellaneous itemized deduction on Schedule A (Form 1040). Generally, the amount of miscellaneous itemized deductions you can deduct is limited to the amount that is more than 2% of your adjusted gross income. It may be further limited if your adjusted gross income is more than \$126,600 (\$63,300 if you are married filing separately). For more information, see chapter 22 and the instructions for Schedule A (Form 1040).

## Introduction

This chapter discusses rules for deducting the ordinary and necessary business-related expenses connected with:

- Travel away from home,
- Entertainment,
- Gifts, and
- Local transportation.

An **ordinary expense** is one that is common and accepted in your field of trade, business, or profession. A **necessary expense** is one that is helpful and appropriate for your business. An expense does not have to be indispensable to be considered necessary.

This chapter also discusses:

- What records you need to prove your expenses,
- How to handle reimbursements of your employee business expenses, and
- How to report your expenses on Forms 2106 and 2106-EZ.

**Expenses fully reimbursed.** You will not need to read this chapter if **all** of the following are true.

- 1) You fully accounted to your employer for your work-related expenses.
- 2) You received full reimbursement for your expenses.
- 3) Your employer required you to return any excess reimbursement and you did so.
- 4) Box 13 of your Form W-2 shows no amount with a code L.

If you meet these four conditions, there is no need to show the expenses or the reimbursements on your return. See *Reimbursements*, later, if you would like more information on reimbursements and accounting to your employer.

**TIP** *If you meet these conditions and your employer included reimbursements on your Form W-2 in error, ask your employer for a corrected Form W-2.*

If you do not meet all of these conditions, you generally must complete Form 2106 or 2106-EZ and itemize your deductions to claim your expenses. See *Completing Forms 2106 and 2106-EZ*, later.

## Useful Items

You may want to see:

### Publication

- 463** Travel, Entertainment, Gift, and Car Expenses
- 535** Business Expenses

### Form (and Instructions)

- Schedule A (Form 1040)** Itemized Deductions
- Schedule C (Form 1040)** Profit or Loss From Business

- Schedule C-EZ (Form 1040)** Net Profit From Business
- Schedule F (Form 1040)** Profit or Loss From Farming
- Form 2106** Employee Business Expenses
- Form 2106-EZ** Unreimbursed Employee Business Expenses

## Travel Expenses

If you temporarily travel away from your tax home, you can use this section to determine if you have deductible travel expenses. This section defines “tax home,” “temporary,” and different types of travel expenses. It also discusses the rules for travel inside and outside the United States and deductible convention expenses.

**Travel expenses defined.** For tax purposes, travel expenses are the ordinary and necessary expenses of traveling away from home for your business, profession, or job.

You will find examples of deductible travel expenses in *Table 28-1*.

**Traveling away from home.** You are traveling away from home if:

- 1) Your duties require you to be away from the general area of your tax home (defined later) substantially longer than an ordinary day’s work, and
- 2) You need to get sleep or rest to meet the demands of your work while away from home.

This rest requirement is not satisfied by merely napping in your car. You do not have to be away from your tax home for a whole day or from dusk to dawn as long as your relief from duty is long enough to get necessary sleep or rest.

**Example 1.** You are a railroad conductor. You leave your home terminal on a regularly scheduled round-trip run between two cities and return home 16 hours later. During the run, you have 6 hours off at your turnaround point where you eat two meals and rent a hotel room to get necessary sleep before starting the return trip. You are considered to be away from home, and you can deduct travel expenses.

**Example 2.** You are a truck driver. You leave your terminal and return to it later the same day. You get an hour off at your turnaround point to eat. Because you are not off to get necessary sleep and the brief time off is not an adequate rest period, your trip is not considered as travel away from home. You cannot deduct travel expenses.

## Tax Home

To deduct travel expenses, you must first determine the location of your tax home.

Generally, your tax home is your regular place of business or post of duty, regardless of where you maintain your family home. It includes the **entire city or general area** in which your business or work is located. If you have more than one regular place of business, your tax home is your main place of business. See *Main place of business or work*, later. If you do not have a regular

or a main place of business because of the nature of your work, then your tax home may be the place where you regularly live. See *No main place of business or work*, later.

If you do not have a regular place of business or post of duty and there is no place where you regularly live, you are considered a transient (an itinerant) and your tax home is wherever you work. As a transient, you cannot claim a travel expense deduction because you are never considered away from home.

**Main place of business or work.** If you have more than one place of work, consider the following when determining your main place of business or work.

- 1) The total time you ordinarily spend working in each area.
- 2) The degree of your business activity in each area.
- 3) The relative amount of your income from each area.

**Example.** You live in Cincinnati where you have a seasonal job for 8 months each year and earn \$25,000. You work the other 4 months in Miami, also at a seasonal job, and earn \$9,000. Cincinnati is your main place of work because you spend most of your time there and earn most of your income there.

**No main place of business or work.** You may have a tax home even if you do not have a regular or main place of work. Your tax home may be the home where you regularly live.

**Factors used to determine tax home.** If you do not have a regular or main place of business or work, use the following three factors to see if you have a tax home.

- 1) You perform part of your business in the area of your main home and use that home for lodging while doing business in the area.
- 2) You have living expenses at your main home that you duplicate because your business requires you to be away from that home.
- 3) You have not abandoned the area in which both your traditional place of lodging and your main home are located; you have a member or members of your family living at your main home; or you often use that home for lodging.

If you satisfy all three factors, your tax home is the home where you regularly live, and you may be able to deduct travel expenses. If you satisfy only two factors, you may have a tax home depending on all the facts and circumstances. If you satisfy only one factor, you are a transient; your tax home is wherever you work and you cannot deduct travel expenses.

**Example.** You are single and live in Boston in an apartment you rent. You have worked for your employer in Boston for a number of years. Your employer enrolls you in a 12-month executive training program. You do not expect to return to work in Boston after you complete your training.

During your training, you do not do any work in Boston. Instead, you receive classroom and on-the-job training through-

out the United States. You keep your apartment in Boston and return to it frequently. You use your apartment to conduct your personal business. You also keep up your community contacts in Boston. When you complete your training, you are transferred to Los Angeles.

You do not satisfy factor (1) because you did not work in Boston. You satisfy factor (2) because you had duplicate living expenses. You also satisfy factor (3) because you did not abandon your apartment in Boston as your traditional home, you kept your community contacts, and you frequently returned to live in your apartment. You have a tax home in Boston for travel expense deduction purposes.

**Living away from your tax home.** If you (and your family) live in an area outside your tax home (main place of work), you cannot deduct the cost of traveling between your tax home and your family home. You also cannot deduct the cost of meals and lodging while at your tax home. See *Example 1* that follows.

If you are working temporarily in the same city where you and your family live, you may be considered as traveling away from home. See *Example 2*, below.

**Example 1.** You are a truck driver and you and your family live in Tucson. You are employed by a trucking firm that has its terminal in Phoenix. At the end of your long runs, you return to your home terminal in Phoenix and spend one night there before returning home. You cannot deduct any expenses you have for meals and lodging in Phoenix or the cost of traveling from Phoenix to Tucson. This is because Phoenix is your tax home.

**Example 2.** Your family home is in Pittsburgh, where you work 12 weeks a year. The rest of the year you work for the same employer in Baltimore. In Baltimore, you eat in restaurants and sleep in a rooming house. Your salary is the same whether you are in Pittsburgh or Baltimore.

Because you spend most of your working time and earn most of your salary in Baltimore, that city is your tax home. You cannot deduct any expenses you have for meals and lodging there. However, when you return to work in Pittsburgh, you are away from your tax home even though you stay at your family home. You can deduct the cost of your round trip between Baltimore and Pittsburgh. You can also deduct your part of your family's living expenses for meals and lodging while you are living and working in Pittsburgh.

## Temporary Assignment or Job

You may regularly work within the city or general area of your tax home and also work at another location. It may not be practical to return home from this other location at the end of each work day.

If your assignment or job away from your main place of work is **temporary**, your tax home does not change. You are considered to be away from home for the whole period you are away from your main place of work. Your travel expenses are deductible. Generally, a temporary assignment in a single location is one that is realistically expected to last (and does in fact last) for one year or less.

However, if your assignment or job is **indefinite**, the location of the assignment or job becomes your new tax home and you cannot deduct your travel expenses while there. An assignment or job in a single location is considered indefinite if it is realistically expected to last for more than one year, whether or not it actually lasts for more than one year.

If your assignment is indefinite, you must include in your income any amounts you receive from your employer for living expenses, even if they are called travel allowances and you account to your employer for them. You may be able to deduct the cost of relocating to your new tax home as a moving expense. See chapter 19 for more information.

**Exception for federal crime investigations or prosecutions.** If you are a federal employee participating in a federal crime investigation or prosecution, you are not subject to the one-year rule for deducting temporary travel expenses. This means you may be able to deduct travel expenses even if you are away from your tax home for more than one year.

For you to qualify, the Attorney General must certify that you are traveling:

- 1) For the federal government,
- 2) In a temporary duty status, and
- 3) To investigate or prosecute, or provide support services for the investigation or prosecution of, a federal crime.

You can deduct your otherwise allowable travel expenses throughout the period of certification.

**Determining temporary or indefinite.** You must determine whether your assignment is temporary or indefinite when you start work. If you expect employment to last for one year or less, it is temporary unless there are facts and circumstances that indicate otherwise. Employment that is initially temporary may become indefinite due to changed circumstances. A series of assignments to the same location, all for short periods but that together cover a long period, may be considered an indefinite assignment.

**Going home on days off.** If you go back to your tax home from a temporary assignment on your days off, you are not considered away from home while you are in your hometown. You cannot deduct the cost of your meals and lodging there. However, you can deduct your travel expenses, including meals and lodging, while traveling from the area of your temporary place of work to your hometown and back to work. You can claim these expenses up to the amount it would have cost you for meals and lodging had you stayed at your temporary place of work.

If you keep your hotel room during your visit home, you can deduct the cost of your hotel room. In addition, you can deduct your expenses of returning home up to the amount you would have spent for meals had you stayed at your temporary place of work.

**Probationary work period.** If you take a job that requires you to move, with the understanding that you will keep the job if your work is satisfactory during a probationary period, the job is indefinite. You cannot deduct any of your expenses for

meals and lodging during the probationary period.

**Members of the Armed Forces.** If you are a member of the U.S. Armed Forces on a permanent duty assignment overseas, you are not traveling away from home. You cannot deduct your expenses for meals and lodging. You cannot deduct these expenses even if you have to maintain a home in the United States for your family members who are not allowed to accompany you overseas. If you are transferred from one permanent duty station to another, you may have deductible moving expenses, which are explained in chapter 19.

A naval officer assigned to permanent duty aboard a ship that has regular eating and living facilities has a tax home aboard ship for travel expense purposes.

## What Are Travel Expenses?

Once you have determined that you are traveling away from your tax home, you can determine what travel expenses are deductible.



When you travel away from home on business, you should keep records of all the expenses you have and any advances you receive from your employer. You can use a log, diary, notebook, or any other written record to keep track of your expenses. The types of expenses you need to record, along with supporting documentation, are described in *Table 28-2*.

## Deductible Travel Expenses

Deductible travel expenses include those ordinary and necessary expenses you have when you travel away from home on business. The type of expense you can deduct depends on the facts and your circumstances.

*Table 28-1* summarizes travel expenses you may be able to deduct. You may have other deductible travel expenses that are not covered there, depending on the facts and your circumstances.

Additional rules on the cost of meals and on paying travel expenses for others are explained next.

**Meals.** Unless you meet the rules for business entertainment, you cannot deduct the cost of meals if it is not necessary for you to stop for sleep or rest to properly perform your duties. These rules are explained later under *Entertainment Expenses*.

**50% limit on meals.** You can use either the actual cost of your meals or a standard amount to figure your meals expense. (See *Standard Meal Allowance* later in this section.) However, you can generally deduct only 50% of the cost of your unreimbursed business-related meals.

If you are reimbursed for the cost of your meals, how you apply the 50% limit depends on whether your employer's reimbursement plan was accountable or non-accountable. The 50% limit applies whether the unreimbursed meal expense is for business travel or business entertainment. The 50% limit is explained later under *Entertainment Expenses*. Accountable and

**Table 28-1. Travel Expenses You Can Deduct**

This chart summarizes expenses you can deduct when you travel away from home for business purposes. Additional rules on meals and paying travel expenses for others are explained under *Deductible Travel Expenses*.

IF you have expenses for:	THEN you can deduct the costs of:
<b>Transportation</b>	Travel by airplane, train, bus, or car between your home and your business destination. If you were provided with a ticket or you are riding free as a result of a frequent traveler or similar program, your cost is zero. If you travel by ship, see <i>Luxury Water Travel</i> and <i>Cruise ships</i> (under <i>Conventions</i> ) in Publication 463 for additional rules and limits.
<b>Taxi, commuter bus, and airport limousine</b>	Fares for these and other types of transportation that take you to or from: 1) The airport or station and your hotel, and 2) The hotel and the work location of your customers or clients, your business meeting place, or your temporary work location.
<b>Baggage and shipping</b>	Sending baggage and sample or display material between your regular and temporary work locations.
<b>Car</b>	Operating and maintaining your car when traveling away from home on business. You can deduct actual expenses or the standard mileage rate as well as business-related tolls and parking. If you rent a car while away from home on business, you can deduct only the business-use portion of the expenses.
<b>Lodging and meals</b>	Your lodging and meals if your business trip is overnight or long enough that you need to stop for sleep or rest to properly perform your duties. Meals include amounts spent for food, beverages, taxes, and related tips. See <i>Meals</i> for additional rules and limits.
<b>Cleaning</b>	Dry cleaning and laundry.
<b>Telephone</b>	Business calls while on your business trip. This includes business communication by fax machine or other communication devices.
<b>Tips</b>	Tips you pay for any expenses in this chart.
<b>Other</b>	Other similar ordinary and necessary expenses related to your business travel. These expenses might include transportation to or from a business meal, public stenographer's fees, computer rental fees, and operating and maintaining a house trailer.

nonaccountable plans are discussed later under *How To Report*.

**Lavish or extravagant.** You cannot deduct expenses for meals that are lavish or extravagant. An expense is not considered lavish or extravagant if it is reasonable based on the facts and circumstances. Expenses will not be disallowed merely because they are more than a fixed dollar amount or take place at deluxe restaurants, hotels, nightclubs, or resorts.

**Travel expenses for another individual.** If a spouse, dependent, or other individual goes with you (or your employee) on a business trip or to a business convention, you generally cannot deduct his or her travel expenses. You can only deduct the travel expenses you have for an accompanying individual if that individual:

- 1) Is your employee,
- 2) Has a bona fide business purpose for the travel, and

- 3) Would otherwise be allowed to deduct the travel expenses.

**Exception for business associate.** If a business associate travels with you and meets the conditions in (2) and (3) above, you can claim the deductible travel expenses you have for that person. A business associate is someone with whom you can reasonably expect to actively conduct business. It does not matter if you have already conducted business with the person as long as you reasonably expect to do so. A business associate can be a customer, client, supplier, employee, agent, partner, or professional advisor.

**Bona fide business purpose.** For a bona fide business purpose to exist, you must prove a real business purpose for the individual's presence. Incidental services, such as typing notes or assisting in entertaining customers, are not enough to warrant a deduction.



**Example.** Jerry drives to Chicago on business and takes his wife, Linda, with him. Linda is not Jerry's employee. Even if her presence serves a bona fide business purpose, her expenses are not deductible.

Jerry pays \$115 a day for a double room. A single room costs \$90 a day. He can deduct the total cost of driving his car to and from Chicago, but only \$90 a day for his hotel room. If he uses public transportation, he can deduct only his fare.

## Standard Meal Allowance

You generally can deduct a standard amount for your daily meals and incidental expenses (**M&IE**) while you are traveling away from home on business. **Incidental expenses** include, but are not limited to, your costs for the following items.

- 1) Laundry, dry cleaning, and pressing of clothing.
- 2) Fees and tips for persons who provide services, such as food servers and luggage handlers.

Incidental expenses do not include taxicab fares or the costs of telegrams or telephone calls. In this chapter, "standard meal allowance" refers to the federal rate for M&IE (that varies based on where and when you travel).



**Federal employees should refer to the federal travel regulations at 41 CFR 301 for changes affecting their claims for reimbursement of these expenses.**

The standard meal allowance method is an alternative to the actual cost method and allows you to deduct a set amount, depending on where and when you travel, instead of keeping records of your actual costs. If you use the standard meal allowance, you still must keep records to prove the time, place, and business purpose of your travel. See the recordkeeping rules explained later under *Recordkeeping*.



**There is no optional standard lodging amount similar to the standard meal allowance. Your allowable lodging expense deduction is your actual cost.**

**Who can use the standard meal allowance.** You can use the standard meal allowance whether you are an employee or self-employed, and whether or not you are reimbursed for your traveling expenses. You cannot use the standard meal allowance if you are related to your employer as defined next.

**Related to employer.** You are related to your employer if:

- 1) Your employer is your brother or sister, half brother or half sister, spouse, ancestor, or lineal descendant,
- 2) Your employer is a corporation in which you own, directly or indirectly, more than 10% in value of the outstanding stock, or
- 3) Certain fiduciary relationships exist between you and your employer involving grantors, trusts, beneficiaries, etc.

You may be considered to indirectly own stock, for purposes of (2), if you have an

interest in a corporation, partnership, estate, or trust that owns the stock or if a family member or partner owns the stock.

**Limit on standard meal allowance.** If you are not reimbursed or if you are reimbursed under a nonaccountable plan for meal expenses, you can generally deduct only 50% of the standard meal allowance. If you are reimbursed under an accountable plan and you are deducting amounts that are more than your reimbursements, you can deduct only 50% of the excess amount. The 50% limit is discussed in more detail under *Entertainment Expenses*, and accountable and nonaccountable plans are discussed later under *How To Report*.

**Other expenses that can qualify for the standard meal allowance.** You can use the standard meal allowance to prove meal expenses you have when you travel in connection with investment and other income-producing property. You can also use it to prove meal expenses you have when you travel for qualifying educational purposes. You **cannot** use the standard meal allowance to prove the amount of your meals when you travel for medical or charitable purposes.

**Amount of standard meal allowance.** The standard meal allowance is the federal M&IE rate. For travel in 1999, the rate is **\$30 a day** for most areas in the United States. Other locations in the United States are designated as high-cost areas, qualifying for higher standard meal allowances. *Appendix A* in Publication 463 lists the locations qualifying for rates of \$34, \$38, \$42, or \$46 a day.

If you travel to more than one location in one day, use the rate in effect for the area where you stop for sleep or rest. If you work in the transportation industry, however, see *Special rate for transportation workers*, later.

**Standard meal allowance for areas outside the continental United States.** The standard meal allowance rates do not apply to travel in Alaska, Hawaii, or any other locations outside the continental United States. The federal per diem rates for these locations are published monthly in the *Maximum Travel Per Diem Allowances for Foreign Areas*.



Your employer may have these rates available, or you can purchase the publication from the:

Superintendent of Documents  
U.S. Government Printing Office  
P.O. Box 371954  
Pittsburgh, PA 15250-7954



You can also order it by calling the Government Printing Office at 1-202-512-1800 (not a toll-free number).



**Internet access.** Per diem rates are also available on the Internet. If you have a computer and a modem, you can access domestic per diem rates at:

[www.policyworks.gov/perdiem](http://www.policyworks.gov/perdiem)

You can access foreign per diem rates at:

[www.state.gov/www/perdiems](http://www.state.gov/www/perdiems)

**Special rate for transportation workers.** You can use a special standard meal allowance if you work in the transportation industry. You are in the transportation industry if your work:

- 1) Directly involves moving people or goods by airplane, barge, bus, ship, train, or truck, and
- 2) Regularly requires you to travel away from home and, during any single trip, usually involves travel to areas eligible for different standard meal allowance rates.

If this applies to you, you can claim a **\$38 a day** standard meal allowance (\$42 for travel outside the continental United States).

Using the special rate for transportation workers eliminates the need for you to determine the standard meal allowance for every area where you stop for sleep or rest. If you choose to use the special rate for any trip, you must use the special rate (and not use the regular standard meal allowance rates) for all trips you take that year.

## Travel for days you depart and return.

For both the day you depart for and the day you return from a business trip, you must prorate the standard meal allowance. You can do so by one of two methods.

- 1) Method 1: You can claim  $\frac{3}{4}$  of the standard meal allowance, or
- 2) Method 2: You can use any method that you consistently apply and that is in accordance with reasonable business practice.

**Example.** Jen is employed in New Orleans as a convention planner. In March, her employer sent her on a 3-day trip to Washington, DC, to attend a planning seminar. She left her home in New Orleans at 10 a.m. on Wednesday and arrived in Washington, DC, at 5:30 p.m. After spending two nights there, she flew back to New Orleans on Friday and arrived back home at 8:00 p.m. Jen's employer gave her a flat amount to cover her expenses and included it with her wages.

Under Method 1, Jen can claim  $2\frac{1}{2}$  days of the standard meal allowance for Washington, DC:  $\frac{3}{4}$  of the daily rate for Wednesday and Friday (the days she departed and returned), and the full daily rate for Thursday.

Under Method 2, Jen could also use any method that she applies consistently and that is in accordance with reasonable business practice. For example, she could claim 3 days of the standard meal allowance even though a federal employee would be limited to only  $2\frac{1}{2}$  days.

## Travel in the United States

The following discussion applies to travel in the United States. For this purpose, the United States includes the 50 states and the District of Columbia. The treatment of your travel expenses depends on how much of your trip was business related and on how much of your trip occurred within the United States.

## Trip Primarily for Business

You can deduct all your travel expenses if your trip was entirely business related. If your trip was primarily for business and, while at your business destination, you extended your stay for a vacation, made a nonbusiness side trip, or had other non-business activities, you can deduct your business-related travel expenses. These expenses include the travel costs of getting to and from your business destination and any business-related expenses at your business destination.

**Example.** You work in Atlanta and take a business trip to New Orleans. On your way home, you stop in Mobile to visit your parents. You spend \$630 for the 9 days you are away from home for travel, meals, lodging, and other travel expenses. If you had not stopped in Mobile, you would have been gone only 6 days, and your total cost would have been \$580. You can deduct \$580 for your trip, including the round-trip transportation to and from New Orleans. The cost of your meals is subject to the 50% limit on meals mentioned earlier.

## Trip Primarily for Personal Reasons

If your trip was primarily for personal reasons, such as a vacation, the entire cost of the trip is a nondeductible personal expense. However, you can deduct any expenses you have while at your destination that are directly related to your business.

A trip to a resort or on a cruise ship may be a vacation even if the promoter advertises that it is primarily for business. The scheduling of incidental business activities during a trip, such as viewing videotapes or attending lectures dealing with general subjects, will not change what is really a vacation into a business trip.

## Part of Trip Outside the United States

If part of your trip is outside the United States, use the rules described later under *Travel Outside the United States* for that part of the trip. For the part of your trip that is inside the United States, use the rules in this section. Travel outside the United States does not include travel from one point in the United States to another point in the United States. The following discussion can help you determine whether your trip was entirely within the United States.

**Public transportation.** If you travel by public transportation, any place in the United States where that vehicle makes a scheduled stop is a point in the United States. Once the vehicle leaves the last scheduled stop in the United States on its way to a point outside the United States, you apply the rules under *Travel Outside the United States*.

**Example.** You fly from New York to Puerto Rico with a scheduled stop in Miami. You return to New York nonstop. The flight from New York to Miami is in the United States, so only the flight from Miami to Puerto Rico is outside the United States. Because there are no scheduled stops between Puerto Rico and New York, all of the return trip is outside the United States.

**Private car.** Travel by private car in the United States is travel between points in the United States, even when you are on your way to a destination outside the United States.

**Example.** You travel by car from Denver to Mexico City and return. Your travel from Denver to the border and from the border back to Denver is travel in the United States, and the rules in this section apply. The rules under *Travel Outside the United States* apply to your trip from the border to Mexico City and back to the border.

## Travel Outside the United States

If any part of your business travel is outside the United States, some of your deductions for the cost of getting to and from your destination may be limited. For this purpose, the United States includes the 50 states and the District of Columbia.

How much of your travel expenses you can deduct depends in part upon how much of your trip outside the United States was business related.

See chapter 1 of Publication 463 for information on luxury water travel.

## Travel Entirely for Business or Considered Entirely for Business

You can deduct all your travel expenses of getting to and from your business destination if your trip is entirely for business or considered entirely for business.

**Travel entirely for business.** If you travel outside the United States and you spend the entire time on business activities, you can deduct all of your travel expenses.

**Travel considered entirely for business.** Even if you did not spend your entire time on business activities, your trip is considered entirely for business if you meet at least one of the following four exceptions.

**Exception 1 – No substantial control.** Your trip is considered entirely for business if you did not have substantial control over arranging the trip. You are not considered to have substantial control merely because you have control over the timing of your trip.

You are considered not to have substantial control over your trip if you:

- 1) Are an employee who was reimbursed or paid a travel expense allowance,
- 2) Are not related to your employer, and
- 3) Are not a managing executive.

“Related to your employer” was defined earlier in this chapter under *Standard Meal Allowance*. A “managing executive” is an employee who has the authority and responsibility, without being subject to the veto of another, to decide on the need for the business travel.

A self-employed person generally has substantial control over arranging business trips.

**Exception 2 – Outside U.S. no more than a week.** Your trip is considered entirely for business if you were outside the United States for a week or less, combining

business and nonbusiness activities. One week means seven consecutive days. In counting the days, do not count the day you leave the United States, but do count the day you return to the United States.


**Exception 3 – Less than 25% of time on personal activities.** Your trip is considered entirely for business if you were outside the United States for more than a week, but you spent less than 25% of the total time you were outside the United States on nonbusiness activities. For this purpose, count both the day your trip began and the day it ended.

**Exception 4 – Vacation not a major consideration.** Your trip is considered entirely for business if you can establish that a personal vacation was not a major consideration, even if you have substantial control over arranging the trip.

**Travel not entirely for business.** If you do not meet any of the above exceptions, you may still be able to deduct some of your expenses. See *Travel Primarily for Business*, next.

## Travel Primarily for Business

If you travel outside the United States primarily for business but spend some of your time on nonbusiness activities, you generally cannot deduct all of your travel expenses. You can only deduct the business portion of your cost of getting to and from your destination. You must make an allocation between your business and non-business activities to determine your deductible amount. These travel allocation rules are discussed in chapter 1 of Publication 463.


 **TIP** You do not have to allocate your travel expense deduction if you meet one of the four exceptions listed earlier under *Travel* considered entirely for business. In those cases, you can deduct the total cost of getting to and from your destination.

## Travel Primarily for Vacation

If you travel outside the United States primarily for vacation or for investment purposes, the entire cost of the trip is a nondeductible personal expense. This is true even if you spend some time attending brief professional seminars or a continuing education program. You can, however, deduct your registration fees and any other expenses you have that are directly related to your business.

## Conventions

You can deduct your travel expenses when you attend a convention if you can show that your attendance benefits your trade or business. You cannot deduct the travel expenses for your family. If the convention is for investment, political, social, or other purposes unrelated to your trade or business, you cannot deduct the expenses. You cannot deduct nonbusiness expenses, such as social or sight-seeing expenses.

 **CAUTION** Your appointment or election as a delegate does not, in itself, determine whether you can deduct travel expenses. You can deduct your travel expenses only if your attendance is connected to your own trade or business.

**Convention agenda.** The convention agenda or program generally shows the purpose of the convention. You can show your attendance at the convention benefits your trade or business by comparing the agenda with the official duties and responsibilities of your position. The agenda does not have to deal specifically with your official duties and responsibilities; it will be enough if the agenda is so related to your position that it shows your attendance was for business purposes.

**Foreign conventions.** See chapter 1 of Publication 463 for information on conventions held outside the North American area.

## Entertainment Expenses

You may be able to deduct business-related entertainment expenses you have for entertaining a client, customer, or employee.

You can deduct entertainment expenses only if they are both ordinary and necessary and meet one of the following two tests.

- 1) Directly-related test.
- 2) Associated test.



*The amount you can deduct for entertainment expenses may be limited. Generally, you can deduct only 50% of your unreimbursed entertainment expenses. This limit is discussed later under 50% Limit.*

**Club dues and membership fees.** You cannot deduct dues (including initiation fees) for membership in any club organized for business, pleasure, recreation, or other social purpose. This rule applies to any membership organization if one of its principal purposes is to conduct entertainment activities for members or their guests, or to provide members or their guests with access to entertainment facilities.

The purposes and activities of a club, not its name, will determine whether or not you can deduct the dues. You cannot deduct dues paid to country clubs, golf and athletic clubs, airline clubs, hotel clubs, and clubs operated to provide meals under circumstances generally considered to be conducive to business discussions.

**Entertainment.** Entertainment includes any activity generally considered to provide entertainment, amusement, or recreation. Examples include entertaining guests at nightclubs; at social, athletic, and sporting clubs; at theaters; at sporting events; on yachts; or on hunting, fishing, vacation, and similar trips. You cannot deduct expenses for entertainment that are lavish or extravagant. If you buy a ticket to an entertainment event for a client, you generally cannot deduct more than the face value of the ticket, even if you paid a higher price.

**A meal as a form of entertainment.** Entertainment includes the cost of a meal you provide to a customer or client, whether the meal is a part of other entertainment or by itself. A meal expense includes the cost of food, beverages, taxes, and tips for the meal. To deduct an entertainment-related meal, you or your employee must be pres-

ent when the food or beverages are provided.



*You cannot claim the cost of your meal both as an entertainment expense and as a travel expense.*

**Taking turns paying for meals or entertainment.** Expenses are *not* deductible when a group of business acquaintances take turns picking up each others' meal or entertainment checks without regard to whether any business purposes are served.

**Trade association meetings.** You can deduct expenses for entertainment that are directly related to and necessary for attending business meetings or conventions of certain exempt organizations. These organizations include business leagues, chambers of commerce, real estate boards, trade associations, and professional associations. The expenses of your attendance must be related to your active trade or business. These expenses are subject to the 50% limit on entertainment expenses.

**Additional information.** For more information on entertainment expenses, including discussions of the directly-related and associated tests, see chapter 2 of Publication 463.

### 50% Limit

In general, you can deduct only 50% of your business-related meal and entertainment expenses. (If you are subject to the Department of Transportation's "hours of service" limits, you can deduct a higher percentage. See *Individuals subject to "hours of service" limits*, later.) The 50% limit applies to employees or their employers, and to self-employed persons (including independent contractors) or their clients, depending on whether the expenses are reimbursed. *Figure 28-A* summarizes the general rules explained in this section.

The 50% limit applies to business meals or entertainment expenses you have while:

- 1) Traveling away from home (whether eating alone or with others) on business,
- 2) Entertaining customers at your place of business, a restaurant, or other location, or
- 3) Attending a business convention or reception, business meeting, or business luncheon at a club.

**Covered expenses.** Taxes and tips relating to a business meal or entertainment activity are included in the amount that is subject to the 50% limit. Expenses such as cover charges for admission to a nightclub, rent paid for a room in which you hold a dinner or cocktail party, or the amount paid for parking at a sports arena are also subject to the 50% limit. However, the cost of transportation to and from a business meal or a business-related entertainment activity is not subject to the 50% limit.

**Separating costs.** If you have an expense for goods and services consisting of meals, entertainment, and other services (such as lodging or transportation), you must allocate that expense between the cost of meals and entertainment and the cost of the other

services. You must have a reasonable basis for making this allocation. For example, you must allocate your expenses if a hotel includes one or more meals in its room charge, or if you are provided with one per diem amount to cover both your lodging and meal expenses.

**Application of 50% limit.** The 50% limit on meal and entertainment expenses applies if the expense is otherwise deductible and is not covered by the exception discussed later in this section.

The 50% limit also applies to activities that are not a trade or business. It applies to meal and entertainment expenses incurred for the production of income, including rental or royalty income. It also applies to the cost of meals included in deductible educational expenses.

**When to apply the 50% limit.** You apply the 50% limit after determining the amount that would otherwise qualify for a deduction. You first determine the amount of meal and entertainment expenses that would be deductible under the other rules discussed in this chapter.

**Example 1.** You spend \$100 for a business-related meal. If \$40 of that amount is not allowable because it is lavish and extravagant, the remaining \$60 is subject to the 50% limit. Your deduction cannot be more than \$30 ( $.50 \times \$60$ ).

**Example 2.** You purchase two tickets to a concert and give them to a client. You purchased the tickets through a ticket agent. You paid \$150 for the two tickets, which had a face value of \$60 each (\$120 total). Your deduction cannot be more than \$60 ( $.50 \times \$120$ ).

### Exceptions to the 50% Limit

Generally, business-related meal and entertainment expenses are subject to the 50% limit. *Figure 28-A* can help you determine if the 50% limit applies to you.

Your meal or entertainment expense is *not* subject to the 50% limit if the expense meets the following exceptions.

**Employee's reimbursed expenses.** If you are an employee, you are not subject to the 50% limit on the amount of expenses for which your employer reimburses you under an accountable plan. Accountable plans are discussed later under *Reimbursements*.

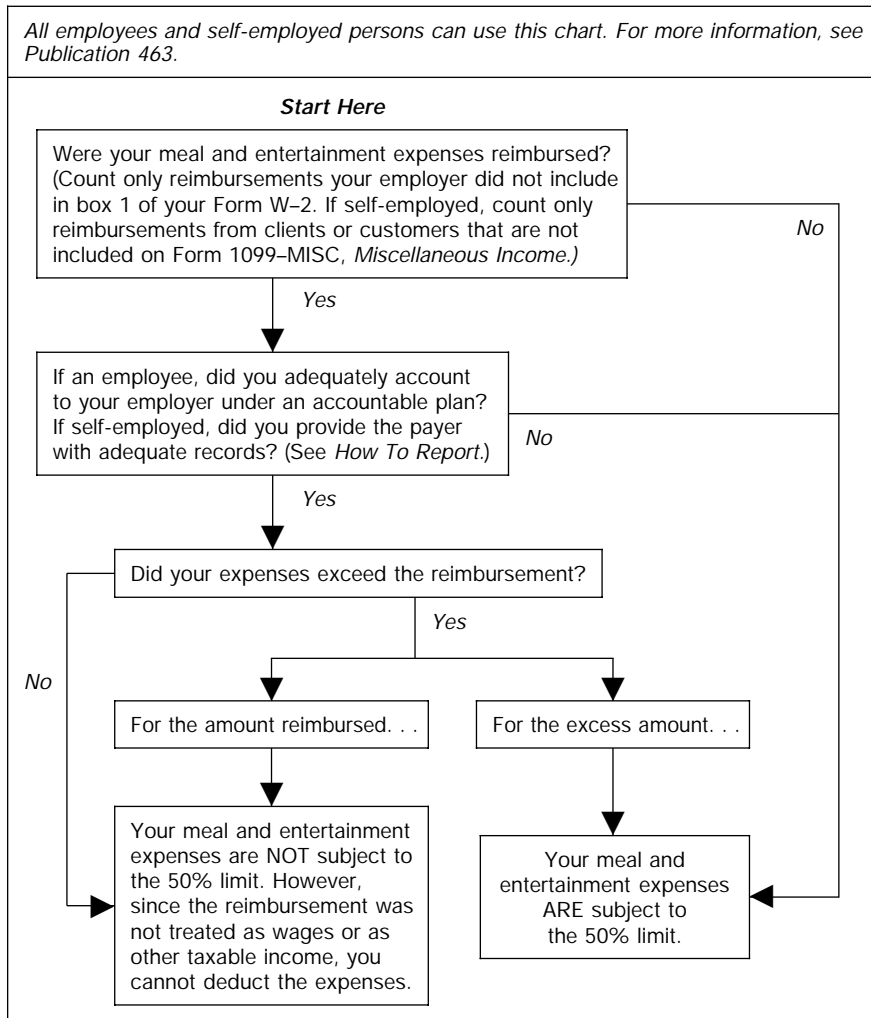
**Individuals subject to "hours of service" limits.** You can deduct a higher percentage of your meal expenses if the meals take place during or incident to any period subject to the Department of Transportation's "hours of service" limits. The percentage is 55% for 1999, and it gradually increases to 80% by the year 2008.

Individuals subject to the Department of Transportation's "hours of service" limits include the following persons.

- 1) Certain air transportation workers (such as pilots, crew, dispatchers, mechanics, and control tower operators) who are under Federal Aviation Administration regulations.
- 2) Interstate truck operators and bus drivers who are under Department of Transportation regulations.

## Figure 28–A. Does the 50% Limit Apply to Your Expenses?

There are exceptions to these rules. See *Exceptions to the 50% Limit* in chapter 2 of Publication 463.



- 3) Certain railroad employees (such as engineers, conductors, train crews, dispatchers, and control operations personnel) who are under Federal Railroad Administration regulations.
- 4) Certain merchant mariners who are under Coast Guard regulations.

## Business Gift Expenses

If you give business gifts in the course of your trade or business, you can deduct all or part of the cost. This section explains the limits and rules for deducting business gifts.

**\$25 limit on business gifts.** You can deduct no more than \$25 for business gifts you give directly or indirectly to any one person during your tax year. A gift to a company that is intended for the eventual personal use or benefit of a particular person or a limited class of people will be considered an indirect gift to that particular person or to the individuals within that class of people who receive the gift.

If you give a gift to a member of a customer's family, the gift is generally considered to be an indirect gift to the customer. This rule does not apply if you have a bona fide, independent business connection with

that family member and the gift is not intended for the customer's eventual use.

If you and your spouse both give gifts, both of you are treated as one taxpayer. It does not matter whether you have separate businesses, are separately employed, or whether each of you has an independent connection with the recipient. If a partnership gives gifts, the partnership and the partners are treated as one taxpayer.

**Incidental costs.** Incidental costs, such as engraving on jewelry, or packaging, insuring, and mailing, are generally not included in determining the cost of a gift for purposes of the \$25 limit.

A related cost is incidental only if it does not add substantial value to the gift. For example, the cost of gift wrapping is an incidental cost. However, the purchase of an ornamental basket for packaging fruit is not an incidental cost if the value of the basket is substantial compared to the value of the fruit.

**Exceptions.** The following items are not included in the \$25 limit for business gifts.

- 1) An item that costs \$4 or less and:
  - a) Has your name clearly and permanently imprinted on the gift, and
  - b) Is one of a number of identical items you widely distribute.

Examples include pens, desk sets, and plastic bags and cases.

- 2) Signs, display racks, or other promotional material to be used on the business premises of the recipient.

**Gift or entertainment.** Any item that might be considered either a gift or an entertainment expense generally will be considered an entertainment expense. However, if you give a customer packaged food or beverages that you intend the customer to use at a later date, treat it as a gift expense.

If you give a customer tickets to a theater performance or sporting event and you do not go with the customer to the performance or event, you have a choice. You can treat the cost of the tickets as either a gift expense or an entertainment expense, whichever is to your advantage.

You can change your treatment of the tickets at a later date, but not after the time allowed for the assessment of income tax. In most instances, this assessment period ends 3 years after the due date of your income tax return.

If you go with the customer to the event, you must treat the cost of the tickets as an entertainment expense. You cannot choose, in this case, to treat the cost of the tickets as a gift expense.

## Local Transportation Expenses

This section discusses expenses you can deduct for local business transportation. This includes the cost of transportation by air, rail, bus, taxi, etc., and the cost of driving and maintaining your car.

Local transportation expenses include the ordinary and necessary costs of all of the following.

- Getting from one workplace to another in the course of your business or profession when you are traveling within your tax home. (Tax home is defined earlier under *Travel Expenses*.)
- Visiting clients or customers.
- Going to a business meeting away from your regular workplace.
- Getting from your home to a temporary workplace when you have one or more regular places of work. These temporary workplaces can be either within the area of your tax home or outside that area.

Local business transportation does **not** include expenses you have while traveling away from home overnight. Those expenses are deductible as travel expenses, which are discussed earlier. However, if you use your car while traveling away from home overnight, use the rules in this section to figure your car expense deduction. See *Car Expenses*, later.

The following discussions apply to you if you have a regular or main job away from your home (residence). If your principal place of business is in your home, see *Office in the home*, later.

**Illustration of local transportation.** Figure 28–B illustrates the rules for when you can deduct local transportation expenses when you have a regular or main job

away from your home. You may want to refer to it when deciding whether you can deduct your local business transportation expenses.

**Temporary work location.** If you have one or more regular places of business away from your home and you commute to a temporary work location in the same trade or business, you can deduct the expenses of the daily round-trip transportation between your home and the temporary location.

If your employment at a work location is realistically expected to last (and does in fact last) for one year or less, the employment is temporary unless there are facts and circumstances that would indicate otherwise. If your employment at a work location is realistically expected to last for more than 1 year or if there is no realistic expectation that the employment will last for 1 year or less, the employment is not temporary, regardless of whether it actually lasts for more than 1 year. If employment at a work location initially is realistically expected to last more than 1 year, that employment will be treated as temporary (unless there are facts and circumstances that would indicate otherwise) until your expectation changes. It will not be treated as temporary after the date you determine it will last more than 1 year.



The above definition of “temporary work location” is the result of a recent change. Under the former definition, “temporary” meant an irregular or short-term basis (generally a matter of days or weeks).



You can file an amended return on Form 1040X, Amended U.S. Individual Income Tax Return, for any year that is affected by this change. However, you generally must file the amended return within three years from the time you filed the original return or within two years from the time you paid the tax, whichever is later.

If you have no regular place of work but ordinarily work in the metropolitan area where you live, you can deduct daily transportation costs between home and a temporary work site **outside** that metropolitan area. Generally, a metropolitan area includes the area within the city limits and the suburbs that are considered part of that metropolitan area. You cannot deduct daily transportation costs between your home and temporary work sites **within** your metropolitan area. These are nondeductible commuting costs.

If the temporary work location is beyond the general area of your regular place of work and you stay overnight, you are traveling away from home. You may have deductible travel expenses as discussed earlier in this chapter.

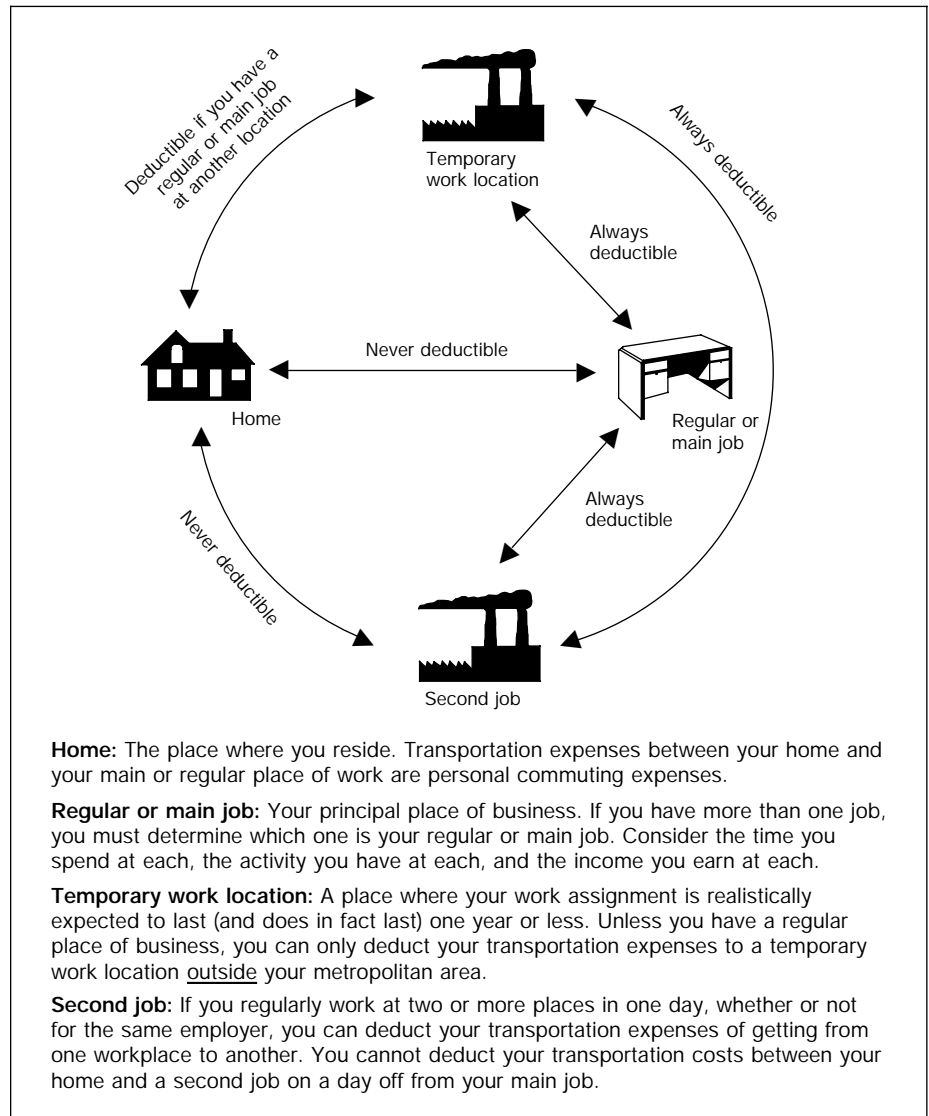
**Two places of work.** If you work at two places in one day, whether or not for the same employer, you can deduct the expense of getting from one workplace to the other. However, if for some personal reason you do not go directly from one location to the other, you cannot deduct more than the amount it would have cost you to go directly from the first location to the second.

## Figure 28-B. When Are Local Transportation Expenses Deductible?

All employees and self-employed persons can use this chart.

(Do not use this chart if your home is your principal place of business.

See *Office in the home*.)



Transportation expenses you have in going between home and a part-time job on a day off from your main job are commuting expenses. You cannot deduct them.

**Armed Forces reservists.** A meeting of an Armed Forces reserve unit is a second place of business if the meeting is held on a day on which you work at your regular job. You can deduct the expense of getting to or from one workplace to the other as just discussed under *Two places of work*.

You usually cannot deduct the expense if the reserve meeting is held on a day on which you do not work at your regular job. In this case, your transportation generally is considered a nondeductible commuting cost. However, you can deduct your transportation expenses if the location of the meeting is temporary and you have one or more regular places of work.

If you ordinarily work in a particular metropolitan area but not at any specific location and the reserve meeting is held at a temporary location outside that metropolitan area, you can deduct your transportation expenses.

If you travel away from home overnight to attend a guard or reserve meeting, you can deduct your travel expenses. These expenses are discussed earlier under *Travel Expenses*.

**Commuting expenses.** You cannot deduct the costs of taking a bus, trolley, subway, taxi, or of driving a car between **your home** and your main or regular place of work. These costs are personal commuting expenses. You cannot deduct commuting expenses no matter how far your home is from your regular place of work. You cannot deduct commuting expenses even if you work during the commuting trip.

**Example.** You had a telephone installed in your car. You sometimes use that telephone to make business calls while commuting to and from work. Sometimes business associates ride with you to and from work, and you have a business discussion in the car. These activities do not change the trip from personal to business. You cannot deduct your commuting expenses.

**Parking fees.** Fees you pay to park your car at your place of business are nondeductible commuting expenses. You can, however, deduct business-related parking fees when visiting a customer or client.

**Advertising display on car.** Putting display material that advertises your business on your car does not change the use of your car from personal use to business use. If you use this car for commuting or other personal uses, you still cannot deduct your expenses for those uses.

**Car pools.** You cannot deduct the cost of using your car in a nonprofit car pool. Do not include payments you receive from the passengers in your income. These payments are considered reimbursements of your expenses. However, if you operate a car pool for a profit, you must include payments from passengers in your income. You can then deduct your car expenses (using the rules in this chapter).

**Hauling tools or instruments.** Hauling tools or instruments in your car while commuting to and from work does not make your car expenses deductible. However, you can deduct any additional costs you have for hauling tools or instruments (such as for renting a trailer you tow with your car).

**Union members' trips from a union hall.** If you get your work assignments at a union hall and then go to your place of work, the costs of getting from the union hall to your place of work are nondeductible commuting expenses. Although you need the union to get your work assignments, you are employed where you work, not where the union hall is located.

**Office in the home.** If you have an office in your home that qualifies as a **principal place of business**, you can deduct your daily transportation costs between your home and another work location in the same trade or business. (See chapter 30 for information on determining if your home office qualifies as a principal place of business.)

If your home office does not qualify as a principal place of business, follow the general rules explained earlier.

**Examples of deductible local transportation.** The following examples show when you can deduct local transportation expenses based on the location of your work and your home.

**Example 1.** You regularly work in an office in the city where you live. Your employer sends you to a one-week training session at a different office in the same city. You travel directly from your home to the training location and return each day. You can deduct the cost of your daily round-trip transportation between your home and the training location.

**Example 2.** Your principal place of business is in your home. You can deduct the cost of round-trip transportation between your qualifying home office and your client's or customer's place of business.

**Example 3.** You have no regular office, and you do not have an office in your home. In this case, the location of your first business contact is considered your office. Transportation expenses between your home and this first contact are nondeductible commuting expenses. Transportation expenses between your last business con-

tact and your home are also nondeductible commuting expenses. Although you cannot deduct the costs of these first and last trips, you can deduct the costs of going from one client or customer to another.

## Car Expenses

If you use your car for business purposes, you may be able to deduct car expenses. You generally can use one of two methods to figure your expenses: actual expenses or the standard mileage rate. In this chapter, "car" includes a van, pickup, or panel truck.



*You may be entitled to a tax credit for an electric vehicle (see chapter 38) or a deduction from gross income for a part of the cost of a clean-fuel vehicle that you place in service during the year. The vehicle must meet certain requirements, and you do not have to use it in your business to qualify for the credit or the deduction. For more information, see chapter 15 of Publication 535.*

## Standard Mileage Rate

You may be able to use the standard mileage rate to figure the deductible cost of operating your car for business purposes. For 1999, the standard mileage rate is **32½ cents** a mile for all business miles driven before April 1. The rate is **31 cents a mile** for business miles driven after March 31. This rate is adjusted periodically.



*If you can and do choose to use the standard mileage rate for a year, you cannot deduct your actual car expenses for that year.*

You generally can use the standard mileage rate regardless of whether you are reimbursed and whether any reimbursement is more or less than the amount figured using the standard mileage rate. See *Reimbursements* under *How To Report*, later.

**Rural mail carriers.** If you are a rural mail carrier, you may be able to treat the amount of qualified reimbursement you received as the amount of your allowable expense. Because the qualified reimbursement is treated as paid under an accountable plan, your employer should not include the amount of reimbursement in your income. And, since the reimbursement equals the expense, you have no deduction to report on your tax return.

A "qualified reimbursement" is the amount of reimbursement you receive that meets both of the following conditions.

- 1) It is given as an equipment maintenance allowance (EMA) to employees of the U.S. Postal Service.
- 2) It is at the rate contained in the 1991 collective bargaining agreement. Any later agreement cannot increase the qualified reimbursement amount by more than the rate of inflation.

See your employer for information on your reimbursement.



*If you are a rural mail carrier and received a qualified reimbursement, you cannot use the standard mileage rate.*

**Choosing the standard mileage rate.** If you want to use the standard mileage rate for a car you own, you must choose to use it in the first year the car is available for use in your business. Then in later years, you can choose to use either the standard mileage rate or actual expenses.

If you want to use the standard mileage rate for a car you lease, you must use it for the entire lease period. For leases that began on or before December 31, 1997, the standard mileage rate must be used for the entire portion of the lease period (including renewals) that is after that date.

If you choose to use the standard mileage rate, you are considered to have chosen not to use the depreciation methods under the Modified Accelerated Cost Recovery System (MACRS). This is because the standard mileage rate includes an allowance for depreciation. Also, you cannot claim the section 179 deduction if you use the standard mileage rate. If you change to the actual expenses method in a later year, but before your car is considered fully depreciated, you have to estimate the remaining useful life of the car and use straight line depreciation. For information on how to figure that depreciation, see the exception in *Methods of depreciation* under *Depreciation Deduction* in chapter 4 of Publication 463.

**Standard mileage rate not allowed.** You cannot use the standard mileage rate if you:

- 1) Use the car for hire (such as a taxi),
- 2) Operate two or more cars at the same time (as in fleet operations),
- 3) Claimed a depreciation deduction using ACRS or MACRS depreciation in an earlier year,
- 4) Claimed a section 179 deduction on the car,
- 5) Claimed actual car expenses after 1997 for a car you leased, or
- 6) Are a rural mail carrier who received a qualified reimbursement. (See *Rural mail carriers*, earlier.)

**Two or more cars.** If you own two or more cars that are used for business at the same time, you cannot use the standard mileage rate for the business use of any car. However, you may be able to deduct your actual expenses for operating each of the cars in your business. See *Actual Car Expenses* in chapter 4 of Publication 463 for information on how to figure your deduction.

You are **not** using two or more cars for business at the same time if you alternate using (use at different times) the cars for business.

**Example 1.** Marcia, a salesperson, owns a car and a van that she alternates using for calling on her customers. She can use the standard mileage rate for the business mileage of the car and the van.

**Example 2.** Maureen owns a car and a van that are both used in her housecleaning business. Her employees use the van and she uses the car to travel to the various customers. Maureen cannot use the standard mileage rate for the car or the van. This is because both vehicles are used in Maureen's business at the same

time. She must use actual expenses for both vehicles.

**Parking fees and tolls.** In addition to using the standard mileage rate, you can deduct any business-related parking fees and tolls. (Parking fees that you pay to park your car at your place of work are nondeductible commuting expenses.)

## Actual Car Expenses

If you do not choose to use the standard mileage rate, you may be able to deduct your actual car expenses.



*If you qualify to use both methods, figure your deduction both ways to see which gives you a larger deduction.*

Actual car expenses include the costs of:

Depreciation	Lease payments	Registration fees
Garage rent	Licenses	Repairs
Gas	Oil	Tires
Insurance	Parking fees	Tolls

**Business and personal use.** If you use your car for both business and personal purposes, you must divide your expenses between business and personal use. You can divide based on the miles driven for each purpose.

**Example.** You are a contractor and drive your car 20,000 miles during the year: 12,000 miles for business use and 8,000 miles for personal use. You can claim only 60% (12,000 ÷ 20,000) of the cost of operating your car as a business expense.

**Interest on car loans.** If you are an employee, you cannot deduct any interest paid on a car loan. This interest is treated as personal interest and is not deductible. However, if you are self-employed and use your car in that business, see chapter 8 of Publication 535.



*If you use a home equity loan to purchase your car, you may be able to deduct the interest. See chapter 25 for more information.*

**Taxes paid on your car.** If you are an employee, you can deduct personal property taxes paid on your car if you itemize deductions. Enter the amount paid on line 7 of Schedule A (Form 1040). (See chapter 24 for more information on taxes.) If you are not an employee, see your form instructions for information on how to deduct personal property taxes paid on your car.

You cannot deduct luxury or sales taxes, even if you use your car 100% for business. Luxury and sales taxes are part of your car's basis and may be recovered through depreciation, discussed later.

**Fines and collateral.** You cannot deduct fines and collateral you pay for traffic violations.

**Depreciation and section 179 deductions.** If you use your car for business purposes as an employee or as a sole proprietor, you may be able to recover its cost by claiming a depreciation or section 179 deduction. The amount you may claim depends on the year you placed the car in

service and the amount of your business use.

For more information, see the instructions for Form 2106 (if you are an employee) or Form 4562 (if you are self-employed). Also see chapter 4 of Publication 463 for a detailed discussion of these deductions.

**Leasing a car.** If you lease a car that you use in your business, you can use the standard mileage rate or actual expenses to figure your deductible car expense.

**Deductible payments.** You can deduct the part of each lease payment that is for the use of the car in your business. You cannot deduct any part of a lease payment that is for personal use of the car, such as commuting.

You must spread any advance payments over the entire lease period. You cannot deduct any payments you make to buy a car, even if the payments are called lease payments.

If you lease a car for 30 days or more, you may have to reduce your lease payment deduction by an "inclusion amount." For information on reporting lease inclusion amounts, see *Leasing a Car* in chapter 4 of Publication 463.

## Sale, Trade-in, or Other Disposition

If you sell, trade in, or otherwise dispose of your car, you may have a taxable gain or a deductible loss. This is true whether you used the standard mileage rate or actual car expenses to deduct the business use of your car. Chapter 15 has information on sales of property. For details on how to report the disposition, see Publication 544.

## Recordkeeping

If you deduct travel, entertainment, business gift, or local transportation expenses, you must be able to prove (substantiate) certain elements of the expense. This section discusses the records you need to keep to prove these expenses.



If you keep timely and accurate records, you will have support to show the IRS if your tax return is ever examined. You will also have proof of expenses that your employer may require if you are reimbursed under an accountable plan. These plans are discussed later under *Reimbursements*.

## How To Prove Expenses

Table 28-2 is a summary of records you need to prove each expense discussed in this chapter. You must be able to prove the elements listed across the top of the chart. You prove them by having the information and receipts (where needed) for the expenses listed in the first column.



*You cannot deduct amounts that you approximate or estimate.*

You should keep adequate records to prove your expenses or have sufficient evidence that will support your own statement. You must generally prepare a written record for it to be considered adequate. This is because written evidence is more reliable

than oral evidence alone. However, if you prepare a record in a computer memory device with the aid of a logging program, it is considered an adequate record.

## Adequate Records

You should keep the proof you need in an account book, diary, statement of expense, or similar record. You should also keep documentary evidence that, together with your records, will support each element of an expense.

**Documentary evidence.** You generally must have documentary evidence, such as receipts, canceled checks, or bills, to support your expenses.

**Exception.** Documentary evidence is not needed if any of the following conditions apply.

- 1) You have meals or lodging expenses while traveling away from home for which you account to your employer under an accountable plan and you use a per diem allowance method that includes meals and/or lodging. (Accountable plans and per diem allowances are discussed later under *Reimbursements*.)
- 2) Your expense, other than lodging, is less than \$75.
- 3) You have a transportation expense for which a receipt is not readily available.

**Adequate evidence.** Documentary evidence ordinarily will be considered adequate if it shows the amount, date, place, and essential character of the expense.

For example, a hotel receipt is enough to support expenses for business travel if it has all of the following information.

- 1) The name and location of the hotel.
- 2) The dates you stayed there.
- 3) Separate amounts for charges such as lodging, meals, and telephone calls.

A restaurant receipt is enough to prove an expense for a business meal if it has all of the following information.

- 1) The name and location of the restaurant.
- 2) The number of people served.
- 3) The date and amount of the expense.

If a charge is made for items other than food and beverages, the receipt must show that this is the case.

**Canceled check.** A canceled check, together with a bill from the payee, ordinarily establishes the cost. However, a canceled check by itself does not prove a business expense without other evidence to show that it was for a business purpose.

**Duplicate information.** You do not have to record information in your account book or other record that duplicates information shown on a receipt as long as your records and receipts complement each other in an orderly manner.

You do not have to record amounts your employer pays directly for any ticket or other travel item. However, if you charge these items to your employer, through a credit card or otherwise, you must keep a record of the amounts you spend.

Table 28–2. **How To Prove Certain Business Expenses**

IF you have expenses for:	THEN you must keep records that show details of the following elements.			
	Amount	Time	Place or Description	Business Purpose and Business Relationship
<b>Travel</b>	Cost of each separate expense for travel, lodging, and meals. Incidental expenses may be totaled in reasonable categories such as taxis, daily meals for traveler, etc.	Dates you left and returned for each trip and number of days spent on business.	Destination or area of your travel (name of city, town, or other designation).	<u>Purpose:</u> Business purpose for the expense or the business benefit gained or expected to be gained.  <u>Relationship:</u> N/A
<b>Entertainment</b>	Cost of each separate expense. Incidental expenses such as taxis, telephones, etc., may be totaled on a daily basis.	Date of entertainment. (Also see <i>Business Purpose</i> .)	Name and address or location of place of entertainment. Type of entertainment if not otherwise apparent. (Also see <i>Business Purpose</i> .)	<u>Purpose:</u> Business purpose for the expense or the business benefit gained or expected to be gained. For entertainment, the nature of the business discussion or activity. If the entertainment was directly before or after a business discussion: the date, place, nature, and duration of the business discussion, and the identities of the persons who took part in both the business discussion and the entertainment activity.  <u>Relationship:</u> Occupations or other information (such as names, titles, or other designations) about the recipients that shows their business relationship to you. For entertainment, you must also prove that you or your employee was present if the entertainment was a business meal.
<b>Gifts</b>	Cost of the gift.	Date of the gift.	Description of the gift.	
<b>Transportation (Car)</b>	Cost of each separate expense. For car expenses, the cost of the car and any improvements, the date you started using it for business, the mileage for each business use, and the total miles for the year.	Date of the expense. For car expenses, the date of the use of the car.	Your business destination (name of city, town, or other designation).	<u>Purpose:</u> Business purpose for the expense.  <u>Relationship:</u> N/A

**Timely-kept records.** You should record the elements of an expense or of a business use at or near the time of the expense or use and support it with sufficient documentary evidence. A timely-kept record has more value than a statement prepared later when generally there is a lack of accurate recall.

You do not need to write down the elements of every expense on the day of the expense. If you maintain a log on a weekly basis which accounts for use during the week, the log is considered a timely-kept record.

If you give your employer, client, or customer an expense account statement, it can also be considered a timely-kept record.

**Proving business purpose.** You must generally provide a written statement of the business purpose of an expense. However, the degree of proof varies according to the circumstances in each case. If the business purpose of an expense is clear from the surrounding circumstances, then you do not need to give a written explanation.

**Confidential information.** You do not need to put confidential information relating to an element of a deductible expense (such as the place, business purpose, or business relationship) in your account book, diary, or other record. However, you do have to record the information elsewhere at or near the time of the expense and have it available to fully prove that element of the expense.

**Incomplete Records**

If you do not have complete records to prove an element of an expense, then you must prove the element by:

- 1) Your own written or oral statement, containing specific information about the element, and
- 2) Other supporting evidence that is sufficient to establish the element.

**Destroyed records.** If you cannot produce a receipt because of reasons beyond your control, you can prove a deduction by reconstructing your records or expenses. Reasons beyond your control include fire, flood, and other casualty.

**Additional Rules**

This section explains when expenses must be kept separate and when expenses can be combined.

**Separating expenses.** Each separate payment is generally considered a separate expense. For example, if you entertain a customer or client at dinner and then go to the theater, the dinner expense and the cost of the theater tickets are two separate expenses. You must record them separately in your records.

**Combining items.** You can make one daily entry in your record for reasonable categories of expenses. Examples are taxi fares, telephone calls, or other incidental travel costs. Meals should be in a separate category. You can include tips with the costs of the services you received.

Expenses of a similar nature occurring during the course of a single event are considered a single expense. For example, if during entertainment at a cocktail lounge, you pay separately for each serving of refreshments, the total expense for the refreshments is treated as a single expense.



**Allocating total cost.** If you can prove the total cost of travel or entertainment but you cannot prove how much it cost for each person who participated in the event, you may have to allocate the total cost among you and your guests on a pro rata basis. An allocation would be needed, for example, if you did not have a business relationship with all of your guests.

**If your return is examined.** If your return is examined, you may have to provide additional information to the IRS. This information could be needed to clarify or to establish the accuracy or reliability of information contained in your records, statements, testimony, or documentary evidence before a deduction is allowed.

## How Long To Keep Records and Receipts

You must keep records as long as they may be needed for the administration of any provision of the Internal Revenue Code. Generally, this means you must keep your records that support your deduction (or an item of income) for 3 years from the date you file the income tax return on which the deduction is claimed. A return filed early is considered filed on the due date. For a more complete explanation, get Publication 583, *Starting a Business and Keeping Records*.

**Reimbursed for expenses.** Employees who give their records and documentation to their employers and are reimbursed for their expenses generally do not have to keep copies of this information. However, you may have to prove your expenses if any of the following conditions apply.

- 1) You claim deductions for expenses that are more than reimbursements.
- 2) Your expenses are reimbursed under a nonaccountable plan.
- 3) Your employer does not use adequate accounting procedures to verify expense accounts.
- 4) You are related to your employer, as defined earlier under *Standard Meal Allowance*.

See the next section, *How To Report*, for a discussion of reimbursements, adequate accounting, and nonaccountable plans.

**Additional information.** Chapter 5 of Publication 463 has more information on recordkeeping, including examples.

## How To Report

This section explains where and how to report the expenses discussed in this chapter. It discusses reimbursements and how to treat them under accountable and nonaccountable plans. It also explains rules for fee-basis officials, certain performing artists, and certain disabled employees. This section ends with an illustration of how to report travel, entertainment, gift, and car expenses on Form 2106-EZ.

**Self-employed.** You must report your income and expenses on Schedule C or C-EZ (Form 1040) if you are a sole proprietor, or on Schedule F (Form 1040) if you

are a farmer. You do not use Form 2106 or 2106-EZ. See your form instructions for information on how to complete your tax return. You can also find information in chapter 16 of Publication 535 if you are a sole proprietor, or in Publication 225, *Farmer's Tax Guide*, if you are a farmer.

**Both self-employed and an employee.** If you are both self-employed and an employee, you must keep separate records for each business activity. Report your business expenses for self-employment on Schedule C, C-EZ, or F (Form 1040), as discussed earlier. Report your business expenses for your work as an employee on Form 2106 or 2106-EZ, as discussed next.

**Employees.** If you are an employee, you generally must complete Form 2106 to deduct your travel, transportation, and entertainment expenses. However, you can use the shorter Form 2106-EZ instead of Form 2106 if you meet both of the following conditions.

- 1) You were not reimbursed for your expenses or, if you were reimbursed, the reimbursement was included in your income (box 1 of your Form W-2).
- 2) If you claim car expenses, you use the standard mileage rate.

For more information on how to report your expenses on Forms 2106 and 2106-EZ, see *Completing Forms 2106 and 2106-EZ*, later.

**Gifts.** If you did not receive any reimbursements (or the reimbursements were all included in box 1 of your Form W-2), the only business expense you are claiming is for business gifts, and the rules for certain individuals (such as performing artists), discussed later under *Special Rules*, do not apply to you, do not complete Form 2106 or 2106-EZ. Instead, claim the amount of your deductible business gifts directly on line 20 of Schedule A (Form 1040).

**Statutory employees.** If you received a Form W-2 and the "Statutory employee" box in box 15 was checked, you report your income and expenses related to that income on Schedule C or C-EZ (Form 1040). Do not complete Form 2106 or 2106-EZ.

Statutory employees include full-time life insurance salespersons, certain agent or commission drivers, traveling salespersons, and certain homeworkers.



*If you are entitled to a reimbursement from your employer but you do not claim it, you cannot claim a deduction for the expenses to which that unclaimed reimbursement applies.*

**Reimbursement for personal expenses.** If your employer reimburses you for non-deductible personal expenses, such as for vacation trips, your employer must report the reimbursement as wage income in box 1 of your Form W-2. You cannot deduct personal expenses.

## Reimbursements

This section explains what to do when you receive an advance or are reimbursed for any of the employee business expenses discussed in this chapter.

If you received an advance, allowance, or reimbursement for your expenses, how

you report this amount and your expenses depends on whether the reimbursement was paid to you under an accountable plan or a nonaccountable plan.

This section explains the two types of plans, how per diem and car allowances simplify proving the amount of your expenses, and the tax treatment of your reimbursements and expenses.

**No reimbursement.** You are not reimbursed or given an allowance for your expenses if you are paid a salary or commission with the understanding that you will pay your own expenses. In this situation, you have no reimbursement or allowance arrangement, and you do not have to read this section on reimbursements. Instead, see *Completing Forms 2106 and 2106-EZ*, later, for information on completing your tax return.

**Reimbursement, allowance, or advance.** A reimbursement or other expense allowance arrangement is a system or plan that an employer uses to pay, substantiate, and recover the expenses, advances, reimbursements, and amounts charged to the employer for employee business expenses. Arrangements include per diem and car allowances.

A per diem allowance is a fixed amount of daily reimbursement your employer gives you for your lodging, meal, and incidental expenses when you are away from home on business. (The term "incidental expenses" is defined earlier under *Standard Meal Allowance*.) A car allowance is an amount your employer gives you for the business use of your car.

Your employer should tell you what method of reimbursement is used and what records you must provide.

## Accountable Plans

To be an accountable plan, your employer's reimbursement or allowance arrangement must include all three of the following rules.

- 1) Your expenses must have a business connection — that is, you must have paid or incurred deductible expenses while performing services as an employee of your employer.
- 2) You must adequately account to your employer for these expenses within a reasonable period of time.
- 3) You must return any excess reimbursement or allowance within a reasonable period of time.

See *Adequate Accounting and Returning Excess Reimbursements*, later.

An **excess reimbursement or allowance** is any amount you are paid that is more than the business-related expenses that you adequately accounted for to your employer. See *Returning Excess Reimbursements*, later, for information on how to handle these excess amounts.

The definition of **reasonable period of time** depends on the facts and circumstances of your situation. However, regardless of the facts and circumstances of your situation, actions that take place within the times specified in the following list will be treated as taking place within a reasonable period of time.

- 1) You receive an advance within 30 days of the time you have an expense.
- 2) You adequately account for your expenses within 60 days after they were paid or incurred.
- 3) You return any excess reimbursement within 120 days after the expense was paid or incurred.
- 4) You are given a periodic statement (at least quarterly) that asks you to either return or adequately account for outstanding advances **and** you comply within 120 days of the statement.

#### Employee meets accountable plan rules.

If you meet the three rules for accountable plans, your employer should not include any reimbursements in your income in box 1 of your Form W-2. If your expenses equal your reimbursement, you do not complete Form 2106. You have no deduction since your expenses and reimbursement are equal.

**TIP** *If your employer included reimbursements in box 1 of your Form W-2 and you meet all three rules for accountable plans, ask your employer for a corrected Form W-2.*

**Accountable plan rules not met.** Even though you are reimbursed under an accountable plan, some of your expenses may not meet all three rules. Those expenses that fail to meet all three rules for accountable plans are treated as having been reimbursed under a nonaccountable plan (discussed later).

**Reimbursement of nondeductible expenses.** You may be reimbursed under your employer's accountable plan for expenses related to that employer's business, some of which are deductible as employee business expenses and some of which are not deductible. The reimbursements you receive for the nondeductible expenses do not meet rule (1) for accountable plans, and they are treated as paid under a nonaccountable plan.

**Example.** Your employer's plan may reimburse you for travel expenses while away from home on business and also for meals when you work late at the office, even though you are not away from home. The part of the arrangement that reimburses you for the nondeductible meals when you work late at the office is treated as paid under a nonaccountable plan.

**TIP** *The employer makes the decision whether to reimburse employees under an accountable plan or a nonaccountable plan. If you are an employee who receives payments under a nonaccountable plan, you cannot convert these amounts to payments under an accountable plan by voluntarily accounting to your employer for the expenses and voluntarily returning excess reimbursements to the employer.*

### Adequate Accounting

One of the three rules for an accountable plan is that you must adequately account to your employer for your expenses. You adequately account by giving your employer documentary evidence of your travel, mileage, and other employee business expenses, such as receipts, along with either

a statement of expense, an account book, a diary, or a similar record in which you entered each expense at or near the time you had it. (See *Recordkeeping*, earlier.)

You must account for **all** amounts you received from your employer during the year as advances, reimbursements, or allowances. This includes amounts you charged to your employer by credit card or other method. You must give your employer the same type of records and supporting information that you would have to give to the IRS if the IRS questioned a deduction on your return. You must pay back the amount of any reimbursement or other expense allowance for which you do not adequately account or that is more than the amount for which you accounted.

### Per Diem and Car Allowances

If your employer reimburses you for your expenses using a per diem or a car allowance, you can generally use the allowance as proof for the amount of your expenses. A per diem or car allowance satisfies the adequate accounting requirements for the amount of your expenses only if all four of the following conditions apply.

- 1) Your employer reasonably limits payments of the travel expenses to those that are ordinary and necessary in the conduct of the trade or business.
- 2) The allowance is similar in form to and not more than the federal rate (defined later).
- 3) You prove the time (dates), place, and business purpose of your expenses to your employer (as explained in *Table 28-2*) within a reasonable period of time.
- 4) You are not related to your employer (as defined earlier under *Standard Meal Allowance*). If you are related to your employer, you must be able to prove your expenses to the IRS even if you have already adequately accounted to your employer and returned any excess reimbursement.

If the IRS finds that an employer's travel allowance practices are not based on reasonably accurate estimates of travel costs (including recognition of cost differences in different areas for per diem amounts), you will not be considered to have accounted to your employer. In this case, you must be able to prove your expenses to the IRS.

**The federal rate.** The federal rate can be figured using any one of the following methods.

- 1) For per diem amounts:
  - a) The regular federal per diem rate.
  - b) The standard meal allowance.
  - c) The high-low rate.
- 2) For car expenses:
  - a) The standard mileage rate.
  - b) A fixed and variable rate (FAVR).

**Regular federal per diem rate.** The regular federal per diem rate is the highest amount that the federal government will pay to its employees for lodging, meal, and incidental expenses (or meal and incidental expenses only) while they are traveling

away from home in a particular area. The rates are different for different locations. Your employer should have these rates available. (Employers can get Publication 1542, which gives the rates in the continental United States for the current year.)

**The standard meal allowance.** The standard meal allowance (discussed earlier) is the federal rate for meals and incidental expenses (M&IE). The rate for most areas of the United States is \$30. Areas qualifying for higher rates are listed in *Appendix A* in Publication 463.

You receive an allowance for meals and incidental expenses only when your employer does one of the following.

- 1) Provides you with lodging (furnishes it in kind).
- 2) Reimburses you, based on your receipts, for the actual cost of your lodging.
- 3) Pays the hotel, motel, etc., directly for your lodging.
- 4) Does not have a reasonable belief that you had (or will have) lodging expenses, such as when you stay with friends or relatives or sleep in the cab of your truck.
- 5) Computes the allowance on a basis similar to that used in computing your compensation, such as number of hours worked or miles traveled.

**High-low rate.** This is a simplified method of computing the federal per diem rate for travel within the continental United States. It eliminates the need to keep a current list of the per diem rate for each city.

Under the high-low method, the per diem amount for travel during 1999 is \$185 (including \$42 for M&IE) for certain high-cost locations. All other areas have a per diem amount of \$115 (including \$34 for M&IE). (Employers can get Publication 1542, which gives the areas eligible for the \$185 per diem amount under the high-low method for all or part of the year.)

**Prorating the standard meal allowance on partial days of travel.** The standard meal allowance is for a full 24-hour day of travel. If you travel for part of a day, such as on the days you depart and return, you must prorate the full-day M&IE rate. These rules apply whether your employer uses the regular federal per diem rate or the high-low rate.

You can use either of the following methods to figure the federal M&IE for that day.

- 1) **Method 1:**
  - a) For the day you depart, add  $\frac{3}{4}$  of the standard meal allowance amount for that day.
  - b) For the day you return, add  $\frac{3}{4}$  of the standard meal allowance amount for the preceding day.
- 2) **Method 2:** Prorate the standard meal allowance using any method that you consistently apply and that is in accordance with reasonable business practice.

**The standard mileage rate.** This is a set rate per mile that you can use to compute your deductible car expenses. For 1999, the standard mileage rate is **32½**

**cents a mile** for all business miles driven before April 1. The rate is **31 cents a mile** for business miles driven after March 31. This rate is adjusted periodically.

**Fixed and variable rate (FAVR).** This is an allowance your employer may use to reimburse your car expenses. Under this method, your employer pays an allowance that includes a combination of payments covering fixed and variable costs, such as a cents-per-mile rate to cover your variable operating costs (such as gas, oil, etc.) plus a flat amount to cover your fixed costs (such as depreciation (or lease payments), insurance, etc.). If your employer chooses to use this method, your employer will request the necessary records from you.

**Reporting your expenses with a per diem or car allowance.** If your reimbursement is in the form of an allowance received under an accountable plan, the following two facts affect your reporting.

- 1) The federal rate.
- 2) Whether the allowance or your actual expenses were more than the federal rate.

The following discussions explain where to report your expenses depending upon how the amount of your allowance compares to the federal rate.

**Allowance LESS than or EQUAL to the federal rate.** If your allowance is less than or equal to the federal rate, the allowance will not be included in box 1 of your Form W-2. You do not need to report the related expenses or the allowance on your return if your expenses are equal to or less than the allowance.

However, if your actual expenses are more than your allowance, you can complete Form 2106 and deduct the excess amount on Schedule A (Form 1040). If you are using actual expenses, you must be able to prove to the IRS the total amount of your expenses and reimbursements for the entire year. If you are using the standard meal allowance or the standard mileage rate, you do not have to prove that amount.

**Example.** Nicole drives 10,000 miles a year for business. Under her employer's accountable plan, she accounts for the time (dates), place, and business purpose of each trip. Her employer pays her a mileage allowance of 20 cents a mile.

Since Nicole's \$3,137.50 (\$812.50 + \$2,325) expenses computed under the standard mileage rate (2,500 miles × 32½ cents and 7,500 miles × 31 cents) are more than her \$2,000 reimbursement (10,000 miles × 20 cents), she itemizes her deductions to claim the excess expenses. Nicole completes Form 2106 (showing **all** of her expenses and reimbursements) and enters \$1,137.50 (\$3,137.50 – \$2,000) as an itemized deduction.

**Allowance MORE than the federal rate.** If your allowance is more than the federal rate, your employer must include the allowance amount up to the federal rate in box 13 of your Form W-2. This amount is not taxable. However, the excess allowance will be included in box 1 of your Form W-2. You must report this part of your allowance as if it were wage income.

If your actual expenses are less than or equal to the federal rate, you do not complete Form 2106 or claim any of your expenses on your return.

However, if your actual expenses are more than the federal rate, you can complete Form 2106 and, generally, deduct those excess expenses. You must report on Form 2106 your reimbursements up to the federal rate (as shown in box 13 of your Form W-2) and all your expenses. You should be able to prove these amounts to the IRS.

**Example.** Joe lives and works in Austin. His employer sent him to San Diego for 4 days and paid the hotel directly for Joe's hotel bill. The employer reimbursed Joe \$50 a day for his meals and incidental expenses. The federal rate for San Diego is \$46 a day.

Joe can prove that his actual meal expenses totaled \$290. His employer's accountable plan will not pay more than \$50 a day for travel to San Diego, so Joe does not give his employer the records that prove that he actually spent \$290. However, he does account for the time, place, and business purpose of the trip. This is Joe's only business trip this year.

Joe was reimbursed \$200 (\$50 × 4 days), which is \$16 more than the federal rate of \$184 (\$46 × 4 days). The employer includes the \$16 as income on Joe's Form W-2 in box 1. The employer also enters \$184 in box 13 of Joe's Form W-2, along with a code L.

Joe completes Form 2106 to figure his deductible expenses. He enters the total of his actual expenses for the year (\$290) on Form 2106. He also enters the reimbursements that were not included in his income (\$184). His total deductible expense, before the 50% limit, is \$106. After he figures the 50% limit on his unreimbursed meals and entertainment, he will include the balance, \$53, as an itemized deduction.

## Returning Excess Reimbursements

Under an accountable plan, you are required to return any excess reimbursement for your business expenses to the person paying the reimbursement or allowance. **Excess reimbursement** means any amount for which you did not adequately account within a reasonable period of time. For example, if you received a travel advance and you did not spend all the money on business-related expenses, or if you do not have proof of all your expenses, you have an excess reimbursement.

"Adequate accounting" and "reasonable period of time" were discussed earlier.

**Travel advance.** You receive a travel advance if your employer provides you with an expense allowance before you actually have the expense, and the allowance is reasonably expected to be no more than your expense. Under an accountable plan, you are required to adequately account to your employer for this advance and to return any excess within a reasonable period of time.

If you do not adequately account for or do not return any excess advance within a reasonable period of time, the amount you do not account for or return will be treated

as having been paid under a nonaccountable plan (discussed later).

**Unproved amounts.** If you do not prove that you actually traveled on each day for which you received a per diem or car allowance (proving the elements described in Table 28-2), you must return this unproved amount of the travel advance within a reasonable period of time. If you do not do this, the unproved amount is considered paid under a nonaccountable plan (discussed later).

**Per diem allowance MORE than federal rate.** If your employer's accountable plan pays you an allowance that is higher than the federal rate, you do not have to return the difference between the two rates for the period you can prove business-related travel expenses. However, the difference will be reported as wages on your Form W-2. This excess amount is considered paid under a nonaccountable plan (discussed later).

**Example.** Your employer sends you on a 5-day business trip to Phoenix and gives you a \$225 (\$45 × 5 days) advance to cover your meals and incidental expenses. The federal per diem for meals and incidental expenses for Phoenix is \$38. Your trip lasts only 3 days. Under your employer's accountable plan, you must return the \$90 (\$45 × 2 days) advance for the 2 days you did not travel. You do not have to return the \$21 difference between the allowance you received and the federal rate for Phoenix [(\$45 – \$38) × 3 days]. However, the \$21 will be reported on your Form W-2 as wages.

## Nonaccountable Plans

A nonaccountable plan is a reimbursement or expense allowance arrangement that does not meet one or more of the three rules listed earlier under *Accountable Plans*.

In addition, even if your employer has an accountable plan, the following payments will be treated as being paid under a nonaccountable plan.

- 1) Excess reimbursements you fail to return to your employer.
- 2) Reimbursements of nondeductible expenses related to your employer's business. See *Reimbursement of non-deductible expenses* earlier under *Accountable Plans*.

If you are not sure if the reimbursement or expense allowance arrangement is an accountable or nonaccountable plan, ask your employer.

**Reporting your expenses under a nonaccountable plan.** Your employer will combine the amount of any reimbursement or other expense allowance paid to you under a nonaccountable plan with your wages, salary, or other pay. Your employer will report the total in box 1 of your Form W-2.

You must complete Form 2106 or 2106-EZ and itemize your deductions to deduct your expenses for travel, transportation, meals, or entertainment. Your meal and entertainment expenses will be subject to the 50% limit discussed earlier under *Entertainment Expenses*. Also, your total expenses will be subject to the 2%-of-adjusted-gross-income limit that applies to most miscellaneous itemized deductions.

**Example.** Kim's employer gives her \$500 a month (\$6,000 for the year) for her business expenses. Kim does not have to provide any proof of her expenses to her employer, and Kim can keep any funds that she does not spend.

Kim is being reimbursed under a non-accountable plan. Her employer will include the \$6,000 on Kim's Form W-2 as if it were wages. If Kim wants to deduct her business expenses, she must complete Form 2106 or 2106-EZ and itemize her deductions.

## Completing Forms 2106 and 2106-EZ

This section briefly describes how employees complete Forms 2106 and 2106-EZ. *Table 28-3* explains what the employer reports on Form W-2 and what the employee reports on Form 2106. The instructions for the forms have more information on completing them.

**Form 2106-EZ.** You may be able to use the shorter Form 2106-EZ to claim your employee business expenses. You can use this form if you meet both of the following conditions.

- 1) You were not reimbursed for your expenses or, if you were reimbursed, the reimbursement was included in your income (box 1 of your Form W-2).
- 2) If you claim car expenses, you use the standard mileage rate.

**Car expenses.** If you used a car to perform your job as an employee, you may be able to deduct certain car expenses. These are generally figured in Part II of Form 2106, and then claimed on line 1, Column A, of Part I of Form 2106. Car expenses using the standard mileage rate can also be figured on Form 2106-EZ by completing Part II and line 1 of Part I.

**Local transportation expenses.** Show your local business transportation expenses that did not involve overnight travel on line 2, Column A, of Form 2106 or on line 2, Part I, of Form 2106-EZ. Also include on this line business expenses you have for parking fees and tolls. Do not include expenses of operating your car or expenses of commuting between your home and work.

**Employee business expenses other than meals and entertainment.** Show your other employee business expenses on lines 3 and 4, Column A, of Form 2106 or lines 3 and 4 of Form 2106-EZ. Do not include expenses for meals and entertainment on those lines. Line 4 is for expenses such as business gifts, educational expenses (tuition and books), office-in-the-home expenses, and trade and professional publications.

**TIP** *If line 4 expenses are the only ones you are claiming, you received no reimbursements (or the reimbursements were all included in box 1 of your Form W-2), and the Special Rules discussed later do not apply to you, do not complete Form 2106 or 2106-EZ. Claim these amounts directly on line 20 of Schedule A (Form 1040). List the type and amount of each expense on the dotted lines and include the total on line 20.*

Table 28-3. Reporting Travel, Entertainment, Gift, and Car Expenses and Reimbursements

IF the type of reimbursement (or other expense allowance) arrangement is under:	THEN the employer reports on Form W-2:	AND the employee reports on Form 2106: *
<b>An accountable plan with:</b>		
<i>Actual expense reimbursement:</i> Adequate accounting made <u>and</u> excess returned	No amount.	No amount.
<i>Actual expense reimbursement:</i> Adequate accounting and return of excess both required <u>but</u> excess not returned	The excess amount as wages in box 1.	No amount.
<i>Per diem or mileage allowance up to the federal rate:</i> Adequate accounting made <u>and</u> excess returned	No amount.	All expenses and reimbursements only if excess expenses are claimed. Otherwise, form is not filed.
<i>Per diem or mileage allowance up to the federal rate:</i> Adequate accounting and return of excess both required <u>but</u> excess not returned	The excess amount as wages in box 1. The amount up to the federal rate is reported only in box 13—it is not reported in box 1.	No amount.
<i>Per diem or mileage allowance exceeds the federal rate:</i> Adequate accounting up to the federal rate only <u>and</u> excess not returned.	The excess amount as wages in box 1. The amount up to the federal rate is reported only in box 13—it is not reported in box 1.	All expenses (and reimbursements reported on Form W-2, box 13) only if expenses in excess of the federal rate are claimed. Otherwise, form is not filed.
<b>A nonaccountable plan with:</b>		
Either adequate accounting or return of excess, or both, not required by plan	The entire amount as wages in box 1.	All expenses.
<b>No reimbursement plan:</b>	The entire amount as wages in box 1.	All expenses.

\* You may be able to use Form 2106-EZ. See *Completing Forms 2106 and 2106-EZ*.

**Meal and entertainment expenses.** Show the full amount of your expenses for business-related meals and entertainment on line 5, Column B, of Form 2106. Include meals while away from your tax home overnight and other business meals and entertainment. Enter 50% of the line 8 meal and entertainment expenses on line 9, Column B, of Form 2106.

If you file Form 2106-EZ, enter the full amount of your meals and entertainment on the line to the left of line 5 and multiply the total by 50%. Enter the result on line 5.

**Hours of service limits.** If you are subject to the Department of Transportation's "hours of service" limits (as explained earlier under *Individuals subject to "hours of service" limits*), use 55% instead of 50% and write "DOT" to the left of line 9 of Form 2106 or line 5 of Form 2106-EZ.

**Reimbursements.** Enter on line 7 of Form 2106 the amounts your employer (or third party) reimbursed you that were **not** included in box 1 of your Form W-2. (You cannot use Form 2106-EZ.) This includes

any reimbursement reported under code **L** in box 13 of Form W-2.

**Allocating your reimbursement.** If you were reimbursed under an accountable plan and want to deduct excess expenses that were not reimbursed, you may have to allocate your reimbursement. This is necessary if your employer pays your reimbursement in the following manner:

- 1) Pays you a single amount that covers meals and/or entertainment, as well as other business expenses, and
- 2) Does not clearly identify how much is for deductible meals and/or entertainment.

You must allocate the reimbursement so that you know how much to enter in Column A and Column B of line 7 of Form 2106.

**Example.** Rob's employer paid him an expense allowance of \$5,000 this year under an accountable plan. The \$5,000 payment consisted of \$2,000 for airfare and \$3,000 for entertainment and car expenses. The employer did not clearly show how

much of the \$3,000 was for the cost of deductible entertainment. Rob actually spent \$6,500 during the year (\$2,000 for airfare, \$2,000 for entertainment, and \$2,500 for car expenses).

Since the airfare allowance was clearly identified, Rob knows that \$2,000 of the payment goes in Column A, line 7 of Form 2106. To allocate the remaining \$3,000, Rob uses the worksheet from the instructions for Form 2106. His completed worksheet follows.

1. Enter the total amount of reimbursements your employer gave you that <b>were not</b> reported to you in box 1 of Form W-2 .....	3,000
2. Enter the total amount of your expenses for the periods covered by this reimbursement .....	4,500
3. Of the amount on line 2, enter your total expense for meals and entertainment .....	2,000
4. Divide line 3 by line 2. Enter the result as a decimal (rounded to two places) .....	.44
5. Multiply line 1 by line 4. Enter the result here and in Column B, line 7 ..	1,320
6. Subtract line 5 from line 1. Enter the result here and in Column A, line 7 ..	1,680

On line 7 of Form 2106, Rob enters \$3,680 (\$2,000 airfare and \$1,680 of the \$3,000) in Column A and \$1,320 (of the \$3,000) in Column B.

**After you complete the form.** After you have completed your Form 2106 or 2106-EZ, follow the directions on that form to deduct your expenses on the appropriate line of your tax return. For most taxpayers, this is on line 20 of Schedule A (Form 1040). However, if you are a government official paid on a fee basis, a performing artist, or a disabled employee with impairment-related work expenses, see *Special Rules*, later.

**Limits on employee business expenses.** Your employee business expenses may be subject to any of the three limits described next. These limits are figured in the following order on the specified form.

**1. Limit on meals and entertainment.**

Certain meal and entertainment expenses are subject to a 50% limit. Employees figure this limit on line 9 of Form 2106 or line 5 of Form 2106-EZ. See *50% Limit* under *Entertainment Expenses*, earlier.

**2. Limit on employee business expenses.**

Employees deduct employee business expenses (as figured on Form 2106 or 2106-EZ) on line 20 of Schedule A (Form 1040). Most miscellaneous itemized deductions, including employee business expenses, are subject to a 2%-of-adjusted-gross-income limit. This limit is figured on line 25 of Schedule A (Form 1040).

**3. Limit on total itemized deductions.**

If your adjusted gross income (line 33 of Form 1040) is more than \$126,600 (\$63,300 if you are married filing separately), the total of certain itemized deductions, including employee business expenses, may be limited. See chapter 22 for more information on this limit.

## Special Rules

This section discusses special rules that apply only to government officials who are paid on a fee basis, performing artists, and disabled employees with impairment-related work expenses.

**Officials paid on a fee basis.** Certain fee-basis officials can claim their employee business expenses whether or not they itemize their other deductions on Schedule A (Form 1040).

Fee-basis officials are persons who are employed by a state or local government and who are paid in whole or in part on a fee basis. They can deduct their business expenses in performing services in that job as an adjustment to gross income rather than as a miscellaneous itemized deduction.

If you are a fee-basis official, include your employee business expenses from line 10 of Form 2106 or line 6 of Form 2106-EZ in the total on line 32 of Form 1040. Write "FBO" and the amount of your employee business expenses in the space to the left of line 32 of Form 1040.



*This special rule is retroactive to 1987, and you can file an amended return on Form 1040X, Amended U.S. Individual Income Tax Return, for any year that is affected by this change. However, you generally must file the amended return within three years from the time you filed the original return or within two years from the time you paid the tax, whichever is later. See chapter 1 for more information on amended returns.*

**Expenses of certain performing artists.**

If you are a performing artist, you may qualify to deduct your employee business expenses as an adjustment to gross income rather than as a miscellaneous itemized deduction. To qualify, you must meet **all** of the following requirements.

- 1) During the tax year, you perform services in the performing arts for at least two employers.
- 2) You receive at least \$200 each from any two of these employers.
- 3) Your related performing-arts business expenses are more than 10% of your gross income from the performance of those services.
- 4) Your adjusted gross income is not more than \$16,000 before deducting these business expenses.

**Special rules for married persons.** If you are married, you must file a joint return unless you lived apart from your spouse at all times during the tax year.

If you file a joint return, you must figure requirements (1), (2), and (3) separately for both you and your spouse. However, requirement (4) applies to your and your spouse's combined adjusted gross income.

**Where to report.** If you meet all of the above requirements, you should first complete Form 2106 or 2106-EZ. Then you include your performing-arts-related expenses from line 10 of Form 2106 or line 6 of Form 2106-EZ in the total on line 32 of Form 1040. Write "QPA" and the amount of your performing-arts-related expenses in the space to the left of line 32 of Form 1040.

If you do not meet all of the above requirements, you do not qualify to deduct

your expenses as an adjustment to gross income. Instead, you must complete Form 2106 or 2106-EZ and deduct your employee business expenses as an itemized deduction on line 20 of Schedule A (Form 1040).

**Impairment-related work expenses of disabled employees.**

If you are an employee with a physical or mental disability, your impairment-related work expenses are not subject to the 2%-of-adjusted-gross-income limit that applies to most other employee business expenses. After you complete Form 2106 or 2106-EZ, enter your impairment-related work expenses from line 10 of Form 2106 or line 6 of Form 2106-EZ on line 27 of Schedule A (Form 1040), and identify the type and amount of this expense on the dotted line next to line 27. Enter your employee business expenses that are **unrelated** to your disability from line 10 of Form 2106 or line 6 of Form 2106-EZ on line 20 of Schedule A.

Impairment-related work expenses are your allowable expenses for attendant care at your workplace and other expenses you have in connection with your workplace that are necessary for you to be able to work. For more information, see chapter 23.

## Illustrated Example

Bill Wilson is an employee of Fashion Clothing Co. in Manhattan, NY. In a typical week, Bill leaves his home on Long Island on Monday morning and drives to Albany to exhibit the Fashion line for 3 days to prospective customers. Then he drives to Troy to show Fashion's new line of merchandise to Town Department Store, an old customer. While in Troy, he talks with Tom Brown, purchasing agent for Town Department Store, to discuss the new line. He later takes John Smith of Attire Co. out to dinner to discuss Attire Co.'s buying Fashion's new line of clothing.

Bill purchased his car on January 3, 1996. He uses the standard mileage rate for car expense purposes. He records his total mileage, business mileage, parking fees, and tolls for the year. Bill timely records his expenses and other pertinent information in a travel expense log (not shown). He obtains receipts for his expenses for lodging and for any other expenses of \$75 or more.

During the year, Bill drove a total of 25,000 miles of which 20,000 miles were for business. He answers all the questions in Part II of Form 2106. He figures his car expense to be \$6,260 [4,000 business miles × 32½ cents standard mileage rate (\$1,300) and 16,000 × 31 cents standard mileage rate (\$4,960)].

His total employee business expenses are shown in the following table.

<u>Type of Expense</u>	<u>Amount</u>
Parking fees and tolls .....	\$ 325
Car expenses .....	6,260
Meals .....	2,632
Lodging, laundry, dry cleaning .....	8,975
Entertainment .....	1,870
Gifts, education, etc. ....	430
<b>Total</b> .....	<b>\$ 20,492</b>

Bill received an allowance of \$3,600 (\$300 per month) to help offset his expenses. Bill did not have to account to his employer for the reimbursement, and the \$3,600 was included as income in box 1 of his Form W-2.

Because Bill's reimbursement was included in his income and he is using the

standard mileage rate for his car expenses, he files **Form 2106-EZ** with his tax return.

His filled-in form is shown at the end of this chapter.

# Unreimbursed Employee Business Expenses

Department of the Treasury  
Internal Revenue Service

▶ Attach to Form 1040.

Your name <p style="text-align: center;">Bill Wilson</p>	Occupation in which you incurred expenses <p style="text-align: center;">Sales</p>	Social security number <p style="text-align: center;">555 : 00 : 5555</p>
-------------------------------------------------------------	---------------------------------------------------------------------------------------	------------------------------------------------------------------------------

**You May Use This Form ONLY if ALL of the Following Apply:**

- You are an employee deducting expenses attributable to your job.
- You **do not** get reimbursed by your employer for any expenses (amounts your employer included in box 1 of your Form W-2 are not considered reimbursements).
- If you are claiming vehicle expense, you are using the standard mileage rate for 1999.

**Caution:** You can use the standard mileage rate for 1999 **only if:** (a) you owned the vehicle and used the standard mileage rate for the first year you placed the vehicle in service, **OR** (b) you leased the vehicle and used the standard mileage rate for the portion of the lease period after 1997.

### Part I Figure Your Expenses

1 Vehicle expense using the standard mileage rate. Complete Part II and then go to line 1a below.			
a Multiply business miles driven <b>before</b> April 1, 1999, by 32½¢ (.325)	<b>1a</b>	1,300	
b Multiply business miles driven <b>after</b> March 31, 1999, by 31¢ (.31)	<b>1b</b>	4,960	
c Add lines 1a and 1b . . . . .	<b>1c</b>	6,260	
2 Parking fees, tolls, and transportation, including train, bus, etc., that <b>did not</b> involve overnight travel or commuting to and from work . . . . .	<b>2</b>	325	
3 Travel expense while away from home overnight, including lodging, airplane, car rental, etc. <b>Do not</b> include meals and entertainment . . . . .	<b>3</b>	8,975	
4 Business expenses not included on lines 1 through 3. <b>Do not</b> include meals and entertainment	<b>4</b>	430	
5 Meals and entertainment expenses: \$ <u>4,502</u> x 50% (.50) (Employees subject to Department of Transportation (DOT) hours of service limits: Multiply meal expenses by 55% (.55) instead of 50%. For more details, see instructions.) . . . . .	<b>5</b>	2,251	
6 <b>Total expenses.</b> Add lines 1c through 5. Enter here and <b>on line 20 of Schedule A (Form 1040).</b> (Fee-basis state or local government officials, qualified performing artists, and individuals with disabilities: See the instructions for special rules on where to enter this amount.) . . . . .	<b>6</b>	18,241	

### Part II Information on Your Vehicle. Complete this part ONLY if you are claiming vehicle expense on line 1.

7 When did you place your vehicle in service for business use? (month, day, year) ▶ <u>1</u> / <u>3</u> / <u>96</u>	
8 Of the total number of miles you drove your vehicle during 1999, enter the number of miles you used your vehicle for:	
a Business <u>20,000</u> b Commuting <u>2,600</u> c Other <u>2,400</u>	
9 Do you (or your spouse) have another vehicle available for personal use? . . . . .	<input checked="" type="checkbox"/> Yes <input type="checkbox"/> No
10 Was your vehicle available for use during off-duty hours? . . . . .	<input checked="" type="checkbox"/> Yes <input type="checkbox"/> No
11a Do you have evidence to support your deduction? . . . . .	<input checked="" type="checkbox"/> Yes <input type="checkbox"/> No
b If "Yes," is the evidence written? . . . . .	<input checked="" type="checkbox"/> Yes <input type="checkbox"/> No

### General Instructions

Section references are to the Internal Revenue Code.

#### A Change To Note

The standard mileage rate has decreased to 31 cents for each mile of business use **after** March 31, 1999. See line 1 above.

#### Purpose of Form

You may use Form 2106-EZ instead of Form 2106 to claim your unreimbursed employee business expenses if you meet all the requirements listed above Part I.

### Recordkeeping

You cannot deduct expenses for travel (including meals, unless you used the standard meal allowance), entertainment, gifts, or use of a car or other listed property, unless you keep records to prove the time, place, business purpose, business relationship (for entertainment and gifts), and amounts of these expenses. Generally, you must also have receipts for all lodging expenses (regardless of the amount) and any other expense of \$75 or more.

### Additional Information

If you need more information about employee business expenses, you will find the following publications helpful:

- Pub. 463**, Travel, Entertainment, Gift, and Car Expenses
- Pub. 529**, Miscellaneous Deductions
- Pub. 587**, Business Use of Your Home (Including Use by Day-Care Providers)
- Pub. 946**, How To Depreciate Property

# Tax Benefits for Work-Related Education

## Important Change

**Standard mileage rate.** Generally, if you drive your car to and from school, you can deduct 32½ cents per mile driven before April 1, 1999, and 31 cents per mile after March 31. You can use this standard mileage rate for a car you lease, as well as for a car you own. See *Using your car* under *What Educational Expenses Are Deductible?*

## Introduction

If you are working and have work-related educational expenses, you may be able to deduct all or part of the cost of your education as a business expense deduction. This chapter discusses:

- What educational expenses qualify and what educational expenses do not qualify,
- What expenses for qualifying education can be deducted, and
- How to claim the deduction using Schedule A (Form 1040) and Form 2106 or Form 2106-EZ if you are an employee.

Educational expenses that are not work related, such as the costs of sending your children to college, are personal expenses that you cannot deduct as business expenses. However, you may be eligible for other tax benefits. Information on the education tax credits is in chapter 36, on the education IRA and making withdrawals from IRAs for educational expenses in chapter 18, and on cancellation of student loans in chapter 13. Information on student loan interest is in Publication 970, *Tax Benefits for Higher Education*.

## Useful Items

You may want to see:

### Publication

- 463** Travel, Entertainment, Gift, and Car Expenses
- 508** Educational Expenses
- 970** Tax Benefits for Higher Education

### Form (and Instructions)

- 2106** Employee Business Expenses
- 2106-EZ** Unreimbursed Employee Business Expenses

- Schedule A (Form 1040) Itemized Deductions**

## Qualifying Education

You can deduct the costs of qualifying education. This is education that meets **at least one** of the following two tests.

- 1) The education is required by your employer or the law to keep your present salary, status, or job. The required education must serve a bona fide business purpose of your employer.
- 2) The education maintains or improves skills needed in your present work.

You can deduct the expenses for qualifying education even if the education could lead to a degree.

**Education that does not qualify.** Even if the education meets both of the tests above, it does not qualify if it:

- 1) Is needed to meet the minimum educational requirements of your present trade or business, or
- 2) Is part of a program of study that can qualify you for a new trade or business.

See *Nonqualifying Education*, later, for more information.

You can use *Figure 29-A* as a quick check to see if your education qualifies.

## Education Required by Employer or by Law

Once you have met the minimum educational requirements for your job, your employer or the law may require you to get more education. This additional education is qualifying education if it is required for you to keep your present salary, status, or job, and the requirement serves a business purpose of your employer. The education must not be part of a program that will qualify you for a new trade or business.

When you get more education than your employer or the law requires, the additional education is qualifying only if it maintains or improves skills required in your present work. See *Education To Maintain or Improve Skills*.

**Example.** You are a teacher who has satisfied the minimum requirements for teaching. Your employer requires you to take an additional college course each year to keep your teaching job. This is qualifying education even if you eventually receive a master's degree and an increase in salary because of this extra education.

## Education To Maintain or Improve Skills

If your education is not required by your employer or a law, it is qualifying education only if it maintains or improves skills needed in your present work. This could include refresher courses, courses on current developments, and academic or vocational courses.

**Example.** You repair televisions, radios, and stereo systems for XYZ Store. To keep up with the latest changes, you take special

courses in radio and stereo service. These courses maintain and improve skills required in your work.



*If the courses you take are needed to meet the minimum educational requirements for your work or are part of a program of study that can qualify you for a new trade or business, they are not qualifying education.*

**Present work.** Unless required by your employer or the law, education that relates to work you may enter or return to in the future is not qualifying education. Education that prepares you for a future occupation includes any education that keeps you up-to-date for a return to work or that qualifies you to reenter a job you had in the past.

**Temporary absence.** If you stop work for a year or less and then go back to the same kind of work, your absence is ordinarily considered temporary. Education during a vacation, temporary leave, or other temporary absence from your job is considered related to your present job.

**Example.** You quit your biology research job to become a full-time biology graduate student for one year. If you return to work in biology research after completing the courses, the education is related to your present work even if you do not go back to work with the same employer.

## Nonqualifying Education

You cannot deduct the costs of nonqualifying education, even if it meets both of the tests described earlier for qualifying education. Nonqualifying education is education that:

- 1) Is needed to meet the minimum educational requirements of your present trade or business, or
- 2) Is part of a program of study that can qualify you for a new trade or business.

## Education To Meet Minimum Requirements

Education needed to meet the minimum educational requirements for your present trade or business is nonqualifying education. The minimum education necessary is determined by:

- 1) Laws and regulations,
- 2) Standards of your profession, trade, or business, and
- 3) Your employer's requirements.

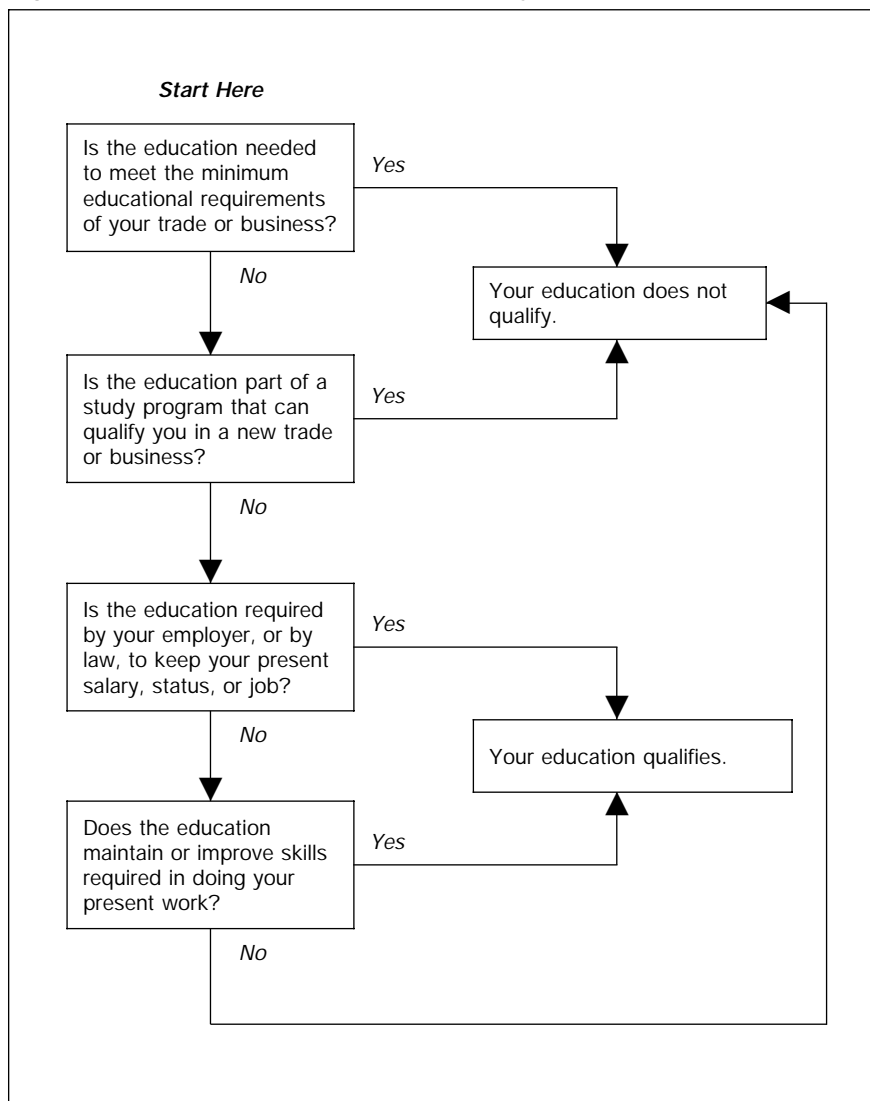
Once you have met the minimum educational requirements that were in effect when you were hired, you do not have to meet minimum educational requirements again. This means that if the minimum requirements change after you were hired, any education you need to meet the new requirements is qualifying education.



*You have not necessarily met the minimum educational requirements of your trade or business simply because you are already doing the work.*



Figure 29–A. Does Your Education Qualify?



**Example 1.** You are a full-time engineering student. You work part time as an engineer for a firm that will employ you as a full-time engineer after you finish college. Although your college engineering courses improve your skills in your present job, you have not met the minimum job requirements for a full-time engineer. The education is nonqualifying education.

**Example 2.** You are an accountant and you have met the minimum educational requirements of your employer. Your employer later changes the minimum educational requirements and requires you to take college courses to keep your job. These additional courses are not minimum requirements because you have already satisfied the initial minimum requirements. The education is qualifying education.

However, education that a new accountant coming into the firm needs to satisfy the new minimum requirements would be nonqualifying education for the new accountant.

### Requirements for Teachers

This discussion applies to teachers and others employed by educational organizations.

The state or school district usually sets

the minimum educational requirements for teachers. The requirement is the college degree or the minimum number of college hours usually required of a person hired for that position.

If no requirements exist, you will have met the minimum educational requirements when you become a faculty member. You generally will be considered a faculty member when **one or more** of the following occurs.

- 1) You have tenure.
- 2) Your years of service count toward obtaining tenure.
- 3) You have a vote in faculty decisions.
- 4) Your school makes contributions for you to a retirement plan other than social security or a similar program.

**Example 1.** The law in your state requires beginning secondary school teachers to have a bachelor's degree, including ten professional education courses. In addition, to keep the job, a teacher must complete a fifth year of training within 10 years from the date of hire. If the employing school certifies to the state Department of Education that qualified teachers cannot be found, the school can hire persons with only 3 years

of college. However, to keep their jobs, these teachers must get a bachelor's degree and the required professional education courses within 3 years.

Under these facts, the bachelor's degree, whether or not it includes the ten professional education courses, is considered the minimum educational requirement for qualification as a teacher in your state.

If you have all of the required education except the fifth year, you have met the minimum educational requirements. The fifth year of training is qualifying education unless it is part of a program of study that will qualify you for a new trade or business.

**Example 2.** Assume the same facts as in *Example 1* except that you have a bachelor's degree and only six professional education courses. The additional four education courses are qualifying education. Although you do not have all the required courses, you have already met the minimum educational requirements.

**Example 3.** Assume the same facts as in *Example 1* except that you are hired with only 3 years of college. The courses you take that lead to a bachelor's degree (including those in education) are nonqualifying education. They are needed to meet the minimum educational requirements for employment as a teacher.

**Example 4.** You have a bachelor's degree and you work as a temporary instructor at a university. At the same time, you take graduate courses toward an advanced degree. The rules of the university state that you can become a faculty member only if you get a graduate degree. Also, you can keep your job as an instructor only as long as you show satisfactory progress toward getting this degree. You have not met the minimum educational requirements to qualify you as a faculty member. The graduate courses are nonqualifying education.

**Certification in a new state.** Once you have met the minimum educational requirements for teachers for your state, you are considered to have met the minimum educational requirements in all states. This is true even if you must get additional education to be certified in another state. Any additional education you need is qualifying education. You have already met the minimum requirements for teaching and teaching in another state is not a new trade or business.

**Example.** You hold a permanent teaching certificate in State A and are employed as a teacher in that state for several years. You move to State B and are promptly hired as a teacher. You are required, however, to complete certain prescribed courses to get a permanent teaching certificate in State B. These additional courses are qualifying education because the teaching position in State B involves the same general kind of work for which you were qualified in State A.

### Education That Qualifies You for a New Trade or Business

Education that is part of a program of study that can qualify you for a new trade or business is nonqualifying education. This

is true even if you do not plan to enter that trade or business.

If you are an employee, a change of duties that involves the same general kind of work is not a new trade or business.

**Example 1.** You are an accountant. Your employer requires you to get a law degree at your own expense. You register at a law school for the regular curriculum that leads to a law degree. Even if you do not intend to become a lawyer, the education is nonqualifying because the law degree will qualify you for a new trade or business.

**Example 2.** You are a general practitioner of medicine. You take a 2-week course to review developments in several specialized fields of medicine. The course does not qualify you for a new profession. It is qualifying education because it maintains or improves skills required in your present profession.

## Bar or CPA Review Course

Review courses to prepare for the bar examination or the certified public accountant (CPA) examination are nonqualifying education. They are part of a program of study that can qualify you for a new profession.

## Teaching and Related Duties

All teaching and related duties are considered the same general kind of work. A change in duties in any of the following ways is not considered a change to a new business.

- 1) Elementary school teacher to secondary school teacher.
- 2) Teacher of one subject, such as biology, to teacher of another subject, such as art.
- 3) Classroom teacher to guidance counselor.
- 4) Classroom teacher to school administrator.

## What Educational Expenses Are Deductible?

If your education meets the requirements described earlier under *Qualifying Education*, you can generally deduct your educational expenses. If you are not self-employed, you can deduct educational expenses only if you itemize your deductions.

You cannot deduct expenses related to tax-exempt and excluded income.

**Deductible expenses.** The following educational expenses can be deducted.

- Tuition, books, supplies, lab fees, and similar items.
- Certain transportation and travel costs.
- Other educational expenses, such as costs of research and typing when writing a paper as part of an educational program.

**Nondeductible expenses.** Educational expenses do not include personal or capital expenses. For example, you cannot deduct the dollar value of vacation time or annual leave you take to attend classes. This amount is a personal expense.

**Unclaimed reimbursement.** If you do not claim reimbursement that you are entitled to receive from your employer, you cannot deduct the expenses that apply to the reimbursement.

**Example.** Your employer agrees to pay your educational expenses if you file a voucher showing your expenses. You do not file a voucher, and you do not get reimbursed. Because you did not file a voucher, you cannot deduct the expenses on your tax return.

## Transportation Expenses

If your education qualifies, you can deduct local transportation costs of going directly from work to school. If you are regularly employed and go to school on a **temporary basis**, you can also deduct the costs of returning from school to home.

If your attendance at school is realistically expected to last (and does in fact last) for 1 year or less, you go to school on a temporary basis unless there are facts and circumstances that would indicate otherwise. If your attendance at school is realistically expected to last for more than 1 year or if there is no realistic expectation that the attendance will last for 1 year or less, the attendance is not temporary, regardless of whether it actually lasts for more than 1 year. If attendance at school initially is realistically expected to last for 1 year or less, but at some later date the attendance is realistically expected to last more than 1 year, that attendance will be treated as temporary (unless there are facts and circumstances that would indicate otherwise) until your expectation changes. It will not be treated as temporary after the date you determine it will last more than 1 year.



*The above explanation of attendance on a temporary basis is the result of a recent change. Under the former definition "temporary" meant an irregular or short-term basis (generally a matter of days or weeks).*



*You can file an amended return on Form 1040X, Amended U.S. Individual Income Tax Return, for any year that is affected by this change. However, you generally must file the amendment within 3 years from the time you filed the return or within 2 years from the time you paid the tax, whichever is later.*

If you are regularly employed and go directly from home to school on a temporary basis, you can deduct the round-trip costs of transportation between your home and school. This is true regardless of the location of the school, the distance traveled, or whether you attend school on nonwork days.

Transportation expenses include the actual costs of bus, subway, cab, or other fares, as well as the costs of using your car. Transportation expenses do not include amounts spent for travel, meals, or lodging while you are away from home overnight.

**Example 1.** You regularly work in Camden, New Jersey, and go directly from work to home. You also attend school every night for 3 months to take a course that improves your job skills. Since you are attending school on a temporary basis, you can deduct your daily round-trip transportation expenses in going between home and school. This is true regardless of the distance traveled.

**Example 2.** Assume the same facts as in *Example 1* except that on certain nights you go directly from work to school and then home. You can deduct your transportation expenses from your regular work site to school and then home.

**Example 3.** Assume the same facts as in *Example 1* except that you attend the school for 9 months on Saturdays, nonwork days. Since you are attending school on a temporary basis, you can deduct your round-trip transportation expenses in going between home and school.

**Example 4.** Assume the same facts as in *Example 1* except that you attend classes twice a week for 15 months. Since your attendance in school is not considered temporary, you cannot deduct your transportation expenses in going between home and school. If you go directly from work to school, you can deduct the one-way transportation expenses of going from work to school. If you go from work to home to school and return home, your transportation expenses cannot be more than if you had gone directly from work to school.

**Using your car.** If you use your car (whether you own or lease it) for transportation to school, you can deduct your actual expenses or use the standard mileage rate to figure the amount you can deduct. The standard mileage rate for 1999 is 32½ cents per mile before April 1 and 31 cents per mile after March 31. Whichever method you use, you can also deduct parking fees and tolls. See *Car Expenses* in chapter 28 for information on deducting your actual expenses of using a car.

## Travel Expenses

You can deduct expenses for travel, meals (subject to the 50% limit), and lodging if:

- 1) You travel overnight to obtain qualified education, and
- 2) The main purpose of the trip is to attend a work-related course or seminar.

Travel expenses for qualifying education are treated the same as travel expenses for other employee business purposes. For more information, see chapter 28.



*You cannot deduct expenses for personal activities, such as sightseeing, visiting, or entertaining.*

**Mainly personal travel.** If your travel away from home is mainly personal, you cannot deduct all of your expenses for travel, meals, and lodging. You can deduct only your expenses for lodging and 50% of your expenses for meals during the time you attend the qualified educational activities.

Whether a trip's purpose is mainly personal or educational depends upon the facts and circumstances. An important factor is

the comparison of time spent on personal activities with time spent on educational activities. If you spend more time on personal activities, the trip is considered mainly educational only if you can show a substantial nonpersonal reason for traveling to a particular location.

**Example 1.** John works in Newark, New Jersey. He traveled to Chicago to take a deductible 1-week course at the request of his employer. While there, he took a sightseeing trip, entertained some friends, and took a side trip to Pleasantville for a day. Since the trip was mainly for business, he can deduct his round-trip airfare to Chicago, but he cannot deduct his transportation expenses of going to Pleasantville. He can deduct only the meals (subject to the 50% limit) and lodging connected with his educational activities.

**Example 2.** Dave works in Nashville and recently traveled to California to take a deductible 2-week seminar. While there, he spent an extra 8 weeks on personal activities. The facts, including the extra 8-week stay, show that his main purpose was to take a vacation. He cannot deduct his round-trip airfare or his meals and lodging for the 8 weeks. He can deduct only his expenses for meals (subject to the 50% limit) and lodging for the 2 weeks he attended the seminar.

**Cruises and conventions.** Certain cruises and conventions offer seminars or courses as part of their itinerary. Even if these are work related, your deduction for travel may be limited. This applies to:

- 1) Travel by ocean liner, cruise ship, or other form of luxury water transportation, and
- 2) Conventions outside the North American area.

For a discussion of the limits on travel expense deductions that apply to cruises and conventions, see *Luxury Water Travel and Conventions* in Publication 463.

## Meal Expenses

If your educational expenses qualify for deduction, you can deduct the cost of meals that qualify as travel expenses.

**50% limit.** You can deduct only 50% of your qualifying business-related meals if you were not reimbursed by your employer. This includes meals while traveling away from home to obtain your education. Employees must use Form 2106 or Form 2106-EZ to apply the 50% limit.

## Travel as Education

You cannot deduct the cost of travel that is a form of education, even if it is directly related to your duties in your work or business.

**Example.** You are a French language teacher. While on sabbatical leave granted for travel, you traveled through France to improve your knowledge of the French language. You chose your itinerary and most of your activities to improve your French

language skills. You cannot deduct your travel expenses as educational expenses. This is true even if you spent most of your time learning French by visiting French schools and families, attending movies or plays, and engaging in similar activities.

## Student Loan Interest Expense

You may be able to deduct interest you pay on a qualified student loan. This deduction is available whether or not the education is work-related, and even if you do not itemize deductions on Schedule A (Form 1040). For more information on the deduction of student loan interest, see Publication 970.

## Expenses Relating to Tax-Exempt and Excluded Income

Some educational assistance you receive may be tax-exempt or excluded from your income. This is income you receive that you are not required to report as income on your tax return.

Since you do not pay tax on this income, you may not be able to deduct the related expenses. Examples of tax-exempt or excluded income include scholarships, veterans' educational assistance, and the Education Savings Bond Program. If you received assistance from any of these sources, see *Expenses Relating to Tax-Exempt and Excluded Income* in Publication 508.

## Where To Deduct Expenses

Self-employed persons and employees report their educational expenses differently.

The following information explains what forms you must use to deduct your qualified educational expenses.

### Self-Employed Persons

If you are self-employed, you must report your qualified educational expenses on the appropriate form used to report your business income and expenses (Schedule C, C-EZ, or F). See the instructions for the form you file for information on how to complete it.

### Employees

If you are an employee, you can deduct qualified educational expenses only if they were not reimbursed by your employer or if they exceeded your reimbursement. (Amounts your employer paid under a non-accountable plan and included in box 1 of your Form W-2 are not considered reimbursements.) How you treat any reimbursement you receive depends on the type of reimbursement arrangement and the amount of the reimbursement. For information on how to report your reimbursement, see chapter 28.

Include your qualified educational expenses with your deduction for any other

employee business expenses on line 20 of Schedule A (Form 1040). (Special rules for expenses of certain performing artists and fee-basis officials and for impairment-related work expenses are explained later.) This deduction is subject to the 2%-of-adjusted-gross-income limit that applies to most miscellaneous itemized deductions.

**Form 2106 or 2106-EZ.** To figure your deduction for employee business expenses, including qualified educational expenses, you generally must complete Form 2106 or Form 2106-EZ.

**Form not required.** Do not complete either Form 2106 or Form 2106-EZ if:

- You were not reimbursed for any of your expenses, and
- You are not claiming travel, transportation, or meal expenses.

If you meet both of these requirements, enter the expenses directly on line 20 of Schedule A (Form 1040). (Special rules for expenses of certain performing artists and fee-basis officials and for impairment-related work expenses are explained later.)

**Using Form 2106-EZ.** This form is shorter and easier to use than Form 2106. You can use this form if:

- You were not reimbursed for any of your expenses, and
- You are using the standard mileage rate if you are claiming vehicle expenses.

If you do not meet both of these requirements, use Form 2106.


**Performing artists and fee-basis officials.** If you are a qualified performing artist, or a state (or local) government official who is paid in whole or in part on a fee basis, you can deduct your qualified educational expenses as an adjustment to gross income rather than as an itemized deduction.

For more information on qualified performing artists and fee-basis officials, see chapter 28.

**Impairment-related work expenses.** If you are disabled and have impairment-related work expenses that enable you to get qualifying education, you can deduct them on line 27 of Schedule A (Form 1040). They are not subject to the 2%-of-adjusted-gross-income limit.

For more information on impairment-related work expenses, see chapter 28.

## Recordkeeping

 You must keep records as proof of any deduction claimed on your tax return. Generally, you should keep your records for 3 years from the date of filing the return and claiming the deduction.

For specific information about keeping records of business expenses, see *Recordkeeping* in chapter 28.

## Miscellaneous Deductions

### Important Reminder

**Limit on itemized deductions.** If your adjusted gross income is more than \$126,600 (\$63,300 if you are married filing separately), you may have to reduce the amount of certain itemized deductions, including your miscellaneous deductions.

### Introduction

This chapter explains which expenses you can claim as miscellaneous itemized deductions on **Schedule A** (Form 1040). You must reduce the total of most miscellaneous itemized deductions by 2% of your adjusted gross income. This chapter covers the following topics.

- Deductions subject to the 2% limit.
- Deductions not subject to the 2% limit.
- Expenses you cannot deduct.



You must keep records to verify your deductions. You should keep receipts, canceled checks, financial account statements, and other documentary evidence. For more information on recordkeeping, get Publication 552, *Recordkeeping for Individuals*.

### Useful Items

You may want to see:

#### Publication

- 463** Travel, Entertainment, Gift, and Car Expenses
- 525** Taxable and Nontaxable Income
- 529** Miscellaneous Deductions
- 535** Business Expenses
- 587** Business Use of Your Home (Including Use by Day-Care Providers)
- 946** How To Depreciate Property

#### Form (and Instructions)

- 2106** Employee Business Expenses
- 2106-EZ** Unreimbursed Employee Business Expenses

## Deductions Subject to the 2% Limit

You can deduct the following expenses as miscellaneous itemized deductions on Schedule A (Form 1040). You can claim the amount of expenses that is more than 2% of your adjusted gross income. You figure your deduction on Schedule A by subtracting 2% of your adjusted gross income from the total amount of these expenses. Your adjusted gross income is the amount on line 34, Form 1040.

Generally, you apply the 2% limit after you apply any other deduction limit. For example, the 50% (or 55%) limit on business-related meals and entertainment (discussed in chapter 28) is applied before you subtract 2% of your adjusted gross income.

Deductions subject to the 2% limit are discussed in the two general categories that are shown on Schedule A: **unreimbursed employee expenses** and **other expenses** (including tax preparation fees).

**Impairment-related work expenses.** If you have a physical or mental disability, certain expenses you incur that allow you to work may not be subject to the 2% limit. See *Impairment-Related Work Expenses*, under *Deductions Not Subject to the 2% Limit*, later.

**Performing artists.** If you are a qualifying performing artist, you may be able to deduct your employee business expenses as an adjustment to gross income rather than as a miscellaneous itemized deduction. See *Special Rules* in chapter 28 if you need more information about this exception.

**State and local government officials paid on a fee basis.** If you performed services as an employee of a state or local government and you were paid in whole or in part on a fee basis, you can claim your trade or business expenses in performing those services as an adjustment to gross income, rather than as a miscellaneous deduction. See *Officials Paid on a Fee Basis* under *Deductions Not Subject to the 2% Limit*, later.

## Unreimbursed Employee Expenses

You can deduct only unreimbursed employee expenses that are:

- 1) Paid or incurred during your tax year,
- 2) For carrying on your trade or business of being an employee, and
- 3) Ordinary and necessary business expenses.

An expense is **ordinary** if it is common and accepted in your type of trade or business. An expense is **necessary** if it is appropriate and helpful to your trade or business.

You may be able to deduct the following items as unreimbursed employee expenses.

- Business bad debt of an employee.
- Education that is employment related (see chapter 29).
- Licenses and regulatory fees.

- Malpractice insurance premiums.
- Medical examinations required by an employer.
- Occupational taxes.
- Passport for a business trip.
- Subscriptions to professional journals and trade magazines related to your work.
- Travel, transportation, entertainment, gift, and car expenses related to your work (see chapter 28).

### Business Liability Insurance

You can deduct insurance premiums you paid for protection against personal liability for wrongful acts on the job.

### Damages for Breach of Employment Contract

If you break an employment contract, you can deduct damages you pay your former employer if the damages are attributable to the pay you received from that employer.

### Depreciation on Computers or Cellular Telephones

You can claim a depreciation deduction for a computer or cellular telephone that you use in your work as an employee if its use is:

- 1) For the convenience of your employer, and
- 2) Required as a condition of your employment.

For more information about the rules and exceptions to the rules affecting the allowable deductions for a home computer or cellular telephone, see Publication 529.

### Dues to Chambers of Commerce and Professional Societies

You may be able to deduct dues paid to professional organizations (such as bar associations and medical associations) and to chambers of commerce, and similar organizations, if membership helps you carry out the duties of your job. Similar organizations include:

- Boards of trade,
- Business leagues,
- Civic or public service organizations,
- Real estate boards, and
- Trade associations.

You **cannot** deduct dues paid to an organization if one of its main purposes is to:

- 1) Conduct entertainment activities for members or their guests, or
- 2) Provide members or their guests with access to entertainment facilities.

Dues paid to airline, hotel, and luncheon clubs are not deductible. See *Club Dues* under *Nondeductible Expenses* for more information.

**Lobbying and political activities.** You may not be able to deduct that part of your dues that is for certain lobbying and political

activities. See *Dues used for lobbying*, under *Lobbying Expenses*, later.

## Home Office

If you use a part of your home regularly and exclusively for business purposes, you may be able to deduct a part of the operating expenses and depreciation of your home.

You can claim this deduction for the business use of a part of your home only if you use that part of your home **regularly** and **exclusively** as:

- 1) Your principal place of business for any trade or business in which you engage, or
- 2) A place to meet or deal with your patients, clients, or customers in the normal course of your trade or business.

You can also claim this deduction for a separate structure not attached to your home (even if neither (1) nor (2) above applies) if you use it regularly and exclusively for your trade or business.

The regular and exclusive business use must be **for the convenience of your employer** and not just appropriate and helpful in your job. Get Publication 587 for more detailed information and a worksheet.

## Job Search Expenses

You can deduct certain expenses you have in looking for a new job in your present occupation, even if you do not get a new job. You cannot deduct these expenses if:

- 1) You are looking for a job in a new occupation,
- 2) There was a substantial break between the ending of your last job and your looking for a new one, or
- 3) You are seeking a job for the first time.

**Employment and outplacement agency fees.** You can deduct employment and outplacement agency fees you pay in looking for a new job in your present occupation.

**Employer pays you back.** If, in a later year, your employer pays you back for employment agency fees, you must include the amount you receive in your gross income up to the amount of your tax benefit in the earlier year (see *Recoveries* in chapter 13).

**Employer pays the employment agency.** If your employer pays the fees directly to the employment agency and you are not responsible for them, you do not include them in your gross income.

**Résumé.** You can deduct amounts you spend for typing, printing, and mailing copies of a résumé to prospective employers if you are looking for a new job in your present occupation.

**Travel and transportation expenses.** If you travel to an area and, while there, you look for a new job in your present occupation, you may be able to deduct travel expenses to and from the area. You can deduct the travel expenses if the trip is primarily to look for a new job. The amount of time you spend on personal activity compared to the amount of time you spend

in looking for work is important in determining whether the trip is primarily personal or is primarily to look for a new job.

Even if you cannot deduct the travel expenses to and from an area, you can deduct the expenses of looking for a new job in your present occupation, while in the area.

If you use the standard mileage rate to figure your car expenses, use 32.5 cents per mile through March 31, 1999, and 31 cents per mile thereafter. See chapter 28 for more information.

## Licenses and Regulatory Fees

You can deduct the amount you pay each year to state or local governments for licenses and regulatory fees for your trade, business, or profession.

## Occupational Taxes

You can deduct an occupational tax charged at a flat rate by a locality for the privilege of working or conducting a business in the locality. If you are an employee, you can claim occupational taxes only as a miscellaneous deduction subject to the 2% limit; you cannot claim them as a deduction for taxes elsewhere on your return.

## Repayment of Income Aid Payment

An "income aid payment" is one that is received under an employer's plan to aid employees who lose their jobs because of lack of work. If you repay a lump-sum income aid payment that you received and included in income in an earlier year, you can deduct the repayment.

## Research Expenses of a College Professor

If you are a college professor, you can deduct research expenses, including travel expenses, for teaching, lecturing, or writing and publishing on subjects that relate directly to the field of your teaching duties. You must have undertaken the research as a means of carrying out the duties expected of a professor and without expectation of profit apart from salary. However, you cannot deduct the cost of travel as a form of education.

## Tools Used in Your Work

Generally, you can deduct amounts you spend for tools used in your work if the tools wear out and are thrown away within one year from the date of purchase. You can depreciate the cost of tools that have a useful life substantially beyond the tax year. For more information about depreciation, get Publication 946.

## Union Dues and Expenses

You can deduct dues and initiation fees you pay for union membership.

You can also deduct assessments for benefit payments to unemployed union members. However, you cannot deduct the part of the assessments or contributions that provides funds for the payment of sick, accident, or death benefits. Also, you cannot deduct contributions to a pension fund,

even if the union requires you to make the contributions.

You may not be able to deduct amounts you pay to the union that are related to certain lobbying and political activities. See *Lobbying Expenses* under *Nondeductible Expenses*, later.

## Work Clothes and Uniforms

You can deduct the cost and upkeep of work clothes if the following two requirements are met.

- 1) You must wear them as a condition of your employment.
- 2) The clothes are not suitable for everyday wear.



*It is not enough that you wear distinctive clothing. The clothing must be specifically required by your employer. Nor is it enough that you do not, in fact, wear your work clothes away from work. The clothing must not be suitable for taking the place of your regular clothing.*

Examples of workers who may be able to deduct the cost and upkeep of work clothes are: delivery workers, firefighters, health care workers, law enforcement officers, letter carriers, professional athletes, and transportation workers (air, rail, bus, etc.).

Musicians and entertainers can deduct the cost of theatrical clothing and accessories if they are not suitable for everyday wear.

However, work clothing consisting of white cap, white shirt or white jacket, white bib overalls, and standard work shoes, which a painter is required by his union to wear on the job, is not distinctive in character or in the nature of a uniform. Similarly, the costs of buying and maintaining blue work clothes worn by a welder at the request of a foreman are not deductible.

**Protective clothing.** You can deduct the cost of protective clothing required in your work, such as safety shoes or boots, safety glasses, hard hats, and work gloves.

Examples of workers who may be required to wear safety items are: carpenters, cement workers, chemical workers, electricians, fishing boat crew members, machinists, oil field workers, pipe fitters, steamfitters, and truck drivers.

**Military uniforms.** You generally cannot deduct the cost of your uniforms if you are on full-time active duty in the armed forces. However, if you are an armed forces reservist, you can deduct the unreimbursed cost of your uniform if military regulations restrict you from wearing it except while on duty as a reservist. In figuring the deduction, you must reduce the cost by any nontaxable allowance you receive for these expenses.

If local military rules do not allow you to wear fatigue uniforms when you are off duty, you can deduct the amount by which the cost of buying and keeping up these uniforms is more than the uniform allowance you receive.

You can deduct the cost of your uniforms if you are a civilian faculty or staff member of a military school.

## Other Expenses

You can deduct certain other expenses as miscellaneous itemized deductions subject to the 2%-of-adjusted-gross-income limit. These are expenses you pay:

- 1) To produce or collect income that must be included in your gross income,
- 2) To manage, conserve, or maintain property held for producing such income, or
- 3) To determine, contest, pay, or claim a refund of any tax.

You can deduct other expenses you pay for the purposes in (1) and (2) above only if they are reasonably and closely related to these purposes. Some of these other expenses are explained in the following discussions.

If the expenses you pay produce income that is only partially taxable, see *Tax-Exempt Income Expenses*, later, under *Nondeductible Expenses*.

### Appraisal Fees

You can deduct appraisal fees if you pay them to figure a casualty loss or the fair market value of donated property.

### Certain Casualty and Theft Losses

You can deduct casualty and theft losses on property used in performing services as an employee from Form 4684, lines 32 and 38b, or Form 4797, line 18b(1). For casualty and theft losses on income-producing property, see *Certain Casualty and Theft Losses*, under *Deductions Not Subject to the 2% Limit*, later. For other casualty and theft losses, see chapter 27.

### Clerical Help and Office Rent

You can deduct office expenses, such as rent and clerical help, that you have in connection with your investments and collecting the taxable income on them.

### Depreciation on Home Computer

You can deduct depreciation on your home computer if you use it to produce income (for example, to manage your investments that produce taxable income). You generally must depreciate the computer using the straight line method over the Alternative Depreciation System (ADS) recovery period. But if you work as an employee and also use the computer in that work, see Publication 946.

### Excess Deductions of an Estate

If the total deductions in the estate's last tax year are more than the estate's gross income for that year, the beneficiaries succeeding to the estate's property can claim the excess as a miscellaneous deduction. Do not include deductions for personal exemptions and charitable contributions when figuring the total deductions. The beneficiaries can claim the deduction only for the tax year in which or with which the estate terminates, whether the year of termination is a normal year or a short tax year. For more

information, see Publication 559, *Survivors, Executors, and Administrators*.

### Fees to Collect Interest and Dividends

You can deduct fees you pay to a broker, bank, trustee, or similar agent to collect your taxable bond interest or dividends on shares of stock. But you cannot deduct a fee you pay to a broker to buy investment property, such as stocks or bonds. You must add the fee to the cost of the property.

You cannot deduct the fee you pay to a broker to sell securities. You can use the fee only to figure gain or loss from the sale. See the instructions for columns (d) and (e) of Schedule D (Form 1040) for information on how to report the fee.

### Hobby Expenses

You can generally deduct hobby expenses, but only up to the amount of hobby income. A hobby is not a business because it is not carried on to make a profit. See *Activity not for profit* in chapter 13 under *Miscellaneous Taxable Income*.

### Indirect Deductions of Pass-Through Entities

Pass-through entities include partnerships, S corporations, and mutual funds. Deductions of pass-through entities are passed through to the partners or shareholders. If the deductions are miscellaneous itemized deductions, they are generally subject to the 2% limit.

**Information returns.** You should receive information returns from pass-through entities. Partnerships and S corporations issue **Schedule K-1**, which lists the items and amounts you must report, and identifies the tax return schedules and lines to use.

**Example.** You are a member of an investment club that is formed solely to invest in securities. The club is treated as a partnership. The partnership's income is solely from taxable dividends, interest, and gains from sales of securities. In this case, you can deduct your share of the partnership's operating expenses as a miscellaneous itemized deduction subject to the 2% limit. However, if the investment club partnership has investments that also produce nontaxable income, you cannot deduct your share of the partnership's expenses that produce the nontaxable income. You should receive a copy of Schedule K-1 (Form 1065), *Partner's Share of Income, Credits, Deductions, etc.*

**Allocated expenses of mutual funds.** The allocable investment expenses of nonpublicly offered mutual funds are subject to the 2% limit. Publicly offered mutual funds do not pass investment expenses through to shareholders.

A "publicly offered" mutual fund is one that is:

- 1) Continuously offered pursuant to a public offering,
- 2) Regularly traded on an established securities market, or
- 3) Held by or for at least 500 persons at all times during the tax year.

Contact your mutual fund if you are not sure if your fund is publicly offered.

**Nonpublicly offered mutual funds.** These funds will send you a Form 1099-DIV, *Dividends and Distributions*, or a substitute form, showing your share of gross income and investment expenses. You can claim the expenses only as a miscellaneous itemized deduction subject to the 2% limit.

**Publicly offered mutual funds.** These funds will send you a Form 1099-DIV, or a substitute form, showing the net amount of dividend income (gross dividends minus investment expenses). This net figure is the amount you report on your return.

### Investment Fees and Expenses

You can deduct investment fees, custodial fees, trust administration fees, and other expenses you paid for managing your investments that produce taxable income.

### Legal Expenses

You can usually deduct legal expenses that you incur in attempting to produce or collect taxable income or that you pay in connection with the determination, collection, or refund of any tax.

You can also deduct legal expenses that are:

- Related to either doing or keeping your job, such as those you paid to defend yourself against criminal charges arising out of your trade or business,
- For tax advice related to a divorce if the bill specifies how much is for tax advice and it is determined in a reasonable way, or
- To collect taxable alimony.

You deduct expenses of resolving tax issues relating to profit or loss from business (Schedule C or C-EZ), rentals or royalties (Schedule E), or farm income and expenses (Schedule F), on the appropriate schedule. You deduct the expenses of resolving nonbusiness tax issues on Schedule A (Form 1040).

### Loss on Deposits in an Insolvent or Bankrupt Financial Institution

For information on whether, and if so, how you may deduct a loss on your deposit in a qualified financial institution, see *Deposits in insolvent or bankrupt financial institution* in chapter 15.

### Repayments of Income

If you had to repay an amount that you included in income in an earlier year, you may be able to deduct the amount you repaid. If the amount you had to repay was ordinary income of \$3,000 or less, the deduction is subject to the 2% limit. If it is more than \$3,000, see *Repayments Under Claim of Right* under *Deductions Not Subject to the 2% Limit*, later.

### Repayments of Social Security Benefits

For information on how to deduct your repayments of certain social security benefits, see *Repayments More Than Gross Benefits* in chapter 12.

## Safe Deposit Box Rent

You can deduct safe deposit box rent if you use the box to store taxable income-producing stocks, bonds, or investment-related papers and documents. You cannot deduct the rent if you use the box only for jewelry, other personal items, or tax-exempt securities.

## Service Charges on Dividend Reinvestment Plans

You can deduct service charges you pay as a subscriber in a dividend reinvestment plan. These service charges include payments for:

- 1) Holding shares acquired through a plan,
- 2) Collecting and reinvesting cash dividends, and
- 3) Keeping individual records and providing detailed statements of accounts.

## Tax Preparation Fees

You can usually deduct tax preparation fees in the year you pay them. Thus, on your 1999 return, you can deduct fees paid in 1999 for preparing your 1998 return.

These fees include the cost of tax preparation software programs and tax publications. They also include any fee you paid for electronic filing of your return.

Deduct expenses of preparing tax schedules relating to profit or loss from business (Schedule C or C-EZ), rentals or royalties (Schedule E), or farm income and expenses (Schedule F) on the appropriate schedule. Deduct the expenses of preparing the remainder of the return on line 21, Schedule A (Form 1040).

## Trustee's Administrative Fees for IRA

You can deduct an IRA trustee's administrative fees that are billed separately and that you paid in connection with your individual retirement arrangement (IRA) (if they are ordinary and necessary). They are deductible as a miscellaneous deduction on Schedule A (Form 1040). For more information about IRAs, see chapter 18.

## Deductions Not Subject to the 2% Limit

You can deduct the expenses listed below as miscellaneous itemized deductions. They are not subject to the 2% limit. Report these expenses on line 27, Schedule A (Form 1040).

## List of Deductions

- Amortizable premium on taxable bonds.
- Casualty and theft losses from income-producing property.
- Federal estate tax on income in respect of a decedent.
- Gambling losses up to the amount of gambling winnings.

- Impairment-related work expenses of persons with disabilities.
- Repayments of more than \$3,000 under a claim of right.
- Unrecovered investment in a pension.

## Amortizable Premium on Taxable Bonds

In general, if the amount you pay for a bond is greater than its stated principal amount, the excess is bond premium. You can elect to amortize the premium on taxable bonds. The amortization of the premium is generally an offset to interest income on the bond rather than a separate deduction item.

Part of the premium on some bonds may be a miscellaneous deduction not subject to the 2% limit. For more information, see *Amortizable Premium on Taxable Bonds* in Publication 529, and *Bond Premium Amortization* in chapter 3 of Publication 550, *Investment Income and Expenses*.

## Certain Casualty and Theft Losses

You can deduct casualty and theft losses on income-producing property from Form 4684, lines 32 and 38b, or Form 4797, line 18b(1). For casualty and theft losses on property used in performing services as an employee, see *Certain Casualty and Theft Losses*, under *Other Expenses*, earlier. For other casualty and theft losses, see chapter 27.

## Federal Estate Tax on Income in Respect of a Decedent

You can deduct the federal estate tax attributable to income in respect of a decedent that you as a beneficiary include in your gross income. Income in respect of the decedent is gross income that the decedent would have received had death not occurred and that was not properly includable in the decedent's final income tax return. See Publication 559 for more information.

## Gambling Losses Up to the Amount of Gambling Winnings

You must report the full amount of your gambling winnings on line 21, Form 1040. You deduct your gambling losses on line 27, Schedule A (Form 1040). You cannot deduct gambling losses that are more than your winnings. Only gambling losses incurred during the year can be deducted on Schedule A (Form 1040).



*You cannot reduce your gambling winnings by your gambling losses. You must report the full amount of your winnings as income and claim your losses as an itemized deduction. Therefore, your records should show your winnings separately from your losses.*



**Diary of winnings and losses.** You must keep an accurate diary or similar record of your losses and winnings. Your diary should contain at least the following information.

- 1) The date and type of your specific wager or wagering activity.
- 2) The name and address or location of the gambling establishment.

- 3) The names of other persons present with you at the gambling establishment.
- 4) The amount(s) you won or lost.

See Publication 529 for more information.

## Impairment-Related Work Expenses

If you have a physical or mental disability that limits your being employed, or substantially limits one or more of your major life activities, such as performing manual tasks, walking, speaking, breathing, learning, and working, you can deduct your impairment-related work expenses.

Impairment-related work expenses are ordinary and necessary business expenses for attendant care services at your place of work and other expenses in connection with your place of work that are necessary for you to be able to work.

**Where to report.** If you are an employee, you enter impairment-related work expenses on Form 2106 or Form 2106-EZ. Enter on line 27, Schedule A (Form 1040) that part of the amount on line 10 of Form 2106, or line 6 of Form 2106-EZ that is related to your impairment. Enter the amount that is unrelated to your impairment on line 20, Schedule A (Form 1040).

## Repayments Under Claim of Right

If you had to repay more than \$3,000 that you included in your income in an earlier year because at the time you thought you had an unrestricted right to it, you may be able to deduct the amount you repaid, or take a credit against your tax. See *Repayments* in chapter 13 for more information.

## Unrecovered Investment in Pension

If a retiree had contributed to the cost of a pension or annuity, the retiree can exclude from income a part of each payment received as a tax-free return of the retiree's investment. If the retiree dies before the entire investment is recovered, any unrecovered investment can be deducted on the retiree's final income tax return. See chapter 11 for more information about the tax treatment of pensions and annuities.

## Officials Paid on a Fee Basis

If you are a fee-basis official, you can claim your expenses in performing services in that job as an adjustment to income rather than as a miscellaneous itemized deduction. To qualify as a fee-basis official, you must be employed by a state or local government and be paid in whole or in part on a fee basis.

**Where to report.** If you qualify as a fee-basis official, you should first complete Form 2106 or Form 2106-EZ. Then you include your expenses in performing services in that job from line 10 of Form 2106 or from line 6 of Form 2106-EZ on line 32 of Form

1040. Then write "FBO" and the amount of those expenses on the dotted line next to line 32 (Form 1040).

## Nondeductible Expenses

Examples of nondeductible expenses are listed next. The list is followed by discussions of additional nondeductible expenses that are more common to most people.

### List of Nondeductible Expenses

- Broker's commissions that you paid in connection with your IRA or other investment property.
- Burial or funeral expenses, including the cost of a cemetery lot.
- Capital expenses.
- Fees and licenses, such as car licenses, marriage licenses, and dog tags.
- Hobby losses.
- Home repairs, insurance, and rent.
- Illegal bribes and kickbacks—See *Bribes and kickbacks* in chapter 16 of Publication 535.
- Losses from the sale of your home, furniture, personal car, etc.
- Personal disability insurance premiums.
- Personal, living, or family expenses.
- The value of wages never received or lost vacation time.

### Campaign Expenses

You cannot deduct campaign expenses of a candidate for any office, even if the candidate is running for reelection to the office. These include qualification and registration fees for primary elections.

**Legal fees.** You cannot deduct legal fees paid to defend charges that arise from participation in a political campaign.

### Check-Writing Fees

If you have a personal checking account, you cannot deduct fees charged by the bank for the privilege of writing checks, even if the account pays interest.

### Club Dues

Generally, you cannot deduct the cost of membership in any club organized for business, pleasure, recreation, or other social purpose. This includes business, social, athletic, luncheon, sporting, airline, and hotel clubs. For exceptions, see *Dues to Chambers of Commerce and Professional Societies* under *Unreimbursed Employee Expenses*, earlier.

### Commuting Expenses

You cannot deduct commuting expenses (the cost of transportation between your home and your main or regular place of work). If you haul tools, instruments, or other items, in your car to and from work,

you can deduct only the additional cost of hauling the items, such as the rent on a trailer to carry the items.

### Fines or Penalties

You cannot deduct fines or penalties you pay to a governmental unit for violating a law. This includes an amount paid in settlement of your actual or potential liability for a fine or penalty (civil or criminal). Fines or penalties include parking tickets, tax penalties, and penalties deducted from teachers' paychecks after an illegal strike.

### Health Spa Expenses

You cannot deduct health spa expenses, even if there is a job requirement to stay in excellent physical condition, such as might be required of a law enforcement officer.

### Homeowners' Insurance Premiums

You cannot deduct premiums that you pay or that are placed in escrow for insurance on your home, such as fire and liability or mortgage insurance.

### Home Security System

You cannot deduct the cost of a home security system as a miscellaneous deduction. However, you may be able to claim a deduction for a home security system as a business expense if you have a home office. See *Home Office*, earlier, and Publication 587.

### Investment-Related Seminars

You cannot deduct any expenses for attending a convention, seminar, or similar meeting for investment purposes.

### Life Insurance Premiums

You cannot deduct premiums you pay on your life insurance. You may be able to deduct, as alimony, premiums you pay on life insurance policies assigned to your former spouse. See chapter 20 for information on alimony.

### Lobbying Expenses

You generally cannot deduct amounts paid or incurred for lobbying expenses. These include expenses to:

- 1) Influence legislation,
- 2) Participate or intervene in any political campaign for, or against, any candidate for public office,
- 3) Attempt to influence the general public, or segments of the public, about elections, legislative matters, or referendums, or
- 4) Communicate directly with covered executive branch officials in any attempt to influence the official actions or positions of such officials.

Lobbying expenses also include any amounts paid or incurred for research, preparation, planning, or coordination of any of these activities.

**Dues used for lobbying.** If a tax-exempt organization notifies you that part of the dues or other amounts you pay to the

organization are used to pay nondeductible lobbying expenses, you cannot deduct that part. See *Lobbying Expenses* in Publication 529 for information on *Exceptions*.

### Lost or Mislaid Cash or Property

You cannot deduct a loss based on the mere disappearance of money or property. However, an accidental loss or disappearance of property can qualify as a casualty if it results from an identifiable event that is sudden, unexpected, or unusual. See chapter 27.

**Example.** A car door is accidentally slammed on your hand, breaking the setting of your diamond ring. The diamond falls from the ring and is never found. The loss of the diamond is a casualty.

### Lunches With Co-Workers

You cannot deduct the expenses of lunches with co-workers, except while traveling away from home on business. See chapter 28 for information on deductible expenses while traveling away from home.

### Meals While Working Late

You cannot deduct the cost of meals while working late. However, you may be able to claim a deduction if it is a deductible entertainment expense or if you are traveling away from home. See chapter 28 for information on deductible entertainment expenses and expenses while traveling away from home.

### Personal Legal Expenses

You cannot deduct personal legal expenses such as those for the following.

- 1) Custody of children.
- 2) Breach of promise (to marry) suit.
- 3) Civil or criminal charges resulting from a personal relationship.
- 4) Damages for personal injury.
- 5) Preparation of a title (or defense or perfection of a title).
- 6) Preparation of a will.
- 7) Property claims or property settlement in a divorce.

You cannot deduct these expenses even if a result of the legal proceeding is the loss of income-producing property.

### Political Contributions

You cannot deduct contributions made to a political candidate, a campaign committee, or a newsletter fund.

### Professional Accreditation Fees

You cannot deduct professional accreditation fees such as the following.

- 1) Accounting certificate fees paid for the initial right to practice accounting.
- 2) Bar exam fees and incidental expenses in securing admission to the bar.
- 3) Medical and dental license fees paid to get initial licensing.



### Professional Reputation

You cannot deduct expenses of radio and TV appearances to increase your personal prestige or establish your professional reputation.

### Relief Fund Contributions

You cannot deduct contributions paid to a private plan that pays benefits to any covered employee who cannot work because of any injury or illness not related to the job.

### Residential Telephone Service

You cannot deduct any charge (including taxes) for basic local telephone service for the first telephone line to your residence, even if it is used in a trade or business.

### Stockholders' Meetings

You cannot deduct transportation and other expenses you pay to attend stockholders' meetings of companies in which you own stock but have no other interest. You cannot deduct these expenses even if you are attending the meeting to get information that

would be useful in making further investments.

### Tax-Exempt Income Expenses

You cannot deduct expenses to produce tax-exempt income. You cannot deduct interest on a debt incurred or continued to buy or carry tax-exempt securities.

If you have expenses to produce both taxable and tax-exempt income, but you cannot identify the expenses that produce each type of income, you must divide the expenses based on the amount of each type of income to determine the amount that you can deduct.

**Example.** During the year, you received taxable interest of \$4,800 and tax-exempt interest of \$1,200. In earning this income, you had total expenses of \$500 during the year. You cannot identify the amount of each expense item that is for each income item. Therefore, you calculate that 80% ( $\$4,800/\$6,000$ ) of the expense is for the taxable interest and 20% ( $\$1,200/\$6,000$ ) is for the tax-exempt interest. You can deduct, subject to the 2% limit, expenses of \$400 (80% of \$500).

### Travel Expenses for Another Individual

You generally cannot deduct travel expenses you pay or incur for a spouse, dependent, or other individual who accompanies you (or your employee) on business travel. See chapter 28 for more information on deductible travel expenses.

### Voluntary Unemployment Benefit Fund Contributions

You cannot deduct voluntary unemployment benefit fund contributions you make to a union fund or a private fund. However, you can deduct contributions as taxes if state law requires you to make them to a state unemployment fund that covers you for the loss of wages from unemployment caused by business conditions.

### Wristwatches

You cannot deduct the cost of a wristwatch, even if there is a job requirement that you know the correct time to properly perform your duties.

# Part Six.

## Figuring Your Taxes and Credits

The eight chapters in this part explain how to figure your tax and how to figure the tax of certain children who have more than \$1,400 of investment income. They also discuss tax credits that, unlike deductions are subtracted directly from your tax and reduce your tax, dollar for dollar. Chapter 37 discusses the earned income credit and how you may be able to get part of the credit paid to you in advance throughout the year.

### 31.

## How To Figure Your Tax

### Introduction

After you have figured your income and deductions as explained in Parts One through Five, your next step is to figure your tax. This chapter discusses:

- The general steps you take to figure your tax,
- An additional tax you may have to pay called the alternative minimum tax, and
- The conditions you must meet if you want the IRS to figure your tax.

### Figuring Your Tax

Your income tax liability is based on your taxable income. After you figure your income tax, subtract your tax credits and add any other taxes you may owe. The result is your total tax. Compare your total tax with your total payments to determine whether you are entitled to a refund or owe additional tax.

This section provides a general outline of how to figure your tax. You can find step-by-step directions in the instructions for Forms 1040EZ, 1040A, and 1040. If you are unsure of which tax form you should file, see *Which Form Should I Use?* in chapter 1.

**Tax.** Most taxpayers use either the Tax Table or the Tax Rate Schedules to figure their income tax. However, there are special methods for the following items.

- Capital gain income (see chapter 17).
- Investment income over \$1,400 of children under age 14 (see chapter 32).
- Lump-sum distributions (see chapter 11).
- Farm income (see Schedule J (Form 1040), *Farm Income Averaging*).

**Credits.** After you figure your income tax, you determine your tax credits. This chapter does not explain whether you are eligible for

these credits. You can find that information in chapters 33 through 38 and your form instructions. See the following table for credits you may be able to subtract from your income tax.

CREDITS	
For information on:	See chapter:
Adoption .....	38
Child and dependent care .....	33
Child tax credit .....	35
Education .....	36
Elderly or disabled .....	34
Foreign tax .....	38
Mortgage interest .....	38
Prior year minimum tax .....	38
Qualified electric vehicle .....	38

Some credits (such as the earned income credit) are not listed above because they are treated as payments. See *Payments*, later.

There are other credits that are not discussed in this publication. These include the following items.

- General business credit, which is made up of a number of separate business-related credits. These generally are reported on Form 3800, *General Business Credit*, and are discussed in chapter 4 of Publication 334.
- Empowerment zone employment credit, which is for certain employers whose employees work and live in an empowerment zone. See Publication 954, *Tax Incentives for Empowerment Zones and Other Distressed Communities*, and the instructions for Form 8844, *Empowerment Zone Employment Credit*.
- District of Columbia first-time homebuyer credit, which is for certain persons who buy a main home in the District. See the instructions for Form 8859, *District of Columbia First-Time Homebuyer Credit*.
- Credit for fuel from a nonconventional source, which is for the person who sold the fuel. See the instructions for line 48 of Form 1040 and section 29 of the Code.

**Other taxes.** After you subtract your tax credits, you must determine if there are any other taxes you must pay. This chapter does not explain these other taxes. You can find that information in other chapters of this publication and your form instructions. See the following table for other taxes you may need to add to your income tax.

### OTHER TAXES

For information on:	See chapter:
Tax on qualified retirement plans and IRAs .....	11, 18
Advance earned income credit payments .....	37
Household employment taxes .....	33
Social security and Medicare tax on unreported tips .....	7
Employee tax on tips .....	7

Another tax you may have to pay, the alternative minimum tax, is discussed later in this chapter.

There are other taxes that are not discussed in this publication. These include the following items.

- 1) *Self-employment tax.* You must figure this tax if either of the following applies to you (or your spouse if you file a joint return):
  - a) You were self-employed and your net earnings from self-employment from other than church employee income were \$400 or more, or
  - b) You had church employee income of \$108.28 or more.See the instructions for Schedule SE (Form 1040) and Publication 533, *Self-Employment Tax*.
- 2) *Recapture taxes.* You may have to pay these taxes if you previously claimed an investment credit, a low-income housing credit, a mortgage interest credit, a qualified electric vehicle credit, or an Indian employment credit. See the instructions for line 56 of Form 1040.
- 3) *Section 72(m)(5) excess benefits tax.* If you are (or were) a 5% owner of a business and you received a distribution that exceeds the benefits provided for you under the qualified pension or annuity plan formula, you may have to pay this additional tax. See Publication 560, *Retirement Plans for Small Business (SEP, SIMPLE, and Keogh Plans)*.
- 4) *Uncollected social security and Medicare tax on group-term life insurance.* If your former employer provides you with more than \$50,000 of group-term life insurance coverage, you must pay the employee part of social security and Medicare taxes on those premiums. The amount should be shown in box 13 of your Form W-2 with codes M and N.
- 5) *Tax on golden parachute payments.* This tax applies if you, as a key em-

ployee, received an "excess parachute payment" (EPP) due to a change in a corporation's ownership or control. See the instructions for line 56 of Form 1040.

- 6) **Tax on accumulated distribution of trusts.** This applies if you are the beneficiary of a trust that accumulated its income instead of distributing it currently. See the instructions for Form 4970, *Tax on Accumulation Distribution of Trusts*.
- 7) **Additional Tax on MSAs.** If amounts contributed to, or distributed from, your medical savings account do not meet the rules for these accounts, you may have to pay additional taxes. See Publication 969, *Medical Savings Accounts*, and Forms 8853, *Medical Savings Accounts and Long-Term Care Insurance Contracts*, and 5329, *Additional Taxes Attributable to IRAs, Other Qualified Retirement Plans, Annuities, Modified Endowment Contracts, and MSAs*.

**Payments.** After you determine your total tax, you must figure the total payments you have already made for the year. Include credits that are treated as payments. This chapter does not explain these payments and credits. You can find that information in other chapters of this publication and your form instructions. See the following table for amounts you can include in your total payments.

PAYMENTS	See chapter:
<b>For information on:</b>	
Child tax credit (additional) .....	35
Earned income credit .....	37
Estimated tax paid .....	5
Excess social security and RRTA tax withheld .....	38
Federal income tax withheld .....	5
Regulated investment company credit ..	38
Tax paid with extension .....	1

Another credit that is treated as a payment is the credit for federal excise tax paid on fuels. This credit is for persons who have a nontaxable use of certain fuels, such as diesel fuel and kerosene. It is claimed on line 63 of Form 1040. See Publication 378, *Fuel Tax Credits and Refunds*, and Form 4136, *Credit for Federal Tax Paid on Fuels*.

**Refund or balance due.** To determine whether you are entitled to a refund or owe additional tax, compare your total payments with your total tax. If you are entitled to a refund, see your form instructions for information on having it directly deposited into your financial account instead of receiving a paper check.

## Alternative Minimum Tax

This section briefly discusses an additional tax you may have to pay.

The tax law gives special treatment to some kinds of income and allows special deductions and credits for some kinds of expenses. Taxpayers who benefit from the law in these ways may have to pay at least a minimum amount of tax through an addi-

tional tax. This additional tax is called the alternative minimum tax (AMT).

You may have to pay the alternative minimum tax if your taxable income for regular tax purposes, combined with certain adjustments and tax preference items, is more than:

- \$45,000 if your filing status is married filing a joint return (or a qualifying widow(er) with dependent child),
- \$33,750 if your filing status is single or head of household, or
- \$22,500 if your filing status is married filing a separate return.

**Adjustments and tax preference items.** The more common adjustments and tax preference items include:

- Addition of **personal exemptions**,
- Addition of the **standard deduction** (if claimed),
- Addition of **itemized deductions** claimed for state and local taxes, certain interest, most miscellaneous deductions, and part of medical expenses,
- Subtraction of any **refund of state and local taxes** included in gross income,
- Changes to accelerated **depreciation** of certain property,
- Difference between **gain or loss** on the sale of property reported for regular tax purposes and AMT purposes,
- Addition of certain income from **incentive stock options**,
- Change in certain **passive activity loss** deductions,
- Addition of certain **depletion** that is more than the adjusted basis of the property,
- Addition of part of the deduction for certain **intangible drilling costs**, and
- Addition of **tax-exempt interest** on certain private activity bonds.

**More information.** For more information about the alternative minimum tax, see the instructions for Form 1040, line 51, and **Form 6251**, *Alternative Minimum Tax—Individuals*.

## Tax Figured by IRS

If you file by April 17, 2000, you can have the IRS figure your tax for you on Form 1040EZ, Form 1040A, or Form 1040.

If the IRS figures your tax and you paid too much, you will receive a refund. If you did not pay enough, you will receive a bill for the balance. To avoid interest or the penalty for late payment, you must pay the bill within 30 days of the date of the bill or by the due date for your return, whichever is later.

**When the IRS cannot figure your tax.** The IRS cannot figure your tax for you if any of the following apply.

- 1) You want your refund directly deposited.
- 2) You want any of your refund applied to your 2000 estimated tax.

- 3) Any of your income for the year was from **other than** wages, salaries, tips, interest, dividends, taxable social security benefits, unemployment compensation, IRA distributions, pensions, and annuities.
- 4) Your taxable income is \$100,000 or more.
- 5) You itemize deductions.
- 6) You file any of the following forms.
  - a) Form 2555, *Foreign Earned Income*.
  - b) Form 2555-EZ, *Foreign Earned Income Exclusion*.
  - c) Form 4137, *Social Security and Medicare Tax on Unreported Tip Income*.
  - d) Form 4970, *Tax on Accumulation Distribution of Trusts*.
  - e) Form 4972, *Tax on Lump-Sum Distributions*.
  - f) Form 6198, *At-Risk Limitations*.
  - g) Form 6251, *Alternative Minimum Tax—Individuals*.
  - h) Form 8606, *Nondeductible IRAs*, on which a conversion to a Roth IRA is reported.
  - i) Form 8615, *Tax for Children Under Age 14 Who Have Investment Income of More Than \$1,400*.
  - j) Form 8814, *Parents' Election To Report Child's Interest and Dividends*.
  - k) Form 8839, *Qualified Adoption Expenses*.
  - l) Form 8853, *Medical Savings Accounts and Long-Term Care Insurance Contracts*.

## Filing the Return

After you complete the line entries for the tax form you are filing (discussed next), attach the peel-off label, enter your social security number(s), sign the return, and mail it. If you do not have a peel-off label, fill in your name and address. See chapter 1 for more information.

### Form 1040EZ Line Entries

Read lines 1 through 8 and fill in the lines that apply to you. If you are filing a joint return, write your taxable income and your spouse's taxable income to the left of line 6.

**Earned income credit.** If you can take this credit, as discussed in chapter 37, the IRS will figure it for you. Print "EIC" in the space to the right of the word "below" on line 8b. Enter the amount and type of any nontaxable earned income in the boxes for line 8b.

### Form 1040A Line Entries

Read lines 1 through 24 and fill in the lines that apply to you. If you are filing a joint return, write your taxable income and your spouse's taxable income to the left of line 24. Complete lines 26, 27, and 35 through 37b if they apply to you. Do not fill in lines 27 and 37a if you want the IRS to figure the

credits shown on those lines. Also, enter any write-in information that applies to you in the space to the left of line 39.

**Credit for child and dependent care expenses.** If you can take this credit, as discussed in chapter 33, complete Schedule 2 and attach it to your return. Enter the amount of the credit on line 26 (Form 1040A). The IRS will not figure this credit.

**Credit for the elderly or the disabled.** If you can take this credit, as discussed in chapter 34, attach Schedule 3. Print "CFE" in the space to the left of line 27. The IRS will figure this credit for you. On Schedule 3, check the box in Part I for your filing status and age, and fill in line 13 of Part III. Complete Part II and line 11 of Part III if they apply.

**Earned income credit.** If you can take this credit, as discussed in chapter 37, the IRS will figure it for you. Print "EIC" directly to the

right of line 37a. Enter the amount and type of any nontaxable earned income in the spaces provided on line 37b. If you have a qualifying child, you must fill in Schedule EIC and attach it to your return.

### Form 1040 Line Entries

Read lines 1 through 39 and fill in the lines that apply to you.

If you are filing a joint return, write your taxable income and your spouse's taxable income in the space above the words "Adjusted Gross Income" on the front of your return.

Read lines 41 through 63. Fill in the lines that apply to you, but do not fill in the "Total" lines. Do not fill in lines 42 and 59a if you want the IRS to figure the credits shown on those lines.

Fill in any forms or schedules asked for on the lines you completed, and attach them to your return.

**Credit for child and dependent care expenses.** If you can take this credit, as discussed in chapter 33, complete Form 2441 and attach it to your return. Enter the amount of the credit on line 41. The IRS will not figure this credit.

**Credit for the elderly or the disabled.** If you can take this credit, as discussed in chapter 34, attach Schedule R. Print "CFE" on the dotted line next to line 42 of Form 1040. The IRS will figure the credit for you. On Schedule R, check the box in Part I for your filing status and age, and fill in line 13 of Part III. Complete Part II and line 11 of Part III if they apply.

**Earned income credit.** If you can take this credit, as discussed in chapter 37, the IRS will figure it for you. Print "EIC" directly to the right of line 59a of Form 1040. Enter the amount and type of any nontaxable earned income in the spaces provided on line 59b. If you have a qualifying child, you must fill in Schedule EIC and attach it to your return.

## Tax on Investment Income of Certain Minor Children

### Important Reminder

**Parent's election to report child's interest and dividends.** You may be able to elect to include your child's interest and dividends on your tax return. If you make this election, the child does not have to file a return. See *Parent's Election To Report Child's Interest and Dividends*, later.

### Introduction

This chapter discusses two special tax rules that apply to certain investment income of a child under age 14.

- 1) The child's parent may be able to choose to include the child's interest and dividend income on the parent's return rather than file a return for the child. (See *Parent's Election To Report Child's Interest and Dividends*, later.)
- 2) If the child's interest, dividends, and other investment income total more than \$1,400, part of that income may be taxed at the parent's tax rate instead of the child's tax rate. (See *Tax for Children Under Age 14 Who Have Investment Income of More Than \$1,400*, later.)

In both cases, the term "child" includes a legally adopted child and a stepchild. These rules apply whether or not the child is a dependent.

These rules do **not** apply if:

- 1) The child is not required to file a tax return, or
- 2) Neither of the child's parents were living at the end of the tax year.

### Useful Items

You may want to see:

#### Publication

- 929** Tax Rules for Children and Dependents

#### Form (and Instructions)

- 8615** Tax for Children Under Age 14 Who Have Investment Income of More Than \$1,400

- 8814** Parents' Election To Report Child's Interest and Dividends

### Which Parent's Return To Use

If a child's parents are married to each other and file a joint return, use the joint return to figure the tax on the investment income of a child under 14. For parents who do not file a joint return, the following discussions explain which parent's tax return must be used to figure the tax. Only the parent whose tax return is used can make the election described under *Parent's Election To Report Child's Interest and Dividends*. The tax rate and other return information from that parent's return are used to compute the child's tax as explained later under *Tax for Children Under Age 14 Who Have Investment Income of More Than \$1,400*.

**Parents are married.** If the child's parents file separate returns, use the return of the parent with the greater taxable income.

**Parents not living together.** If the child's parents are married to each other but not living together, and the parent with whom the child lives (the custodial parent) is considered unmarried, use the return of the custodial parent. If the custodial parent is not considered unmarried, use the return of the parent with the greater taxable income.

For an explanation of when a married person living apart from his or her spouse is considered unmarried, see *Head of Household* in chapter 2.

**Parents are divorced.** If the child's parents are divorced or legally separated, and the parent who had custody of the child for the greater part of the year (the custodial parent) has not remarried, use the return of the custodial parent.

**Custodial parent remarried.** If the custodial parent has remarried, the stepparent (rather than the noncustodial parent) is treated as the child's other parent. Therefore, if the custodial parent and the stepparent file a joint return, use that joint return. Do not use the return of the non-custodial parent.

If the custodial parent and the stepparent are married, but file separate returns, use the return of the one with the greater taxable income. If the custodial parent and the stepparent are married but not living together, the earlier discussion under *Parents not living together*, applies.

**Parents never married.** If a child's parents did not marry each other, but lived together all year, use the return of the parent with the greater taxable income. If the parents did not live together all year, the rules explained earlier under *Parents are divorced*, apply.

**Widows and widowers.** If a widow or widower remarries, the new spouse is treated as the child's other parent. The rules explained earlier under *Custodial parent remarried*, apply.

## Parent's Election To Report Child's Interest and Dividends

You may be able to elect to include your child's interest and dividend income (including capital gain distributions) on your tax return. If you do, your child will not have to file a return.

You can make this election for 1999 only if **all** the following conditions are met.

- 1) Your child was under age 14 on January 1, 2000.
- 2) Your child is required to file a return for 1999 unless you make this election.
- 3) Your child had income only from interest and dividends (including capital gain distributions and Alaska Permanent Fund dividends).
- 4) The dividend and interest income was less than \$7,000.
- 5) No estimated tax payment was made for 1999 and no 1998 overpayment was applied to 1999 under your child's name and social security number.
- 6) No federal income tax was taken out of your child's income under the backup withholding rules.
- 7) You are the parent whose return must be used when applying the special tax rules for children under 14. (See *Which Parent's Return To Use*, earlier.)

These conditions are also shown in *Figure 32-A*.

**How to make the election.** Make the election by attaching **Form 8814** to your Form 1040 or Form 1040NR. Attach a separate Form 8814 for each child for whom you make the election. You can make the election for one or more children and not for others.

If you file Form 8814, you cannot file Form 1040A or Form 1040EZ.

### Effect of Making the Election

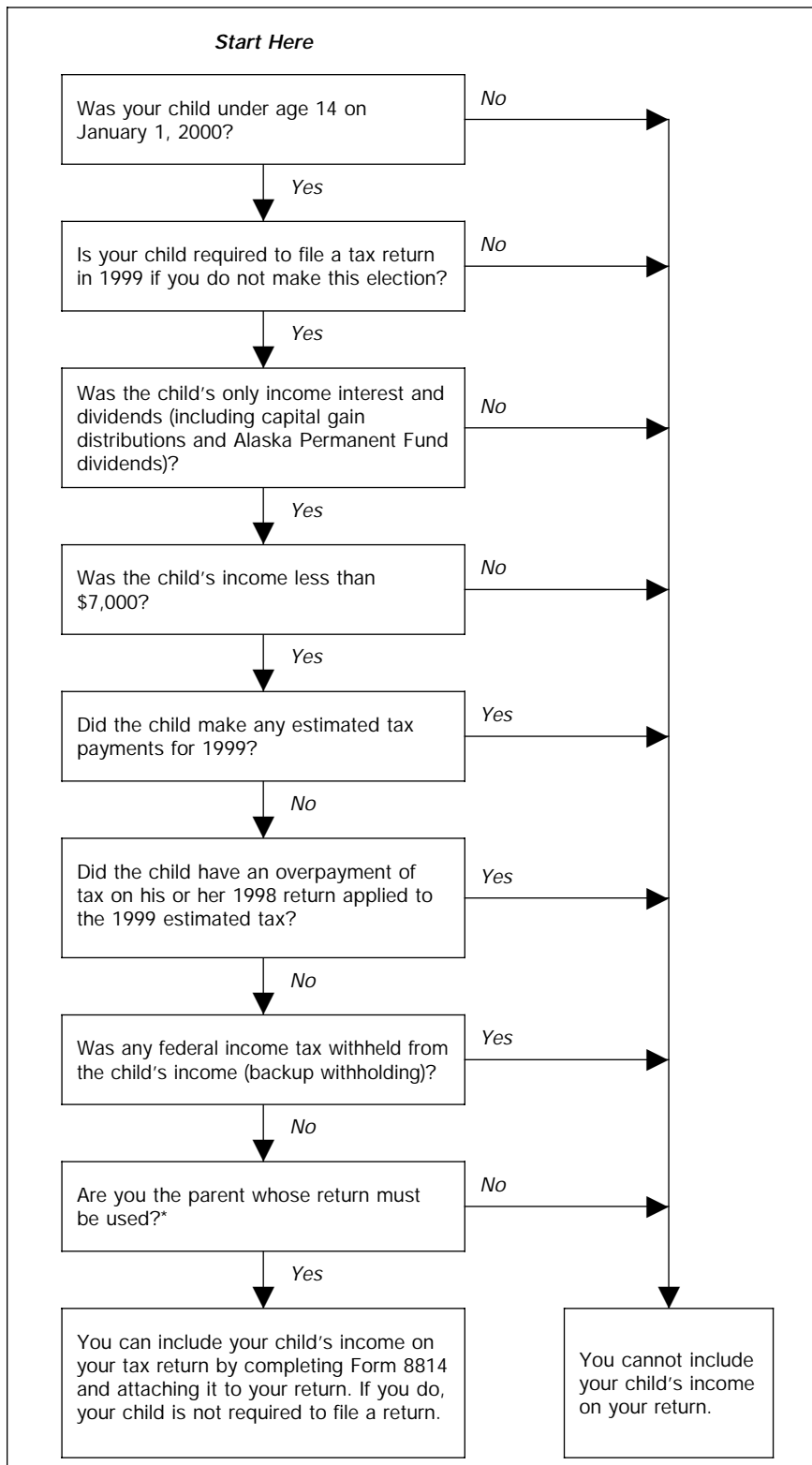
The federal income tax on your child's income may be more if you make the Form 8814 election rather than file a return for the child.

**Rates may be higher.** If you use Form 8814, the child's income may be taxed at a higher rate on your return than it would be on the child's own return.

**Deductions you cannot take.** By making the Form 8814 election, you cannot take any of the following deductions the child would be entitled to on his or her return.

- 1) The higher standard deduction for a blind child.
- 2) The deduction for a penalty on an early withdrawal of your child's savings.
- 3) Itemized deductions (such as your child's investment expenses or charitable contributions).

Figure 32–A. Can You Include Your Child's Income On Your Tax Return?



\*See *Which Parent's Return To Use*

**Reduced deductions or credits.** If you use Form 8814, your increased adjusted gross income may reduce certain deductions or credits on your return. These include your deduction for contributions to a traditional individual retirement arrangement (IRA), itemized deductions for medical expenses, casualty and theft losses, and

certain miscellaneous expenses. Your increased adjusted gross income may also reduce your child tax credit, education credit, or earned income credit.

**Penalty for underpayment of estimated tax.** If you make this election for 1999 and did not have enough tax withheld or pay

enough estimated tax to cover the tax you owe, you may be subject to a penalty. If you plan to make this election for 2000, you may need to increase your federal income tax withholding or your estimated tax payments to avoid the penalty. See chapter 5 for more information.

### Figuring Child's Income

Use **Part I** of Form 8814 to figure your child's interest and dividend income to report on your return. Only the amount over \$1,400 is added to your income. This amount is shown on line 6 of Form 8814. Include this amount on line 21 of Form 1040 or Form 1040NR. Write "Form 8814" in the space next to line 21. If you file more than one Form 8814, include the total amounts from line 6 of all your Forms 8814 on line 21.

**Capital gain distributions.** If your child's dividend income included any capital gain distributions, see *Capital gain distributions*, under *Figuring Child's Income* in Publication 929.

### Figuring Additional Tax

Use **Part II** of Form 8814 to figure the tax on the \$1,400 of your child's interest and dividends that you do not include in your income. This tax is added to the tax figured on your income.

This additional tax is the **smaller** of:

- 1)  $15\% \times (\text{your child's gross income} - \$700)$ , or
- 2) \$105.

Include the amount from line 9 of all your Forms 8814 in the total on line 40, Form 1040, or line 39, Form 1040NR. Check box a on Form 1040, line 40, or Form 1040NR, line 39.

### Illustrated Example

David and Linda Parks are married and will file separate tax returns for 1999. Their only child, Philip, is 8. Philip received a Form 1099-INT showing \$3,200 taxable interest income and a Form 1099-DIV showing \$300 ordinary dividends. His parents decide to include that income on one of their returns so they will not have to file a return for Philip.

First, David and Linda each figure their taxable income (Form 1040, line 39) without Philip's income. David's taxable income is \$41,700 and Linda's is \$59,300. Because her taxable income is greater, Linda can elect to include Philip's income on her return.

On Form 8814, Linda enters her name and social security number, then Philip's name and social security number. She enters Philip's taxable interest income, \$3,200, on line 1a. Philip had no tax-exempt interest income, so she leaves line 1b blank. Linda enters Philip's ordinary dividends, \$300, on line 2. Philip did not have any capital gain distributions, so she leaves line 3 blank.

Linda adds lines 1a and 2 and enters the result, \$3,500, on line 4. From that amount she subtracts the \$1,400 base amount shown on line 5 and enters the result, \$2,100, on line 6. This is the part of Philip's income that Linda must add to her income.

Linda includes the \$2,100 in the total on line 21 of her Form 1040 and in the space next to that line prints "Form 8814 - \$2,100." Adding that amount to her income increases each of the amounts on lines 22, 33, 34, 37, and 39 of her Form 1040 by \$2,100. Linda is not claiming any deductions or credits that are affected by the increase to her income. Therefore, her revised taxable income on line 39 is \$61,400 (\$59,300 + \$2,100).

On Form 8814, Linda subtracts the \$700 shown on line 7 from the \$3,500 on line 4 and enters the result, \$2,800, on line 8. Because that amount is not less than \$700, she enters \$105 on line 9. This is the tax on the first \$1,400 of Philip's income, which Linda did not have to add to her income. She must add this additional tax to the tax figured on her revised taxable income.

The tax on her \$61,400 revised taxable income is \$14,683. She adds \$105, and enters the \$14,788 total on line 40 of Form 1040, and checks box a.

Linda attaches Form 8814 to her Form 1040.

## Tax for Children Under Age 14 Who Have Investment Income of More Than \$1,400

Part of a child's 1999 investment income may be subject to tax at the parent's tax rate if:

- 1) The child was under age 14 on January 1, 2000,
- 2) The child's investment income was more than \$1,400, and
- 3) The child is required to file a return for 1999.

Figure 32-B illustrates these requirements.

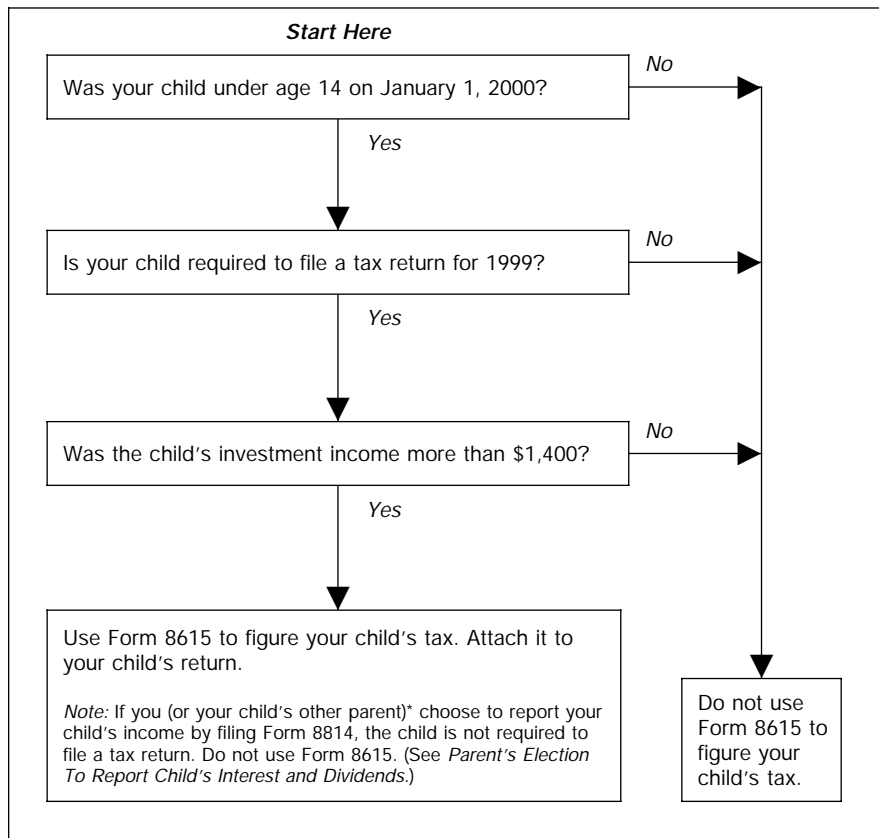
If you do not or cannot choose to include the child's income on your return, figure the child's tax on **Form 8615**. Attach the form to the child's Form 1040, Form 1040A, or Form 1040NR.

On Form 8615, enter your name and social security number and your child's name and social security number in the spaces provided. (If you filed a joint return, enter the name and social security number listed first on the joint return.) Check the box for your filing status. Then figure the child's tax on Form 8615 in these steps.

1. Figure the child's net investment income.
2. Figure a tentative tax on the net investment income based on the parent's tax rate.
3. Figure the child's tax.

**Alternative minimum tax.** A child may be subject to alternative minimum tax (AMT) if he or she has certain items given preferential treatment under the tax laws or certain adjustments to taxable income that total

Figure 32-B. Do You Have To Use Form 8615 To Figure Your Child's Tax?



\*See *Which Parent's Return To Use*

more than an exemption amount. See *Alternative Minimum Tax* in chapter 31.

AMT is figured on Form 6251. For information on special limits that apply to a child who files Form 6251, see *Alternative Minimum Tax* in Publication 929.

### Parent's Return

See *Which Parent's Return To Use*, at the beginning of this chapter, for information on which parent's return information must be used on Form 8615.

**Different tax years.** If you and the child do not have the same tax year, complete Form 8615 using the information on your return for the tax year that ends in the child's tax year.

**Estimated information.** If the information needed from your return is not known by the time the child's return is due (usually April 15), you can file the return using estimates.

You can use any reasonable estimate. This includes using information from last year's return. If you use an estimated amount on Form 8615, write "Estimated" next to the appropriate line(s).

When you get the correct information, file an amended return on Form 1040X, *Amended U.S. Individual Income Tax Return*.

Instead of using estimated information, you may want to request an extension of time to file. Extensions are discussed in chapter 1.

### Part I. Figuring Net Investment Income

The first step in figuring a child's tax using Form 8615 is to figure the child's net investment income. To do that, use Part I of Form 8615.

**Line 1 (investment income).** If the child had **no earned income**, enter the adjusted gross income shown on the child's return. Adjusted gross income is shown on line 34 of Form 1040; line 19 of Form 1040A; or line 34 of Form 1040NR. Form 1040EZ cannot be used if Form 8615 must be filed.

If the child had **earned income**, figure the amount to enter on line 1 of Form 8615 by using the worksheet in the instructions for the form.

However, if the child has excluded any foreign earned income or deducted either a loss from self-employment or a net operating loss from another year, use the worksheet in Publication 929 to figure the amount to enter on line 1 of Form 8615.

**Investment income defined.** Investment income is generally all income other than salaries, wages, and other amounts received as pay for work actually done. It includes taxable interest, dividends, capital gains, the taxable part of social security and pension payments, and certain distributions from trusts. Investment income includes amounts produced by assets the child obtained with earned income (such as interest on a savings account into which the child deposited wages).

# Parents' Election To Report Child's Interest and Dividends

▶ See instructions below and on back.  
▶ Attach to parents' Form 1040 or Form 1040NR.

Name(s) shown on your return

Linda Parks

Your social security number

111 : 00 : 1111

**Caution:** The Federal income tax on your child's income, including capital gain distributions, may be less if you file a separate tax return for the child instead of making this election. This is because you cannot take certain tax benefits that your child could take on his or her own return. For details, see **Tax Benefits You May Not Take** on the back.

**A** Child's name (first, initial, and last)

Philip Parks

**B** Child's social security number

000 : 00 : 0000

**c** If more than one Form 8814 is attached, check here

## Part I Child's Interest and Dividends To Report on Your Return

<b>1a</b> Enter your child's <b>taxable</b> interest. If this amount is different from the amounts shown on the child's Forms 1099-INT and 1099-OID, see the instructions . . . . .	<b>1a</b>	3,200	
<b>b</b> Enter your child's <b>tax-exempt</b> interest. <b>DO NOT</b> include this amount on line 1a . . . . .	<b>1b</b>		
<b>2</b> Enter your child's ordinary dividends, including any Alaska Permanent Fund dividends. If your child received any ordinary dividends as a nominee, see the instructions . . . . .	<b>2</b>	300	
<b>3</b> Enter your child's capital gain distributions. If your child received any capital gain distributions as a nominee, see the instructions . . . . .	<b>3</b>		
<b>4</b> Add lines 1a, 2, and 3. If the total is \$1,400 or less, skip lines 5 and 6 and go to line 7. If the total is \$7,000 or more, <b>do not</b> file this form. Your child <b>must</b> file his or her own return to report the income . . . . .	<b>4</b>	3,500	
<b>5</b> Base amount . . . . .	<b>5</b>	1,400	00
<b>6</b> Subtract line 5 from line 4. If you checked the box on line C above or if you entered an amount on line 3, see the instructions. Also, include this amount in the total on Form 1040, line 21, or Form 1040NR, line 21. In the space next to line 21, enter "Form 8814" and show the amount. Go to line 7 below. ▶	<b>6</b>	2,100	

## Part II Tax on the First \$1,400 of Child's Interest and Dividends

<b>7</b> Amount not taxed . . . . .	<b>7</b>	700	00
<b>8</b> Subtract line 7 from line 4. If the result is zero or less, enter -0- . . . . .	<b>8</b>	2,800	
<b>9 Tax.</b> Is the amount on line 8 less than \$700? <input type="checkbox"/> <b>No.</b> Enter \$105 here and see the <b>Note</b> below. <input type="checkbox"/> <b>Yes.</b> Multiply line 8 by 15% (.15). Enter the result here and see the <b>Note</b> below. } . . . . .	<b>9</b>	105	

**Note:** If you checked the box on line C above, see the instructions. Otherwise, include the amount from line 9 in the tax you enter on Form 1040, line 40, or Form 1040NR, line 39. Be sure to check box **a** on Form 1040, line 40, or Form 1040NR, line 39.

## General Instructions

**Purpose of Form.** Use this form if you elect to report your child's income on your return. If you do, your child will not have to file a return. You can make this election if your child meets **all** of the following conditions:

- Was under age 14 on January 1, 2000.
- Is required to file a 1999 return.
- Had income only from interest and dividends, including Alaska Permanent Fund dividends.
- Had gross income for 1999 that was less than \$7,000.
- Had no estimated tax payments for 1999 (including any overpayment of tax from his or her 1998 return applied to 1999 estimated tax).

- Had no Federal income tax withheld from his or her income.

You must also qualify. See **Parents Who Qualify To Make the Election** below.

**How To Make the Election.** To make the election, complete and attach Form(s) 8814 to your tax return and file your return by the due date (including extensions). A separate Form 8814 must be filed for **each** child whose income you choose to report.

**Parents Who Qualify To Make the Election.** You qualify to make this election if you file Form 1040 or Form 1040NR and any of the following apply:

- You are filing a joint return for 1999 with the child's other parent.
- You and the child's other parent were married to each other but file separate

returns for 1999 AND you had the **higher** taxable income. If you do not know if you had the higher taxable income, see **Pub. 929**, Tax Rules for Children and Dependents.

- You were unmarried, treated as unmarried for Federal income tax purposes, or separated from the child's other parent by a divorce or separate maintenance decree. You must have had custody of your child for most of the year (you were the custodial parent). If you were the custodial parent and you remarried, you may make the election on a joint return with your new spouse. But if you and your new spouse do not file a joint return, you qualify to make the election only if you had **higher** taxable income than your new spouse.

(continued)



**Nontaxable income.** For this purpose, investment income includes only amounts that the child must include in total income. Nontaxable investment income, such as tax-exempt interest and the nontaxable part of social security and pension payments, is not included.

**Income from property received as a gift.** A child's investment income includes all income produced by property belonging to the child. This is true even if the property was transferred to the child regardless of when the property was transferred or purchased or who transferred it.

A child's investment income includes income produced by property given as a gift to the child. This includes gifts to the child from grandparents or any other person and gifts made under the Uniform Gift to Minors Act.

**Example.** Amanda Black, 13, received the following income:

- Dividends — \$600
- Wages — \$2,100
- Taxable interest — \$1,200
- Tax-exempt interest — \$100
- Net capital gains — \$100.

The dividends were on stock given to her by her grandparents. Amanda's investment income is \$1,900. This is the total of the dividends (\$600), taxable interest (\$1,200), and net capital gains (\$100). Her wages are earned (not investment) income because they are pay received for work actually done. Her tax-exempt interest is not included because it is nontaxable.

**Trust income.** If a child is the beneficiary of a trust, distributions of taxable interest, dividends, capital gains, and other investment income from the trust are investment income to the child.

**Line 2 (deductions).** If the child does not itemize deductions on Schedule A (Form 1040 or Form 1040NR), enter \$1,400 on line 2.

If the child does itemize deductions, enter on line 2 the larger of:

- 1) \$700 plus the child's itemized deductions that are directly connected with the production of investment income, or
- 2) \$1,400.

**Directly connected.** Itemized deductions are directly connected with the production of investment income if they are for expenses paid to produce or collect taxable income or to manage, conserve, or maintain property held for producing income. These expenses include custodian fees and service charges, service fees to collect taxable interest and dividends, and certain investment counsel fees.

These expenses are added to certain other miscellaneous deductions on Schedule A (Form 1040). Only the amount greater than 2% of the child's adjusted gross income can be deducted. See chapter 30 for more information.

**Example 1.** Roger, 12, has investment income of \$8,000, no other income, no adjustments to income, and itemized de-

ductions of \$300 (net of the 2% of adjusted gross income limit) that are directly connected with his investment income. His adjusted gross income is \$8,000, which is entered on line 1. Line 2 is \$1,400 because that is more than the sum of \$700 and his directly-connected itemized deductions of \$300.

**Example 2.** Eleanor, 8, has investment income of \$16,000 and an early withdrawal penalty of \$100. She has no other income. She has itemized deductions of \$1,050 (net of the 2% of adjusted gross income limit) that are directly connected with the production of her investment income. Her adjusted gross income, entered on line 1, is \$15,900 (\$16,000 - \$100). Line 2 is \$1,750. This is the larger of:

- 1) \$700 plus the \$1,050 of directly connected itemized deductions, or
- 2) \$1,400.

## Part II. Figuring Tentative Tax at Parent's Tax Rate

The tentative tax is the difference between the tax on the parent's taxable income figured with the child's net investment income and the tax figured without it.

When figuring the tentative tax, do not refigure any of the exclusions, deductions, or credits on the parent's return because of the child's net investment income. For example, do not refigure the medical expense deduction.

Figure the tentative tax on lines 6 through 13 of Form 8615.

**Note.** If the child has any capital gains or losses, get Publication 929 for help in completing Part II of Form 8615.

**Line 7 (net investment income of other children).** If the tax return information of the parent is also used on any other child's Form 8615, enter on line 7 the total amounts from line 5 of all the other children's Forms 8615. Do not include the amount from line 5 of the Form 8615 being completed.

**Example.** Paul and Jane Persimmon have three children, Sharon, Jerry, and Mike, who must attach Form 8615 to their tax returns. The children's net investment income amounts on line 5 of their Forms 8615 are:

- Sharon — \$800
- Jerry — \$600
- Mike — \$1,000

Line 7 of Sharon's Form 8615 would show \$1,600, the total of the amounts on line 5 of Jerry's and Mike's Forms 8615.

Line 7 of Jerry's Form 8615 would show \$1,800 (\$800 + \$1,000).

Line 7 of Mike's Form 8615 would show \$1,400 (\$800 + \$600).

**Other children's information not available.** If the net investment income of the other children is not available when the return is due, either file the return using estimates or get an extension of time to file. See *Estimated information*, earlier.

**Lines 12a and 12b (dividing the tentative tax).** If line 7 is blank, skip lines 12a and 12b and enter the amount from line 11 on line 13.

If an amount is entered on line 7, divide the tentative tax shown on line 11 among the children according to each child's share of the total net investment income. This is done on lines 12a, 12b, and 13. Add the amount on line 7 to the amount on line 5 and enter the total on line 12a. Divide the amount on line 5 by the amount on line 12a and enter the result as a decimal on line 12b.

**Example.** In the earlier example under *Line 7 (net investment income of other children)*, Sharon's Form 8615 shows \$1,600 on line 7. Line 12a is \$2,400, the total of lines 5 and 7 (\$800 + \$1,600). The decimal on line 12b is .333, figured as follows and rounded to three places.

$$\frac{\$800}{\$2,400} = .333$$

## Part III. Figuring the Child's Tax

The final step in figuring a child's tax using Form 8615 is to determine the **larger** of:

- 1) The total of:
  - a) The child's share of the tentative tax based on the parent's tax rate, plus
  - b) The tax on the child's taxable income in excess of net investment income, figured at the child's tax rate, or
- 2) The tax on the child's taxable income, figured at the child's tax rate.

This is the child's tax. It is figured on lines 14 through 18 of Form 8615.

## Illustrated Example

The following example includes a completed Form 8615.

John and Laura Brown have one child, Sara. She is 13 and has \$2,750 taxable interest and dividend income and \$1,500 earned income. She does not itemize deductions. John and Laura file a joint return with John's name and social security number listed first. They claim three exemptions, including an exemption for Sara, on their return.

Because Sara is under age 14 and has more than \$1,400 investment income, part of her income may be subject to tax at her parents' rate. A completed Form 8615 must be attached to her return.

Sara's father, John, fills out Sara's return for her.

John enters his name and social security number on Sara's Form 8615 because his name and number are listed first on the joint return he and Laura are filing. He checks the box for married filing jointly.

He enters Sara's investment income, \$2,750, on line 1. Sara does not itemize deductions, so John enters \$1,400 on line 2. He enters \$1,350 (\$2,750 - \$1,400) on line 3.

Sara's taxable income, as shown on line 24 of her Form 1040A, is \$2,500. This is her total income (\$4,250) minus her standard deduction (\$1,750). Her standard deduction

is limited to the amount of her earned income plus \$250. John enters \$2,500 on line 4.

John compares lines 3 and 4 and enters the smaller amount, \$1,350, on line 5.

John enters \$48,000 on line 6. This is the taxable income from line 39 of their joint Form 1040 return. Sara is an only child, so line 7 is blank. He adds line 5 (\$1,350), line 6 (\$48,000), and line 7 and enters \$49,350 on line 8.

Using the column for married filing jointly in the Tax Table, John finds the tax on

\$49,350. He enters the tax, \$8,229, on line 9. He enters \$7,851 on line 10. This is the tax from line 40 of John and Laura's Form 1040. He enters \$378 on line 11 (\$8,229 – \$7,851).

Because line 7 is blank, John skips lines 12a and 12b and enters \$378 on line 13.

John subtracts line 5 (\$1,350) from line 4 (\$2,500) and enters the result, \$1,150, on line 14. Using the column for single filing status in the Tax Table, John finds the tax on \$1,150. He enters this tax, \$174, on line

15. He adds lines 13 (\$378) and 15 (\$174) and enters \$552 on line 16.

Using the column for single filing status in the Tax Table, John finds the tax on \$2,500 (line 4). He enters this tax, \$377, on line 17.

John compares lines 16 and 17 and enters the larger amount, \$552, on line 18 of Sara's Form 8615. He also enters that amount on line 25 of Sara's Form 1040A.

John also completes Schedule 1 (Form 1040A) for Sara.

**Tax for Children Under Age 14  
Who Have Investment Income of More Than \$1,400**

Department of the Treasury  
Internal Revenue Service

▶ **Attach ONLY to the child's Form 1040, Form 1040A, or Form 1040NR.**

Child's name shown on return Sara L. Brown Child's social security number  
117 : 00 : 1111

**A** Parent's name (first, initial, and last). **Caution:** See instructions on back before completing. **B** Parent's social security number  
007 : 00 : 0001

**C** Parent's filing status (check one):  
 Single  Married filing jointly  Married filing separately  Head of household  Qualifying widow(er)

**Part I Child's Net Investment Income**

1	Enter the child's investment income, such as taxable interest and dividends. See instructions. If this amount is \$1,400 or less, <b>stop</b> ; do not file this form	1	2,750
2	If the child <b>did not</b> itemize deductions on <b>Schedule A</b> (Form 1040 or Form 1040NR), enter \$1,400. If the child <b>did</b> itemize deductions, see instructions	2	1,400
3	Subtract line 2 from line 1. If the result is zero or less, <b>stop</b> ; do not complete the rest of this form but <b>do</b> attach it to the child's return	3	1,350
4	Enter the child's <b>taxable income</b> from Form 1040, line 39; Form 1040A, line 24; or Form 1040NR, line 38	4	2,500
5	Enter the <b>smaller</b> of line 3 or line 4	5	1,350

**Part II Tentative Tax Based on the Tax Rate of the Parent Listed on Line A**

6	Enter the parent's <b>taxable income</b> from Form 1040, line 39; Form 1040A, line 24; Form 1040EZ, line 6; TeleFile Tax Record, line K; Form 1040NR, line 38; or Form 1040NR-EZ, line 14. If less than zero, enter -0-	6	48,000
7	Enter the total net investment income, if any, from Forms 8615, line 5, of <b>all other</b> children of the parent identified above. <b>Do not</b> include the amount from line 5 above	7	
8	Add lines 5, 6, and 7	8	49,350
9	Enter the tax on line 8 based on the <b>parent's</b> filing status. See instructions. If the <b>Capital Gain Tax Worksheet</b> or <b>Schedule D</b> or <b>J</b> (Form 1040) is used to figure the tax, check here ▶ <input type="checkbox"/>	9	8,229
10	Enter the parent's tax from Form 1040, line 40; Form 1040A, line 25; Form 1040EZ, line 10; TeleFile Tax Record, line K; Form 1040NR, line 39; or Form 1040NR-EZ, line 15. If any tax is from <b>Form 4972</b> or <b>8814</b> , see instructions. If the <b>Capital Gain Tax Worksheet</b> or <b>Schedule D</b> or <b>J</b> (Form 1040) was used to figure the tax, check here ▶ <input type="checkbox"/>	10	7,851
11	Subtract line 10 from line 9 and enter the result. If line 7 is blank, also enter this amount on line 13 and go to <b>Part III</b>	11	378
12a	Add lines 5 and 7	12a	
b	Divide line 5 by line 12a. Enter the result as a decimal (rounded to at least three places)	12b	x
13	Multiply line 11 by line 12b	13	378

**Part III Child's Tax**—If lines 4 and 5 above are the same, enter -0- on line 15 and go to line 16.

14	Subtract line 5 from line 4	14	1,150
15	Enter the tax on line 14 based on the <b>child's</b> filing status. See instructions. If the <b>Capital Gain Tax Worksheet</b> or <b>Schedule D</b> or <b>J</b> (Form 1040) is used to figure the tax, check here ▶ <input type="checkbox"/>	15	174
16	Add lines 13 and 15	16	552
17	Enter the tax on line 4 based on the <b>child's</b> filing status. See instructions. If the <b>Capital Gain Tax Worksheet</b> or <b>Schedule D</b> or <b>J</b> (Form 1040) is used to figure the tax, check here ▶ <input type="checkbox"/>	17	377
18	Enter the <b>larger</b> of line 16 or line 17 here and on Form 1040, line 40; Form 1040A, line 25; or Form 1040NR, line 39	18	552

**General Instructions**

**Purpose of Form**

For children under age 14, investment income over \$1,400 is taxed at the parent's rate if the parent's rate is higher than the child's rate. If the child's investment income is more than \$1,400, use this form to figure the child's tax.



See **Pub. 929**, Tax Rules for Children and Dependents, if the child, the parent, or any of the parent's other children under age 14 received capital gain distributions or farm income. It has information on how

to figure the tax using the **Capital Gain Tax Worksheet** or **Schedule D** or **J**, which may result in less tax.

**Investment Income**

For this form, "investment income" includes all taxable income other than earned income as defined on page 2. It includes taxable interest, dividends, capital gains, rents, royalties, etc. It also includes taxable social security benefits, pension and annuity income, and income (other than earned income) received as the beneficiary of a trust.

**Who Must File**

Generally, Form 8615 must be filed for any child who was under age 14 on January 1, 2000, had more than \$1,400 of investment income, and is required to file a tax return. But if neither parent was alive on December 31, 1999, do not use Form 8615. Instead, figure the child's tax in the normal manner.

**Note:** The parent may be able to elect to report the child's interest and dividends (including capital gain distributions) on the parent's return. If the parent makes this election, the child will not have to file a return or Form 8615. However, the Federal

## Child and Dependent Care Credit

### Important Change

**Pending legislation.** Legislation affecting this credit was pending at the time of printing. For guidance, visit the IRS's web site at [www.irs.gov](http://www.irs.gov) or see your tax forms instructions. Publication 553, *Highlights of 1999 Tax Changes*, will also contain information about this and other tax law changes.

### Important Reminders

**Taxpayer identification number needed for each qualifying person.** You must include on line 2 of Form 2441 or Schedule 2 (Form 1040A) the name and taxpayer identification number (generally the social security number) of each qualifying person. See *Taxpayer identification number* under *Qualifying Person Test*, later.

**You may have to pay employment taxes.** If you pay someone to come to your home and care for your dependent or spouse, you may be a household employer who has to pay employment taxes. 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. See *Employment Taxes for Household Employers*, later.

### Introduction

This chapter discusses the **credit for child and dependent care expenses** and covers the following topics.

- Tests you must meet to claim the credit.
- How to figure the credit.
- How to claim the credit.
- Employment taxes you may have to pay as a household employer.

You may be able to claim the credit if you pay someone to care for your dependent who is under age 13 or for your spouse or dependent who is not able to care for himself or herself. The credit can be up to 30% of your expenses. To qualify, you must pay these expenses so you can work or look for work.



*This credit should not be confused with the **child tax credit** discussed in chapter 35.*

**Dependent care benefits.** If you received any dependent care benefits from your employer during the year, you may be able to exclude from your income all or part of

them. You must complete Part III of Form 2441 or Schedule 2 (Form 1040A) before you can figure the amount of your credit. See *Employer's Dependent Care Benefits* under *How To Figure the Credit*.

### Useful Items

You may want to see:

#### Publication

- 501** Exemptions, Standard Deduction, and Filing Information
- 503** Child and Dependent Care Expenses
- 926** Household Employer's Tax Guide

#### Form (and Instructions)

- 2441** Child and Dependent Care Expenses
- Schedule 2 (Form 1040A)** Child and Dependent Care Expenses for Form 1040A Filers
- Schedule H (Form 1040)** Household Employment Taxes
- W-7** Application for IRS Individual Taxpayer Identification Number
- W-10** Dependent Care Provider's Identification and Certification

## 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 keep up a home that you live in with the qualifying person or persons. (See *Keeping Up a Home Test*.)
- 3) 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*.)
- 4) 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*.)
- 5) You must make payments for child and dependent care to someone you (or 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. (See *Payments to Relatives* under *Work-Related Expense Test*.)
- 6) Your filing status must be 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 discussed later under *Joint Return Test* applies to you.

- 7) You must identify the care provider on your tax return. (See *Provider Identification Test*.)
- 8) If you exclude dependent care assistance benefits provided by your employer, you must exclude less than the dollar limit for qualifying expenses (generally, less than \$2,400 if one qualifying person was cared for, or less than \$4,800 if two or more qualifying persons were cared for). (See *Reduced Dollar Limit* under *How To Figure the Credit*, later.)

These tests are presented in *Figure 33-A* and are also explained in detail in this chapter.

### 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 dependent who was under age 13 when the care was provided and for whom you can claim an exemption,
- 2) Your spouse who was physically or mentally not able to care for himself or herself, or
- 3) Your dependent who was physically or mentally not able to care for himself or herself and for whom you can claim an exemption (or could claim an exemption except the person had \$2,750 or more of gross income).

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

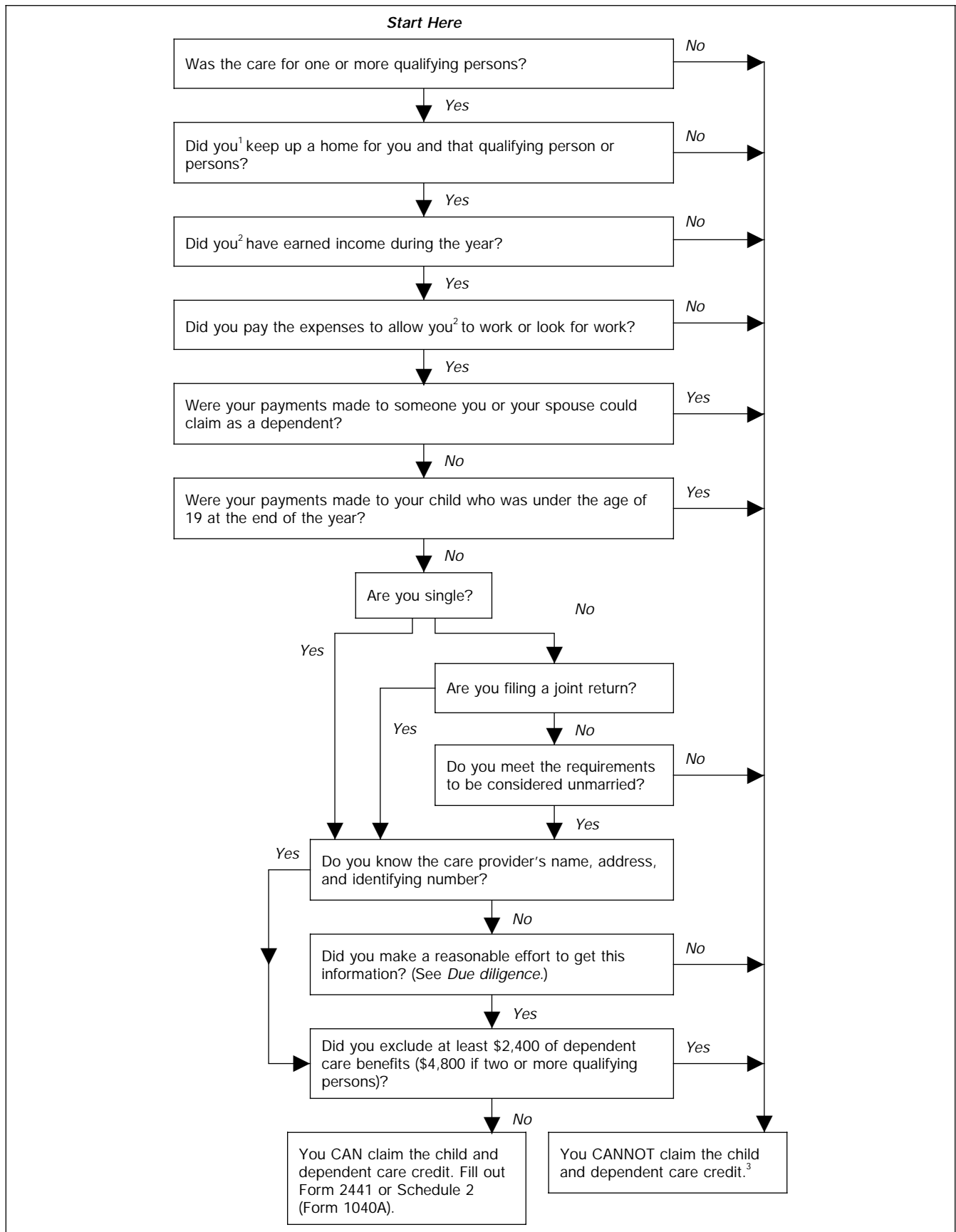
**Physically or mentally not able to care for oneself.** Persons who cannot dress, clean, or feed themselves because of physical or mental problems are considered not able to care for themselves. Also, persons who must have constant attention to prevent them from injuring themselves or others are considered 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. To apply for an ITIN, file Form W-7

Figure 33–A. Can You Claim the Credit?



<sup>1</sup>This includes your spouse if you were married.

<sup>2</sup>This also applies to your spouse, unless your spouse was disabled or a full-time student.

<sup>3</sup>If you had expenses that met the requirements for 1998, except that you did not pay them until 1999, you may be able to claim those expenses in 1999. See *Expenses not paid until the following year* under *How To Figure the Credit*.

with the IRS. The ITIN is entered wherever an SSN is requested on a tax return.

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. File Form W-7A, *Application for Taxpayer Identification Number for Pending U.S. Adoptions*.

## Child of Divorced or Separated Parents

To be a qualifying person, your child usually must be your dependent for whom you can claim an exemption. But an exception may apply if you are divorced or separated. Under the exception, if you are the custodial parent, you can treat your child as a qualifying person even if you cannot claim the child's exemption. If you are the noncustodial parent, you cannot treat your child as a qualifying person even if you can claim the child's exemption.

This exception applies if **all** of the following are true.

- 1) One or both parents had custody of the child for more than half of the year.
- 2) One or both parents provided more than half of the child's support for the year.
- 3) Either—
  - a) The custodial parent signed **Form 8332, Release of Claim to Exemption for Child of Divorced or Separated Parents**, or a similar statement, agreeing not to claim the child's exemption for the year, or
  - b) The noncustodial parent provided at least \$600 for the child's support and can claim the child's exemption under a pre-1985 decree of divorce or separate maintenance, or written agreement.

For purposes of 3(a), a similar statement includes a divorce decree or separation agreement that went into effect after 1984 that allows the noncustodial parent to claim the child's exemption without any conditions, such as payment of support.

You can use *Figure 33-B* to see whether this exception applies to you. If it applies, only the custodial parent can treat the child as a qualifying person. If the exception does not apply, follow the regular rules for a qualifying person under *Qualifying Person Test*, earlier.

**Example.** You are divorced and have custody of your 8-year-old child. You sign Form 8332 to allow your ex-spouse to take the exemption. You pay child care expenses so you can work. Your child is a qualifying person and you, the custodial parent, can claim the credit for those expenses, even though your ex-spouse claims an exemption for the child.

**Custodial parent.** You are the custodial parent if, during the year, you have custody of your child longer than your child's other parent has custody.

**Divorced or separated.** For purposes of determining whether your child is a qualifying person, you are considered divorced or separated if **either** of the following applies.

- 1) You are divorced or separated under a decree of divorce or separate maintenance or a written separation agreement, or
- 2) You lived apart from your spouse for all of the last 6 months of the year.

## Keeping Up a Home Test

To claim the credit, you must keep up a home. You and one or more qualifying persons must live in the home.

You are keeping up a home if you (and your spouse if you are married) pay more than half the cost of running it for the year.

**Home.** The home you keep up must be the main home for both you and the qualifying person. Your home can be the qualifying person's main home even if he or she does not live there all year because of his or her:

- 1) Birth,
- 2) Death, or
- 3) Temporary absence due to:
  - a) Sickness,
  - b) School,
  - c) Business,
  - d) Vacation,
  - e) Military service, or
  - f) Custody agreement.

**Costs of keeping up 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.

**Costs not included.** 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.

## 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 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. It also includes nontaxable earned income such as parsonage allowances, meals and lodging furnished for the convenience of the employer, voluntary salary deferrals, military basic quarters and subsistence allowances and in-kind quarters and subsistence, and military pay earned in a combat zone.

**Members of certain religious faiths opposed to social security.** Certain income earned by 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 may not be considered earned income for this purpose. See *Earned Income Test* in Publication 503.

**What is not earned income?** Earned income does not include pensions or annuities, social security payments, workers' compensation, interest, dividends, or unemployment compensation. It also does not include scholarship or fellowship grants, except for amounts paid to you (and reported on Form W-2) for teaching, research, or other services.

**Rule for student-spouse or spouse not able to care for self.** 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.

Figure the earned income of the non-working spouse described under (1) or (2) above as explained under *Earned Income Limit*, later.

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 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 attend school only at night, you are not a full-time student. However, as part of your full-time course of study, you may attend some night classes.

**School.** The term school includes elementary schools, junior and senior high schools, colleges, universities, and technical, trade, and mechanical schools. It does not include on-the-job training courses, correspondence schools, and night schools.

## Work-Related Expense Test

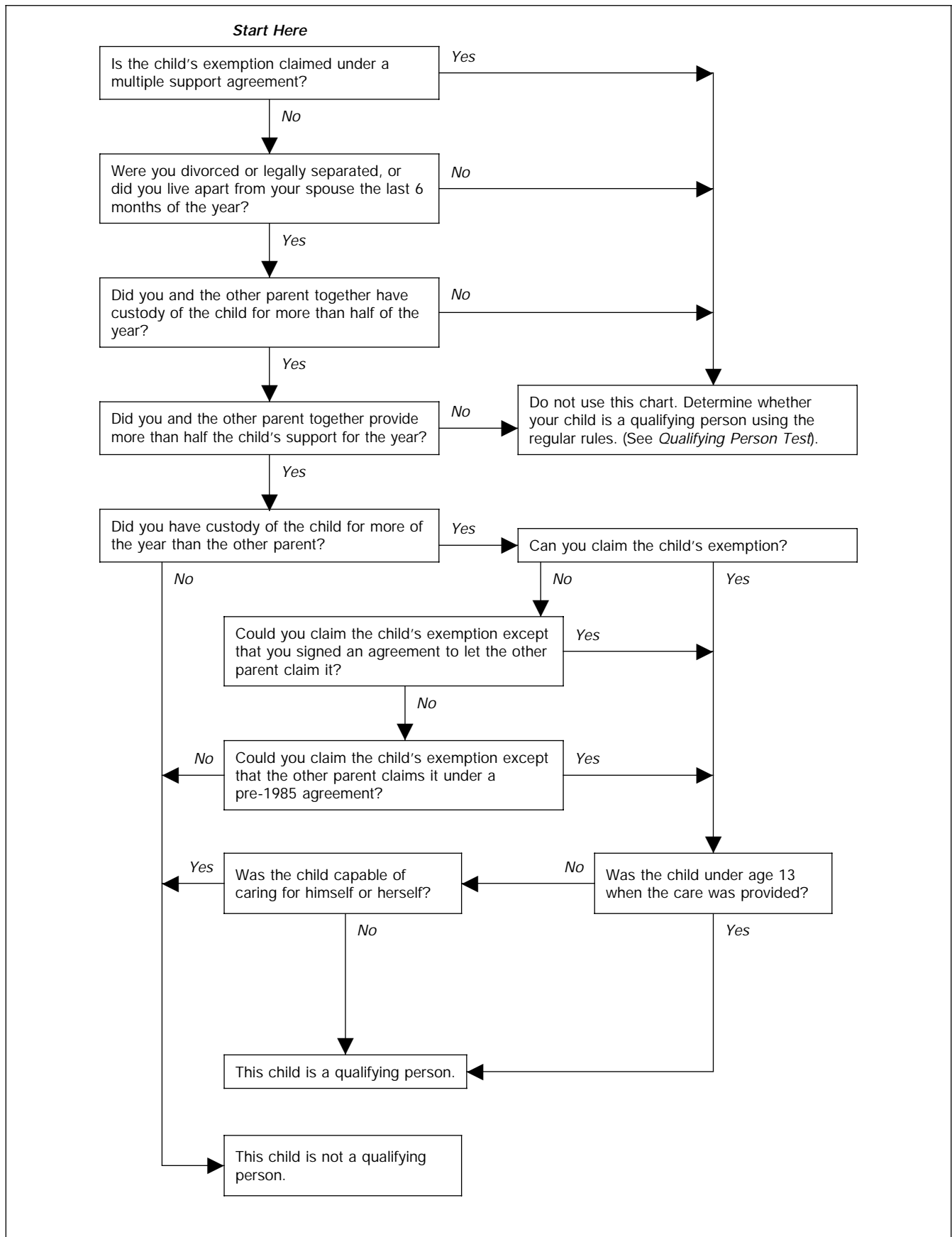
Child and dependent care expenses must be work related to qualify for the credit. Expenses are considered work related only if both of the following are true.

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

## Working or Looking for Work

To be work related, your expenses must 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

Figure 33-B. Is a Child of Divorced or Separated Parents a Qualifying Person?



physically or mentally not able to care for himself 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 sitter while you and your spouse go out to eat is not normally a work-related expense.

Expenses are not considered work related merely because you had them while you were working. They must enable you to be gainfully employed. For example, you are not gainfully employed if you do unpaid volunteer work or volunteer work for a 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 \$200 a month (\$2,400 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 \$200 a month, your work-related expenses are limited to \$500 (2½ months × \$200).

**Payments while you are out sick.** Do not count as work-related expenses amounts you pay for child and dependent care while you are off work because of illness. These amounts are not paid to allow you to work. This applies even if you get sick pay and are still considered an employee.

### 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. 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 amounts paid for these items if they are incident to and cannot be separated from the cost of caring for the qualifying person.

**Education.** Expenses to attend first grade 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 educational activities as a part of its preschool child-care service. You can count the total cost in figuring the credit.

**Example 2.** Your 5-year-old child goes to kindergarten in the morning. In the afternoon, she attends an after-school day care program at the same school. Your total cost for sending her to the school is \$3,000,

of which \$1,800 is for the after-school day care program. Only the \$1,800 qualifies for figuring the credit.

**Example 3.** 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 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 provides 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.

**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 **not** 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 expense test if they are at least partly for the well-being and protection of a qualifying person.

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. See *Household Services* in Publication 503 for more information.

In this chapter, the term housekeeper refers to any household employee whose services include the care of a qualifying person.

**Taxes paid on wages.** The taxes you pay on wages for qualifying child and dependent care services are work-related expenses. See *Employment Taxes for Household Employers*, later.

### Payments to Relatives

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 was under age 19 at the end of the year, even if he or she is not your dependent.

## 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.
- 4) Your spouse does not live in your home for the last 6 months of the year.

**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. Use Part I of Form 2441 or Schedule 2 (Form 1040A) to show the information.

**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, 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** to request the required information from the care provider. If you do not use Form W-10, you can get the 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 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 information.



You should keep this information with your tax records. Do not send Form W-10 (or other document containing this information) to the Internal Revenue Service.

**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 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 their identifying 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 page 2" in the columns calling for the information you do not have. On the bottom of page 2, explain that you requested the information from the care provider, but the provider did not give you the information. This 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.

## Figuring Total Work-Related Expenses

To figure the credit for 1999 work-related expenses, count only those you paid by December 31, 1999.

**Expenses prepaid 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 expenses for the later year as if they were actually paid in that later year.

**Expenses not paid until the following year.** Do *not* count 1998 expenses that you paid in 1999 as work-related expenses for 1999. You may be able to claim an additional credit for them on your 1999 return, but you must figure it separately. See *Payments for previous year's expenses* under *Amount of Credit* in Publication 503.



If you had expenses in 1999 that you did not pay until 2000, you cannot count them when figuring your 1999 credit. You may be able to claim a credit for them on your 2000 return.

**Expenses reimbursed.** If a state social services agency pays you a nontaxable amount to reimburse you for some of your child and dependent care expenses, 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.

## Employer's Dependent Care Benefits

Dependent care benefits include:

- 1) Amounts your employer pays directly to either you or your care provider for the care of your qualifying person while you work, and
- 2) The fair market value of care in a day-care facility provided or sponsored by your employer.

Your salary may have been reduced to pay for these benefits. If you received benefits, they should be shown on your W-2 form. See *Statement for employee*, later.

**Exclusion.** 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 it does, you must complete Part III of either Form 2441 or Schedule 2 (Form 1040A) to claim the exclusion even if you cannot take the credit. You cannot use Form 1040EZ.

The amount you can exclude 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).

**Statement for employee.** Your employer must give you a Form W-2, *Wage and Tax Statement* (or similar statement), showing in box 10 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 in box 1 of your Form W-2.

**Forfeitures.** Forfeitures are amounts credited to your dependent care benefit account (flexible spending account) and included in the amount shown in box 10 of your Form W-2, but not received because you did not incur the expense. When figuring your exclusion, subtract any forfeitures from the total dependent care benefits reported by your employer. To do this, enter the forfeited amount on line 11 of Form 2441 or Schedule 2 (Form 1040A).



Forfeitures do not include amounts that you expect to receive in the future.

**Claiming the credit.** 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 earned income or your spouse's earned income for the year, if you are **married** at the end of the year.

Earned income 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.

**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 in 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.** You should disregard community property laws when you figure earned income for this credit.

**Student-spouse or spouse not able to care for self.** Your spouse who is either 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 \$200 if there is one qualifying person in your home, or at least \$400 if there are two or more.

**Spouse works.** If your spouse works during that month, use the higher of \$200 (or \$400) 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 \$200 (or \$400) 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 \$200 (or \$400) for that month.

## 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 \$2,400 for one qualifying person, or \$4,800 for two or more qualifying persons.

**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 \$2,400 limit if you paid work-related expenses for the care of one qualifying person at any time during the year. Use \$4,800 if you paid work-related expenses for the care of more than one qualifying person at any time during the year.

## Reduced Dollar Limit

If you received dependent care benefits from your employer that you exclude from your income, you must subtract that amount from the dollar limit that applies to you. Your reduced dollar limit is figured on lines 20 through 24 of Form 2441 or Schedule 2 (Form 1040A). See *Employer's Dependent Care Benefits*, earlier, for information on excluding these benefits.

**Example.** George is a widower with one child and earns \$24,000 a year. He pays work-related expenses of \$1,900 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 dependent care benefit plan. This \$1,000 is excluded from George's income.

Although the dollar limit for his work-related expenses is \$2,400 (one qualifying person), George figures his credit on only \$1,400 of the \$1,900 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 .....	\$2,400
2) <b>Minus:</b> Dependent care benefits George excludes from income .....	-1,000
3) Reduced dollar limit on expenses George can use for the credit .....	<u>\$1,400</u>

## 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 line 34 of Form 1040 or line 19 of Form 1040A. The following table shows the percentage to use based on adjusted gross income.

Adjusted Gross Income		Percentage
Over	But not over	
\$0	\$10,000	30%
10,000	12,000	29%
12,000	14,000	28%
14,000	16,000	27%
16,000	18,000	26%
18,000	20,000	25%
20,000	22,000	24%
22,000	24,000	23%
24,000	26,000	22%
26,000	28,000	21%
28,000	No limit	20%

**Tax credit not refundable.** You cannot get a refund for any part of the credit that is more than your tax.



*Legislation affecting this credit was pending at the time of printing. For guidance, visit the IRS's web site at [www.irs.gov](http://www.irs.gov) or see your tax forms instructions. Publication 553, Highlights of 1999 Tax Changes, will also contain information about this and other tax law changes.*

## How To Claim the Credit

To claim the credit, you can file Form 1040 or Form 1040A. You cannot claim the credit on Form 1040EZ.

**Form 1040.** You must complete **Form 2441** and attach it to your Form 1040. Enter the credit on line 41 of your Form 1040. An example of a filled-in Form 2441 is at the end of this chapter.

**Form 1040A.** You must complete **Schedule 2** (Form 1040A) and attach it to your Form 1040A. Enter the credit on line 26 of your Form 1040A.



**Recordkeeping.** You should keep records of your work-related expenses. Also, if your dependent or spouse is not able to care for himself or herself, your records should show both the nature and the length of the disability. Other records you should keep to support your claim for the credit are described earlier under *Provider Identification Test*.

## 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 who has to have an employer identification number (EIN) and 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.

For more information on a household employer's tax responsibilities, see Publication 926 and Schedule H (Form 1040) and its instructions.

**State employment taxes.** 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 workers' compensation insurance. A list of state employment tax agencies, including addresses and phone numbers, is in Publication 926.

## Example

The following example shows how to figure the credit for child and dependent care expenses for two children when employer dependent care benefits are involved. The filled-in Form 2441 is shown at the end of this chapter.

**Illustrated example.** Joan Thomas is divorced and has two children, ages 3 and 9. She works at ACME Computers. Her

adjusted gross income (AGI) is \$29,000, and the entire amount is earned income.

Joan's younger child (Susan) stays at her employer's on-site child-care center while she works. The benefits from this child-care center qualify to be excluded from her income. Her employer reports the value of this service as \$3,000 for the year. This \$3,000 is shown in box 10 of her Form W-2,

but is not included in taxable wages in box 1.

A neighbor cares for Joan's older child (Seth) after school, on holidays, and during the summer. She pays her neighbor \$2,400 for this care.

Joan figures her credit on Form 2441 as follows.

Work-related expenses Joan paid .....	<u>\$2,400</u>
Dollar limit .....	<u>\$4,800</u>
Minus: Dependent care benefits excluded from Joan's income .....	<u>-3,000</u>
Reduced dollar limit .....	<u>\$1,800</u>
Lesser of Expenses paid (\$2,400) or Dollar limit (\$1,800) .....	\$1,800
Percentage for AGI of \$29,000 .....	x .20
<b>Amount of credit (20% of \$1,800)</b> .....	<u><b>\$ 360</b></u>

Department of the Treasury  
Internal Revenue Service

▶ Attach to Form 1040.  
▶ See separate instructions.

Name(s) shown on Form 1040

Joan Thomas

Your social security number

559 00 3436

**Before you begin**, you need to understand the following terms. See **Definitions** on page 1 of the instructions.

- **Dependent Care Benefits**
- **Qualifying Person(s)**
- **Qualified Expenses**
- **Earned Income**

**Part I** **Persons or Organizations Who Provided the Care**—You must complete this part. (If you need more space, use the bottom of page 2.)

1	(a) Care provider's name	(b) Address (number, street, apt. no., city, state, and ZIP code)	(c) Identifying number (SSN or EIN)	(d) Amount paid (see instructions)
	Pat Green	12 Ash Avenue Hometown, TX 75240	240-00-3811	2,400
	ACME Computers	(See W-2)		

Did you receive dependent care benefits?

No → Complete only Part II below.  
 Yes → Complete Part III on the back next.

**Caution:** If the care was provided in your home, you may owe employment taxes. See the instructions for Form 1040, line 55.

**Part II** **Credit for Child and Dependent Care Expenses**

**2** Information about your **qualifying person(s)**. If you have more than two qualifying persons, see the instructions.

(a) Qualifying person's name		(b) Qualifying person's social security number	(c) Qualified expenses you incurred and paid in 1999 for the person listed in column (a)
First	Last		
Seth	Thomas	559 00 1234	2,400
Susan	Thomas	559 00 5678	

<b>3</b> Add the amounts in column (c) of line 2. DO NOT enter more than \$2,400 for one qualifying person or \$4,800 for two or more persons. If you completed Part III, enter the amount from line 24 . . . . .	<b>3</b>	1,800																																											
<b>4</b> Enter YOUR <b>earned income</b> . . . . .	<b>4</b>	29,000																																											
<b>5</b> If married filing a joint return, enter YOUR SPOUSE'S earned income (if your spouse was a student or was disabled, see the instructions); <b>all others</b> , enter the amount from line 4 . . . . .	<b>5</b>	29,000																																											
<b>6</b> Enter the <b>smallest</b> of line 3, 4, or 5 . . . . .	<b>6</b>	1,800																																											
<b>7</b> Enter the amount from Form 1040, line 34 . . . . .	<b>7</b>	29,000																																											
<b>8</b> Enter on line 8 the decimal amount shown below that applies to the amount on line 7																																													
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28,000—No limit		.20																																											
<b>9</b> Multiply line 6 by the decimal amount on line 8. Enter the result here and on Form 1040, line 41. But if this amount is more than the amount on Form 1040, line 40, or you paid 1998 expenses in 1999, see the instructions for the amount to enter on line 41 . . . . .	<b>9</b>	360																																											

**Part III** Dependent Care Benefits

<b>10</b>	Enter the total amount of <b>dependent care benefits</b> you received for 1999. This amount should be shown in box 10 of your W-2 form(s). DO NOT include amounts that were reported to you as wages in box 1 of Form(s) W-2 . . . . .	<b>10</b>	3,000
<b>11</b>	Enter the amount forfeited, if any. See the instructions . . . . .	<b>11</b>	
<b>12</b>	Subtract line 11 from line 10 . . . . .	<b>12</b>	3,000
<b>13</b>	Enter the total amount of <b>qualified expenses</b> incurred in 1999 for the care of the <b>qualifying person(s)</b> . . . . .	<b>13</b>	5,400
<b>14</b>	Enter the <b>smaller</b> of line 12 or 13 . . . . .	<b>14</b>	3,000
<b>15</b>	Enter YOUR <b>earned income</b> . . . . .	<b>15</b>	29,000
<b>16</b>	If married filing a joint return, enter YOUR SPOUSE'S earned income (if your spouse was a student or was disabled, see the instructions for line 5); if married filing a separate return, see the instructions for the amount to enter; <b>all others</b> , enter the amount from line 15 . . . . .	<b>16</b>	29,000
<b>17</b>	Enter the <b>smallest</b> of line 14, 15, or 16 . . . . .	<b>17</b>	3,000
<b>18</b>	<b>Excluded benefits.</b> Enter here the <b>smaller</b> of the following: <ul style="list-style-type: none"> <li>• The amount from line 17, or</li> <li>• \$5,000 (\$2,500 if married filing a separate return <b>and</b> you were required to enter your spouse's earned income on line 16).</li> </ul>	<b>18</b>	3,000
<b>19</b>	<b>Taxable benefits.</b> Subtract line 18 from line 12. Also, include this amount on Form 1040, line 7. On the dotted line next to line 7, enter "DCB" . . . . .	<b>19</b>	-0-

To claim the child and dependent care credit, complete lines 20–24 below.

<b>20</b>	Enter \$2,400 (\$4,800 if two or more qualifying persons) . . . . .	<b>20</b>	4,800
<b>21</b>	Enter the amount from line 18 . . . . .	<b>21</b>	3,000
<b>22</b>	Subtract line 21 from line 20. If zero or less, <b>STOP</b> . You cannot take the credit. <b>Exception.</b> If you paid 1998 expenses in 1999, see the instructions for line 9 . . . . .	<b>22</b>	1,800
<b>23</b>	Complete line 2 on the front of this form. DO NOT include in column (c) any benefits shown on line 18 above. Then, add the amounts in column (c) and enter the total here . . . . .	<b>23</b>	2,400
<b>24</b>	Enter the <b>smaller</b> of line 22 or 23. Also, enter this amount on line 3 on the front of this form and complete lines 4–9 . . . . .	<b>24</b>	1,800

# 34.

## Credit for the Elderly or the Disabled

### Important Change

**Pending legislation.** Legislation affecting this credit was pending at the time of printing. For guidance, visit the IRS's web site at [www.irs.gov](http://www.irs.gov) or see your tax forms instructions. Publication 553, *Highlights of 1999 Tax Changes*, will also contain information about this and other tax law changes.

### Introduction

If you qualify, the law provides a number of credits that can reduce the tax you owe for a year. One of these credits is the credit for the elderly or the disabled.

This chapter explains:

- Who qualifies for the credit for the elderly or the disabled, and
- How to figure this credit.

The maximum credit available is \$1,125. You may be able to take this credit if you are:

- 65 or older, or
- Retired on permanent and total disability.

### Useful Items

You may want to see:

#### Publication

- 524** Credit for the Elderly or the Disabled
- 554** Older Americans' Tax Guide

#### Forms (and Instructions)

- Schedule 3 (Form 1040A)** Credit for the Elderly or the Disabled for Form 1040A Filers
- Schedule R (Form 1040)** Credit for the Elderly or the Disabled

## Can You Take the Credit?

You can take the credit for the elderly or the disabled if:

- 1) You are a **qualified individual**, and
- 2) Your income is not more than certain limits.

You can use *Figure 34-A* and *Figure 34-B* as guides to see if you qualify.

Use *Figure 34-A* first to see if you are a qualified individual. If you are, go to *Figure 34-B* to make sure your income is not too high to take the credit.



**TIP** You can take the credit only if you file Form 1040 or Form 1040A. You cannot take the credit if you file Form 1040EZ.

### Qualified Individual

You are a qualified individual for this credit if you are a U.S. citizen or resident and, at the end of the tax year, you are:

- 1) Age 65 or older, or
- 2) Under age 65, retired on permanent and total disability, and
  - a) Received taxable disability income, and
  - b) Did not reach mandatory retirement age (defined later under *Disability income*) before the tax year.

**Age 65.** You are considered to be age 65 on the day before your 65th birthday. Therefore, you are 65 at the end of the year if your 65th birthday is on January 1 of the following year.

### U.S. Citizen or Resident

You must be a U.S. citizen or resident (or be treated as a resident) to take the credit. Generally, you cannot take the credit if you were a nonresident alien at any time during the tax year.

**Exceptions.** You may be able to take the credit if you are a nonresident alien who is married to a U.S. citizen or resident at the end of the tax year and you and your spouse choose to treat you as a U.S. resident. If you make that choice, both you and your spouse are taxed on your worldwide income.

If you were a nonresident alien at the beginning of the year and a resident at the end of the year, and you were married to a U.S. citizen or resident at the end of the year, you may be able to choose to be treated as a U.S. resident for the entire year. In that case, you may be allowed to take the credit. For information on these choices, see chapter 1 of Publication 519, *U.S. Tax Guide for Aliens*.

### Married Persons

Generally, if you are married at the end of the tax year, you and your spouse must file a joint return to take the credit. However, if you and your spouse did not live in the same household at any time during the tax year, you can file either joint or separate returns and still take the credit.

**Head of household.** You can file as head of household and qualify to take the credit, even if your spouse lived with you during the first 6 months of the year, if you meet all the tests. See *Head of Household* in chapter 2 for the tests you must meet.

### Under Age 65

If you are under age 65, you can qualify for the credit only if you are retired on permanent and total disability. If you retired after January 1, 1977, you are retired on permanent and total disability if you were permanently and totally disabled when you retired.

Even if you do not retire formally, you are considered retired on disability when you have stopped working because of your disability.

**Permanent and total disability.** You are permanently and totally disabled if you cannot engage in any substantial gainful activity because of your physical or mental condition. A physician must certify that the condition has lasted or can be expected to last continuously for 12 months or more, or that the condition can be expected to result in death. See *Physician's statement*, later.

**Substantial gainful activity.** Substantial gainful activity is the performance of significant duties over a reasonable period of time while working for pay or profit, or in work generally done for pay or profit.

Full-time work (or part-time work done at your employer's convenience) in a competitive work situation for at least the minimum wage conclusively shows that you are able to engage in substantial gainful activity.

Substantial gainful activity is not work you do 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 work may show that you are able to engage in substantial gainful activity.

The fact that you have not worked for some time is not, of itself, conclusive evidence that you cannot engage in substantial gainful activity.

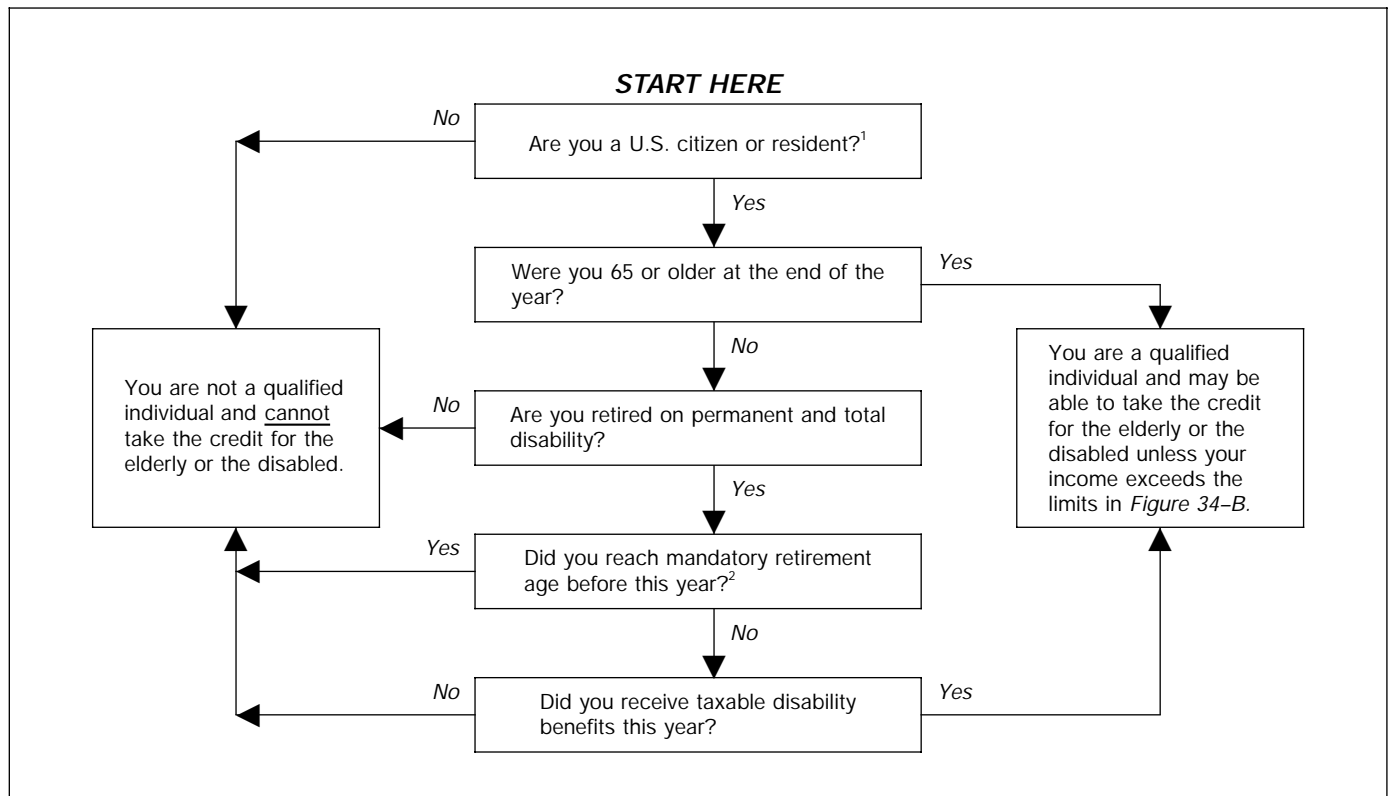
The following examples illustrate the tests of substantial gainful activity.

**Example 1.** Trisha, a sales clerk, retired on disability. She is 53 years old and now works as a full-time babysitter for the minimum wage. Even though Trisha is doing different work, she is able to do the duties of her new job in a full-time competitive work situation for the minimum wage. She cannot take the credit because she is able to engage in substantial gainful activity.

**Example 2.** Tom, a bookkeeper, retired on disability. He is 59 years old and now drives a truck for a charitable organization. He sets his own hours and is not paid. Duties of this nature generally are performed for pay or profit. Some weeks he works 10 hours, and some weeks he works 40 hours. Over the year he averages 20 hours a week. The kind of work and his average hours a week conclusively show that Tom is able to engage in substantial gainful activity. This is true even though Tom is not paid and he sets his own hours. He cannot take the credit.

**Example 3.** John, who retired on disability, took a job with a former employer on a trial basis. The purpose of the job was to see if John could do the work. The trial period lasted for 6 months during which John was paid the minimum wage. Because of John's disability, he was assigned only light duties of a nonproductive "make-work" nature. The activity was gainful because John was paid at least the minimum wage. But

Figure 34–A. Are You a Qualified Individual?



<sup>1</sup>If you were a nonresident alien at any time during the tax year and were married to a U.S. citizen or resident at the end of the tax year, see *U.S. Citizen or Resident under Qualified Individual*. If you and your spouse choose to treat you as a U.S. resident, answer yes to this question.

<sup>2</sup>Mandatory retirement age is the age set by your employer at which you would have been required to retire, had you not become disabled.

Figure 34–B. Income Limits

IF your filing status is	THEN even if you qualify (see Figure A), you CANNOT take the credit if ...	
	Your adjusted gross income (AGI)* is equal to or more than ...	OR your nontaxable social security and other nontaxable pension(s) is equal to or more than ...
Single, Head of household, or Qualifying widow(er) with dependent child	\$17,500	\$5,000
Married filing a joint return <b>and</b> both spouses qualify in <i>Figure A</i>	\$25,000	\$7,500
Married filing a joint return <b>and</b> only one spouse qualifies in <i>Figure A</i>	\$20,000	\$5,000
Married filing a separate return <b>and</b> you did not live with your spouse at any time during the year	\$12,500	\$3,750

\*AGI is the amount on Form 1040A, line 19, or Form 1040, line 34

the activity was not substantial because his duties were nonproductive. These facts do not, by themselves, show that John is able to engage in substantial gainful activity.

**Example 4.** Joan, who retired on disability from employment as a bookkeeper, lives with her sister who manages several motel units. Joan assists her sister for one or two hours a day by performing duties such as washing dishes, answering phones, registering guests, and bookkeeping. Joan can select the time of day when she feels most fit to perform the tasks undertaken. Work of this nature, performed off and on during the day at Joan's convenience, is not activity of a "substantial and gainful" nature even if she is paid for the work. The performance of these duties does not, of itself, show that Joan is able to engage in substantial gainful activity.

**Sheltered employment.** Certain work offered at qualified locations to physically or mentally impaired persons is considered sheltered employment. These qualified locations are in sheltered workshops, hospitals and similar institutions, homebound programs, and Department of Veterans Affairs (VA) sponsored homes.

Compared to commercial employment, pay is lower for sheltered employment. Therefore, one usually does not look for sheltered employment if he or she can get other employment. The fact that one has accepted sheltered employment is not proof of that person's ability to engage in substantial gainful activity.

**Physician's statement.** If you are under age 65, you must have your physician complete a statement certifying that you were permanently and totally disabled on the date you retired.

You do not have to file this statement with your Form 1040 or Form 1040A, but you **must** keep it for your records. The instructions for either Schedule R (Form 1040) or Schedule 3 (Form 1040A) include a statement your physician can complete and that you can keep for your records.

**Veterans.** If the Department of Veterans Affairs (VA) certifies that you are permanently and totally disabled, you can substitute VA Form 21-0172, *Certification of Permanent and Total Disability*, for the physician's statement you are required to keep. VA Form 21-0172 must be signed by a person authorized by the VA to do so. You can get this form from your local VA regional office.

**Physician's statement obtained in earlier year.** If you got a physician's statement in an earlier year **and**, due to your continued disabled condition, you were unable to engage in any substantial gainful activity during 1999, you may not need to get another physician's statement for 1999. For a detailed explanation of the conditions you must meet, see the instructions for Part II of Schedule R (Form 1040) or Schedule 3 (Form 1040A). If you meet the required conditions, check the box on line 2 of Part II of Schedule R (Form 1040) or Schedule 3 (Form 1040A).

If you checked box 4, 5, or 6 in Part I of either Schedule R or Schedule 3, print in the space above the box on line 2 in Part II, the first name(s) of the spouse(s) for whom the box is checked.

Table 34-1. Initial Amounts

IF your filing status is ...	THEN enter on line 10 of Schedule R (Form 1040) or Schedule 3 (Form 1040A) ...
<b>Single, head of household, or qualifying widow or widower and you are</b>	
<ul style="list-style-type: none"> <li>• 65 or older . . . . .</li> <li>• under 65 and retired on permanent and total disability<sup>1</sup> . . . . .</li> </ul>	<ul style="list-style-type: none"> <li>\$5,000</li> <li>\$5,000</li> </ul>
<b>Married filing a joint return and</b>	
<ul style="list-style-type: none"> <li>• both of you are 65 or older . . . . .</li> <li>• both of you are under 65 and one of you retired on permanent and total disability<sup>1</sup> . . . . .</li> <li>• both of you are under 65 and both of you retired on permanent and total disability<sup>2</sup> . . . . .</li> <li>• one of you is 65 or older, and the other is under 65 and retired on permanent and total disability<sup>3</sup>.</li> <li>• one of you is 65 or older, and the other is under 65 and <b>not</b> retired on permanent and total disability. . . . .</li> </ul>	<ul style="list-style-type: none"> <li>\$7,500</li> <li>\$5,000</li> <li>\$7,500</li> <li>\$7,500</li> <li>\$5,000</li> </ul>
<b>Married filing a separate return and did not live with your spouse at any time during the year and</b>	
<ul style="list-style-type: none"> <li>• 65 or older . . . . .</li> <li>• under 65 and retired on permanent and total disability<sup>1</sup> . . . . .</li> </ul>	<ul style="list-style-type: none"> <li>\$3,750</li> <li>\$3,750</li> </ul>

<sup>1</sup>Amount cannot be more than the taxable disability income.

<sup>2</sup>Amount cannot be more than your combined taxable disability income.

<sup>3</sup>Amount is \$5,000 plus the taxable disability income of the spouse under age 65, but not more than \$7,500.

**Disability income.** If you are under age 65, you can qualify for the credit only if you have taxable disability income. Disability income must meet the following two requirements.

- 1) The income must be paid under your employer's accident or health plan or pension plan.
- 2) The income must be wages (or payments in lieu of wages) for the time you are absent from work because of permanent and total disability.

**Payments that are not disability income.** Any payment you receive from a plan that does not provide for disability retirement is not disability income. Any lump-sum payment for accrued annual leave that you receive when you retire on disability is a salary payment and is not disability income.

For purposes of the credit for the elderly or the disabled, disability income does not include amounts you receive after you reach mandatory retirement age. **Mandatory retirement age** is the age set by your employer at which you would have had to retire, had you not become disabled.

### Income Limits

To determine if you can claim the credit, you must consider two income limits. The first limit is the amount of your adjusted gross income (AGI). The second limit is the amount of nontaxable social security and other nontaxable pensions you received. The limits are shown in *Figure 34-B*, earlier.

If the amount of your AGI and nontaxable pensions are less than the income limits, you may be able to claim the credit. See *Figuring the Credit*, next.



If the amount of your AGI or nontaxable pensions is equal to or more than the income limits, you cannot take the credit.

## Figuring the Credit

You can figure the credit yourself (see the explanation that follows), or the IRS will figure it for you. See *Credit Figured for You*, later.

**Figuring the credit yourself.** If you figure the credit yourself, fill out the front of either Schedule R (if you are filing Form 1040) or Schedule 3 (if you are filing Form 1040A). Next, fill out Part III of either Schedule R or Schedule 3.



There are four steps in Part III to determine the amount of your credit:

- 1) Determine your **initial amount** (lines 10-12).
- 2) Total any **nontaxable social security** and certain other nontaxable pensions and disability benefits you received (lines 13a, 13b, and 13c).
- 3) Determine your **excess adjusted gross income** (lines 14-17).
- 4) Determine your credit (lines 18-20).

These steps are discussed in more detail next.



## Step 1. Determine Initial Amount

To figure the credit, you must first determine your initial amount. See Table 34-1, *Initial Amounts*.

**Initial amounts for persons under age 65.** If you are a qualified individual under age 65, your initial amount cannot be more than your taxable disability income.

## Step 2. Total Certain Nontaxable Pensions and Benefits

You must reduce your initial amount by the total amount of nontaxable social security and certain other nontaxable payments (listed below) you receive during the year.

Enter these nontaxable payments on line 13a or 13b, and total them on line 13c. If you are married filing a joint return, you must enter the combined amount of nontaxable payments both you and your spouse receive.

**TIP** Worksheets are provided in the Form 1040 or Form 1040A instructions to help you determine if any part of your social security benefits (or equivalent railroad retirement benefits) is taxable.

Include the following nontaxable payments in the amounts you enter on lines 13a and 13b.

- **Nontaxable social security payments.** This is the nontaxable part of the amount of benefits shown in box 5 of Form SSA-1099, which includes disability benefits, before deducting any amounts withheld to pay premiums on supplementary Medicare insurance, and before any reduction because of receipt of a benefit under worker's compensation.  
Do not include a lump-sum death benefit payment you may receive as a surviving spouse, or a surviving child's insurance benefit payments you may receive as a guardian.
- **Social security equivalent part of tier 1 railroad retirement pension payments** that are not taxed. This is the nontaxable part of the amount of benefits shown in box 5 of Form RRB-1099.
- **Nontaxable pension or annuity payments** or disability benefits that are paid under a law administered by the Department of Veterans Affairs (VA).  
Do not include amounts received as a pension, annuity, or similar allowance for personal injuries or sickness resulting from active service in the armed forces of any country or in the National Oceanic and Atmospheric Administration or the Public Health Service, or as a disability annuity under section 808 of the Foreign Service Act of 1980.
- **Pension or annuity payments** or disability benefits that are excluded from income under any provision of federal

law other than the Internal Revenue Code.

Do not include amounts that are a return of your cost of a pension or annuity. These amounts do not reduce your initial amount.



*You should be sure to take into account all of the nontaxable amounts you receive. These amounts are verified by the IRS through information supplied by other government agencies.*

## Step 3. Determine Excess Adjusted Gross Income

You also must reduce your initial amount by your excess adjusted gross income. Figure your excess adjusted gross income on lines 14 through 17.

You figure your excess adjusted gross income as follows:

- 1) Subtract from your adjusted gross income (line 34 of Form 1040 or line 19 of Form 1040A) the amount shown for your filing status in the following list:
  - a) **\$7,500** if you are single, a head of household, or a qualifying widow(er) with a dependent child,
  - b) **\$10,000** if you are married filing a joint return, or
  - c) **\$5,000** if you are married filing a separate return and you and your spouse did not live in the same household at any time during the tax year.
- 2) Divide the result of (1) by 2.

## Step 4. Determine Your Credit

To determine if you can take the credit, you must add the amounts in Step 2 and Step 3.

IF the total of Steps 2 and 3 is:	THEN ...
Equal to or more than the amount in Step 1	You <b>cannot</b> take the credit.
Less than the amount in Step 1	You <b>can</b> take the credit.

**Figuring the credit.** If you can take the credit, subtract the total of Step 2 and Step 3 from the amount in Step 1 and multiply the result by 15%. This is your credit.

In certain cases, the amount of your credit may be limited. See *Limits on Credit*, later.

**Example.** You are 66 years old and your spouse is 64. Your spouse is not disabled. You file a joint return on Form 1040. Your adjusted gross income is \$14,630. Together you received \$3,200 from social security, which was nontaxable. You figure the credit as follows:

1) Initial amount .....	\$5,000
2) Subtract the total of:	
a) Social security and other nontaxable pensions .....	\$3,200
b) Excess adjusted gross income	
[(\$14,630 - \$10,000) ÷ 2] .....	2,315
3) Balance (Not less than -0-) .....	<u>-0-</u>
4) <b>Credit</b> .....	<u>-0-</u>

You cannot take the credit since your nontaxable social security (line 2a) plus your excess adjusted gross income (line 2b) is more than your amount on line 1.

## Limits on Credit

The amount of your credit may be limited if:

- 1) The amount of your credit is more than your tax liability, or
- 2) You file Form 2441, *Child and Dependent Care Expenses*.

Be sure to read your form instructions before claiming your credit.



*Legislation affecting this credit was pending at the time of printing. For guidance, visit the IRS's web site at [www.irs.gov](http://www.irs.gov) or see your tax forms instructions. Publication 553, Highlights of 1999 Tax Changes, will also contain information about this and other tax law changes.*

**Credit more than tax liability.** Your credit for the elderly or the disabled cannot be more than the amount of your tax liability. Therefore, you cannot get a refund for any part of the credit that is more than your tax.

## Credit Figured for You

If you choose to have the Internal Revenue Service (IRS) figure the credit for you, read the following discussions for filing Form 1040 or Form 1040A. If you want the IRS to figure your tax, see chapter 31.

**Form 1040.** If you want the IRS to figure your credit, see *Form 1040 Line Entries* under *Tax Figured by IRS* in chapter 31.

**Form 1040A.** If you want the IRS to figure your credit, see *Form 1040A Line Entries* under *Tax Figured by IRS* in chapter 31.

## Examples

The following examples illustrate the credit for the elderly or the disabled. The initial amounts are taken from Table 34-1, shown earlier.

**Example 1.** Jerry Ash is 68 years old and single, and files Form 1040A. He received the following income for the year:

Nontaxable social security .....	\$3,120
Interest (taxable) .....	215
Pension (all taxable) .....	3,600
Wages from a part-time job .....	4,245

Jerry's adjusted gross income is \$8,060 (\$4,245 + \$3,600 + \$215). Jerry figures the credit on Schedule 3 (Form 1040A) as follows:

1) Initial amount .....	\$5,000
2) Subtract the total of:	
a) Social security and other nontaxable pensions .....	\$3,120
b) Excess adjusted gross income [(\$8,060 - \$7,500) ÷ 2] ..	280
3) Balance .....	<u>\$1,600</u>

4) **Credit** (15% of \$1,600) ..... \$ 240  
 Jerry's credit is \$240. He files Schedule 3 (Form 1040A) and shows this amount on line 27 of Form 1040A.

**Example 2.** James Davis is 58 years old and single, and files Form 1040A. In 1997 he retired on permanent and total disability, and he is still permanently and totally disabled. He filed the required physician's statement with his return for 1997, and his physician signed on line B of the statement. This year James checks the box in Part II of Schedule 3. He does not need to get another statement for 1999.

He received the following income for the year:

Nontaxable social security .....	\$3,000
Interest (taxable) .....	100
Taxable disability pension .....	8,400

James' adjusted gross income is \$8,500 (\$8,400 + \$100). He figures the credit on Schedule 3 as follows:

1) Initial amount .....	\$5,000
2) Taxable disability pension .....	<u>\$8,400</u>
3) Smaller of (1) or (2) .....	\$5,000
4) Subtract the total of:	
a) Nontaxable disability benefits (social security) .....	\$3,000
b) Excess adjusted gross income	
[((\$8,500 - \$7,500) + 2)] .....	<u>500</u> 3,500
5) Balance (Not less than 0) .....	<u>\$1,500</u>
6) <b>Credit</b> (15% of \$1,500) .....	<u>\$ 225</u>

His credit is \$225. He enters \$225 on line 27 of Form 1040A.

**Example 3.** William White is 53. His wife Helen is 49. William had a stroke 10 years ago and retired on permanent and total disability. He is still permanently and totally disabled because of the stroke. In November of last year, Helen was injured in an accident at work and retired on permanent and total disability.

William received nontaxable social security disability benefits of \$3,000 during the year and a taxable disability pension of \$6,000. Helen earned \$9,200 from her job

and received a taxable disability pension of \$1,000. Their joint return on Form 1040 shows adjusted gross income of \$16,200 (\$6,000 + \$9,200 + \$1,000).

Helen got her doctor to complete the physician's statement in the instructions for Schedule R. Helen is not required to include the statement with her return, but she must keep it for her records.

William had filed a physician's statement with their return for the year he had the stroke. His doctor had signed on line B of that physician's statement to certify that William was permanently and totally disabled. William must fill out Part II of Schedule R. He checks the box in Part II and writes his first name in the space above line 2.

William and Helen use Schedule R to figure their \$135 credit for the elderly or the disabled. They attach Schedule R to their joint return and enter \$135 on line 42 of Form 1040. See their filled-in Schedule R and Helen's filled-in physician's statement on the next three pages.

**Schedule R  
(Form 1040)**

Department of the Treasury  
Internal Revenue Service

**Credit for the Elderly or the Disabled**

▶ **Attach to Form 1040.** ▶ **See separate instructions for Schedule R.**

OMB No. 1545-0074

**1999**

Attachment  
Sequence No. **16**

Name(s) shown on Form 1040

William M. White and Helen A. White

Your social security number

220 : 00 : 3333

You may be able to take this credit and reduce your tax if by the end of 1999:

- You were age 65 or older, **OR**
- You were under age 65, you retired on **permanent and total** disability, and you received taxable disability income.

But you must also meet other tests. See the separate instructions for Schedule R.

**TIP** In most cases, the IRS can figure the credit for you. See the instructions.

**Part I Check the Box for Your Filing Status and Age**

If your filing status is:	And by the end of 1999:	Check only one box:
Single, Head of household, or Qualifying widow(er) with dependent child	1 You were 65 or older . . . . .	1 <input type="checkbox"/>
	2 You were under 65 and you retired on permanent and total disability	2 <input type="checkbox"/>
Married filing a joint return	3 Both spouses were 65 or older . . . . .	3 <input type="checkbox"/>
	4 Both spouses were under 65, but only one spouse retired on permanent and total disability . . . . .	4 <input type="checkbox"/>
	5 Both spouses were under 65, and both retired on permanent and total disability . . . . .	5 <input checked="" type="checkbox"/>
	6 One spouse was 65 or older, and the other spouse was under 65 and retired on permanent and total disability . . . . .	6 <input type="checkbox"/>
	7 One spouse was 65 or older, and the other spouse was under 65 and <b>NOT</b> retired on permanent and total disability . . . . .	7 <input type="checkbox"/>
Married filing a separate return	8 You were 65 or older and you lived apart from your spouse for all of 1999 . . . . .	8 <input type="checkbox"/>
	9 You were under 65, you retired on permanent and total disability, and you lived apart from your spouse for all of 1999 . . . . .	9 <input type="checkbox"/>

**Did you check box 1, 3, 7, or 8?** — Yes —▶ Skip Part II and complete Part III on back.  
 — No —▶ Complete Parts II and III.

**Part II Statement of Permanent and Total Disability** (Complete **only** if you checked box 2, 4, 5, 6, or 9 above.)

**IF: 1** You filed a physician's statement for this disability for 1983 or an earlier year, or you filed or got a statement for tax years after 1983 and your physician signed line B on the statement, **AND** William

**2** Due to your continued disabled condition, you were unable to engage in any substantial gainful activity in 1999, check this box . . . . . ▶

- If you checked this box, you do not have to get another statement for 1999.
- If you **did not** check this box, have your physician complete the statement on page 4 of the instructions. You **must** keep the statement for your records.

**Part III** Figure Your Credit

<b>10 If you checked (in Part I):</b>		<b>Enter:</b>							
Box 1, 2, 4, or 7		\$5,000	}	<b>10</b> 7,500					
Box 3, 5, or 6		\$7,500							
Box 8 or 9		\$3,750							
<table border="1"> <tr> <td rowspan="2"><b>Did you check box 2, 4, 5, 6, or 9 in Part I?</b></td> <td><b>Yes</b> →</td> <td>You <b>must</b> complete line 11.</td> </tr> <tr> <td><b>No</b> →</td> <td>Enter the amount from line 10 on line 12 and go to line 13.</td> </tr> </table>		<b>Did you check box 2, 4, 5, 6, or 9 in Part I?</b>	<b>Yes</b> →	You <b>must</b> complete line 11.	<b>No</b> →	Enter the amount from line 10 on line 12 and go to line 13.			
<b>Did you check box 2, 4, 5, 6, or 9 in Part I?</b>	<b>Yes</b> →		You <b>must</b> complete line 11.						
	<b>No</b> →	Enter the amount from line 10 on line 12 and go to line 13.							
<b>11 If you checked:</b>									
<ul style="list-style-type: none"> <li>Box 6 in Part I, add \$5,000 to the taxable disability income of the spouse who was under age 65. Enter the total.</li> <li>Box 2, 4, or 9 in Part I, enter your taxable disability income.</li> <li>Box 5 in Part I, add your taxable disability income to your spouse's taxable disability income. Enter the total.</li> </ul>			}	<b>11</b> 7,000					
<p><b>TIP</b> For more details on what to include on line 11, see the instructions.</p>									
<b>12</b> If you completed line 11, enter the <b>smaller</b> of line 10 or line 11. <b>all others</b> , enter the amount from line 10				<b>12</b> 7,000					
<b>13</b> Enter the following pensions, annuities, or disability income that you (and your spouse if filing a joint return) received in 1999:									
<b>a</b> Nontaxable part of social security benefits, and Nontaxable part of railroad retirement benefits treated as social security. See instructions.		<b>13a</b>	3,000						
<b>b</b> Nontaxable veterans' pensions, and Any other pension, annuity, or disability benefit that is excluded from income under any other provision of law. See instructions.		<b>13b</b>							
<b>c</b> Add lines 13a and 13b. (Even though these income items are not taxable, they <b>must</b> be included here to figure your credit.) If you did not receive any of the types of nontaxable income listed on line 13a or 13b, enter -0- on line 13c		<b>13c</b>	3,000						
<b>14</b> Enter the amount from Form 1040, line 34		<b>14</b>	16,200						
<b>15 If you checked (in Part I):</b>		<b>Enter:</b>							
Box 1 or 2		\$7,500	}	<b>15</b> 10,000					
Box 3, 4, 5, 6, or 7		\$10,000							
Box 8 or 9		\$5,000							
<b>16</b> Subtract line 15 from line 14. If zero or less, enter -0-		<b>16</b>	6,200						
<b>17</b> Enter one-half of line 16		<b>17</b>	3,100						
<b>18</b> Add lines 13c and 17		<b>18</b>		6,100					
<b>19</b> Subtract line 18 from line 12. If zero or less, <b>stop</b> ; you <b>cannot</b> take the credit. Otherwise, go to line 20		<b>19</b>		900					
<b>20</b> Multiply line 19 by 15% (.15). Enter the result here and on Form 1040, line 42. But if this amount is more than the amount on Form 1040, line 40, or you are filing Form 2441, see the instructions for the amount of credit you may take		<b>20</b>		135					

---

## Instructions for Physician's Statement

### Taxpayer

If you retired after 1976, enter the date you retired in the space provided on the statement below.

1. He or she cannot engage in any substantial gainful activity because of a physical or mental condition, and

2. A physician determines that the disability has lasted or can be expected to last continuously for at least a year or can lead to death.

### Physician

A person is permanently and totally disabled if **both** of the following apply:

---

### Physician's Statement (keep for your records)

---

I certify that Helen A. White

Name of disabled person

was permanently and totally disabled on January 1, 1976, or January 1, 1977, **OR** was permanently and totally disabled on the date he or she retired. If retired after 1976, enter the date retired. ► November 30, 1999

**Physician:** Sign your name on **either** line A or B below.

**A** The disability has lasted or can be expected to last continuously for at least a year . . .

Physician's signature

Date

Juanita D. Doctor

2/7/00

**B** There is no reasonable probability that the disabled condition will ever improve . . .

Physician's signature

Date

Physician's name

Juanita D. Doctor

Physician's address

1900 Green St., Hometown, MD 20000

## Child Tax Credit

### Important Changes

**Pending legislation.** Legislation affecting this credit was pending at the time of printing. For guidance, visit the IRS's web site at [www.irs.gov](http://www.irs.gov) or see your tax forms instructions. Publication 553, *Highlights of 1999 Tax Changes*, will also contain information about this and other tax law changes.

**Child tax credit increased.** The maximum child tax credit for each qualifying child has increased from \$400 to \$500.

### Introduction

The child tax credit is a credit that can reduce your tax. You may be able to take a credit on your tax return of up to \$500 for each of your qualifying children.

The child tax credit is not the same as the credit for child and dependent care expenses. For information on the credit for child and dependent care expenses, see chapter 33.

This chapter gives you information about the child tax credit. It explains:

- Who is a qualifying child?
- How much is the credit?
- How do I claim the credit?
- Why should I check my tax withholding?

**If you have no tax.** Credits, such as the child tax credit, the adoption credit, or the credit for child and dependent care expenses, are used to reduce tax. If the tax on line 40 (Form 1040) or line 25 (Form 1040A) is zero, do not figure the child tax credit because there is no tax to reduce. However, if you have three or more qualifying children, you may qualify for the additional child tax credit on line 60 (Form 1040) or line 38 (Form 1040A).

### Useful Items

You may want to see:

#### Form (and Instructions)

- 8812** Additional Child Tax Credit
- W-4** Employee's Withholding Allowance Certificate

## Qualifying Child

A qualifying child for purposes of the child tax credit must be all of the following.

- 1) Under age 17 at the end of 1999.
- 2) A citizen or resident of the United States.
- 3) Claimed as your dependent.
- 4) Your:
  - a) Son or daughter,
  - b) Stepson or stepdaughter,
  - c) Adopted child,
  - d) Grandchild, or
  - e) Eligible foster child.

**Adopted child.** A child placed with you by an authorized placement agency for legal adoption is an adopted child even if the adoption is not final.

**Grandchild.** A grandchild is any descendant of your son, daughter, or adopted child and includes your great-grandchild, great-great-grandchild, etc.

**Eligible foster child.** An eligible foster child is any child you cared for as your own and who lived with you as a member of your household for the entire year.

## Amount of Credit

The maximum credit you can claim is \$500 for each qualifying child.

## Limits on the Credit

Your credit may be limited depending on the amount of your tax liability and your modified adjusted gross income (AGI).

You must reduce your child tax credit if:

- 1) Your tax liability is less than the credit, or
- 2) Your modified AGI is above the amount shown below for your filing status.
  - Married filing jointly – \$110,000
  - Single, head of household, or qualifying widow(er) – \$75,000
  - Married filing separately, – \$55,000

**Tax liability.** Your tax liability is the amount on line 40 (Form 1040) or line 25 (Form 1040A). If this amount is zero, you cannot take this credit because there is no tax to reduce. But if you have three or more qualifying children, you may be able to take the **additional child tax credit**. See *Additional Child Tax Credit*, later.



Legislation affecting this credit was pending at the time of printing. For guidance, visit the IRS's web site at [www.irs.gov](http://www.irs.gov) or see your tax forms instructions. Publication 553, *Highlights of 1999 Tax Changes*, will also contain information about this and other tax law changes.

**Modified AGI.** For purposes of the child tax credit, your modified AGI is your AGI plus the following amounts that may apply to you.

- Any amount excluded from income because of the exclusion of income from Puerto Rico.
- Any amount on lines 43 and 48 of Form 2555, *Foreign Earned Income*.
- Any amount on line 18 of Form 2555-EZ, *Foreign Earned Income Exclusion*.
- Any amount on line 15 of Form 4563, *Exclusion of Income for Bona Fide Residents of American Samoa*.

If you do not have any of the above, modified AGI is the AGI amount on line 34 (Form 1040) or line 19 (Form 1040A).

## Claiming the Credit

To claim the child tax credit, you must file Form 1040 or Form 1040A. You must provide the name and identification number (usually a social security number) on your tax return for each qualifying child.

Answer the *Questions* in your form instructions for line 43 (Form 1040) or line 28 (Form 1040A) to find out which child tax credit worksheet you can use to compute the credit. (See the filled-in example, later.)



If you answer "Yes" to question 1, 2, or 4 in your Form 1040 instructions or question 1 or 3 in your Form 1040A instructions, you must complete the Child Tax Credit Worksheet in Publication 972, *Child Tax Credit*.

**Example.** Amy Brown files as head of household and has three dependent children under age 17. The children are qualifying children for purposes of the child tax credit. Amy's only income is her salary of \$33,500, of which total social security and Medicare taxes withheld were \$2,563. Amy chooses to itemize her deductions and file Form 1040. Her AGI, shown on line 34 of her Form 1040, is \$33,500.

Amy does not file Form 2555, 2555-EZ, or 4563. She does not exclude income from Puerto Rico. Her modified AGI is \$33,500.

Amy's tax, shown on line 40 of her Form 1040, is \$1,819. She claims a \$960 credit for child and dependent care expenses on line 41. She has no other credits.

After answering the *Questions* in the Form 1040 instructions, she completes the

child tax credit worksheet to figure her child tax credit of \$859. Amy's completed questions and child tax credit worksheet are shown later.

Amy reads the *TIP* in the worksheet and finds that she may be able to take the additional child tax credit. See *Additional Child Tax Credit*, and Amy's completed Form 8812, later.

## Additional Child Tax Credit

This credit is for certain people who have three or more qualifying children, as defined earlier. The additional child tax credit may give you a refund even if you do not owe any tax.

**How to claim the additional child tax credit.** To claim the additional child tax credit, follow the steps below.

- 1) Make sure you figured the amount, if any, of your child tax credit. See *Claiming the Credit*, earlier.
- 2) Use Form 8812 to see if you can take the additional child tax credit only if:
  - a) You answered "Yes" on line 4 or line 5 of the *Child Tax Credit Worksheet*, and
  - b) The amount on line 1 of your *Child Tax Credit Worksheet* is \$1,500 or more.
- 3) If you have an additional child tax credit on line 9 of Form 8812, carry it to line 60 (Form 1040) or line 38 (Form 1040A).

## Checking Your Withholding

The child tax credit decreases your tax. You can check your tax withholding by using Worksheet 7 in Publication 919, *How Do I Adjust My Tax Withholding?*


If you are having too much tax withheld, and you prefer to have the money during the year, you may be able to decrease your withholding. You do this by completing a new Form W-4 and giving it to your employer.

## Filled-in Questions for Amy Brown


### Questions

### Who Must Use the Worksheets in Publication 972?


1. Are you excluding income from Puerto Rico OR are you filing any of the following forms?
  - Form 2555 or 2555-EZ (relating to foreign earned income)
  - Form 4563 (exclusion of income for residents of American Samoa)

**No.** *Continue* →  **Yes.** 

You must use the worksheets in Pub. 972 to figure your child tax credit instead of the forms instructions.
2. Is the amount on Form 1040, line 34, more than the amount shown below for your filing status?
  - Married filing jointly – \$110,000
  - Single, head of household, or qualifying widow(er) – \$75,000
  - Married filing separately – \$55,000

**No.** *Continue* →  **Yes.** 

You must use the worksheets in Pub. 972 to figure your child tax credit instead of the forms instructions.
3. Do you have three or more qualifying children for the child tax credit?

**No.**   **Yes.** *Continue* →

You can use the **shorter** worksheet in the Form 1040 instructions to figure your child tax credit.
4. Are you claiming any of the following credits?
  - Adoption credit, Form 8839 (see the instructions for Form 1040, line 45)
  - Mortgage interest credit, Form 8396 (see the instructions for Form 1040, line 47)
  - District of Columbia first-time homebuyer credit, Form 8859

**No.** Use the **shorter** worksheet in the Form 1040 instructions to figure your child tax credit.  **Yes.** You must use the worksheets in Pub. 972 to figure your child tax credit instead of the forms instructions. You will also need the form(s) listed above for any credit(s) you are claiming.

**Filled-in Child Tax Credit Worksheet — Amy Brown**  
(Page references are to the Form 1040 instructions.)

**Child Tax Credit Worksheet—Line 43**

*Keep for Your Records*



**Do not** use this worksheet if you answered “Yes” to question 1, 2, or 4 on page 33. Instead, use Pub. 972.



**Before you begin:** ✓ If you are claiming an education credit, be sure you have completed Form 8863.

1. Number of qualifying children: 3 × \$500. Enter the result. 

<b>1</b>	1,500
----------	-------

2. Enter the amount from Form 1040, line 40. 

<b>2</b>	1,819
----------	-------

3. Add the amounts from Form 1040:

Line 41	<u>960</u>			
Line 42	+ _____			
Line 44	+ _____			
	Enter the total.	<table border="1" style="float: right;"><tr><td style="width: 20px; text-align: center;"><b>3</b></td><td style="width: 100px; text-align: center;">960</td></tr></table>	<b>3</b>	960
<b>3</b>	960			

4. Are the amounts on lines 2 and 3 the same?

Yes. You cannot take this credit because there is no tax to reduce. However, see the **TIP** below before completing the rest of your Form 1040.

No. Subtract line 3 from line 2. 

<b>4</b>	859
----------	-----

5. Is the amount on line 1 more than the amount on line 4?

Yes. Enter the amount from line 4. See the **TIP** below. } **This is your child tax credit.**

<b>5</b>	859
----------	-----

No. Enter the amount from line 1. }

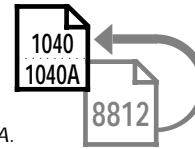
*Enter this amount on Form 1040, line 43.*

You may be able to take the **additional child tax credit** on Form 1040, line 60, only if you answered “Yes” on line 4 or line 5 above **AND** the amount on line 1 is \$1,500 or more.

- First, complete your Form 1040 through line 59b.
- Then, use Form 8812 to figure any additional child tax credit.



# Additional Child Tax Credit



Department of the Treasury  
Internal Revenue Service

Complete and attach to Form 1040 or 1040A.

Name(s) shown on return  
Amy Brown

Your social security number  
012 00 5678

### Before you begin:

- ✓ Complete the Child Tax Credit Worksheet that applies to you. See the instructions for Form 1040, line 43, or Form 1040A, line 28.
- ✓ Have your W-2 form(s) available.
- ✓ If you, or your spouse if filing jointly, had more than one employer for 1999 and total wages of over \$53,700, figure any excess social security and railroad retirement (RTTA) taxes withheld. See the instructions for Form 1040, line 62, or Form 1040A, line 39.

**1** Enter the total of the social security and Medicare taxes from Form(s) W-2, boxes 4 and 6.

- If married filing jointly, include your spouse's amounts with yours.
- If you worked for a railroad, see the instructions on back.

1 2,563

**2** **1040 filers:** Enter the total of the amounts from Form 1040, lines 27 and 52, plus any uncollected social security and Medicare or RTTA taxes included on line 56.

**1040A filers:** Enter -0-

2 0

**3** Add lines 1 and 2.

3 2,563

**4** **1040 filers:** Enter the total of the amounts from Form 1040, lines 59a and 62.

**1040A filers:** Enter the total of the amount from Form 1040A, line 37a, plus any excess social security and RTTA taxes withheld that you entered to the left of line 39.

4 0

**5** Is the amount on line 3 more than the amount on line 4?

**No.**  **Yes.** Subtract line 4 from line 3.

You cannot take this credit.  
Complete the rest of your  
Form 1040 or Form 1040A.

5 2,563

**6** Enter the amount from line 1 of the Child Tax Credit Worksheet on page 34 of the Form 1040 instructions or page 36 of the Form 1040A instructions. If you used Pub. 972, enter the amount from line 8 of the worksheet on page 3 of the publication.

6 1,500

**7** Enter the amount from Form 1040, line 43, or Form 1040A, line 28.

7 859

**8** Is the amount on line 6 more than the amount on line 7?

**No.**  **Yes.** Subtract line 7 from line 6.

You cannot take this credit.  
Complete the rest of your  
Form 1040 or Form 1040A.

8 641

**9** Is the amount on line 5 more than the amount on line 8?

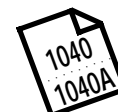
**No.** Enter the amount from line 5.

**Yes.** Enter the amount from line 8.

9 641

**This is your additional child tax credit.**

Enter this amount on  
Form 1040, line 60, or  
Form 1040A, line 38.



# Education Credits

## Important Changes

**Tax from recapture of education credits.** You may owe this tax if you claimed an education credit on your 1998 tax return and, in 1999, you, your spouse if filing jointly, or your dependent received a refund of qualified tuition and related expenses or tax-free educational assistance. See *Recapture of credit under No double benefit allowed*.

**Pending legislation.** Legislation affecting this credit was pending at the time of printing. For guidance, visit the IRS's web site at [www.irs.gov](http://www.irs.gov) or see your tax forms instructions. Publication 553 *Highlights of 1999 Tax Changes*, will also contain information about this and other tax law changes.

## Introduction

This chapter discusses the Hope credit and the lifetime learning credit. It will:

- Give you general information that applies to both of the credits,
- Give you specific information about each of the credits,
- Help you choose which of the credits to claim, and
- Show you how to figure the credit you choose.

## Useful Items

You may want to see:

### Publication

- 970** Tax Benefits for Higher Education

### Form (and Instructions)

- 8863** Education Credits (Hope and Lifetime Learning Credits)

## Education Tax Credits

The following two tax credits are available to persons who pay higher education costs.

- The Hope credit.
- The lifetime learning credit.



If a student receives a tax-free withdrawal from an education IRA in a particular tax year, none of that student's expenses can be used as the basis of a higher education credit for that tax year. However, the student can waive the tax-free treatment. See Waiver of tax-free treatment *under* No double benefit allowed.

## Rules That Apply to Both Credits

The amount of each credit is determined by the amount you pay for qualified tuition and related expenses for students and the amount of your modified adjusted gross income. Education credits are subtracted from your tax but they are nonrefundable. This means if the credits are more than your tax, the excess is not refunded to you.



If you are married filing separately you cannot claim the higher education credits.

**What expenses qualify.** The credits are based on qualified tuition and related expenses you pay for yourself, your spouse, or a dependent for whom you claim an exemption on your tax return. The credits are allowed for qualified tuition and related expenses paid for an academic period beginning in the same year as the year the payment is made (but see *Prepaid expenses*, later). In general, qualified tuition and related expenses are tuition and fees required for enrollment or attendance at an eligible educational institution. Student activity fees and fees for course-related books, supplies and equipment are included in qualified tuition and related expenses **only if** the fees must be paid **to the institution** as a condition of enrollment or attendance.

**Prepaid expenses.** If you pay qualified tuition and related expenses for an academic period that begins in the first three months of the following year, you can use the prepaid amount in figuring your credit. For example, if you paid \$2,000 in December 1999 for qualified tuition for the winter 2000 semester beginning in January 2000, you can use that \$2,000 in figuring your 1999 credit.

**Payments with borrowed funds.** You claim an education credit for the qualified tuition and related expenses paid with the proceeds of a loan. The credit is claimed in the year in which the expenses are paid, not in the year in which the loan is repaid.

**What expenses do not qualify.** Qualified tuition and related expenses do not include the cost of insurance, medical expenses (including student health fees), room and board, transportation or similar personal, living or family expenses, even if the fee must be paid to the institution as a condition of enrollment or attendance.

Qualified tuition and related expenses generally do not include expenses that relate to any course of instruction or other education that involves sports, games, or hobbies, or any noncredit course. However, if the course of instruction or other education is part of the student's degree program or, in the case of the lifetime learning credit, is taken by the student to acquire or improve job skills, these expenses can qualify.

**Dependent for whom you claim an exemption.** You claim an exemption for a dependent if you list that person in the *Exemptions* section of your tax return. (See chapter 3 for details on exemptions for dependents.)

**Eligible educational institution.** An eligible educational institution is any college, university, vocational school, or other post-secondary educational institution eligible to participate in a student aid program administered by the Department of Education. It includes virtually all accredited, public, nonprofit, and proprietary (privately owned profit-making) postsecondary institutions. The educational institution should be able to tell you if it is an eligible educational institution.

**Academic period.** An academic period includes a semester, trimester, quarter, or other period. For purposes of the education credits, an academic period begins on the first day of classes and does not include periods of student orientation, counseling or vacation.

**No double benefit allowed.** If you pay higher education expenses with certain tax-free funds, or claim a deduction for higher education expenses on your tax return, you cannot claim a credit for those same expenses.

**Adjustments to qualified expenses.** If you pay higher education expenses with certain **tax-free** funds, you cannot claim a credit for those amounts. You must reduce the qualified expenses by the amount of any tax-free funds. Tax-free funds could include scholarships, Pell grants, employer-provided educational assistance, veterans' educational assistance, and any other nontaxable payments (other than gifts, bequests, or inheritances) received for educational expenses. Do not reduce the qualified expenses by amounts paid with the student's earnings, loans, gifts, inheritances, and personal savings. Also, do not reduce the qualified expenses by any scholarship reported as income on the student's return or any scholarship which, by its terms, cannot be applied to qualified tuition and related expenses.

**Waiver of tax-free treatment.** The designated beneficiary of an education IRA can waive the tax-free treatment of the withdrawal and elect to pay any tax that would otherwise be owed on the withdrawal. The beneficiary or the beneficiary's parents may then be eligible to claim a Hope credit or lifetime learning credit for qualified higher education expenses paid in that tax year.

**Refunds.** Qualified tuition and related expenses do not include expenses that are refunded. If you receive a refund in the same year in which you paid the expenses, or in the following year, but before you file your tax return for the year you paid them, simply reduce the amount of the expenses by the amount of the refund received. If you receive the refund after you file your tax return, see *Recapture of credit*, next.

**Recapture of credit.** If, in a later year, you receive tax-free educational assistance for, or a refund of, an expense you used to figure a higher education credit, you may have to recapture all or part of the credit. You must refigure your education credits as if the assistance or refund was received in the year the expenses were paid. Include the difference, if any, on your return for the

year in which the assistance or refund was received. Include it on the "total tax" line of your return. Next to the line, enter the amount and "ECR."

**Who can claim the credit.** If there are higher education costs for your dependent child, either you or your child, but not both of you, can claim a credit for a particular year. If you claim an exemption for your child on your tax return, only you can claim a credit. If you do not claim an exemption for your child on your tax return, only your child can claim a credit.

**Expenses paid by others.** If someone other than you, your spouse, or your claimed dependent makes a payment directly to an eligible educational institution to pay for a student's qualified tuition and related expenses, the student is treated as receiving the payment from the other person. The qualified tuition and related expenses are considered paid to the institution by the student.

**Example.** Ms. Allen makes a payment directly to an eligible educational institution in 1999 for her grandson's qualified tuition and related expenses. For purposes of claiming an education credit, the grandson is treated as receiving the money from Ms. Allen and, in turn, paying his qualified tuition and related expenses.

**Expenses paid by dependent.** If you claim an exemption for your child on your tax return, treat any expenses paid by your child as if you had paid them. Include these expenses when figuring the amount of your Hope or lifetime learning credit.



**Qualified tuition and related expenses paid directly to an eligible educational institution for your dependent under a court-approved divorce decree are treated as paid by your dependent.**

## Income Phaseout

Your education credits are phased out (gradually reduced) if your modified adjusted gross income is between \$40,000 and \$50,000 (\$80,000 and \$100,000 in the case of a joint return).



**You cannot claim any higher education credits if your modified adjusted gross income is \$50,000 or more (\$100,000 or more in the case of a joint return).**

**Modified adjusted gross income.** For most taxpayers, modified adjusted gross income will be their adjusted gross income (AGI) as figured on their federal income tax return. However, you must make adjustments to your AGI if you excluded income earned abroad or from certain U.S. territories or possessions. If this applies to you, increase your AGI by the following amounts you excluded from your income.

- 1) Foreign earned income of U.S. citizens or residents living abroad.
- 2) Housing costs of U.S. citizens or residents living abroad.
- 3) Income from sources within Puerto Rico, Guam, American Samoa, or the Northern Mariana Islands.

**How the phaseout works.** The phaseout (reduction) works on a sliding scale. The higher your modified adjusted gross income, the more your credits are reduced. You figure the reduction, if any, in Part III of Form 8863.

## Hope Credit

You may be able to claim a Hope credit of up to \$1,500 for qualified tuition and related expenses paid for **each** eligible student. You can take into account expenses paid in 1999 for academic periods beginning after December 31, 1998, and before April 1, 2000. The credit can be claimed for **only 2 years** for each eligible student.

**Eligible student for the Hope credit.** You can claim a Hope credit only for an eligible student who meets all of the following requirements.

- 1) Has not **completed the first 2 years** of postsecondary education (generally, the freshman and sophomore years of college).
- 2) Is enrolled in a program that leads to a degree, certificate, or other recognized educational credential.
- 3) Is taking at least **half of the normal full-time work load** for his or her course of study for at least one academic period beginning during the calendar year.
- 4) Is free of any felony conviction for possessing or distributing a controlled substance.

**Completion of first 2 years.** A student awarded 2 years of academic credit for postsecondary work completed prior to the beginning of the year has completed the first 2 years of postsecondary education.

Any academic credit awarded solely on the basis of the student's performance on proficiency examinations is disregarded in determining whether the student has completed 2 years of postsecondary education.

**Half of normal full-time workload.** The standard for what is half of the normal full-time work load is determined by each eligible educational institution. However, the standard may not be lower than standards for half-time established by the Department of Education under the Higher Education Act of 1965.

**Amount of credit.** The amount of the Hope credit is 100% of the first \$1,000 **plus** 50% of the next \$1,000 you pay for each eligible student's qualified tuition and related expenses. The maximum amount of Hope credit you can claim in 1999 is \$1,500 times the number of eligible students. You can claim the full \$1,500 for each eligible student for whom you pay at least \$2,000 for qualified expenses. However, the credit may be reduced based on your modified adjusted gross income. See *Income Phaseout*, earlier.

**Example.** Jon and Karen are married and file a joint tax return. For 1999, they claim an exemption for their dependent daughter on their tax return and their modified adjusted gross income is \$70,000. Their daughter is in her sophomore (second) year of studies at the local university and Jon and

Karen pay \$4,300 in 1999 for her tuition costs.

Jon and Karen, their daughter, and the local university meet all of the requirements for the Hope credit. Jon and Karen can claim a \$1,500 Hope credit in 1999. This is the maximum amount allowed for 1999.

**How to figure the Hope credit.** The Hope credit is figured in Parts I and III of Form 8863. An illustrated example using Form 8863 appears later.

## Lifetime Learning Credit

You may be able to claim a lifetime learning credit of up to \$1,000 for qualified tuition and related expenses paid for **all** students enrolled in eligible educational institutions. You can take into account expenses paid in 1999 for academic periods beginning after December 31, 1998, and before April 1, 2000.

The lifetime learning credit is different than the Hope credit in the following ways.

- 1) The lifetime learning credit is not based on the student's work load. It is allowed for one or more courses.
- 2) The lifetime learning credit is not limited to students in the first 2 years of postsecondary education.
- 3) Expenses for graduate-level degree work are eligible.
- 4) Expenses related to a course of instruction or other education that involves sports, games, hobbies, or other noncredit courses are eligible **if** they are part of a course of instruction to acquire or improve job skills.
- 5) There is no limit on the number of years for which the lifetime learning credit can be claimed for each student.
- 6) The amount you can claim as a lifetime learning credit does not vary (increase) based on the number of students for whom you pay qualified expenses.

**Amount of credit.** The amount of the lifetime learning credit is 20% of the first \$5,000 you pay for qualified tuition and related expenses for all students in the family. The maximum amount of lifetime learning credit you can claim for 1999 is \$1,000 (20% × \$5,000). However, that amount may be reduced based on your modified adjusted gross income. See *Income Phaseout*, earlier.

**Example.** Bruce and Toni are married and file a joint tax return. For 1999, their modified adjusted gross income is \$50,000. Toni is attending the community college (an eligible educational institution) to earn credits towards an associate's degree in nursing; she already has a bachelor's degree in history and wants to become a nurse. In August 1999, Toni paid \$2,000 for her fall 1999 semester. Bruce and Toni can claim a \$400 (20% × \$2,000) lifetime learning credit on their 1999 joint tax return.

**How to figure the lifetime learning credit.** The lifetime learning credit is figured in Parts II and III of Form 8863. An illustrated example using Form 8863 appears later.

## Choosing Which Credit To Claim

For each student, you can elect for any tax year only **one** of the credits **or** a tax-free withdrawal from an education IRA. (See *Education IRAs* in chapter 18 for more information.) For example, if you elect to take the Hope credit for a child on your 1999 tax return, you cannot, for that same child, also claim the lifetime learning credit for 1999 or take a tax-free withdrawal from an education IRA for 1999.

### Lifetime learning credit after Hope credit.

You can claim the Hope credit for the first 2 years of a student's postsecondary education and claim the lifetime learning credit for that same student in later tax years.

**More than one student.** If you pay qualified expenses for more than one student in the same year, you can choose to take credits on a per-student, per-year basis. This means that, for example, you can claim the Hope credit for one student and the lifetime learning credit for another student in the same tax year.

## How To Claim the Credits

You elect to claim education credits and you figure their amount by completing **Form 8863**. Use Part I for the Hope credit and Part II for the lifetime learning credit. In both parts, you enter the student's name and taxpayer identification number (usually a social security number) and the amount of qualified expenses paid in 1999. You then complete Part III to compute the amount to

enter on line 44 of Form 1040 or line 29 of Form 1040A. Attach the completed Form 8863 to your return.



*Legislation affecting this credit was pending at the time of printing. For guidance, visit the IRS's web site at [www.irs.gov](http://www.irs.gov) or see your tax forms instructions. Publication 553, Highlights of 1999 Tax Changes, will also contain information about this and other tax law changes.*

An eligible educational institution (such as a college or university) that receives payment of qualified tuition and related expenses should issue **Form 1098-T, Tuition Payments Statement**, to each student by February 1, 2000. The information on Form 1098-T will help you determine whether you can claim an education tax credit for 1999. The following information should be included on the 1999 form.

- 1) The name, address, and taxpayer identification number of the educational institution.
- 2) The name, address, and taxpayer identification number of the student.
- 3) Whether the student was enrolled for at least half of the full-time academic workload.
- 4) Whether the student was enrolled exclusively in a graduate-level program.

The eligible educational institution may ask for a completed **Form W-9S, Request for Student's or Borrower's Social Security Number and Certification**, or similar state-

ment, to obtain the information needed to complete (2) above.

## Illustrated Example

Dave and Valerie are married and file a joint tax return. For 1999, they claim exemptions for their two dependent children on their tax return, and their modified adjusted gross income is \$72,000. Their son, Sean, will receive his bachelor's degree in psychology from the state college in May 2000. Their daughter, Corey, enrolled full-time at that same college in August 1998 to begin working on her bachelor's degree in physical education. In December 1998, Dave and Valerie paid \$2,000 for each child's tuition for the winter 1999 semester. In July 1999, they paid \$2,200 in tuition costs for each of them for the fall 1999 semester.

Dave and Valerie, their children, and the college meet all of the requirements for the higher education credits. Because Sean is beyond the second (sophomore) year of his postsecondary education, his expenses do not qualify for the Hope credit. But, amounts paid for Sean's expenses in 1999 for academic periods after 1998 and before April 1, 2000, qualify for the lifetime learning credit. Corey is in her first (freshman) year of postsecondary education and expenses paid for her in 1999 for academic periods beginning after 1998 and before April 1, 2000, qualify for the Hope credit.

Dave and Valerie figure their total higher education credits for 1999, \$1,940, as shown in the completed Form 8863. They can claim the full amount because their modified adjusted gross income is not more than \$80,000. They carry the amount from Form 8863 to line 44 of Form 1040, and they attach the **Form 8863** to their return.

## Education Credits (Hope and Lifetime Learning Credits)

1999

Attachment  
 Sequence No. **51**

▶ See instructions on pages 3 and 4. ▶ Attach to Form 1040 or Form 1040A.

Name(s) shown on return Your social security number  
 Dave and Valerie Jones 987 : 00 : 6543

### Part I Hope Credit

1 (a) Student's name  First, Last	(b) Student's social security number	(c) Qualified expenses (but do not enter more than \$2,000 for each student). See instructions	(d) Enter the smaller of the amount in column (c) or \$1,000	(e) Subtract column (d) from column (c)	(f) Enter one-half of the amount in column (e)
Corey Jones	137 : 00 : 9642	2,000	1,000	1,000	500
2 Add the amounts in columns (d) and (f) . . . . .					<b>2</b> 1,000
3 Add the amounts on line 2, columns (d) and (f) . . . . . ▶					<b>3</b> 1,500

### Part II Lifetime Learning Credit

4 (a) Student's name  First Last	(b) Student's social security number	(c) Qualified expenses. See instructions
Caution: You cannot take the Hope credit and the lifetime learning credit for the same student. Sean Jones	246 : 00 : 9731	2,200
5 Add the amounts on line 4, column (c), and enter the total . . . . .		<b>5</b> 2,200
6 Enter the smaller of line 5 or \$5,000 . . . . .		<b>6</b> 2,200
7 Multiply line 6 by 20% (.20) . . . . . ▶		<b>7</b> 440

### Part III Allowable Education Credits

8 Add lines 3 and 7. . . . .					<b>8</b> 1,940
9 Enter: \$100,000 if married filing jointly; \$50,000 if single, head of household, or qualifying widow(er) . . . . .	<b>9</b>	100,000			
10 Enter the amount from Form 1040, line 34 (or Form 1040A, line 19)* . . . . .	<b>10</b>	72,000			
11 Subtract line 10 from line 9. If line 10 is greater than or equal to line 9, stop; you cannot take any education credits . . . . .	<b>11</b>	28,000			
12 Enter: \$20,000 if married filing jointly; \$10,000 if single, head of household, or qualifying widow(er) . . . . .	<b>12</b>	20,000			
13 If line 11 is greater than or equal to line 12, enter the amount from line 8 on line 14 and go to line 15. If line 11 is less than line 12, divide line 11 by line 12. Enter the result as a decimal (rounded to at least three places) . . . . .	<b>13</b>	×			
14 Multiply line 8 by line 13 . . . . . ▶	<b>14</b>	1,940			
15 Enter your tax from Form 1040, line 40 (or Form 1040A, line 25) . . . . .	<b>15</b>	9,475			
16 Enter the total, if any, of your credits from Form 1040, lines 41 and 42 (or from Form 1040A, lines 26 and 27) . . . . .	<b>16</b>	0			
17 Subtract line 16 from line 15. If line 16 is greater than or equal to line 15, stop; you cannot take any education credits . . . . .	<b>17</b>	9,475			
18 <b>Education credits.</b> Enter the smaller of line 14 or line 17 here and on Form 1040, line 44 (or Form 1040A, line 29) . . . . . ▶	<b>18</b>	1,940			

\*See Pub. 970 for the amount to enter if you are filing Form 2555, 2555-EZ, or 4563, or you are excluding income from Puerto Rico.

# Earned Income Credit

## Important Changes

**Certain people must use Publication 596.** Certain people must use Publication 596 to see if they can take the EIC and to figure the amount of the credit. You must use Publication 596 if any of the following situations applies to you.

- Your investment income (Rule 5) is more than \$2,350 **and** you are filing Form 4797 (relating to sale of business property).
- You are filing Schedule E (Form 1040).
- You are claiming a loss on Form 1040, line 12, 13, or 18.
- You are reporting income or a loss from the rental of personal property not used in a trade or business.
- You, (or your spouse if filing a joint return) received any distributions from a pension, annuity, or IRA that are not fully taxable.
- You owe alternative minimum tax (AMT), found on Form 1040, line 51, or included in the total found on Form 1040A, line 34.

For information on how you can get free IRS publications, see *How To Get More Information* in the back of this publication.

**Earned income amount is more.** The amount you can earn and still get the credit has increased for 1999. The amount you earn must be less than:

- \$26,928 with one qualifying child,
- \$30,580 with more than one qualifying child, or
- \$10,200 without a qualifying child.

**Investment income amount is more.** The maximum amount of investment income you can have and still get the credit has increased for 1999. You can have investment income up to \$2,350. For most people, investment income is taxable interest and dividends, tax-exempt interest, and capital gain net income. To get more detailed information, see Rule 5, later.

## Important Reminders

**Modified AGI (adjusted gross income).** Your modified AGI used to limit your credit includes:

- 1) Tax-exempt interest, and
- 2) The nontaxable part of a pension, annuity, or individual retirement arrangement (IRA) distribution, except any amount that is nontaxable due to a

trustee-to-trustee transfer or a rollover distribution.

Also, the amount of business losses that must be added back to AGI to figure modified AGI is 75%.

If you qualify for the 2000 advance payment of the earned income credit, use these increases to figure your 2000 modified AGI.

See Publication 596, *Earned Income Credit*, for more detailed information on modified AGI.

**Advance payment of the earned income credit in your paycheck.** If you qualify for the earned income credit in 2000, you can receive part of it in each paycheck throughout the year. See *Advance Earned Income Credit*, later, for more information.

**Earned income credit has no effect on certain welfare benefits.** The earned income credit and advance earned income credit payments you receive will not be used to determine whether you are eligible for the following benefit programs, or how much you can receive from these programs.

- Temporary assistance for needy families (TANF).
- Medicaid and supplemental security income (SSI).
- Food stamps.
- Low-income housing.

**Social security numbers.** You must provide a correct and valid social security number (SSN) for yourself, your spouse, and any qualifying children. If an SSN is missing or incorrect, you may not get the credit. See Rule 1, later.

**Form 8862 to claim EIC after disallowance.** You must file Form 8862, *Information To Claim Earned Income Credit After Disallowance*, to claim earned income credit if you are denied the credit unless the credit was denied because of a mathematical or clerical error. See Publication 596 for more information.

## Introduction

The earned income credit (EIC) is a tax credit for people who work and have earned income under \$30,580. A tax credit usually means more money in your pocket. It reduces the amount of tax you owe. The EIC may also give you a refund.

**How do you get the earned income credit?** To get the earned income credit, you must:

- 1) Qualify by meeting certain rules, and
- 2) File a tax return, even if you:
  - a) Do not owe any tax,
  - b) Did not earn enough money to file a return, or
  - c) Did not have income taxes withheld from your pay.

When you complete your return, you can figure your earned income credit by using a worksheet in the instructions for the re-

turn. Or, if you prefer, you can let the IRS figure the credit for you.

**How will this chapter help you?** This chapter will explain the following:

- What rules you must meet to qualify for the credit,
- How to figure the credit, and
- How to get advance payment of the credit in your paycheck.

To learn about the rules you must meet, first read *Do You Qualify for the Credit?* later.

## Useful Items

You may want to see:

### Publication

- 504** Divorced or Separated Individuals
- 533** Self-Employment Tax
- 596** Earned Income Credit

### Form (and Instructions)

- Schedule EIC** Earned Income Credit (Qualifying Child Information)
- Schedule SE (Form 1040)** Self-Employment Tax
- W-5** Earned Income Credit Advance Payment Certificate
- 8862** Information To Claim Earned Income Credit After Disallowance

## Do You Qualify for the Credit?

To see if you can claim the EIC, you must first meet all of the rules explained in Part A, *Rules for Everyone*. Then you must meet the rules in Part B, *Rules If you Have a Qualifying Child* or Part C, *Rules If You Do Not Have a Qualifying Child*. There are two final rules you must meet in Part D, *Figuring and Claiming the EIC*. You qualify for the credit if you meet all the rules in each part that applies to you. For example:

- If you have a qualifying child, the rules in *Parts A, B, and D* apply to you.
- If you do not have a qualifying child, the rules in *Parts A, C, and D* apply to you.

**Do you have a qualifying child?** Basically, a qualifying child is a child who:

- 1) Is your son, daughter, adopted child, grandchild, stepchild, or eligible foster child, **and**
- 2) Was (at the end of 1999) under age 19, under age 24 and a full-time student, or any age and permanently and totally disabled during the year, **and**
- 3) Lived with you in the United States for more than half of 1999 (for all of 1999 if the child is your eligible foster child).

See Rule 7 for more detailed information.

Table 37–1. Earned Income Credit in a Nutshell

Part A Rules for Everyone	Part B More Rules If You Have a Qualifying Child	Part C More Rules If You Do Not Have a Qualifying Child
<b>Rule 1.</b> You must have a valid social security number.	<b>Rule 7.</b> Your child must meet the relationship, age, and residency tests.	<b>Rule 10.</b> You must be at least age 25 but under age 65.
<b>Rule 2.</b> Your filing status cannot be “Married filing separately.”	<b>Rule 8.</b> Your qualifying child cannot be the qualifying child of another person with a higher modified AGI.	<b>Rule 11.</b> You cannot be the dependent of another person.
<b>Rule 3.</b> You must be a U.S. citizen or resident alien all year.	<b>Rule 9.</b> You cannot be a qualifying child of another person.	<b>Rule 12.</b> You cannot be a qualifying child of another person.
<b>Rule 4.</b> You cannot file Form 2555 or Form 2555-EZ. (Relating to foreign earned income.)		<b>Rule 13.</b> You must have lived in the United States more than half of the year.
<b>Rule 5.</b> Your investment income must be \$2,350 or less.		
<b>Rule 6.</b> You must have earned income.		
<b>Part D Figuring Earned Income and Modified Adjusted Gross Income (AGI)</b>		
<b>Rule 14.</b> Your earned income must be less than: <ul style="list-style-type: none"> <li>• \$30,580 if you have more than one qualifying child.</li> <li>• \$26,928 if you have one qualifying child, or</li> <li>• \$10,200 if you do not have a qualifying child.</li> </ul>		
<b>Rule 15.</b> Your modified AGI must be less than: <ul style="list-style-type: none"> <li>• \$30,580 if you have more than one qualifying child.</li> <li>• \$26,928 if you have one qualifying child, or</li> <li>• \$10,200 if you do not have a qualifying child.</li> </ul>		

**Table 37–1. Earned Income Credit in a Nutshell.** Use *Table 37–1* as a guide to *Parts A, B, C, and D*. The table is a summary list of all the rules in each part. Each rule listed has a rule number. Use the rule number to find a more detailed discussion of that rule in this chapter.

If you meet all six rules in this part, then read either *Part B* or *Part C* (whichever applies) for more rules you must meet.

**Other taxpayer identification number.** You cannot get the EIC if, instead of an SSN, you (or your spouse if filing a joint return) have an individual taxpayer identification number (ITIN). ITINs are issued by the Internal Revenue Service to noncitizens who cannot get an SSN.

### If Improper Claim Made in Prior Year

You must file Form 8862 if your 1997 or 1998 EIC was reduced or disallowed for any reason other than a math or clerical error. But do not file Form 8862 if, after your EIC was reduced or disallowed in an earlier year, you filed Form 8862 (or other documents) and your EIC was then allowed. Also do not file Form 8862 or take the credit if it was determined that your error was due to reckless or intentional disregard of the EIC rules or fraud.

**More information.** See Publication 596 for more detailed information about the disallowance period and Form 8862.


## Part A. Rules for Everyone


This part of the chapter discusses Rules 1 through 6. You must meet all six rules to qualify for the earned income credit. If you do not meet all six rules, you cannot get the credit and you do not need to read the rest of the chapter.

### Rule 1. You Must Have a Social Security Number (SSN)

To claim the earned income credit, you **must** have a valid SSN for you, your spouse (if filing a joint return), and your qualifying child.

**SSN that allows you to work.** To claim the EIC, you **must** have a valid SSN for you, your spouse (if filing a joint return) and any qualifying child (See Rule 7.) SSNs are issued by the Social Security Administration. Most SSNs are issued to U.S. citizens or to persons who have permission from the Immigration and Naturalization Service to work in the United States. Some SSNs are issued solely for use in applying for or receiving federally funded benefits. You can claim the EIC only if you have an SSN that allows you to work. If your social security card says “Not valid for employment,” you cannot get the EIC.

 *If you were a U. S. citizen when you received your SSN, you meet this rule.*

 *If an SSN for you or your spouse is missing from your tax return or is incorrect, you may not get the EIC.*

**No SSN.** If you do not have a valid SSN that allows you to work, put “No” directly to the right of line 59a (Form 1040), line 37a (Form 1040A), or to the right of the word “below” on line 8b (Form 1040EZ).

**Getting an SSN.** If you, your spouse, or your child does not have an SSN, apply for one by filing **Form SS–5** with the Social Security Administration.

**Filing deadline approaching and still no SSN.** If the filing deadline is approaching and you still do not have an SSN, you have two choices.

- 1) Request an automatic 4-month extension (Form 4868). This extension does not give you extra time to pay any tax owed. You should pay any amount you expect to owe to avoid interest or penalty charges. (See the instructions for Form 4868, *Application for Automatic Extension of Time to File U.S. Individual Income Tax Return*.)
- 2) File the return on time without claiming the earned income credit. After receiving the SSN, file an amended return (Form 1040X) claiming the EIC. Attach a filled-in Schedule EIC if you have a qualifying child.

## Rule 2. Your Filing Status Cannot Be “Married filing separately”

If you are married, you usually must file a joint return to claim the EIC. Your filing status cannot be “Married filing separately.”

**Spouse did not live with you.** If you are married and your spouse did not live in your home at any time during the last 6 months of the year, you may be able to file as head of household, instead of married filing separately. In that case, you may be able to claim the EIC. For detailed information about filing as head of household, see chapter 2.

## Rule 3. You Must Be a U. S. Citizen or Resident Alien All Year

You cannot claim the earned income credit if you are a nonresident alien for any part of the year, unless:

- 1) You are married to a U.S. citizen or a resident alien, **and**
- 2) You choose to be treated as a resident alien for all of 1999 by filing a joint return.

For more information on making this choice, get Publication 519, *U.S. Tax Guide for Aliens*.

## Rule 4. You Cannot File Form 2555 or Form 2555-EZ

You cannot claim the earned income credit if you file Form 2555, *Foreign Earned Income*, or Form 2555-EZ, *Foreign Earned Income Exclusion*. You file these forms to exclude income earned in foreign countries from your gross income, or to deduct or exclude a foreign housing amount. U. S. possessions are not foreign countries. See Publication 54, *Tax Guide for U.S. Citizens and Resident Aliens Abroad*, for more detailed information.

## Rule 5. Your Investment Income Must Be \$2,350 or Less

You cannot claim the earned income credit if your investment income is more than \$2,350. For most people, investment income is the total of the following amounts.

- Taxable interest (line 8a of Form 1040 or 1040A).
- Tax-exempt interest (line 8b of Form 1040 or 1040A).
- Dividend income (line 9 of Form 1040 or 1040A).
- Capital gain net income (line 13 of Form 1040, if more than zero).

However, if you are reporting income from the rental of personal property on Form 1040, line 21, or are filing Schedule E (Form 1040), or are reporting a gain on Form 4797, get Publication 596 for more information.

## Rule 6. You Must Have Earned Income

This credit is called the “earned income credit” because, to qualify, you must work and have earned income. If you are married and file a joint return, you meet this rule if at least one spouse works and has earned income. Earned income includes all the income you get from working — even if it is not taxable. You will figure your earned income in *Part D* by adding your taxable and nontaxable earned income.

### Taxable Earned Income

Taxable earned income includes:

- 1) Wages, salaries, and tips,
- 2) Earnings from self-employment, and
- 3) Income received as a statutory employee.

For some examples of items that are included or not included in earned income, see *Table 37-2, Examples of Taxable and Nontaxable Earned Income*, later. Some of the items listed are discussed in more detail later.

**Wages, salaries, and tips.** Wages, salaries, and tips you receive for working are earned income. They are reported to you on Form W-2, box 1. You should report these on line 1 (Form 1040EZ) or line 7 (Forms 1040A and 1040).



*If you were a household employee who did not receive a Form W-2 because your employer paid you less than \$1,100 in 1999, be sure to include the amount you were paid on line 7 (Form 1040 or 1040A) or line 1 (Form 1040EZ).*

**Self-employed persons and statutory employees.** If you are self-employed or received income as a statutory employee, you must use Form 1040 or Publication 596 to see if you qualify to get the EIC and to figure the amount of the EIC.

### Nontaxable Earned Income

This includes anything of value (money, goods, or services) that is not taxable that you received from your employer for your work. Common types of nontaxable earned income are listed in the following paragraphs.

**Salary deferrals and reductions.** Salary deferrals and reductions include the following amounts.

- Salary deferrals are contributions from your pay to certain retirement plans (such as a 401(k) plan or the Federal Thrift Savings Plan). These amounts are shown in box 13 of your Form W-2. The “Deferred compensation” box (box 15) of your Form W-2 should be checked.
- Salary reductions, such as under a cafeteria plan unless they are included in box 1 of your Form W-2. A cafeteria plan is a benefit plan offered by your employer that allows you to choose among two or more benefits consisting of cash and benefits that are not taxed. If you choose a benefit that is not taxed

(such as accident and health insurance), the amount of the salary reduction is nontaxable earned income when figuring the EIC.

- Mandatory contributions to a state or local retirement plan.

**Meals and lodging.** Meals and lodging include the following amounts.

- Military employee basic housing and subsistence allowances, the value of in-kind housing and subsistence, and combat zone compensation. These amounts are shown in box 13 of your Form W-2 with code “Q.” See Publication 3, *Armed Forces’ Tax Guide*, for detailed information.
- Meals and lodging provided for the convenience of your employer.
- Housing allowance or rental value of a parsonage for the clergy unless the item is not included on Schedule SE, line 2.

**Excludable employer-provided benefits.** Excludable employer-provided benefits include the following amounts.

- Dependent care benefits (line 18 of Form 2441 or Schedule 2 (Form 1040A)).
- Adoption benefits (Form 8839, line 30).
- Educational assistance benefits (these may be shown in box 14 of your Form W-2).

### Native Americans

If you are a Native American and received amounts for services performed as an employee that are exempt from federal income tax under the Internal Revenue Code or because of a treaty, agreement, Act of Congress, or other federal law, these amounts are nontaxable earned income when figuring the EIC. (However, any tax-exempt income you received for performing services as a self-employed individual is not earned income when figuring the EIC.)

### Approved Form 4361 or Form 4029

This section is for persons who have an approved:

- Form 4361, *Application for Exemption from Self-Employment Tax for Use by Ministers, Members of Religious Orders and Christian Science Practitioners*, or
- Form 4029, *Application for Exemption from Social Security and Medicare Taxes and Waiver of Benefits*.

Each approved form exempts certain income from social security taxes. Each form is discussed in this section in terms of what is or is not earned income for purposes of the EIC.

**Form 4361.** Even if you have an approved Form 4361, amounts you received for performing ministerial duties as an employee count as earned income. This includes wages, salaries, tips, and “other employee compensation.” “Other employee compensation” includes nontaxable compensation such as housing allowances or the rental value of a parsonage that you receive for



services as an employee. Amounts you received for performing ministerial duties, but not as an employee, do not count as earned income. Examples include fees for performing marriages and honoraria for delivering speeches.

**Form 4029.** Even if you have an approved Form 4029, all wages, salaries, tips, and other employee compensation count as earned income. However, amounts you received as a self-employed individual do not count as earned income. Also, in figuring earned income, do not subtract losses on Schedule C, C-EZ, or F from wages on line 7 of Form 1040.

## Disability Benefits

If you retired on disability, benefits you receive under your employer's disability retirement plan are considered earned income until you reach minimum retirement age. Minimum retirement age generally is the earliest age at which you could have received a pension or annuity if you were not disabled. You must report your taxable disability payments on line 7 of either Form 1040 or Form 1040A until you reach minimum retirement age.

Beginning on the day after you reach minimum retirement age, payments you receive are taxable as a pension and are not considered earned income. Report taxable pension payments on Form 1040, lines 16a and 16b (or Form 1040A, lines 11a and 11b).

**Disability insurance payments.** Payments you received from a disability insurance policy that you paid the premiums for are not earned income. It does not matter whether you have reached minimum retirement age. If this policy is through your employer, the amount may be shown in box 13 of your Form W-2 with code "J."

## Income That is Not Earned Income

Examples of items that are **NOT** earned income include interest and dividends, pensions and annuities, social security and railroad retirement benefits, alimony and child support, welfare benefits, workers' compensation benefits, unemployment compensation (insurance), and veterans' benefits, including VA rehabilitation payments. Do **NOT** include any of these items in your nontaxable or taxable earned income.

**Earnings while an inmate.** Amounts paid to inmates in penal institutions for their work are not earned income when figuring the earned income credit. These amounts include amounts received through a work release program or while in a halfway house.

**Workfare payments.** Nontaxable workfare payments are not earned income for the EIC. These are cash payments certain people receive from a state or local agency that administers public assistance programs funded under the federal Temporary Assistance for Needy Families (TANF) program in return for certain work activities such as work experience activities (including remodeling or repairing public housing) if sufficient private sector employment is not

available, or community service program activities.

**Community property.** If you are married, qualify to file as head of household, and live in a state that has 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 the EIC, even though you must include it in your gross income on your income tax return. Your earned income includes the entire amount you earned, even if part of it is treated as belonging to your spouse under your state's community property laws.

## Part B. Rules If You Have a Qualifying Child

Use *Part B* if you:

- 1) Have a qualifying child, and
- 2) Have met all the rules in *Part A*.

This part of the chapter discusses Rules 7 through 9. You must meet all three rules, in addition to the rules in *Parts A* and *D*, to qualify for the earned income credit with a qualifying child.

You must file Form 1040 or Form 1040A to claim the EIC with a qualifying child. (You cannot file Form 1040EZ). You must also complete Schedule EIC and attach it to your return.

**TIP** *If you do not meet Rule 7, you do not have a qualifying child. Read Part C to find out if you can get the earned income credit.*

## Rule 7. Your Child Must Meet the Relationship, Age, and Residency Tests

Your child is a qualifying child if your child meets three tests. The three tests are:

- 1) Relationship,
- 2) Age, and
- 3) Residency.

The three tests are illustrated in *Figure 37-1*. The paragraphs that follow contain more information about each test.

### Relationship Test

Your child must be either your son, daughter, adopted child, grandchild, stepchild, or eligible foster child. The following definitions clarify the relationship test.

**Adopted child.** Your adopted child includes a child placed with you for adoption by an authorized placement agency, even if the adoption is not final.

**Grandchild.** For the EIC, this means any descendant of your son, daughter, or adopted child. For example, a grandchild includes your great-grandchild, great-great-grandchild, etc.

**Child not a dependent.** Your child does not have to be your dependent to be a qualifying child, unless he or she is married.

**Married child.** If your child was married at the end of the year, he or she does not meet the relationship test unless either of these two situations applies to you.

- 1) You can claim the child's exemption, or
- 2) The reason that you cannot claim the child's exemption is that you gave that right to your child's other parent:
  - a) When you completed Form 8332 or a similar written statement, or
  - b) In a pre-1985 agreement (such as a separation agreement or divorce decree).

**Eligible foster child.** For the EIC, a person is your eligible foster child if:

- 1) You cared for that child as you would your own child, and
- 2) The child lived with you for the **whole** year, except for temporary absences (explained later).

**TIP** *The eligible foster child does not have to be related to you.*

**Example.** You and your sister live together. You are 30. Your sister is 15. When your parents died 2 years ago, you took over the care of your sister, but you did not adopt her. Your sister meets the relationship test. She is considered your eligible foster child because she lived with you all year and because you cared for her as you would your own child.

## Age Test

Your child must be:

- 1) Under age 19 at the end of 1999,
- 2) A full-time student under age 24 at the end of 1999, or
- 3) Permanently and totally disabled at any time during 1999, regardless of age.

The following definitions clarify the age test.

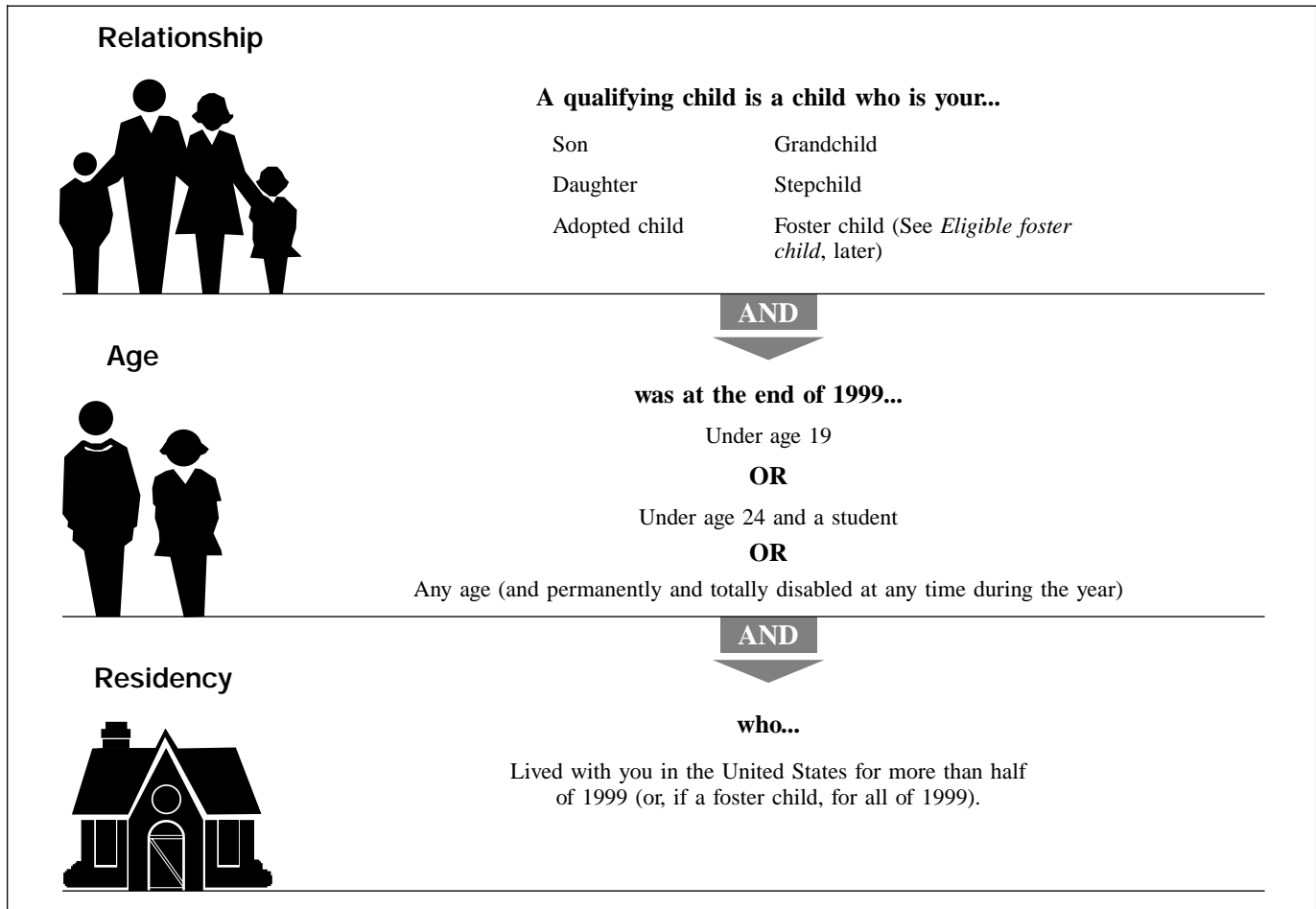
**Full-time student.** A full-time student is a student who is enrolled for the number of hours or courses the school considers to be full-time attendance.

**Student defined.** To qualify as a student your child must be, during some part of each of 5 calendar months during the calendar year:

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

**TIP** *The 5 calendar months need not be consecutive.*

Figure 37-1. Tests for Qualifying Child



**School defined.** A school can be an elementary school, junior and senior high school, a college, university, or a technical, trade, or mechanical school. However, on-the-job training courses, correspondence schools, and night schools do not count as schools for the EIC. (But see *Night school*, later.)

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

**Night school.** Your child is not a full-time student if he or she attends school only at night. However, full-time attendance at a school may include some attendance at night as part of a full-time course of study.

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

- 1) He or she cannot engage in any substantial gainful activity because of a physical or mental condition.
- 2) A doctor determines the condition has lasted or can be expected to last continuously for at least a year or can lead to death.

### Residency Test

Your child must have lived with you in the United States for more than half of 1999 (all of 1999 if an eligible foster child). The following definitions clarify the residency test.

**Home.** Your home can be any location where you regularly live within one of the 50 states or the District of Columbia.

**Homeless shelter.** You do not need a traditional home. For example, if your child lived with you for more than half the year in one or more homeless shelters, your child meets the residency test.

**Military personnel stationed outside the United States.** U.S. military personnel stationed 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.

**Extended active duty.** Extended active duty means you are called or ordered to duty for an indefinite period or for 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 serve less than 90 days.

**Birth or death of a child.** If your child was born or died in 1999, he or she is considered to meet the residency test if your home was the child's home for the entire time he or she was alive during 1999.

**Temporary absences.** Count time that you or your child is away from home on a temporary absence due to a special circumstance as time lived at home. Examples of a special circumstance include:

- Illness,

- Attending school,
- Business,
- Vacation, and
- Military service.

**Social security number.** Your qualifying child must have a valid social security number (SSN) unless the child was born and died in 1999. You cannot claim the EIC if:

- 1) Your qualifying child's SSN is missing from your tax return or is incorrect,
- 2) Your qualifying child's SSN was issued solely for use in applying for or receiving federally funded benefits,
- 3) Your qualifying child's social security card says "Not valid for employment," or
- 4) Instead of an SSN, your qualifying child has:
  - a) An individual taxpayer identification number (ITIN), which is issued to a noncitizen who cannot get an SSN, or
  - b) An adoption taxpayer identification number (ATIN), which is issued to adopting parents who cannot get an SSN for the child being adopted until the adoption is final.

If you have two qualifying children and only one has a valid SSN, you can claim the EIC on the basis of that child only. For more

information about SSNs, see *SSN that allows you to work*, earlier.

## Rule 8. Your Qualifying Child Cannot Be the Qualifying Child of Another Person With a Higher Modified AGI

Sometimes a child meets the rules to be a qualifying child of more than one person. However, only one person can claim the credit using that child. The paragraphs that follow will help you decide who can claim the EIC when more than one person has the same qualifying child.

**Note.** For most people modified AGI is the same as AGI (line 33, Form 1040, line 18, Form 1040A, or line 8, Form 1040EZ). Modified AGI is explained in detail in Part D.

**Which person can claim the EIC.** If you and someone else have the same qualifying child, the person with the higher modified adjusted gross income (AGI) is the only one who may be able to claim the EIC using that child. The person with the lower modified AGI cannot use that child to claim the EIC. This is true even if the person with the higher modified AGI does not claim the EIC or meet all of the rules to claim the EIC. If the other person is your spouse and you file a joint return, this rule does not apply. If three or more persons have the same qualifying child, the person with the highest modified AGI is the only one who may be able to claim the EIC.

If your qualifying child meets the tests to be a qualifying child of any other person for 1999 and you have the higher modified AGI, you meet this rule. If you do not have the higher modified AGI, **STOP.** You cannot claim the credit either with or without a qualifying child. Put "No" beside line 59a (Form 1040) or line 37a (Form 1040A).

**Example 1.** You and your son lived with your mother all year. You are 25 years old. Your only income was \$9,300 from a part-time job. Your mother's only income was \$15,000 from her job.

Your son is a qualifying child of both you and your mother because he meets the relationship, age, and residency tests for both you and your mother. However, because you both have the same qualifying child, only one of you can claim the EIC. Because your mother's modified AGI (\$15,000) is more than your modified AGI (\$9,300), only your mother may be able to claim the EIC. You cannot claim the credit for persons either with or without a qualifying child.

**Example 2.** The facts are the same as in *Example 1*, but your mother had investment income of \$3,000. Your mother cannot claim the EIC because her investment income is more than \$2,350. (See Rule 5.) Even though your mother cannot claim the EIC, you cannot claim it either because your mother's modified AGI is more than yours.

**Example 3.** You and your sister shared a household for the entire year. You have 3 young children who lived in the household. Your sister does not have any children.

However, she cares for your children as if they were her own. You earn \$15,000 and she earns \$20,000. Neither of you had any other income.

The children meet the age and residency tests for both you and your sister. They meet the relationship test for you because they are your children. They also meet the relationship test for your sister because they lived with her in the same household for the whole year and she cared for them as if they were her own. Therefore, they qualify as her eligible foster children.

Your children are qualifying children for both you and your sister. However, because your sister's modified AGI is higher than yours, she is the only one who can claim the credit.



*You and your sister cannot split the three qualifying children between you. You cannot claim the credit even though your sister enters the names of only two of the children on her Schedule EIC. (Schedule EIC has spaces for the names of only two qualifying children because the credit is the same amount for two or more qualifying children.)*

**Example 4.** The facts are the same as in *Example 3*, except that your oldest child is a full-time college student. Your sister does not care for this child as if the child were her own. Only the two younger children are qualifying children of both you and your sister. Your sister is the only one who may be able to claim the EIC on the basis of these two children because her modified AGI is higher than your modified AGI. Your oldest child is a qualifying child of you, but not your sister. Only you may be able to claim the EIC on the basis of this child.

**Example 5.** You, your spouse, and your 10-year-old-son lived together until July 15, 1999, when your spouse moved out of the household. In November 1999, you and your spouse were divorced. Your modified AGI was \$13,000. Your former spouse's modified AGI was \$18,000. Your son is a qualifying child of both you and your former spouse, because your son lived with each of you for more than half the year. However, because your former spouse's modified AGI (\$18,000) was more than your modified AGI (\$13,000), only your former spouse can claim the earned income credit for 1999.

**Unmarried couples living together.** If an unmarried couple lives together with a qualifying child of both persons, the person with the higher modified AGI is the only one who may be eligible to claim the credit. The person with the lower modified AGI cannot claim the credit either with or without a qualifying child.

## Rule 9. You Cannot Be a Qualifying Child of Another Person

If you (or your spouse if filing a joint return) are a qualifying child of another person, 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 of the rules to claim the EIC. Put "No" beside line 59a (Form 1040) or line 37a (Form 1040A).

Basically, you are a qualifying child of another person (your parent, guardian, foster parent, etc.) if:

- You are that person's son, daughter, adopted child, stepchild, grandchild, or eligible foster child,
- At the end of the year you were under age 19, under age 24 and a full-time student, or any age if you were permanently and totally disabled at any time during the year, **and**
- You lived with that person in the United States for more than half of the year (all year if you were an eligible foster child). For the EIC, U.S. military personnel stationed outside the United States on extended active duty are considered to live in the United States during that duty period. See *Military personnel stationed outside the United States* earlier, if you need more information.

**Example.** You and your daughter lived with your mother all year. You are 22 years old and attended a trade school full time. You had a part-time job and earned \$5,700. You had no other income. Because you meet the relationship, age, and residency tests, you are a qualifying child of your mother. She can claim the EIC if she meets all the other requirements. Because you are your mother's qualifying child, you cannot claim the EIC. This is so even if your mother cannot or does not claim the EIC.

## Part C. Rules If You Do Not Have a Qualifying Child

Use *Part C* if you:

- 1) Do not have a qualifying child, and
- 2) Have met all the rules in *Part A*.

This part of the chapter discusses *Rules 10 through 13*. You must meet all four rules, in addition to the rules in *Parts A and D*, to qualify for the earned income credit without a qualifying child.



*If you have a qualifying child, the rules in this part do not apply to you. You can claim the credit only if you meet all the rules in Parts A, B, and D. See Rule 7 to find out if you have a qualifying child.*

## Rule 10. 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 1999. If you are married filing a joint return, either you or your spouse must be at least age 25 but under age 65 at the end of 1999. It does not matter which spouse meets the age test, as long as one of the spouses does.

If neither you nor your spouse meets the age test, put "No" directly to the right of line 59a (Form 1040), line 37a (Form 1040A), or to the right of the word "below" on line 8b (Form 1040EZ).

**Example 1.** You are age 28 and unmarried. You meet this rule.

**Example 2.** You are married and will file a joint return. You are age 23 and your spouse is age 27. You meet this rule because your spouse is at least age 25 but under age 65.

## Rule 11. You Cannot Be the Dependent of Another Person

If you are *not* filing a joint return, you meet this rule if:

- You checked box 6a on Form 1040 or 1040A, **or**
- You checked the “No” box on line 5 of Form 1040EZ.

If you are filing a joint return, you meet this rule if:

- You checked both box 6a and box 6b on Form 1040 or 1040A, **or**
- You and your spouse checked the “No” box on line 5 of Form 1040EZ.

If you are not sure whether someone else can claim you (or your spouse if filing a joint return) as a dependent, read the rules for claiming a dependent in chapter 3.

If someone else can claim you (or your spouse if filing a joint return) as a dependent on his or her return, but does not, you still cannot claim the credit.

**Example 1.** In 1999, you were age 25, single, and living at home with your parents. You worked and were not a student. You earned \$7,500. Your parents cannot claim you as a dependent. When you file your return, you claim an exemption for yourself by checking the “No” box on line 5 of your Form 1040EZ. You meet this rule.

**Example 2.** The facts are the same as in *Example 1*, except that you earned \$2,000. Your parents can claim you as a dependent but decide not to. You do not meet this rule. You cannot claim the credit because your parents could have claimed you as a dependent.

## Rule 12. You Cannot Be a Qualifying Child of Another Person

If you (or your spouse if filing a joint return) are a qualifying child of another person, you cannot claim the earned income credit. This is true even if the person for whom you are a qualifying child does not claim the EIC or meet all of the rules to claim the EIC. Put “No” beside line 59a (Form 1040), line 37a (Form 1040A), or to the right of the word “below” on line 8b (Form 1040EZ).

You are a qualifying child of another person (your parent, guardian, foster parent, etc.) if:

- You are that person's son, daughter, adopted child, stepchild, grandchild, or eligible foster child,
- At the end of the year you were under age 19, under age 24 and a full-time

Table 37–2. Examples of Taxable and Nontaxable Earned Income

Taxable Earned Income	Nontaxable Earned Income
Wages, salaries, and tips.	Salary deferrals and reductions.
Union strike benefits.	Meals and lodging provided for the convenience of your employer.
Long-term disability benefits received before minimum retirement age.	Excludable dependent care benefits.
Net earnings from self-employment.	
Gross income earned as a statutory employee.	

student, or any age if you were permanently and totally disabled at any time during the year, **and**

- You lived with that person in the United States for more than half of the year (all year if you were an eligible foster child). For the EIC, U.S. military personnel stationed outside the United States on extended active duty are considered to live in the United States during that duty period. See *Military personnel stationed outside the United States*, earlier, if you need more information.

**Example.** You lived with your mother all year. You are age 26 and permanently and totally disabled. Your only income was from a community center where you went twice a week to answer telephones. You earned \$1,500 for the year.

Because you meet the relationship, age, and residency tests, you are a qualifying child of your mother. She can claim the EIC if she meets all the rules. Because you are a qualifying child of your mother, you cannot claim the EIC. This is so even if your mother cannot or does not claim the EIC.

## Rule 13. You Must Have Lived in the United States More Than Half of the Year

Your home (and your spouse's if filing a joint return) must have been in the United States for more than half the year. If not, put “No” directly to the right of line 59a (Form 1040), line 37a (Form 1040A), or to the right of the word “below” on line 8b (Form 1040EZ).

**Home.** Your home can be any location where you regularly live within one of the 50 states or the District of Columbia.

**Homeless shelter.** You do not need a traditional home. If you lived in one or more homeless shelters in the United States for more than half the year, you meet this rule.

**Military personnel stationed outside the United States.** U.S. military personnel stationed outside the U.S. on extended active duty are considered to live in the United States during that duty period for the earned income credit.

**Extended active duty.** Extended active duty means you are called or ordered to duty for an indefinite period or for 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 serve less than 90 days.

## Part D. Figuring and Claiming the EIC

Use this part if you have met all the rules in *Parts A and B*, or all the rules in *Parts A and C*.

This part of the chapter discusses *Rules 14 and 15*. You must meet both rules, in addition to the rules in *Parts A and B*, or *Parts A and C*, to qualify for the earned income credit.

This part of the chapter also explains how to figure the amount of your credit. You have two choices.

- 1) Have the IRS figure the EIC for you. If you want to do this, see *IRS Will Figure the EIC for You*.
- 2) Figure the EIC yourself. If you want to do this, see *How To Figure the EIC Yourself*.

## Rule 14. Your Total Earned Income Must Be Less Than:

- \$30,580 if you have more than one qualifying child,
- \$26,928 if you have one qualifying child, or
- \$10,200 if you do not have a qualifying child.

Earned income is explained in Rule 7 in *Part A* and some examples are shown in *Table 37–2, Examples of Taxable and Nontaxable Earned Income*. You figure your total earned income by adding your nontaxable earned income and your taxable earned income.

**Self-employed persons and statutory employees.** If you are self-employed or received income as a statutory employee, you must use Form 1040 or Publication 596 to see if you qualify to get the EIC and to figure the amount of your total earned income and the amount of EIC.

**Taxable earned income.** You figure your taxable earned income by starting with the amount on the *Wages* line on your tax return (line 7, Forms 1040 and 1040A, line 1, Form 1040EZ). You then subtract the following amounts from the amount on the *Wages* line on your tax return.

- Any taxable scholarship or fellowship grant not reported on a Form W–2.

- Any amount you received for work done while an inmate in a penal institution that is included in the total on line 7 (Form 1040 or Form 1040A) or line 1 (Form 1040EZ).
- Any amount on line 2 of Schedule SE that was also reported on line 7 (Form 1040), if you are a member of the clergy.

**Nontaxable earned income.** You figure your nontaxable earned income by adding the amounts of any nontaxable earned income items you had during the year. Examples of nontaxable earned income items are shown in Rule 6.

**Total earned income.** You figure your total earned income by adding your taxable earned income and your nontaxable earned income. You will need this amount when you figure the amount of your EIC.

If your total earned income is more than:

- \$30,580 if you have more than one qualifying child,
- \$26,928 if you have one qualifying child, or
- \$10,200 if you do not have a qualifying child,

you cannot get the EIC. You do not need to read the rest of this chapter. You can go back and finish the rest of your tax return.

## Rule 15. Your Modified AGI Must Be Less Than:

- \$30,580 if you have more than one qualifying child,
- \$26,928 if you have one qualifying child, or
- \$10,200 if you do not have a qualifying child.

**Modified adjusted gross income (AGI).** Modified AGI for most people is the same as AGI. AGI includes items such as taxable social security benefits and unemployment benefits. AGI is the amount on line 33 (Form 1040), line 18 (Form 1040A), or line 4 (Form 1040EZ). You must also add in certain amounts such as tax-exempt interest and some other gains and losses. But if you are filing Schedule C, C-EZ, D, E, or F, or if you claim a loss from the rental of personal property not used in a trade or business, you **must** get Publication 596 to figure your modified AGI. You must also get Publication 596 if you, (or your spouse if filing a joint return) received any distributions from a pension, annuity, or IRA that are not fully taxable.

**Community property.** If you are married, qualify to file as head of household, and live in a state that has community property laws, your adjusted gross income (AGI) for the EIC includes that portion of both your and your spouse's wages that you are required to include in gross income. This is different from Rule 6 used to determine your earned income.

**Roth IRA conversion.** If you converted your traditional IRA to a Roth IRA during 1998 and elected to spread the taxable amount over 4 years, only 25% of the taxable amount is reported each tax year. This

25% is added to your AGI on line 16b of Form 1040, or line 10b of Form 1040A. **Do not** add to your modified AGI for 1999 the remaining amounts that will be included in your income for 2000 and 2001. (However, you may have to include those amounts in your 1999 AGI if you make a withdrawal from the Roth IRA. See Publication 590 for details about withdrawals.)

**Example.** Bob will file Form 1040A. His AGI (line 18) is \$12,000. He will report \$300 of tax-exempt interest from a municipal bond on line 8b. His modified AGI for the EIC is \$12,300 (\$12,000 + \$300).

## IRS Will Figure the EIC for You

The IRS will figure the amount of your EIC for you if you follow the steps explained in this section. If you have a qualifying child, complete and attach Schedule EIC.



*Please do not follow these steps unless you qualify for the EIC. Read the rules in Parts A, B, C, and D to see if you qualify.*



*If you want the IRS to also figure the amount of your income tax, see Publication 967, The IRS Will Figure Your Tax.*

## Form 1040

If you file Form 1040 and want the IRS to figure your credit for you, follow these steps.

- 1) Print **EIC** directly to the right of line 59a. Also, if you have any earned income that is not taxed, enter the amount and type of that income on line 59b. See *Table 37-2* for examples of earned income that is not taxed. Then, if you have any of the situations listed later under *Special Instructions*, follow those instructions.
- 2) Complete all other parts of your return that apply to you (including line 54), but do not fill in lines 64, 65, or 68. If you do not have a qualifying child, stop here.
- 3) If you have a qualifying child, complete Schedule EIC according to its instructions. Be sure to enter the child's social security number on line 4 of that schedule. If you do not, your credit may be reduced or disallowed. Attach Schedule EIC to your return.

## Form 1040A

If you file Form 1040A and want the IRS to figure your credit for you, follow these steps.

- 1) Print **EIC** directly to the right of line 37a. Also, if you have earned income that is not taxed, enter the amount and type of that income on line 37b. See *Table 37-2* for examples of earned income that is not taxed. Then, if you have any of the situations listed later under *Special Instructions*, follow those instructions.
- 2) Complete all other parts of your return that apply to you (including line 33), but do not fill in lines 39, 40, or 43. If you do not have a qualifying child, stop here.

- 3) If you have a qualifying child, complete Schedule EIC according to its instructions. Be sure to enter the child's social security number on line 4 of that schedule. If you do not, your credit may be reduced or disallowed. Attach Schedule EIC to your return.

## Form 1040EZ

If you file Form 1040EZ and want the IRS to figure your credit for you, follow these steps.

- 1) Print **EIC** in the space to the right of the word "below" on line 8b. Also, if you have earned income that is not taxed, enter the amount and type in the spaces marked "Type" and "\$" on line 8b. See *Table 37-2* for examples of earned income that is not taxed. Then, if you have any of the situations listed later under *Special Instructions*, follow those instructions.
- 2) Complete all other parts of your return that apply to you, but do not fill in lines 9, 11a, or 12.

## Special Instructions

Use the following special instructions, if the situation applies to you.

**Qualifying child information (Schedule EIC).** Whether the IRS figures your credit or you figure it yourself, you must give the IRS information about your qualifying child. To do this, complete Schedule EIC and attach it to your Form 1040 or Form 1040A.

The information you enter on Schedule EIC must show that the child meets all the tests for a qualifying child. (See Rule 7.) The schedule has space for information about only two qualifying children because the amount of your credit is the same whether you have two, three, or more qualifying children.



*Do not file Form 1040EZ if you have a qualifying child and qualify for the credit. You must file Form 1040 or Form 1040A.*

### Minister or member of a religious order.

If you were a member of the clergy who is filing Schedule SE and line 2 of that schedule includes an amount that is also included on Form 1040, line 7, print "Clergy" directly to the right of line 59a, Form 1040. Also show the amount included on both lines (for example, "Clergy \$800"). If you received a housing allowance or were provided housing and you were required to include the allowance or the rental value of the parsonage on Schedule SE, line 2, do not include it as nontaxable earned income on line 59b of Form 1040.

**Household employee.** If you were a household employee who did not receive a Form W-2 because your employer paid you less than \$1,100 in 1999, print "HSH" and the amount paid that was not reported on Form W-2 in the space to the right of the words "W-2 form(s)" on line 1 (Form 1040EZ), or on the dotted line next to line 7 (Form 1040), or in the space to the left of line 7 (Form 1040A). Also, be sure to include that amount in the total for line 1 of Form 1040EZ or line 7 of either Form 1040 or Form 1040A.

**Inmates.** If you were an inmate in a penal institution and the total on line 7 (Form 1040 or Form 1040A), or line 1 (Form 1040EZ) includes an amount paid to you for work performed while an inmate, print "PRI" and the amount paid on the dotted line next to line 7 (Form 1040), in the space to the left of line 7 (Form 1040A), or in the space to the right of the words "W-2 form(s)" on line 1 (Form 1040EZ).

## How To Figure the EIC Yourself

This part of this chapter explains how to use the EIC Worksheet and how to report the credit on your return. To figure the amount of your earned income credit, you can use the Earned Income Credit Worksheet (EIC Worksheet) in the instruction booklet for Form 1040, Form 1040A, or Form 1040EZ, and the *Earned Income Credit (EIC) Table* in the tax form instruction booklet. However, certain people must use Publication 596 to figure the amount of the credit. You must use Publication 596 if any of the following situations applies to you.

- Your investment income (Rule 5) is \$2,350 or more **and** you are filing Form 4797 (relating to the sale of business property).
- You are filing Schedule E (Form 1040).
- You are claiming a loss on Form 1040, line 12, 13, or 18.
- You are reporting income or a loss from the rental of personal property not used in a trade or business.
- You, (or your spouse if filing a joint return) received any distributions from a pension, annuity, or IRA that are not fully taxable.
- You owe alternative minimum tax (AMT), found on Form 1040, line 51, or included in the total found on Form 1040A, line 34.

The amount of your earned income credit depends on:

- Whether you have no qualifying child, one qualifying child, or two or more qualifying children,
- The amount of your earned income (defined in Rule 7) and modified AGI (defined in Rule 15), and
- Whether you owe alternative minimum tax.



**You must use Publication 596 to figure the amount of the credit if you owe the AMT.**

**Form 1040 and EIC Worksheet.** If you file Form 1040 and want to figure the credit yourself, follow these steps.

- 1) Go to your form instruction booklet and turn to the instructions for **Lines 59a and 59b** and look for **Worksheet A or Worksheet B**.
- 2) Complete the EIC Worksheet that applies to your situation according to its instructions. If you were self-employed

or used Schedule C or C-EZ as a statutory employee, complete **Worksheet B**. Find the amount of your credit in the EIC Table in your instruction booklet.

- 3) Enter the amount of your earned income credit from **Worksheet A or B** on Form 1040, line 59a.
- 4) Enter the amount and type of any nontaxable earned income on Form 1040, line 59b.
- 5) Keep the EIC Worksheet for your records. Do not attach it to your income tax return. If you do not have a qualifying child, stop here.
- 6) If you have a qualifying child, complete Schedule EIC according to its instructions. Be sure to enter the child's social security number on line 4 of that schedule. If you do not, your credit may be reduced or disallowed. Attach Schedule EIC to your return.

**Form 1040A and EIC Worksheet.** If you file Form 1040A and want to figure the credit yourself, follow these steps.

- 1) Go to your form instruction booklet and turn to the instructions for **Lines 37a and 37b** and look for the **EIC Worksheet**.
- 2) Complete the EIC Worksheet according to its instructions. Find the amount of your credit in the EIC Table in your form instruction booklet.
- 3) Enter the amount of your earned income credit from line 6 of the EIC Worksheet on Form 1040A, line 37a.
- 4) Enter the amount and type of any nontaxable earned income on Form 1040A, line 37b.
- 5) Keep the EIC Worksheet for your records. Do not attach it to your income tax return. If you do not have a qualifying child, stop here.
- 6) If you have a qualifying child, complete Schedule EIC according to its instructions. Be sure to enter the child's social security number on line 4 of that schedule. If you do not, your credit may be reduced or disallowed. Attach Schedule EIC to your return.

**Form 1040EZ and EIC Worksheet.** If you file Form 1040EZ and want to figure the credit yourself, follow these steps.

- 1) Go to your form instruction booklet and turn to the instructions for **Lines 8a and 8b** and look for the **EIC Worksheet**.
- 2) Complete the EIC Worksheet according to its instructions. Find the amount of your credit in the EIC Table in your form instruction booklet.
- 3) Enter the amount of your earned income credit from line 6 of the EIC Worksheet on Form 1040EZ, line 8a.
- 4) Enter the amount and type of any nontaxable earned income on Form 1040EZ, line 8b.

- 5) Keep the EIC Worksheet for your records. Do not attach it to your income tax return.

## Examples

The following two comprehensive examples (complete with filled-in forms) may be helpful when figuring the earned income credit. The two examples are:

- 1) John and Janet Smith with one qualifying child and using Form 1040A, and
- 2) Kelly Green, age 30, a student, with no qualifying child and using Form 1040EZ.

### Example 1. John and Janet Smith (Form 1040A)

John and Janet Smith are married and will file a joint return. They have one child—Amy, who is 3 years old. Amy lived with John and Janet for all of 1999. John worked and earned \$9,500. Janet worked part of the year and earned \$1,500. Their total earned income and modified AGI is \$11,000. John and Janet qualify for the earned income credit and fill out the EIC Worksheet and Schedule EIC. The Smiths will attach Schedule EIC to Form 1040A when they send their completed return to the IRS.

They took the following steps to complete Schedule EIC and the EIC Worksheet.

#### Completing Schedule EIC

The Smiths complete Schedule EIC because they have a qualifying child. They enter "John and Janet Smith" and John's SSN (the SSN that appears first on their Form 1040A) on the line at the top of Schedule EIC. The Smiths fill out *Qualifying Child Information* (lines 1–6).

**Line 1.** The Smiths enter the first name and last name for Amy in the column "Child 1."

**Line 2.** They enter the year of birth for Amy (1996).

**Lines 3a and 3b.** The Smiths skip these lines because Amy was born after 1978.

**Line 4.** They enter Amy's SSN. (See Rule 7, earlier.)

**Line 5.** The Smiths enter "Daughter" for Amy. This column shows Amy's relationship to John and Janet.

**Line 6.** The Smiths enter "12" for Amy. This is how many months Amy lived with them in 1999.

#### Completing the EIC Worksheet

In Step 1 the Smiths completed Schedule EIC with information about their qualifying child. Next, they will complete the EIC Worksheet to figure their earned income credit amount.

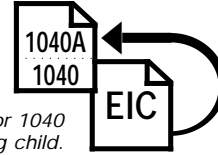
**Line 1.** The Smiths enter \$11,000 (their total earned income).

**Line 2.** The Smiths go to the **Earned Income Credit Table** in the Form 1040A instructions. The Smiths find their income of \$11,000 within the range of \$10,200 to \$12,500. They follow this line across to the column "One child" and find \$2,312 and enter it on this line 2.

**Filled-in Schedule EIC—John and Janet Smith**  
(Page references are to the Schedule EIC instructions.)

**SCHEDULE EIC**  
(Form 1040A or 1040)

**Earned Income Credit**  
Qualifying Child Information



OMB No. 1545-0074

**1999**

Attachment  
Sequence No. **43**

Department of the Treasury  
Internal Revenue Service

*Complete and attach to Form 1040A or 1040  
only if you have a qualifying child.*

Name(s) shown on return

John and Janet

Smith

Your social security number

2 2 2 0 0 2 2 2 2

**Before you begin:** See the instructions for Form 1040A, lines 37a and 37b, or Form 1040, lines 59a and 59b, to make sure that (1) you can take the EIC and (2) you have a qualifying child.



- If you take the EIC even though you are not eligible, you may not be allowed to take the credit for up to 10 years. See back of schedule for details.
- It will take us longer to process your return and issue your refund if you do not fill in all lines that apply for each qualifying child.
- If you do not enter the child's correct social security number on line 4, at the time we process your return, we may reduce or disallow your EIC.

**Qualifying Child Information**

**Child 1**

**Child 2**

	First name	Last name	First name	Last name
<b>1 Child's name</b> If you have more than two qualifying children, you only have to list two to get the maximum credit.	Amy	Smith		
<b>2 Child's year of birth</b>	Year <u>1 9 9 6</u> <i>If born after 1980, skip lines 3a and 3b; go to line 4.</i>		Year _____ <i>If born after 1980, skip lines 3a and 3b; go to line 4.</i>	
<b>3 If the child was born before 1981—</b>				
<b>a</b> Was the child under age 24 at the end of 1999 and a student?	<input type="checkbox"/> Yes. <i>Go to line 4.</i>	<input type="checkbox"/> No. <i>Continue</i>	<input type="checkbox"/> Yes. <i>Go to line 4.</i>	<input type="checkbox"/> No. <i>Continue</i>
<b>b</b> Was the child permanently and totally disabled during any part of 1999?	<input type="checkbox"/> Yes. <i>Continue</i>	<input type="checkbox"/> No. The child is not a qualifying child.	<input type="checkbox"/> Yes. <i>Continue</i>	<input type="checkbox"/> No. The child is not a qualifying child.
<b>4 Child's social security number (SSN)</b> The child must have an SSN as defined on page 42 of the Form 1040A instructions or page 41 of the Form 1040 instructions unless the child was born and died in 1999. If your child was born and died in 1999 and did not have an SSN, enter "Died" on this line and attach a copy of the child's birth certificate.	0 0 0 : 0 0 : 2 2 2 4			
<b>5 Child's relationship to you</b> (for example, son, daughter, grandchild, foster child, etc.)	Daughter			
<b>6 Number of months child lived with you in the United States during 1999</b> • If the child lived with you for more than half of 1999 but less than 7 months, enter "7". • If the child was born or died in 1999 and your home was the child's home for the entire time he or she was alive during 1999, enter "12".	<u>1 2</u> months <i>Do not enter more than 12 months.</i>		_____ months <i>Do not enter more than 12 months.</i>	



Do you want part of the EIC added to your take-home pay in 2000? To see if you qualify, get Form W-5 from your employer or by calling the IRS at 1-800-TAX-FORM (1-800-829-3676).

**Line 3.** The Smiths enter their modified AGI of \$11,000.

**Line 4.** The Smiths check the "Yes" box because lines 1 and 3 are the same (\$11,000). They skip line 5 and enter the amount from line 2 (\$11,000) on line 6.

**Line 6.** The Smiths' EIC is \$2,312.

## Example 2. Kelly Green (Form 1040EZ)

Kelly Green is age 30 and a full-time student. She lived with her parents in the United States for all of 1999. She had a part-time job and earned \$6,040. She earned \$20 interest on a savings account. She is not eligible to be claimed as a dependent on her parents' return. Although she lived with her parents, she is not their qualifying child because she does not meet the age test. She does not have any children.

Kelly qualifies for the earned income credit. Kelly will file Form 1040EZ and complete the EIC Worksheet.

### Completing the EIC Worksheet

Kelly figures the amount of her earned income credit on the *EIC Worksheet* as follows.

**Line 1.** She enters \$6,040 (her total earned income).

**Line 2.** Kelly goes to the *Earned Income Credit Table* in the forms instruction booklet. She finds her earned income of \$6,040 in the range of \$6,000 to \$6,050. Kelly follows this line across to the column "No children" and finds \$319. She enters \$319 on line 2.

**Line 3.** Kelly enters \$6,060 (her modified AGI).

**Line 4.** Kelly checks the "No" box because lines 1 and 3 are not the same (\$6,040 and \$6,060).

**Line 5.** Kelly checks the "No" box because the amount on line 3 (\$6,060) is more than \$5,700. She goes to the *Earned Income Credit Table* in the forms instruction booklet. She finds her earned income of \$6,060 in the range of \$6,050 to \$6,100. Kelly follows this line across to the column "No children" and finds \$316. She enters \$316 on line 5. She looks at the amounts on lines 5 and 2. \$316 is the smaller amount.

**Line 6.** She enters \$316 here and on Form 1040EZ, line 8a. The \$316 is Kelly's earned income credit.

## Advance Earned Income Credit

Would you like to get part of your earned income credit now instead of waiting until after the end of the year? If you work for someone and expect to qualify for the earned income credit in 2000, you can choose to get part of the credit in advance. Give your employer a 2000 **Form W-5, Earned Income Credit Advance Payment Certificate**, and your employer will include part of the credit regularly in your pay. The advance payment is only available if you have at least one qualifying child.

**Who can get the advance payment of the earned income credit?** To get part of the earned income credit paid to you throughout the year in your paycheck, you must meet all the following rules.

- 1) You must expect that your earned income and modified AGI will each be less than a certain amount. The amount in 1999 was \$26,928. The amount for 2000 will be higher. (See the 2000 Form W-5 for the 2000 amount.)
- 2) You must have a qualifying child.
- 3) You must expect to meet all the rules in *Parts A, B, and D* of this chapter or in the instructions for Form W-5.

**Persons who are not entitled to receive advance payments.** Under certain circumstances, even if you meet these rules, you may not be entitled to get EIC. If your wages are not subject to federal income tax, social security tax, or Medicare tax withholding, you cannot get the advance payment of the earned income credit. If you are a farm worker and are paid on a daily basis, your employer is not required to pay you the advance amount of the credit.

### How To Get Advance Payments for 2000

To get part of the credit in advance, you must fill out a 2000 Form W-5. After you have read the instructions and answered the questions on Form W-5, give the lower part of the form to your employer. Keep the top part for your records.

**More than one employer.** If you have more than one employer, give a certificate to only one of them. If you are married and both you and your spouse are employed and expect to qualify for the credit, you may give a Form W-5 to your employer and your spouse may give one to his or her employer.



If you receive advance earned income credit payments in 2000, you must file Form 1040 or Form 1040A for 2000. You must file a return to report what you already received and to take advantage of any additional earned income credit that you may qualify for.

**Receipt of advance payments you do not qualify for.** If you receive advance payments and later find out that you do not qualify for the EIC, you will have to pay back any advance payment you are not entitled to when you file your Form 1040 or Form 1040A.

**When to give your employer a new Form W-5.** The 2000 Form W-5 you give to your employer is valid until December 31, 2000. If you expect to qualify for the earned income credit in 2001 and you want to receive advance payments, you must give your employer a **new** Form W-5 in 2001. Do this each year you think you are eligible for the credit.

If you no longer want to get advance payments or if your situation changes and you no longer qualify for the earned income credit, you must give your employer a new Form W-5. Check the **No** box on line 1 of the new form.

If your spouse files a Form W-5 with his or her employer, you must file a new Form W-5 with your employer. Check the **Yes** box on line 4.

### Advance Payments Received in 1999

If you received advance payments of the earned income credit in 1999, you must file a tax return to report the payments. Report the amount on line 54 (Form 1040), or line 33 (Form 1040A). Your Form W-2, box 9, will show the amount you received.



You cannot use Form 1040EZ to report your advance payments.



## Filled-in EIC Worksheet—John and Janet Smith

### Earned Income Credit (EIC) Worksheet—Lines 37a and 37b

*Keep for Your Records*



#### Part 1

#### All Filers

1. Enter your total earned income from Step 8, Box D, on page 41.

<b>1</b>	11,000
----------	--------

2. Look up the amount on line 1 above in the EIC Table on pages 44–46 to find the credit. Enter the credit here.

<b>2</b>	2,312
----------	-------

If line 2 is zero, You cannot take the credit. Put “No” directly to the right of line 37a.

3. Enter your modified adjusted gross income from Step 6, Box A, on page 40.

<b>3</b>	11,000
----------	--------

4. Are the amounts on lines 3 and 1 the same?

- Yes.** Skip line 5; enter the amount from line 2 on line 6.
- No.** Go to line 5.

#### Part 2

#### Filers Who Answered “No” on Line 4

5. Is the amount on line 3 less than:
- \$5,700 if you do not have a qualifying child, OR
  - \$12,500 if you have one or more qualifying children?

**Yes.** Leave line 5 blank; enter the amount from line 2 on line 6.

**No.** Look up the amount on line 3 in the EIC Table on pages 44–46 to find the credit. Enter the credit here.

*Look at the amounts on lines 5 and 2. Then, enter the SMALLER amount on line 6.*

<b>5</b>	
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#### Part 3

#### Your Earned Income Credit

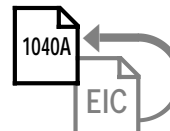
6. **This is your earned income credit.**

<b>6</b>	2,312
----------	-------

*Enter this amount on Form 1040A, line 37a.*

**Reminder—**

- ✓ Be sure you entered the amount and the type of any nontaxable earned income (Step 7, Box B, on page 41) on Form 1040A, line 37b.
- ✓ If you have a qualifying child, complete and attach Schedule EIC.



If your 1997 or 1998 EIC was reduced or disallowed, see page 42 to find out if you must file Form 8862 to take the credit for 1999.

Earned Income Credit (EIC) Worksheet—Lines 8a and 8b

Keep for Your Records



**Part 1**

**All Filers**

1. Enter your total earned income from Step 4, Box D, on page 16. 

<b>1</b>	6,040
----------	-------

2. Look up the amount on line 1 above in the EIC Table on page 19 to find the credit. Enter the credit here. 

<b>2</b>	319
----------	-----

If line 2 is zero, You cannot take the credit.  
*Print "No" in the space to the right of the word "below" on line 8b.*

3. Enter your modified adjusted gross income from Step 2, Box A, on page 15. 

<b>3</b>	6,060
----------	-------

4. Are the amounts on lines 3 and 1 the same?  
 **Yes.** Skip line 5; enter the amount from line 2 on line 6.  
 **No.** Go to line 5.

**Part 2**

**Filers Who Answered "No" on Line 4**

5. Is the amount on line 3 less than \$5,700?  
 **Yes.** Leave line 5 blank; enter the amount from line 2 on line 6.  
 **No.** Look up the amount on line 3 in the EIC Table on page 19 to find the credit. Enter the credit here. 

<b>5</b>	316
----------	-----

*Look at the amounts on lines 5 and 2. Then, enter the SMALLER amount on line 6.*

**Part 3**

**Your Earned Income Credit**

6. **This is your earned income credit.**

<b>6</b>	316
----------	-----

**Reminder—**  
✓ Be sure you entered the type and amount of any nontaxable earned income (Step 3, Box B, on page 16) on Form 1040EZ, line 8b.

*Enter this amount on Form 1040EZ, line 8a.*



If your 1997 or 1998 EIC was reduced or disallowed, see page 16 to find out if you must file Form 8862 to take the credit for 1999.

# EIC Eligibility Checklist

*You may claim the EIC if you answer YES to all the following questions.\**

	YES	NO
1. Do you, your spouse, and your qualifying child each have a valid SSN that allows you to work? (See Rule 1.)	<input type="checkbox"/>	<input type="checkbox"/>
2. Is your filing status married filing jointly, head of household, qualifying widow(er), or single? (See Rule 2.) <b>Caution:</b> If you are a nonresident alien, answer YES only if your filing status is married filing jointly and you are married to a U.S. citizen or resident alien.	<input type="checkbox"/>	<input type="checkbox"/>
3. Answer YES if you are not filing Form 2555 or Form 2555-EZ (related to foreign earned income). (See Rule 4.)	<input type="checkbox"/>	<input type="checkbox"/>
4. Is your investment income \$2,350 or less? (See Rule 5.)	<input type="checkbox"/>	<input type="checkbox"/>
5. Is your total earned income at least \$1 but less than: ● \$10,200 if you do not have a qualifying child. ● \$26,928 if you have one qualifying child, or ● \$30,580 if you have more than one qualifying child? (See Rules 6 and 14.)	<input type="checkbox"/>	<input type="checkbox"/>
6. Is your modified AGI less than: ● \$10,200 if you do not have a qualifying child. ● \$26,928 if you have one qualifying child, or ● \$30,580 if you have more than one qualifying child? (See Rule 15.)	<input type="checkbox"/>	<input type="checkbox"/>
7. Answer <b>YES</b> if you (and your spouse if filing a joint return) are not a qualifying child of another person. (See Rules 9 and 12.)	<input type="checkbox"/>	<input type="checkbox"/>
<b>STOP: If you have a qualifying child, answer questions 8 and 9 and skip 10–12. If you do not have a qualifying child, skip questions 8 and 9 and answer 10–12.*</b>		
8. Does your child meet the age, residency, and relationship tests for a qualifying child? (See Rule 7.)	<input type="checkbox"/>	<input type="checkbox"/>
9. Is your child a qualifying child only for you? Answer <b>YES</b> if your qualified child is also a qualifying child for another person but your modified AGI is higher than the other person's. (See Rule 8.)	<input type="checkbox"/>	<input type="checkbox"/>
10. Was your main home (and your spouse's if filing a joint return) in the United States for more than half the year? (See Rule 13.)	<input type="checkbox"/>	<input type="checkbox"/>
11. Were you (or your spouse if filing a joint return) at least age 25 but under 65 at the end of 1999? (See Rule 10.)	<input type="checkbox"/>	<input type="checkbox"/>
12. Answer <b>YES</b> if you (and your spouse if filing a joint return) cannot be claimed as a dependent on anyone else's return. Answer <b>NO</b> if you (or your spouse if filing a joint return) can be claimed as a dependent on someone else's return. (See Rule 11.)	<input type="checkbox"/>	<input type="checkbox"/>

\* **PERSONS WITH A QUALIFYING CHILD:** If you answered **YES** to questions 1 through 9, you can claim the EIC. Remember to fill out Schedule EIC and attach it to your Form 1040 or Form 1040A. You cannot use Form 1040EZ.

**PERSONS WITHOUT A QUALIFYING CHILD:** If you answered **YES** to questions 1 through 7, and 10 through 12, you can claim the EIC.

**If you answered NO to any question that applies to you:** You are not eligible for the EIC.

## Other Credits

### Important Change

**Excess withholding of social security tax and tier 1 railroad retirement tax.** Social security and tier 1 railroad retirement tax (RRTA) were both withheld at a rate of 6.2% on the first \$72,600 of wages in 1999. If you had two or more employers and they withheld too much social security or RRTA tax during 1999, you may be entitled to a credit of the excess withholding. For more information about the credit and how to get it, see *Credit for Excess Social Security Tax or Railroad Retirement Tax Withheld under Refundable Credits*, later.

### Introduction

In addition to the child and dependent care credit (chapter 33), the credit for the elderly or the disabled (chapter 34), the child tax credit (chapter 35), the education credits (chapter 36), and the earned income credit (chapter 37), you may be able to claim other tax credits. Even though the general business credit is one of the other tax credits that you may be able to claim, it is not discussed in this chapter. See Publication 334, *Tax Guide for Small Business*, for a discussion of the credits that are included in the general business credit. This chapter discusses seven other credits which you subtract directly from your tax to reduce your tax liability. It is divided into two parts, *Nonrefundable credits*, and *Refundable credits*.

**Nonrefundable credits.** The first part of the chapter, *Nonrefundable Credits*, covers five credits that you subtract directly from your tax. These credits may reduce your tax to zero. If these credits are more than your tax, the excess is not refunded to you.

**Refundable credits.** The second part of this chapter, *Refundable Credits*, covers two credits that are treated as payments and are refundable to you. These credits are added to the federal income tax withheld and any estimated tax payments you made. If this total is more than your total tax, the excess will be refunded to you.

### Useful Items

You may want to see:

#### Publication

- 514** Foreign Tax Credit for Individuals
- 564** Mutual Fund Distributions
- 936** Home Mortgage Interest Deduction
- 968** Tax Benefits of Adoption

### Form (and Instructions)

- 1116** Foreign Tax Credit (Individual, Estate, Trust, or Nonresident Alien Individual)
- 8396** Mortgage Interest Credit
- 8801** Credit For Prior Year Minimum Tax—Individuals, Estates, and Trusts
- 8828** Recapture of Federal Mortgage Subsidy
- 8834** Qualified Electric Vehicle Credit
- 8839** Qualified Adoption Expenses

## Nonrefundable Credits

The following credits are discussed in this part.

- Adoption credit.
- Foreign tax credit.
- Mortgage interest credit.
- Credit for prior year minimum tax.
- Credit for electric vehicles.

### Adoption Credit

You may be able to take a tax credit of up to \$5,000 for qualifying expenses paid to adopt an eligible child. The credit can be as much as \$6,000 if the expenses are for the adoption of a child with special needs.

**Qualifying expenses.** Qualifying adoption expenses are reasonable and necessary adoption fees, court costs, attorney fees, traveling expenses (including amounts spent for meals and lodging) while away from home, and other expenses directly related to, and whose principal purpose is for, the legal adoption of an eligible child.

**Nonqualifying expenses.** Qualifying adoption expenses do not include expenses:

- That violate state or federal law,
- For carrying out any surrogate parenting arrangement,
- For the adoption of your spouse's child,
- Paid using funds received from any federal, state, or local program,
- Allowed as a credit or deduction under any other federal income tax rule, or
- Paid or reimbursed by your employer or any other person or organization.

**Eligible child.** The term "eligible child" means any individual:

- 1) Under 18 years old, or
- 2) Physically or mentally incapable of caring for himself or herself.

**TIP** After 2001, the adoption credit applies only if the eligible child is a child with special needs.

**Child with special needs.** An eligible child is a child with special needs if:

- 1) He or she is a citizen or resident of the

United States (including the District of Columbia and U.S. possessions) and

- 2) A state determines that the child cannot or should not be returned to his or her parents' home and probably will not be adopted unless adoption assistance is provided to the adoptive parents.

Factors used by states to determine if a child cannot be placed without adoption assistance could include:

- The child's ethnic background,
- The child's age,
- Whether the child is a member of a minority or sibling group, or
- Whether the child has a medical condition or physical, mental, or emotional handicap.



*A foreign child cannot be treated as a child with special needs.*

**How to claim the credit.** To claim the credit, you must complete Form 8839 and attach it to your Form 1040 or Form 1040A. Enter the credit on line 45, Form 1040, or line 30, Form 1040A.

### Foreign Tax Credit

You generally can choose to claim income taxes you paid or accrued during the year to a foreign country or U.S. possession as a credit against your U.S. income tax. Or, you can deduct them as an itemized deduction.

**How to claim the credit.** Your foreign tax credit is subject to a limit based on your taxable income from foreign sources. You generally figure your limit and the credit on Form 1116.

**Election not to file Form 1116.** You will not be subject to the limit and may be able to claim the credit without using Form 1116 if all the following requirements are met.

- 1) You are an individual.
- 2) Your only foreign source income for the tax year is passive income (dividends, interest, royalties, etc.) that is reported to you on a payee statement (such as a Form 1099-DIV or 1099-INT).
- 3) Your qualified foreign taxes for the tax year are not more than \$300 (\$600 if filing a joint return) and are reported on a payee statement.
- 4) You elect this procedure for the tax year.



*If you make this election, you cannot carry back or carry over any unused foreign tax to or from this tax year.*

Enter the credit on line 46, Form 1040. For more information on the foreign tax credit, see Publication 514.

### Mortgage Interest Credit

Mortgage credit certificates issued by state and local governments may entitle a certificate holder to a mortgage interest credit. The certificate must be used in connection with the purchase, qualified rehabilitation, or qualified home improvement of the certificate holder's main home.

**Who qualifies.** You may be able to claim a mortgage interest credit if you were issued a **mortgage credit certificate (MCC)** under a qualified MCC program. The MCC must relate to your main home.

**Amount of credit.** If your mortgage is equal to (or smaller than) the certified indebtedness amount (loan) shown on your MCC, you multiply the certified credit rate, shown on your MCC, by all the interest you paid on your mortgage during the year.

If your mortgage is larger than the certified indebtedness amount shown on your MCC, you multiply the certified credit rate, shown on your MCC, by only the interest allocated to the certified indebtedness amount shown on your MCC.



*If the certificate credit rate is more than 20%, the credit cannot be more than \$2,000.*

**Carryforward.** If your allowable credit is more than your tax liability reduced by certain credits, you can carry forward the unused portion of the credit to your next 3 tax years or until used, whichever comes first.

If you are subject to the \$2,000 limit because your certificate credit rate is more than 20%, no amount over the \$2,000 (or your prorated share of the \$2,000 if you must allocate the credit) may be carried forward.

**Reduced home mortgage interest deduction.** If you claim the credit and itemize your deductions on Schedule A (Form 1040), you must reduce your home mortgage interest deduction. Reduce your deduction by the amount on line 3 of Form 8396, even if part of that amount is to be carried forward to 2000. For more information about the home mortgage interest deduction, see chapter 25.

**Recapture of federal mortgage subsidy.** If your home was financed with a mortgage from a qualified mortgage bond program and you received an MCC after December 31, 1990, you may be subject to a recapture rule. The recapture would generally occur if you sold or disposed of your home during the first 9 years after the date you closed your mortgage loan. See Publication 523, *Selling Your Home*, for more information.

**How to claim the credit.** Figure the credit and any carryforward to next year on Form 8396, and attach it to your Form 1040. Be sure to include any carryforward from 1996, 1997, and 1998. You cannot use a carryforward from 1995 on your tax return for 1999 or any year after 1999.

Include the credit in your total for line 47 (Form 1040), and check box b.

## Credit for Prior Year Minimum Tax

The tax laws give special treatment to some kinds of income and allow special deductions and credits for some kinds of expenses. If you benefit from these laws, you may have to pay at least a minimum amount of tax in addition to any other tax on these items. This is called the alternative minimum tax.

The special treatment of some items of income and expenses only allows you to postpone paying tax until a later year. If in prior years you paid alternative minimum tax because of these tax postponement items, you may be able to claim a credit for prior year minimum tax against your current year's regular tax. The amount of the credit cannot reduce your current year's tax below your current year's tentative alternative minimum tax.

You may be able to take a credit against your regular tax if you:

- 1) Paid alternative minimum tax in 1998,
- 2) Had an unused minimum tax credit that you are carrying forward from 1998 to 1999, or
- 3) Had unallowed qualified electric vehicle credits in 1998.

**How to claim the credit.** Figure your 1999 credit and any carryforward to 2000 on Form 8801, and attach it to your Form 1040. Include the credit in your total for line 47, Form 1040, and check box c. You can carry forward any unused credit for prior year minimum tax to later years until it is completely used.

For additional information about the credit, see the instructions for Form 8801.

## Credit for Electric Vehicles

You may be allowed a tax credit if you placed a qualified electric vehicle in service during the year.

**Qualified electric vehicle.** This is a motor vehicle that:

- 1) Has at least four wheels and is manufactured primarily for use on public streets, roads, and highways,
- 2) Is powered **primarily** by an electric motor that draws its power from rechargeable batteries, fuel cells, or other portable sources of electrical current,
- 3) Is originally used by you, and
- 4) Is acquired for your own use, not for resale.

**Amount of credit.** The credit is equal to 10% of the cost of the vehicle. However, if the vehicle is a depreciable business asset, you must reduce the cost by any section 179 deduction before figuring the credit. Get Publication 463, *Travel, Entertainment, Gift, and Car Expenses*, for information on the section 179 deduction.

The credit is limited to \$4,000 for each vehicle.

**Special rules.** You cannot take the credit if you use the vehicle predominately outside the United States.

The credit will be subject to recapture if, within 3 years after the date you place the vehicle in service, the vehicle is used predominately outside the United States or is modified so that it is no longer eligible for the credit.

**How to claim the credit.** To claim the credit, complete Form 8834, and attach it to your Form 1040. Include the credit in your total for line 47, check box d, and write "8834" on the line next to box d.

## Refundable Credits

The following credits are refundable and are treated as payments of tax.

- Credit for excess social security tax or railroad retirement tax withheld.
- Credit from a regulated investment company.

## Credit for Excess Social Security Tax or Railroad Retirement Tax Withheld

Most employers must withhold social security tax from your wages. Certain government employers (some federal, state, and local governments) do not have to withhold social security tax.

If you work for a railroad employer, that employer must withhold tier 1 railroad retirement (RRTA) tax and tier 2 RRTA tax.

If you worked for two or more employers in 1999, too much social security tax or RRTA may have been withheld from your pay. You can claim the excess as a credit against your income tax. The following table shows the maximum amount of wages subject to tax and the maximum amount of tax that should have been withheld in 1999.

Type of Tax	Maximum wages subject to tax	Maximum tax that should have been withheld
Social Security or RRTA tier 1	\$72,600	\$4,501.20
RRTA tier 2	\$53,700	\$2,631.30



*All wages are subject to Medicare tax withholding.*

**One employer.** If any one employer withheld social security or RRTA tax that exceeded the amounts in the preceding table, you cannot claim the extra amount withheld by that employer as a credit against your income tax. Your employer must adjust this for you.

**Joint return.** If you are filing a joint return, you cannot add the social security or RRTA tax withheld from your spouse's wages to the amount withheld from your wages. Figure the credit separately for both you and your spouse to determine if either of you has excess withholding.

**How to claim the credit.** If you file Form 1040, enter the credit on line 62. If you file Form 1040A, include the credit in the total on line 39. Print "Excess SST" and show the amount of the credit in the space to the left of the line.

**How to figure the credit if you did not work for a railroad.** If you did not work for a railroad during 1999, figure the credit as follows:

1. Add all social security tax withheld (but not more than \$4,501.20 for each employer). Enter the total here .....
2. Enter any uncollected social security tax on tips or group-term life insurance included in the total on Form 1040, line 56 .....
3. Add lines 1 and 2. If \$4,501.20 or less, stop here. You cannot claim the credit .....
4. Social security tax limit ..... 4,501.20
5. Credit. Subtract line 4 from line 3. Enter the result here and on Form 1040, line 62 (or Form 1040A, line 39) .....

**Example.** You are married and file a joint return with your spouse who had no gross income in 1999. During 1999 you worked for the Brown Shoe Company and earned \$45,000 in wages. Social security tax of \$2,790 was withheld. You also worked for another employer in 1999 and earned \$35,000 in wages. \$2,170 of social security tax was withheld from these wages. Because you worked for more than one employer and your total wages were more than \$72,600, you can claim a credit of \$458.80 for the excess social security tax withheld.

1. Add all social security tax withheld (but not more than \$4,501.20 for each employer). Enter the total here ..... \$4,960.00
2. Enter any uncollected social security tax on tips or group-term life insurance included in the total on Form 1040, line 56 ..... -0-
3. Add lines 1 and 2. If \$4,501.20 or less, stop here. You cannot claim the credit ..... 4,960.00
4. Social security tax limit ..... 4,501.20
5. Credit. Subtract line 4 from line 3. Enter the result here and on Form 1040, line 62 (or Form 1040A, line 39) ..... \$458.80

**How to figure the credit if you worked for a railroad.** If you were a railroad employee during 1999, figure the credit as follows:

1. Add all social security and tier 1 RRTA tax withheld (but not more than \$4,501.20 for each employer). Enter the total here .....
2. Enter any uncollected social security and tier 1 RRTA tax on tips or group-term life insurance included in the total on Form 1040, line 56 .....
3. Add lines 1 and 2. If \$4,501.20 or less, enter -0- on line 5 and go to line 6 .....
4. Social security and tier 1 RRTA tax limit ..... 4,501.20
5. Subtract line 4 from line 3 .....
6. Add all tier 2 RRTA tax withheld (but not more than \$2,631.30 for each employer). Enter the total here .....
7. Enter any uncollected tier 2 railroad retirement tax on tips or group-term life insurance included in the total on Form 1040, line 56 .....
8. Add lines 6 and 7. If \$2,631.30 or less, enter -0- on line 10 and go to line 11 .....
9. RRTA tier 2 limit ..... 2,631.30
10. Subtract line 9 from line 8 .....
11. Credit. Add lines 5 and 10. Enter the result here and on Form 1040, line 62 (or Form 1040A, line 39) .

## Credit from a Regulated Investment Company

You must include in your income any amounts that an investment company (for example, a mutual fund) allocated to you as capital gain distributions, even if you did not actually receive them. If the investment company paid a tax on the capital gain, you are allowed a credit for the tax since it is considered paid by you. The company will send you Form 2439, *Notice to Shareholder of Undistributed Long-Term Capital Gains*, showing the undistributed capital gains amount and the tax paid, if any. Claim the credit by entering the amount on line 63, Form 1040, and checking box a. Also attach Copy B of Form 2439 to your return. See *Capital Gain Distributions* in chapter 9 for more information on undistributed capital gains.

# 1999 Tax Table

Use if your taxable income is less than \$100,000.  
If \$100,000 or more, use the Tax Rate Schedules.

**Example.** Mr. and Mrs. Brown are filing a joint return. Their taxable income on line 39 of Form 1040 is \$25,300. First, they find the \$25,300–25,350 income line. Next, they find the column for married filing jointly and read down the column. The amount shown where the income line and filing status column meet is \$3,799. This is the tax amount they should enter on line 40 of their Form 1040.

## Sample Table

At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
<b>Your tax is—</b>					
25,200	25,250	3,784	3,784	4,265	3,784
25,250	25,300	3,791	3,791	4,279	3,791
25,300	25,350	3,799	(3,799)	4,293	3,799
25,350	25,400	3,806	3,806	4,307	3,806

If line 39 (taxable income) is—		And you are—				If line 39 (taxable income) is—		And you are—				If line 39 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		<b>Your tax is—</b>						<b>Your tax is—</b>						<b>Your tax is—</b>			
0	5	0	0	0	0	1,300	1,325	197	197	197	197	2,700	2,725	407	407	407	407
5	15	2	2	2	2	1,325	1,350	201	201	201	201	2,725	2,750	411	411	411	411
15	25	3	3	3	3	1,350	1,375	204	204	204	204	2,750	2,775	414	414	414	414
25	50	6	6	6	6	1,375	1,400	208	208	208	208	2,775	2,800	418	418	418	418
50	75	9	9	9	9	1,400	1,425	212	212	212	212	2,800	2,825	422	422	422	422
75	100	13	13	13	13	1,425	1,450	216	216	216	216	2,825	2,850	426	426	426	426
100	125	17	17	17	17	1,450	1,475	219	219	219	219	2,850	2,875	429	429	429	429
125	150	21	21	21	21	1,475	1,500	223	223	223	223	2,875	2,900	433	433	433	433
150	175	24	24	24	24	1,500	1,525	227	227	227	227	2,900	2,925	437	437	437	437
175	200	28	28	28	28	1,525	1,550	231	231	231	231	2,925	2,950	441	441	441	441
200	225	32	32	32	32	1,550	1,575	234	234	234	234	2,950	2,975	444	444	444	444
225	250	36	36	36	36	1,575	1,600	238	238	238	238	2,975	3,000	448	448	448	448
250	275	39	39	39	39	1,600	1,625	242	242	242	242	<b>3,000</b>					
275	300	43	43	43	43	1,625	1,650	246	246	246	246	3,000	3,050	454	454	454	454
300	325	47	47	47	47	1,650	1,675	249	249	249	249	3,050	3,100	461	461	461	461
325	350	51	51	51	51	1,675	1,700	253	253	253	253	3,100	3,150	469	469	469	469
350	375	54	54	54	54	1,700	1,725	257	257	257	257	3,150	3,200	476	476	476	476
375	400	58	58	58	58	1,725	1,750	261	261	261	261	3,200	3,250	484	484	484	484
400	425	62	62	62	62	1,750	1,775	264	264	264	264	3,250	3,300	491	491	491	491
425	450	66	66	66	66	1,775	1,800	268	268	268	268	3,300	3,350	499	499	499	499
450	475	69	69	69	69	1,800	1,825	272	272	272	272	3,350	3,400	506	506	506	506
475	500	73	73	73	73	1,825	1,850	276	276	276	276	3,400	3,450	514	514	514	514
500	525	77	77	77	77	1,850	1,875	279	279	279	279	3,450	3,500	521	521	521	521
525	550	81	81	81	81	1,875	1,900	283	283	283	283	3,500	3,550	529	529	529	529
550	575	84	84	84	84	1,900	1,925	287	287	287	287	3,550	3,600	536	536	536	536
575	600	88	88	88	88	1,925	1,950	291	291	291	291	3,600	3,650	544	544	544	544
600	625	92	92	92	92	1,950	1,975	294	294	294	294	3,650	3,700	551	551	551	551
625	650	96	96	96	96	1,975	2,000	298	298	298	298	3,700	3,750	559	559	559	559
650	675	99	99	99	99	<b>2,000</b>						3,750	3,800	566	566	566	566
675	700	103	103	103	103	2,000	2,025	302	302	302	302	3,800	3,850	574	574	574	574
700	725	107	107	107	107	2,025	2,050	306	306	306	306	3,850	3,900	581	581	581	581
725	750	111	111	111	111	2,050	2,075	309	309	309	309	3,900	3,950	589	589	589	589
750	775	114	114	114	114	2,075	2,100	313	313	313	313	3,950	4,000	596	596	596	596
775	800	118	118	118	118	2,100	2,125	317	317	317	317	<b>4,000</b>					
800	825	122	122	122	122	2,125	2,150	321	321	321	321	4,000	4,050	604	604	604	604
825	850	126	126	126	126	2,150	2,175	324	324	324	324	4,050	4,100	611	611	611	611
850	875	129	129	129	129	2,175	2,200	328	328	328	328	4,100	4,150	619	619	619	619
875	900	133	133	133	133	2,200	2,225	332	332	332	332	4,150	4,200	626	626	626	626
900	925	137	137	137	137	2,225	2,250	336	336	336	336	4,200	4,250	634	634	634	634
925	950	141	141	141	141	2,250	2,275	339	339	339	339	4,250	4,300	641	641	641	641
950	975	144	144	144	144	2,275	2,300	343	343	343	343	4,300	4,350	649	649	649	649
975	1,000	148	148	148	148	2,300	2,325	347	347	347	347	4,350	4,400	656	656	656	656
<b>1,000</b>						2,325	2,350	351	351	351	351	4,400	4,450	664	664	664	664
1,000	1,025	152	152	152	152	2,350	2,375	354	354	354	354	4,450	4,500	671	671	671	671
1,025	1,050	156	156	156	156	2,375	2,400	358	358	358	358	4,500	4,550	679	679	679	679
1,050	1,075	159	159	159	159	2,400	2,425	362	362	362	362	4,550	4,600	686	686	686	686
1,075	1,100	163	163	163	163	2,425	2,450	366	366	366	366	4,600	4,650	694	694	694	694
1,100	1,125	167	167	167	167	2,450	2,475	369	369	369	369	4,650	4,700	701	701	701	701
1,125	1,150	171	171	171	171	2,475	2,500	373	373	373	373	4,700	4,750	709	709	709	709
1,150	1,175	174	174	174	174	2,500	2,525	377	377	377	377	4,750	4,800	716	716	716	716
1,175	1,200	178	178	178	178	2,525	2,550	381	381	381	381	4,800	4,850	724	724	724	724
1,200	1,225	182	182	182	182	2,550	2,575	384	384	384	384	4,850	4,900	731	731	731	731
1,225	1,250	186	186	186	186	2,575	2,600	388	388	388	388	4,900	4,950	739	739	739	739
1,250	1,275	189	189	189	189	2,600	2,625	392	392	392	392	4,950	5,000	746	746	746	746
1,275	1,300	193	193	193	193	2,625	2,650	396	396	396	396						
						2,650	2,675	399	399	399	399						
						2,675	2,700	403	403	403	403						

Continued on next page

\* This column must also be used by a qualifying widow(er).

1999 Tax Table—Continued

If line 39 (taxable income) is—		And you are—				If line 39 (taxable income) is—		And you are—				If line 39 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—						Your tax is—						Your tax is—			
<b>5,000</b>						<b>8,000</b>						<b>11,000</b>					
5,000	5,050	754	754	754	754	8,000	8,050	1,204	1,204	1,204	1,204	11,000	11,050	1,654	1,654	1,654	1,654
5,050	5,100	761	761	761	761	8,050	8,100	1,211	1,211	1,211	1,211	11,050	11,100	1,661	1,661	1,661	1,661
5,100	5,150	769	769	769	769	8,100	8,150	1,219	1,219	1,219	1,219	11,100	11,150	1,669	1,669	1,669	1,669
5,150	5,200	776	776	776	776	8,150	8,200	1,226	1,226	1,226	1,226	11,150	11,200	1,676	1,676	1,676	1,676
5,200	5,250	784	784	784	784	8,200	8,250	1,234	1,234	1,234	1,234	11,200	11,250	1,684	1,684	1,684	1,684
5,250	5,300	791	791	791	791	8,250	8,300	1,241	1,241	1,241	1,241	11,250	11,300	1,691	1,691	1,691	1,691
5,300	5,350	799	799	799	799	8,300	8,350	1,249	1,249	1,249	1,249	11,300	11,350	1,699	1,699	1,699	1,699
5,350	5,400	806	806	806	806	8,350	8,400	1,256	1,256	1,256	1,256	11,350	11,400	1,706	1,706	1,706	1,706
5,400	5,450	814	814	814	814	8,400	8,450	1,264	1,264	1,264	1,264	11,400	11,450	1,714	1,714	1,714	1,714
5,450	5,500	821	821	821	821	8,450	8,500	1,271	1,271	1,271	1,271	11,450	11,500	1,721	1,721	1,721	1,721
5,500	5,550	829	829	829	829	8,500	8,550	1,279	1,279	1,279	1,279	11,500	11,550	1,729	1,729	1,729	1,729
5,550	5,600	836	836	836	836	8,550	8,600	1,286	1,286	1,286	1,286	11,550	11,600	1,736	1,736	1,736	1,736
5,600	5,650	844	844	844	844	8,600	8,650	1,294	1,294	1,294	1,294	11,600	11,650	1,744	1,744	1,744	1,744
5,650	5,700	851	851	851	851	8,650	8,700	1,301	1,301	1,301	1,301	11,650	11,700	1,751	1,751	1,751	1,751
5,700	5,750	859	859	859	859	8,700	8,750	1,309	1,309	1,309	1,309	11,700	11,750	1,759	1,759	1,759	1,759
5,750	5,800	866	866	866	866	8,750	8,800	1,316	1,316	1,316	1,316	11,750	11,800	1,766	1,766	1,766	1,766
5,800	5,850	874	874	874	874	8,800	8,850	1,324	1,324	1,324	1,324	11,800	11,850	1,774	1,774	1,774	1,774
5,850	5,900	881	881	881	881	8,850	8,900	1,331	1,331	1,331	1,331	11,850	11,900	1,781	1,781	1,781	1,781
5,900	5,950	889	889	889	889	8,900	8,950	1,339	1,339	1,339	1,339	11,900	11,950	1,789	1,789	1,789	1,789
5,950	6,000	896	896	896	896	8,950	9,000	1,346	1,346	1,346	1,346	11,950	12,000	1,796	1,796	1,796	1,796
<b>6,000</b>						<b>9,000</b>						<b>12,000</b>					
6,000	6,050	904	904	904	904	9,000	9,050	1,354	1,354	1,354	1,354	12,000	12,050	1,804	1,804	1,804	1,804
6,050	6,100	911	911	911	911	9,050	9,100	1,361	1,361	1,361	1,361	12,050	12,100	1,811	1,811	1,811	1,811
6,100	6,150	919	919	919	919	9,100	9,150	1,369	1,369	1,369	1,369	12,100	12,150	1,819	1,819	1,819	1,819
6,150	6,200	926	926	926	926	9,150	9,200	1,376	1,376	1,376	1,376	12,150	12,200	1,826	1,826	1,826	1,826
6,200	6,250	934	934	934	934	9,200	9,250	1,384	1,384	1,384	1,384	12,200	12,250	1,834	1,834	1,834	1,834
6,250	6,300	941	941	941	941	9,250	9,300	1,391	1,391	1,391	1,391	12,250	12,300	1,841	1,841	1,841	1,841
6,300	6,350	949	949	949	949	9,300	9,350	1,399	1,399	1,399	1,399	12,300	12,350	1,849	1,849	1,849	1,849
6,350	6,400	956	956	956	956	9,350	9,400	1,406	1,406	1,406	1,406	12,350	12,400	1,856	1,856	1,856	1,856
6,400	6,450	964	964	964	964	9,400	9,450	1,414	1,414	1,414	1,414	12,400	12,450	1,864	1,864	1,864	1,864
6,450	6,500	971	971	971	971	9,450	9,500	1,421	1,421	1,421	1,421	12,450	12,500	1,871	1,871	1,871	1,871
6,500	6,550	979	979	979	979	9,500	9,550	1,429	1,429	1,429	1,429	12,500	12,550	1,879	1,879	1,879	1,879
6,550	6,600	986	986	986	986	9,550	9,600	1,436	1,436	1,436	1,436	12,550	12,600	1,886	1,886	1,886	1,886
6,600	6,650	994	994	994	994	9,600	9,650	1,444	1,444	1,444	1,444	12,600	12,650	1,894	1,894	1,894	1,894
6,650	6,700	1,001	1,001	1,001	1,001	9,650	9,700	1,451	1,451	1,451	1,451	12,650	12,700	1,901	1,901	1,901	1,901
6,700	6,750	1,009	1,009	1,009	1,009	9,700	9,750	1,459	1,459	1,459	1,459	12,700	12,750	1,909	1,909	1,909	1,909
6,750	6,800	1,016	1,016	1,016	1,016	9,750	9,800	1,466	1,466	1,466	1,466	12,750	12,800	1,916	1,916	1,916	1,916
6,800	6,850	1,024	1,024	1,024	1,024	9,800	9,850	1,474	1,474	1,474	1,474	12,800	12,850	1,924	1,924	1,924	1,924
6,850	6,900	1,031	1,031	1,031	1,031	9,850	9,900	1,481	1,481	1,481	1,481	12,850	12,900	1,931	1,931	1,931	1,931
6,900	6,950	1,039	1,039	1,039	1,039	9,900	9,950	1,489	1,489	1,489	1,489	12,900	12,950	1,939	1,939	1,939	1,939
6,950	7,000	1,046	1,046	1,046	1,046	9,950	10,000	1,496	1,496	1,496	1,496	12,950	13,000	1,946	1,946	1,946	1,946
<b>7,000</b>						<b>10,000</b>						<b>13,000</b>					
7,000	7,050	1,054	1,054	1,054	1,054	10,000	10,050	1,504	1,504	1,504	1,504	13,000	13,050	1,954	1,954	1,954	1,954
7,050	7,100	1,061	1,061	1,061	1,061	10,050	10,100	1,511	1,511	1,511	1,511	13,050	13,100	1,961	1,961	1,961	1,961
7,100	7,150	1,069	1,069	1,069	1,069	10,100	10,150	1,519	1,519	1,519	1,519	13,100	13,150	1,969	1,969	1,969	1,969
7,150	7,200	1,076	1,076	1,076	1,076	10,150	10,200	1,526	1,526	1,526	1,526	13,150	13,200	1,976	1,976	1,976	1,976
7,200	7,250	1,084	1,084	1,084	1,084	10,200	10,250	1,534	1,534	1,534	1,534	13,200	13,250	1,984	1,984	1,984	1,984
7,250	7,300	1,091	1,091	1,091	1,091	10,250	10,300	1,541	1,541	1,541	1,541	13,250	13,300	1,991	1,991	1,991	1,991
7,300	7,350	1,099	1,099	1,099	1,099	10,300	10,350	1,549	1,549	1,549	1,549	13,300	13,350	1,999	1,999	1,999	1,999
7,350	7,400	1,106	1,106	1,106	1,106	10,350	10,400	1,556	1,556	1,556	1,556	13,350	13,400	2,006	2,006	2,006	2,006
7,400	7,450	1,114	1,114	1,114	1,114	10,400	10,450	1,564	1,564	1,564	1,564	13,400	13,450	2,014	2,014	2,014	2,014
7,450	7,500	1,121	1,121	1,121	1,121	10,450	10,500	1,571	1,571	1,571	1,571	13,450	13,500	2,021	2,021	2,021	2,021
7,500	7,550	1,129	1,129	1,129	1,129	10,500	10,550	1,579	1,579	1,579	1,579	13,500	13,550	2,029	2,029	2,029	2,029
7,550	7,600	1,136	1,136	1,136	1,136	10,550	10,600	1,586	1,586	1,586	1,586	13,550	13,600	2,036	2,036	2,036	2,036
7,600	7,650	1,144	1,144	1,144	1,144	10,600	10,650	1,594	1,594	1,594	1,594	13,600	13,650	2,044	2,044	2,044	2,044
7,650	7,700	1,151	1,151	1,151	1,151	10,650	10,700	1,601	1,601	1,601	1,601	13,650	13,700	2,051	2,051	2,051	2,051
7,700	7,750	1,159	1,159	1,159	1,159	10,700	10,750	1,609	1,609	1,609	1,609	13,700	13,750	2,059	2,059	2,059	2,059
7,750	7,800	1,166	1,166	1,166	1,166	10,750	10,800	1,616	1,616	1,616	1,616	13,750	13,800	2,066	2,066	2,066	2,066
7,800	7,850	1,174	1,174	1,174	1,174	10,800	10,850	1,624	1,624	1,624	1,624	13,800	13,850	2,074	2,074	2,074	2,074
7,850	7,900	1,181	1,181	1,181	1,181	10,850	10,900	1,631	1,631	1,631	1,631	13,850	13,900	2,081	2,081	2,081	2,081
7,900	7,950	1,189	1,189	1,189	1,189	10,900	10,950	1,639	1,639	1,639	1,639	13,900	13,950	2,089	2,089	2,089	2,089
7,950	8,000	1,196	1,196	1,196	1,196	10,950	11,000	1,646	1,646	1,646	1,646	13,950	14,000	2,096	2,096	2,096	2,096

\* This column must also be used by a qualifying widow(er).

Continued on next page



1999 Tax Table—Continued

If line 39 (taxable income) is—		And you are—				If line 39 (taxable income) is—		And you are—				If line 39 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—						Your tax is—						Your tax is—			
<b>14,000</b>						<b>17,000</b>						<b>20,000</b>					
14,000	14,050	2,104	2,104	2,104	2,104	17,000	17,050	2,554	2,554	2,554	2,554	20,000	20,050	3,004	3,004	3,004	3,004
14,050	14,100	2,111	2,111	2,111	2,111	17,050	17,100	2,561	2,561	2,561	2,561	20,050	20,100	3,011	3,011	3,011	3,011
14,100	14,150	2,119	2,119	2,119	2,119	17,100	17,150	2,569	2,569	2,569	2,569	20,100	20,150	3,019	3,019	3,019	3,019
14,150	14,200	2,126	2,126	2,126	2,126	17,150	17,200	2,576	2,576	2,576	2,576	20,150	20,200	3,026	3,026	3,026	3,026
14,200	14,250	2,134	2,134	2,134	2,134	17,200	17,250	2,584	2,584	2,584	2,584	20,200	20,250	3,034	3,034	3,034	3,034
14,250	14,300	2,141	2,141	2,141	2,141	17,250	17,300	2,591	2,591	2,591	2,591	20,250	20,300	3,041	3,041	3,041	3,041
14,300	14,350	2,149	2,149	2,149	2,149	17,300	17,350	2,599	2,599	2,599	2,599	20,300	20,350	3,049	3,049	3,049	3,049
14,350	14,400	2,156	2,156	2,156	2,156	17,350	17,400	2,606	2,606	2,606	2,606	20,350	20,400	3,056	3,056	3,056	3,056
14,400	14,450	2,164	2,164	2,164	2,164	17,400	17,450	2,614	2,614	2,614	2,614	20,400	20,450	3,064	3,064	3,064	3,064
14,450	14,500	2,171	2,171	2,171	2,171	17,450	17,500	2,621	2,621	2,621	2,621	20,450	20,500	3,071	3,071	3,071	3,071
14,500	14,550	2,179	2,179	2,179	2,179	17,500	17,550	2,629	2,629	2,629	2,629	20,500	20,550	3,079	3,079	3,079	3,079
14,550	14,600	2,186	2,186	2,186	2,186	17,550	17,600	2,636	2,636	2,636	2,636	20,550	20,600	3,086	3,086	3,086	3,086
14,600	14,650	2,194	2,194	2,194	2,194	17,600	17,650	2,644	2,644	2,644	2,644	20,600	20,650	3,094	3,094	3,094	3,094
14,650	14,700	2,201	2,201	2,201	2,201	17,650	17,700	2,651	2,651	2,651	2,651	20,650	20,700	3,101	3,101	3,101	3,101
14,700	14,750	2,209	2,209	2,209	2,209	17,700	17,750	2,659	2,659	2,659	2,659	20,700	20,750	3,109	3,109	3,109	3,109
14,750	14,800	2,216	2,216	2,216	2,216	17,750	17,800	2,666	2,666	2,666	2,666	20,750	20,800	3,116	3,116	3,116	3,116
14,800	14,850	2,224	2,224	2,224	2,224	17,800	17,850	2,674	2,674	2,674	2,674	20,800	20,850	3,124	3,124	3,124	3,124
14,850	14,900	2,231	2,231	2,231	2,231	17,850	17,900	2,681	2,681	2,681	2,681	20,850	20,900	3,131	3,131	3,131	3,131
14,900	14,950	2,239	2,239	2,239	2,239	17,900	17,950	2,689	2,689	2,689	2,689	20,900	20,950	3,139	3,139	3,139	3,139
14,950	15,000	2,246	2,246	2,246	2,246	17,950	18,000	2,696	2,696	2,696	2,696	20,950	21,000	3,146	3,146	3,146	3,146
<b>15,000</b>						<b>18,000</b>						<b>21,000</b>					
15,000	15,050	2,254	2,254	2,254	2,254	18,000	18,050	2,704	2,704	2,704	2,704	21,000	21,050	3,154	3,154	3,154	3,154
15,050	15,100	2,261	2,261	2,261	2,261	18,050	18,100	2,711	2,711	2,711	2,711	21,050	21,100	3,161	3,161	3,161	3,161
15,100	15,150	2,269	2,269	2,269	2,269	18,100	18,150	2,719	2,719	2,719	2,719	21,100	21,150	3,169	3,169	3,169	3,169
15,150	15,200	2,276	2,276	2,276	2,276	18,150	18,200	2,726	2,726	2,726	2,726	21,150	21,200	3,176	3,176	3,176	3,176
15,200	15,250	2,284	2,284	2,284	2,284	18,200	18,250	2,734	2,734	2,734	2,734	21,200	21,250	3,184	3,184	3,184	3,184
15,250	15,300	2,291	2,291	2,291	2,291	18,250	18,300	2,741	2,741	2,741	2,741	21,250	21,300	3,191	3,191	3,191	3,191
15,300	15,350	2,299	2,299	2,299	2,299	18,300	18,350	2,749	2,749	2,749	2,749	21,300	21,350	3,199	3,199	3,199	3,199
15,350	15,400	2,306	2,306	2,306	2,306	18,350	18,400	2,756	2,756	2,756	2,756	21,350	21,400	3,206	3,206	3,206	3,206
15,400	15,450	2,314	2,314	2,314	2,314	18,400	18,450	2,764	2,764	2,764	2,764	21,400	21,450	3,214	3,214	3,214	3,214
15,450	15,500	2,321	2,321	2,321	2,321	18,450	18,500	2,771	2,771	2,771	2,771	21,450	21,500	3,221	3,221	3,221	3,221
15,500	15,550	2,329	2,329	2,329	2,329	18,500	18,550	2,779	2,779	2,779	2,779	21,500	21,550	3,229	3,229	3,229	3,229
15,550	15,600	2,336	2,336	2,336	2,336	18,550	18,600	2,786	2,786	2,786	2,786	21,550	21,600	3,236	3,236	3,236	3,236
15,600	15,650	2,344	2,344	2,344	2,344	18,600	18,650	2,794	2,794	2,794	2,794	21,600	21,650	3,244	3,244	3,257	3,244
15,650	15,700	2,351	2,351	2,351	2,351	18,650	18,700	2,801	2,801	2,801	2,801	21,650	21,700	3,251	3,251	3,271	3,251
15,700	15,750	2,359	2,359	2,359	2,359	18,700	18,750	2,809	2,809	2,809	2,809	21,700	21,750	3,259	3,259	3,285	3,259
15,750	15,800	2,366	2,366	2,366	2,366	18,750	18,800	2,816	2,816	2,816	2,816	21,750	21,800	3,266	3,266	3,299	3,266
15,800	15,850	2,374	2,374	2,374	2,374	18,800	18,850	2,824	2,824	2,824	2,824	21,800	21,850	3,274	3,274	3,313	3,274
15,850	15,900	2,381	2,381	2,381	2,381	18,850	18,900	2,831	2,831	2,831	2,831	21,850	21,900	3,281	3,281	3,327	3,281
15,900	15,950	2,389	2,389	2,389	2,389	18,900	18,950	2,839	2,839	2,839	2,839	21,900	21,950	3,289	3,289	3,341	3,289
15,950	16,000	2,396	2,396	2,396	2,396	18,950	19,000	2,846	2,846	2,846	2,846	21,950	22,000	3,296	3,296	3,355	3,296
<b>16,000</b>						<b>19,000</b>						<b>22,000</b>					
16,000	16,050	2,404	2,404	2,404	2,404	19,000	19,050	2,854	2,854	2,854	2,854	22,000	22,050	3,304	3,304	3,369	3,304
16,050	16,100	2,411	2,411	2,411	2,411	19,050	19,100	2,861	2,861	2,861	2,861	22,050	22,100	3,311	3,311	3,383	3,311
16,100	16,150	2,419	2,419	2,419	2,419	19,100	19,150	2,869	2,869	2,869	2,869	22,100	22,150	3,319	3,319	3,397	3,319
16,150	16,200	2,426	2,426	2,426	2,426	19,150	19,200	2,876	2,876	2,876	2,876	22,150	22,200	3,326	3,326	3,411	3,326
16,200	16,250	2,434	2,434	2,434	2,434	19,200	19,250	2,884	2,884	2,884	2,884	22,200	22,250	3,334	3,334	3,425	3,334
16,250	16,300	2,441	2,441	2,441	2,441	19,250	19,300	2,891	2,891	2,891	2,891	22,250	22,300	3,341	3,341	3,439	3,341
16,300	16,350	2,449	2,449	2,449	2,449	19,300	19,350	2,899	2,899	2,899	2,899	22,300	22,350	3,349	3,349	3,453	3,349
16,350	16,400	2,456	2,456	2,456	2,456	19,350	19,400	2,906	2,906	2,906	2,906	22,350	22,400	3,356	3,356	3,467	3,356
16,400	16,450	2,464	2,464	2,464	2,464	19,400	19,450	2,914	2,914	2,914	2,914	22,400	22,450	3,364	3,364	3,481	3,364
16,450	16,500	2,471	2,471	2,471	2,471	19,450	19,500	2,921	2,921	2,921	2,921	22,450	22,500	3,371	3,371	3,495	3,371
16,500	16,550	2,479	2,479	2,479	2,479	19,500	19,550	2,929	2,929	2,929	2,929	22,500	22,550	3,379	3,379	3,509	3,379
16,550	16,600	2,486	2,486	2,486	2,486	19,550	19,600	2,936	2,936	2,936	2,936	22,550	22,600	3,386	3,386	3,523	3,386
16,600	16,650	2,494	2,494	2,494	2,494	19,600	19,650	2,944	2,944	2,944	2,944	22,600	22,650	3,394	3,394	3,537	3,394
16,650	16,700	2,501	2,501	2,501	2,501	19,650	19,700	2,951	2,951	2,951	2,951	22,650	22,700	3,401	3,401	3,551	3,401
16,700	16,750	2,509	2,509	2,509	2,509	19,700	19,750	2,959	2,959	2,959	2,959	22,700	22,750	3,409	3,409	3,565	3,409
16,750	16,800	2,516	2,516	2,516	2,516	19,750	19,800	2,966	2,966	2,966	2,966	22,750	22,800	3,416	3,416	3,579	3,416
16,800	16,850	2,524	2,524	2,524	2,524	19,800	19,850	2,974	2,974	2,974	2,974	22,800	22,850	3,424	3,424	3,593	3,424
16,850	16,900	2,531	2,531	2,531	2,531	19,850	19,900	2,981	2,981	2,981	2,981	22,850	22,900	3,431	3,431	3,607	3,431
16,900	16,950	2,539	2,539	2,539	2,539	19,900	19,950	2,989	2,989	2,989	2,989	22,900	22,950	3,439	3,439	3,621	3,439
16,950	17,000	2,546	2,546	2,546	2,546	19,950	20,000	2,996	2,996	2,996							

1999 Tax Table—Continued

If line 39 (taxable income) is—		And you are—				If line 39 (taxable income) is—		And you are—				If line 39 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—						Your tax is—						Your tax is—			
<b>23,000</b>						<b>26,000</b>						<b>29,000</b>					
23,000	23,050	3,454	3,454	3,649	3,454	26,000	26,050	3,940	3,904	4,489	3,904	29,000	29,050	4,780	4,354	5,329	4,354
23,050	23,100	3,461	3,461	3,663	3,461	26,050	26,100	3,954	3,911	4,503	3,911	29,050	29,100	4,794	4,361	5,343	4,361
23,100	23,150	3,469	3,469	3,677	3,469	26,100	26,150	3,968	3,919	4,517	3,919	29,100	29,150	4,808	4,369	5,357	4,369
23,150	23,200	3,476	3,476	3,691	3,476	26,150	26,200	3,982	3,926	4,531	3,926	29,150	29,200	4,822	4,376	5,371	4,376
23,200	23,250	3,484	3,484	3,705	3,484	26,200	26,250	3,996	3,934	4,545	3,934	29,200	29,250	4,836	4,384	5,385	4,384
23,250	23,300	3,491	3,491	3,719	3,491	26,250	26,300	4,010	3,941	4,559	3,941	29,250	29,300	4,850	4,391	5,399	4,391
23,300	23,350	3,499	3,499	3,733	3,499	26,300	26,350	4,024	3,949	4,573	3,949	29,300	29,350	4,864	4,399	5,413	4,399
23,350	23,400	3,506	3,506	3,747	3,506	26,350	26,400	4,038	3,956	4,587	3,956	29,350	29,400	4,878	4,406	5,427	4,406
23,400	23,450	3,514	3,514	3,761	3,514	26,400	26,450	4,052	3,964	4,601	3,964	29,400	29,450	4,892	4,414	5,441	4,414
23,450	23,500	3,521	3,521	3,775	3,521	26,450	26,500	4,066	3,971	4,615	3,971	29,450	29,500	4,906	4,421	5,455	4,421
23,500	23,550	3,529	3,529	3,789	3,529	26,500	26,550	4,080	3,979	4,629	3,979	29,500	29,550	4,920	4,429	5,469	4,429
23,550	23,600	3,536	3,536	3,803	3,536	26,550	26,600	4,094	3,986	4,643	3,986	29,550	29,600	4,934	4,436	5,483	4,436
23,600	23,650	3,544	3,544	3,817	3,544	26,600	26,650	4,108	3,994	4,657	3,994	29,600	29,650	4,948	4,444	5,497	4,444
23,650	23,700	3,551	3,551	3,831	3,551	26,650	26,700	4,122	4,001	4,671	4,001	29,650	29,700	4,962	4,451	5,511	4,451
23,700	23,750	3,559	3,559	3,845	3,559	26,700	26,750	4,136	4,009	4,685	4,009	29,700	29,750	4,976	4,459	5,525	4,459
23,750	23,800	3,566	3,566	3,859	3,566	26,750	26,800	4,150	4,016	4,699	4,016	29,750	29,800	4,990	4,466	5,539	4,466
23,800	23,850	3,574	3,574	3,873	3,574	26,800	26,850	4,164	4,024	4,713	4,024	29,800	29,850	5,004	4,474	5,553	4,474
23,850	23,900	3,581	3,581	3,887	3,581	26,850	26,900	4,178	4,031	4,727	4,031	29,850	29,900	5,018	4,481	5,567	4,481
23,900	23,950	3,589	3,589	3,901	3,589	26,900	26,950	4,192	4,039	4,741	4,039	29,900	29,950	5,032	4,489	5,581	4,489
23,950	24,000	3,596	3,596	3,915	3,596	26,950	27,000	4,206	4,046	4,755	4,046	29,950	30,000	5,046	4,496	5,595	4,496
<b>24,000</b>						<b>27,000</b>						<b>30,000</b>					
24,000	24,050	3,604	3,604	3,929	3,604	27,000	27,050	4,220	4,054	4,769	4,054	30,000	30,050	5,060	4,504	5,609	4,504
24,050	24,100	3,611	3,611	3,943	3,611	27,050	27,100	4,234	4,061	4,783	4,061	30,050	30,100	5,074	4,511	5,623	4,511
24,100	24,150	3,619	3,619	3,957	3,619	27,100	27,150	4,248	4,069	4,797	4,069	30,100	30,150	5,088	4,519	5,637	4,519
24,150	24,200	3,626	3,626	3,971	3,626	27,150	27,200	4,262	4,076	4,811	4,076	30,150	30,200	5,102	4,526	5,651	4,526
24,200	24,250	3,634	3,634	3,985	3,634	27,200	27,250	4,276	4,084	4,825	4,084	30,200	30,250	5,116	4,534	5,665	4,534
24,250	24,300	3,641	3,641	3,999	3,641	27,250	27,300	4,290	4,091	4,839	4,091	30,250	30,300	5,130	4,541	5,679	4,541
24,300	24,350	3,649	3,649	4,013	3,649	27,300	27,350	4,304	4,099	4,853	4,099	30,300	30,350	5,144	4,549	5,693	4,549
24,350	24,400	3,656	3,656	4,027	3,656	27,350	27,400	4,318	4,106	4,867	4,106	30,350	30,400	5,158	4,556	5,707	4,556
24,400	24,450	3,664	3,664	4,041	3,664	27,400	27,450	4,332	4,114	4,881	4,114	30,400	30,450	5,172	4,564	5,721	4,564
24,450	24,500	3,671	3,671	4,055	3,671	27,450	27,500	4,346	4,121	4,895	4,121	30,450	30,500	5,186	4,571	5,735	4,571
24,500	24,550	3,679	3,679	4,069	3,679	27,500	27,550	4,360	4,129	4,909	4,129	30,500	30,550	5,200	4,579	5,749	4,579
24,550	24,600	3,686	3,686	4,083	3,686	27,550	27,600	4,374	4,136	4,923	4,136	30,550	30,600	5,214	4,586	5,763	4,586
24,600	24,650	3,694	3,694	4,097	3,694	27,600	27,650	4,388	4,144	4,937	4,144	30,600	30,650	5,228	4,594	5,777	4,594
24,650	24,700	3,701	3,701	4,111	3,701	27,650	27,700	4,402	4,151	4,951	4,151	30,650	30,700	5,242	4,601	5,791	4,601
24,700	24,750	3,709	3,709	4,125	3,709	27,700	27,750	4,416	4,159	4,965	4,159	30,700	30,750	5,256	4,609	5,805	4,609
24,750	24,800	3,716	3,716	4,139	3,716	27,750	27,800	4,430	4,166	4,979	4,166	30,750	30,800	5,270	4,616	5,819	4,616
24,800	24,850	3,724	3,724	4,153	3,724	27,800	27,850	4,444	4,174	4,993	4,174	30,800	30,850	5,284	4,624	5,833	4,624
24,850	24,900	3,731	3,731	4,167	3,731	27,850	27,900	4,458	4,181	5,007	4,181	30,850	30,900	5,298	4,631	5,847	4,631
24,900	24,950	3,739	3,739	4,181	3,739	27,900	27,950	4,472	4,189	5,021	4,189	30,900	30,950	5,312	4,639	5,861	4,639
24,950	25,000	3,746	3,746	4,195	3,746	27,950	28,000	4,486	4,196	5,035	4,196	30,950	31,000	5,326	4,646	5,875	4,646
<b>25,000</b>						<b>28,000</b>						<b>31,000</b>					
25,000	25,050	3,754	3,754	4,209	3,754	28,000	28,050	4,500	4,204	5,049	4,204	31,000	31,050	5,340	4,654	5,889	4,654
25,050	25,100	3,761	3,761	4,223	3,761	28,050	28,100	4,514	4,211	5,063	4,211	31,050	31,100	5,354	4,661	5,903	4,661
25,100	25,150	3,769	3,769	4,237	3,769	28,100	28,150	4,528	4,219	5,077	4,219	31,100	31,150	5,368	4,669	5,917	4,669
25,150	25,200	3,776	3,776	4,251	3,776	28,150	28,200	4,542	4,226	5,091	4,226	31,150	31,200	5,382	4,676	5,931	4,676
25,200	25,250	3,784	3,784	4,265	3,784	28,200	28,250	4,556	4,234	5,105	4,234	31,200	31,250	5,396	4,684	5,945	4,684
25,250	25,300	3,791	3,791	4,279	3,791	28,250	28,300	4,570	4,241	5,119	4,241	31,250	31,300	5,410	4,691	5,959	4,691
25,300	25,350	3,799	3,799	4,293	3,799	28,300	28,350	4,584	4,249	5,133	4,249	31,300	31,350	5,424	4,699	5,973	4,699
25,350	25,400	3,806	3,806	4,307	3,806	28,350	28,400	4,598	4,256	5,147	4,256	31,350	31,400	5,438	4,706	5,987	4,706
25,400	25,450	3,814	3,814	4,321	3,814	28,400	28,450	4,612	4,264	5,161	4,264	31,400	31,450	5,452	4,714	6,001	4,714
25,450	25,500	3,821	3,821	4,335	3,821	28,450	28,500	4,626	4,271	5,175	4,271	31,450	31,500	5,466	4,721	6,015	4,721
25,500	25,550	3,829	3,829	4,349	3,829	28,500	28,550	4,640	4,279	5,189	4,279	31,500	31,550	5,480	4,729	6,029	4,729
25,550	25,600	3,836	3,836	4,363	3,836	28,550	28,600	4,654	4,286	5,203	4,286	31,550	31,600	5,494	4,736	6,043	4,736
25,600	25,650	3,844	3,844	4,377	3,844	28,600	28,650	4,668	4,294	5,217	4,294	31,600	31,650	5,508	4,744	6,057	4,744
25,650	25,700	3,851	3,851	4,391	3,851	28,650	28,700	4,682	4,301	5,231	4,301	31,650	31,700	5,522	4,751	6,071	4,751
25,700	25,750	3,859	3,859	4,405	3,859	28,700	28,750	4,696	4,309	5,245	4,309	31,700	31,750	5,536	4,759	6,085	4,759
25,750	25,800	3,870	3,870	4,419	3,870	28,7											

1999 Tax Table—Continued

If line 39 (taxable income) is—		And you are—				If line 39 (taxable income) is—		And you are—				If line 39 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—						Your tax is—						Your tax is—			
<b>32,000</b>						<b>35,000</b>						<b>38,000</b>					
32,000	32,050	5,620	4,804	6,169	4,804	35,000	35,050	6,460	5,254	7,009	5,316	38,000	38,050	7,300	5,704	7,849	6,156
32,050	32,100	5,634	4,811	6,183	4,811	35,050	35,100	6,474	5,261	7,023	5,330	38,050	38,100	7,314	5,711	7,863	6,170
32,100	32,150	5,648	4,819	6,197	4,819	35,100	35,150	6,488	5,269	7,037	5,344	38,100	38,150	7,328	5,719	7,877	6,184
32,150	32,200	5,662	4,826	6,211	4,826	35,150	35,200	6,502	5,276	7,051	5,358	38,150	38,200	7,342	5,726	7,891	6,198
32,200	32,250	5,676	4,834	6,225	4,834	35,200	35,250	6,516	5,284	7,065	5,372	38,200	38,250	7,356	5,734	7,905	6,212
32,250	32,300	5,690	4,841	6,239	4,841	35,250	35,300	6,530	5,291	7,079	5,386	38,250	38,300	7,370	5,741	7,919	6,226
32,300	32,350	5,704	4,849	6,253	4,849	35,300	35,350	6,544	5,299	7,093	5,400	38,300	38,350	7,384	5,749	7,933	6,240
32,350	32,400	5,718	4,856	6,267	4,856	35,350	35,400	6,558	5,306	7,107	5,414	38,350	38,400	7,398	5,756	7,947	6,254
32,400	32,450	5,732	4,864	6,281	4,864	35,400	35,450	6,572	5,314	7,121	5,428	38,400	38,450	7,412	5,764	7,961	6,268
32,450	32,500	5,746	4,871	6,295	4,871	35,450	35,500	6,586	5,321	7,135	5,442	38,450	38,500	7,426	5,771	7,975	6,282
32,500	32,550	5,760	4,879	6,309	4,879	35,500	35,550	6,600	5,329	7,149	5,456	38,500	38,550	7,440	5,779	7,989	6,296
32,550	32,600	5,774	4,886	6,323	4,886	35,550	35,600	6,614	5,336	7,163	5,470	38,550	38,600	7,454	5,786	8,003	6,310
32,600	32,650	5,788	4,894	6,337	4,894	35,600	35,650	6,628	5,344	7,177	5,484	38,600	38,650	7,468	5,794	8,017	6,324
32,650	32,700	5,802	4,901	6,351	4,901	35,650	35,700	6,642	5,351	7,191	5,498	38,650	38,700	7,482	5,801	8,031	6,338
32,700	32,750	5,816	4,909	6,365	4,909	35,700	35,750	6,656	5,359	7,205	5,512	38,700	38,750	7,496	5,809	8,045	6,352
32,750	32,800	5,830	4,916	6,379	4,916	35,750	35,800	6,670	5,366	7,219	5,526	38,750	38,800	7,510	5,816	8,059	6,366
32,800	32,850	5,844	4,924	6,393	4,924	35,800	35,850	6,684	5,374	7,233	5,540	38,800	38,850	7,524	5,824	8,073	6,380
32,850	32,900	5,858	4,931	6,407	4,931	35,850	35,900	6,698	5,381	7,247	5,554	38,850	38,900	7,538	5,831	8,087	6,394
32,900	32,950	5,872	4,939	6,421	4,939	35,900	35,950	6,712	5,389	7,261	5,568	38,900	38,950	7,552	5,839	8,101	6,408
32,950	33,000	5,886	4,946	6,435	4,946	35,950	36,000	6,726	5,396	7,275	5,582	38,950	39,000	7,566	5,846	8,115	6,422
<b>33,000</b>						<b>36,000</b>						<b>39,000</b>					
33,000	33,050	5,900	4,954	6,449	4,954	36,000	36,050	6,740	5,404	7,289	5,596	39,000	39,050	7,580	5,854	8,129	6,436
33,050	33,100	5,914	4,961	6,463	4,961	36,050	36,100	6,754	5,411	7,303	5,610	39,050	39,100	7,594	5,861	8,143	6,450
33,100	33,150	5,928	4,969	6,477	4,969	36,100	36,150	6,768	5,419	7,317	5,624	39,100	39,150	7,608	5,869	8,157	6,464
33,150	33,200	5,942	4,976	6,491	4,976	36,150	36,200	6,782	5,426	7,331	5,638	39,150	39,200	7,622	5,876	8,171	6,478
33,200	33,250	5,956	4,984	6,505	4,984	36,200	36,250	6,796	5,434	7,345	5,652	39,200	39,250	7,636	5,884	8,185	6,492
33,250	33,300	5,970	4,991	6,519	4,991	36,250	36,300	6,810	5,441	7,359	5,666	39,250	39,300	7,650	5,891	8,199	6,506
33,300	33,350	5,984	4,999	6,533	4,999	36,300	36,350	6,824	5,449	7,373	5,680	39,300	39,350	7,664	5,899	8,213	6,520
33,350	33,400	5,998	5,006	6,547	5,006	36,350	36,400	6,838	5,456	7,387	5,694	39,350	39,400	7,678	5,906	8,227	6,534
33,400	33,450	6,012	5,014	6,561	5,014	36,400	36,450	6,852	5,464	7,401	5,708	39,400	39,450	7,692	5,914	8,241	6,548
33,450	33,500	6,026	5,021	6,575	5,021	36,450	36,500	6,866	5,471	7,415	5,722	39,450	39,500	7,706	5,921	8,255	6,562
33,500	33,550	6,040	5,029	6,589	5,029	36,500	36,550	6,880	5,479	7,429	5,736	39,500	39,550	7,720	5,929	8,269	6,576
33,550	33,600	6,054	5,036	6,603	5,036	36,550	36,600	6,894	5,486	7,443	5,750	39,550	39,600	7,734	5,936	8,283	6,590
33,600	33,650	6,068	5,044	6,617	5,044	36,600	36,650	6,908	5,494	7,457	5,764	39,600	39,650	7,748	5,944	8,297	6,604
33,650	33,700	6,082	5,051	6,631	5,051	36,650	36,700	6,922	5,501	7,471	5,778	39,650	39,700	7,762	5,951	8,311	6,618
33,700	33,750	6,096	5,059	6,645	5,059	36,700	36,750	6,936	5,509	7,485	5,792	39,700	39,750	7,776	5,959	8,325	6,632
33,750	33,800	6,110	5,066	6,659	5,066	36,750	36,800	6,950	5,516	7,499	5,806	39,750	39,800	7,790	5,966	8,339	6,646
33,800	33,850	6,124	5,074	6,673	5,074	36,800	36,850	6,964	5,524	7,513	5,820	39,800	39,850	7,804	5,974	8,353	6,660
33,850	33,900	6,138	5,081	6,687	5,081	36,850	36,900	6,978	5,531	7,527	5,834	39,850	39,900	7,818	5,981	8,367	6,674
33,900	33,950	6,152	5,089	6,701	5,089	36,900	36,950	6,992	5,539	7,541	5,848	39,900	39,950	7,832	5,989	8,381	6,688
33,950	34,000	6,166	5,096	6,715	5,096	36,950	37,000	7,006	5,546	7,555	5,862	39,950	40,000	7,846	5,996	8,395	6,702
<b>34,000</b>						<b>37,000</b>						<b>40,000</b>					
34,000	34,050	6,180	5,104	6,729	5,104	37,000	37,050	7,020	5,554	7,569	5,876	40,000	40,050	7,860	6,004	8,409	6,716
34,050	34,100	6,194	5,111	6,743	5,111	37,050	37,100	7,034	5,561	7,583	5,890	40,050	40,100	7,874	6,011	8,423	6,730
34,100	34,150	6,208	5,119	6,757	5,119	37,100	37,150	7,048	5,569	7,597	5,904	40,100	40,150	7,888	6,019	8,437	6,744
34,150	34,200	6,222	5,126	6,771	5,126	37,150	37,200	7,062	5,576	7,611	5,918	40,150	40,200	7,902	6,026	8,451	6,758
34,200	34,250	6,236	5,134	6,785	5,134	37,200	37,250	7,076	5,584	7,625	5,932	40,200	40,250	7,916	6,034	8,465	6,772
34,250	34,300	6,250	5,141	6,799	5,141	37,250	37,300	7,090	5,591	7,639	5,946	40,250	40,300	7,930	6,041	8,479	6,786
34,300	34,350	6,264	5,149	6,813	5,149	37,300	37,350	7,104	5,599	7,653	5,960	40,300	40,350	7,944	6,049	8,493	6,800
34,350	34,400	6,278	5,156	6,827	5,156	37,350	37,400	7,118	5,606	7,667	5,974	40,350	40,400	7,958	6,056	8,507	6,814
34,400	34,450	6,292	5,164	6,841	5,164	37,400	37,450	7,132	5,614	7,681	5,988	40,400	40,450	7,972	6,064	8,521	6,828
34,450	34,500	6,306	5,171	6,855	5,171	37,450	37,500	7,146	5,621	7,695	6,002	40,450	40,500	7,986	6,071	8,535	6,842
34,500	34,550	6,320	5,179	6,869	5,179	37,500	37,550	7,160	5,629	7,709	6,016	40,500	40,550	8,000	6,079	8,549	6,856
34,550	34,600	6,334	5,186	6,883	5,190	37,550	37,600	7,174	5,636	7,723	6,030	40,550	40,600	8,014	6,086	8,563	6,870
34,600	34,650	6,348	5,194	6,897	5,204	37,600	37,650	7,188	5,644	7,737	6,044	40,600	40,650	8,028	6,094	8,577	6,884
34,650	34,700	6,362	5,201	6,911	5,218	37,650	37,700	7,202	5,651	7,751	6,058	40,650	40,700	8,042	6,101	8,591	6,898
34,700	34,750	6,376	5,209	6,925	5,232	37,700	37,750	7,216	5,659	7,765	6,072	40,700	40,750	8,056	6,109	8,605	6,912
34,750	34,800	6,390	5,216	6,939	5,246	37,750	37,800	7,230	5,666	7,779	6,086	40,750	40,800	8,070	6,116	8,619	6,926
34,800	34,850	6,404	5,224	6,953	5,260	37,800	37,850	7,244	5,674	7,793	6,100	40,800	40,850	8,084	6,124	8,633	6,940
34,850	34,900	6,418	5,231	6,967	5,274	37,850	37,900	7,258	5,681	7,807	6,114	40,850	40,900	8,098	6,131	8,647	6,954
34,900	34,950	6,432	5,239	6,981	5,288	37,900	37,950	7,272	5,689	7,821	6,128	40,900	40,950	8,112	6,139	8,661	6,968
34,950	35,000	6,446	5,246	6,995	5,302	37,950	38,000	7,286	5,696	7,835							

1999 Tax Table—Continued

If line 39 (taxable income) is—		And you are—				If line 39 (taxable income) is—		And you are—				If line 39 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—						Your tax is—						Your tax is—			
<b>41,000</b>						<b>44,000</b>						<b>47,000</b>					
41,000	41,050	8,140	6,154	8,689	6,996	44,000	44,050	8,980	6,731	9,529	7,836	47,000	47,050	9,820	7,571	10,369	8,676
41,050	41,100	8,154	6,161	8,703	7,010	44,050	44,100	8,994	6,745	9,543	7,850	47,050	47,100	9,834	7,585	10,383	8,690
41,100	41,150	8,168	6,169	8,717	7,024	44,100	44,150	9,008	6,759	9,557	7,864	47,100	47,150	9,848	7,599	10,397	8,704
41,150	41,200	8,182	6,176	8,731	7,038	44,150	44,200	9,022	6,773	9,571	7,878	47,150	47,200	9,862	7,613	10,411	8,718
41,200	41,250	8,196	6,184	8,745	7,052	44,200	44,250	9,036	6,787	9,585	7,892	47,200	47,250	9,876	7,627	10,425	8,732
41,250	41,300	8,210	6,191	8,759	7,066	44,250	44,300	9,050	6,801	9,599	7,906	47,250	47,300	9,890	7,641	10,439	8,746
41,300	41,350	8,224	6,199	8,773	7,080	44,300	44,350	9,064	6,815	9,613	7,920	47,300	47,350	9,904	7,655	10,453	8,760
41,350	41,400	8,238	6,206	8,787	7,094	44,350	44,400	9,078	6,829	9,627	7,934	47,350	47,400	9,918	7,669	10,467	8,774
41,400	41,450	8,252	6,214	8,801	7,108	44,400	44,450	9,092	6,843	9,641	7,948	47,400	47,450	9,932	7,683	10,481	8,788
41,450	41,500	8,266	6,221	8,815	7,122	44,450	44,500	9,106	6,857	9,655	7,962	47,450	47,500	9,946	7,697	10,495	8,802
41,500	41,550	8,280	6,229	8,829	7,136	44,500	44,550	9,120	6,871	9,669	7,976	47,500	47,550	9,960	7,711	10,509	8,816
41,550	41,600	8,294	6,236	8,843	7,150	44,550	44,600	9,134	6,885	9,683	7,990	47,550	47,600	9,974	7,725	10,523	8,830
41,600	41,650	8,308	6,244	8,857	7,164	44,600	44,650	9,148	6,899	9,697	8,004	47,600	47,650	9,988	7,739	10,537	8,844
41,650	41,700	8,322	6,251	8,871	7,178	44,650	44,700	9,162	6,913	9,711	8,018	47,650	47,700	10,002	7,753	10,551	8,858
41,700	41,750	8,336	6,259	8,885	7,192	44,700	44,750	9,176	6,927	9,725	8,032	47,700	47,750	10,016	7,767	10,565	8,872
41,750	41,800	8,350	6,266	8,899	7,206	44,750	44,800	9,190	6,941	9,739	8,046	47,750	47,800	10,030	7,781	10,579	8,886
41,800	41,850	8,364	6,274	8,913	7,220	44,800	44,850	9,204	6,955	9,753	8,060	47,800	47,850	10,044	7,795	10,593	8,900
41,850	41,900	8,378	6,281	8,927	7,234	44,850	44,900	9,218	6,969	9,767	8,074	47,850	47,900	10,058	7,809	10,607	8,914
41,900	41,950	8,392	6,289	8,941	7,248	44,900	44,950	9,232	6,983	9,781	8,088	47,900	47,950	10,072	7,823	10,621	8,928
41,950	42,000	8,406	6,296	8,955	7,262	44,950	45,000	9,246	6,997	9,795	8,102	47,950	48,000	10,086	7,837	10,635	8,942
<b>42,000</b>						<b>45,000</b>						<b>48,000</b>					
42,000	42,050	8,420	6,304	8,969	7,276	45,000	45,050	9,260	7,011	9,809	8,116	48,000	48,050	10,100	7,851	10,649	8,956
42,050	42,100	8,434	6,311	8,983	7,290	45,050	45,100	9,274	7,025	9,823	8,130	48,050	48,100	10,114	7,865	10,663	8,970
42,100	42,150	8,448	6,319	8,997	7,304	45,100	45,150	9,288	7,039	9,837	8,144	48,100	48,150	10,128	7,879	10,677	8,984
42,150	42,200	8,462	6,326	9,011	7,318	45,150	45,200	9,302	7,053	9,851	8,158	48,150	48,200	10,142	7,893	10,691	8,998
42,200	42,250	8,476	6,334	9,025	7,332	45,200	45,250	9,316	7,067	9,865	8,172	48,200	48,250	10,156	7,907	10,705	9,012
42,250	42,300	8,490	6,341	9,039	7,346	45,250	45,300	9,330	7,081	9,879	8,186	48,250	48,300	10,170	7,921	10,719	9,026
42,300	42,350	8,504	6,349	9,053	7,360	45,300	45,350	9,344	7,095	9,893	8,200	48,300	48,350	10,184	7,935	10,733	9,040
42,350	42,400	8,518	6,356	9,067	7,374	45,350	45,400	9,358	7,109	9,907	8,214	48,350	48,400	10,198	7,949	10,747	9,054
42,400	42,450	8,532	6,364	9,081	7,388	45,400	45,450	9,372	7,123	9,921	8,228	48,400	48,450	10,212	7,963	10,761	9,068
42,450	42,500	8,546	6,371	9,095	7,402	45,450	45,500	9,386	7,137	9,935	8,242	48,450	48,500	10,226	7,977	10,775	9,082
42,500	42,550	8,560	6,379	9,109	7,416	45,500	45,550	9,400	7,151	9,949	8,256	48,500	48,550	10,240	7,991	10,789	9,096
42,550	42,600	8,574	6,386	9,123	7,430	45,550	45,600	9,414	7,165	9,963	8,270	48,550	48,600	10,254	8,005	10,803	9,110
42,600	42,650	8,588	6,394	9,137	7,444	45,600	45,650	9,428	7,179	9,977	8,284	48,600	48,650	10,268	8,019	10,817	9,124
42,650	42,700	8,602	6,401	9,151	7,458	45,650	45,700	9,442	7,193	9,991	8,298	48,650	48,700	10,282	8,033	10,831	9,138
42,700	42,750	8,616	6,409	9,165	7,472	45,700	45,750	9,456	7,207	10,005	8,312	48,700	48,750	10,296	8,047	10,845	9,152
42,750	42,800	8,630	6,416	9,179	7,486	45,750	45,800	9,470	7,221	10,019	8,326	48,750	48,800	10,310	8,061	10,859	9,166
42,800	42,850	8,644	6,424	9,193	7,500	45,800	45,850	9,484	7,235	10,033	8,340	48,800	48,850	10,324	8,075	10,873	9,180
42,850	42,900	8,658	6,431	9,207	7,514	45,850	45,900	9,498	7,249	10,047	8,354	48,850	48,900	10,338	8,089	10,887	9,194
42,900	42,950	8,672	6,439	9,221	7,528	45,900	45,950	9,512	7,263	10,061	8,368	48,900	48,950	10,352	8,103	10,901	9,208
42,950	43,000	8,686	6,446	9,235	7,542	45,950	46,000	9,526	7,277	10,075	8,382	48,950	49,000	10,366	8,117	10,915	9,222
<b>43,000</b>						<b>46,000</b>						<b>49,000</b>					
43,000	43,050	8,700	6,454	9,249	7,556	46,000	46,050	9,540	7,291	10,089	8,396	49,000	49,050	10,380	8,131	10,929	9,236
43,050	43,100	8,714	6,465	9,263	7,570	46,050	46,100	9,554	7,305	10,103	8,410	49,050	49,100	10,394	8,145	10,943	9,250
43,100	43,150	8,728	6,479	9,277	7,584	46,100	46,150	9,568	7,319	10,117	8,424	49,100	49,150	10,408	8,159	10,957	9,264
43,150	43,200	8,742	6,493	9,291	7,598	46,150	46,200	9,582	7,333	10,131	8,438	49,150	49,200	10,422	8,173	10,971	9,278
43,200	43,250	8,756	6,507	9,305	7,612	46,200	46,250	9,596	7,347	10,145	8,452	49,200	49,250	10,436	8,187	10,985	9,292
43,250	43,300	8,770	6,521	9,319	7,626	46,250	46,300	9,610	7,361	10,159	8,466	49,250	49,300	10,450	8,201	10,999	9,306
43,300	43,350	8,784	6,535	9,333	7,640	46,300	46,350	9,624	7,375	10,173	8,480	49,300	49,350	10,464	8,215	11,013	9,320
43,350	43,400	8,798	6,549	9,347	7,654	46,350	46,400	9,638	7,389	10,187	8,494	49,350	49,400	10,478	8,229	11,027	9,334
43,400	43,450	8,812	6,563	9,361	7,668	46,400	46,450	9,652	7,403	10,201	8,508	49,400	49,450	10,492	8,243	11,041	9,348
43,450	43,500	8,826	6,577	9,375	7,682	46,450	46,500	9,666	7,417	10,215	8,522	49,450	49,500	10,506	8,257	11,055	9,362
43,500	43,550	8,840	6,591	9,389	7,696	46,500	46,550	9,680	7,431	10,229	8,536	49,500	49,550	10,520	8,271	11,069	9,376
43,550	43,600	8,854	6,605	9,403	7,710	46,550	46,600	9,694	7,445	10,243	8,550	49,550	49,600	10,534	8,285	11,083	9,390
43,600	43,650	8,868	6,619	9,417	7,724	46,600	46,650	9,708	7,459	10,257	8,564	49,600	49,650	10,548	8,299	11,097	9,404
43,650	43,700	8,882	6,633	9,431	7,738	46,650	46,700	9,722	7,473	10,271	8,578	49,650	49,700	10,562	8,313	11,111	9,418
43,700	43,750	8,896	6,647	9,445	7,752	46,700	46,750	9,736	7,487	10,285	8,592	49,700	49,750	10,576	8,327	11,125	9,432
43,750	43,800	8,910	6,661	9,459	7,766	46,750	46,800	9,750	7,501	10,299	8,606	49,750	49,800	10,590	8,341	11,139	9,446
43,800	43,850	8,924	6,675	9,473	7,780	46,800	46,850	9,764	7,515	10,313	8,620	49,800	49,850	10,604	8,355	11,153	9,460
43,850	43,900	8,938	6,689	9,487	7,794	46,850	46,900	9,778	7,529	10,327	8,634	49,850	49,900	10,618	8,369	11,167	9,474
43,900	43,950	8,952	6,703	9,501	7,808	46,900	46,950	9,792	7,543	10,341	8,648	49,900	49,950	10,632	8,383	11,181	9

1999 Tax Table—Continued

If line 39 (taxable income) is—		And you are—				If line 39 (taxable income) is—		And you are—				If line 39 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—						Your tax is—						Your tax is—			
<b>50,000</b>						<b>53,000</b>						<b>56,000</b>					
50,000	50,050	10,660	8,411	11,209	9,516	53,000	53,050	11,500	9,251	12,079	10,356	56,000	56,050	12,340	10,091	13,009	11,196
50,050	50,100	10,674	8,425	11,223	9,530	53,050	53,100	11,514	9,265	12,094	10,370	56,050	56,100	12,354	10,105	13,024	11,210
50,100	50,150	10,688	8,439	11,237	9,544	53,100	53,150	11,528	9,279	12,110	10,384	56,100	56,150	12,368	10,119	13,040	11,224
50,150	50,200	10,702	8,453	11,251	9,558	53,150	53,200	11,542	9,293	12,125	10,398	56,150	56,200	12,382	10,133	13,055	11,238
50,200	50,250	10,716	8,467	11,265	9,572	53,200	53,250	11,556	9,307	12,141	10,412	56,200	56,250	12,396	10,147	13,071	11,252
50,250	50,300	10,730	8,481	11,279	9,586	53,250	53,300	11,570	9,321	12,156	10,426	56,250	56,300	12,410	10,161	13,086	11,266
50,300	50,350	10,744	8,495	11,293	9,600	53,300	53,350	11,584	9,335	12,172	10,440	56,300	56,350	12,424	10,175	13,102	11,280
50,350	50,400	10,758	8,509	11,307	9,614	53,350	53,400	11,598	9,349	12,187	10,454	56,350	56,400	12,438	10,189	13,117	11,294
50,400	50,450	10,772	8,523	11,321	9,628	53,400	53,450	11,612	9,363	12,203	10,468	56,400	56,450	12,452	10,203	13,133	11,308
50,450	50,500	10,786	8,537	11,335	9,642	53,450	53,500	11,626	9,377	12,218	10,482	56,450	56,500	12,466	10,217	13,148	11,322
50,500	50,550	10,800	8,551	11,349	9,656	53,500	53,550	11,640	9,391	12,234	10,496	56,500	56,550	12,480	10,231	13,164	11,336
50,550	50,600	10,814	8,565	11,363	9,670	53,550	53,600	11,654	9,405	12,249	10,510	56,550	56,600	12,494	10,245	13,179	11,350
50,600	50,650	10,828	8,579	11,377	9,684	53,600	53,650	11,668	9,419	12,265	10,524	56,600	56,650	12,508	10,259	13,195	11,364
50,650	50,700	10,842	8,593	11,391	9,698	53,650	53,700	11,682	9,433	12,280	10,538	56,650	56,700	12,522	10,273	13,210	11,378
50,700	50,750	10,856	8,607	11,405	9,712	53,700	53,750	11,696	9,447	12,296	10,552	56,700	56,750	12,536	10,287	13,226	11,392
50,750	50,800	10,870	8,621	11,419	9,726	53,750	53,800	11,710	9,461	12,311	10,566	56,750	56,800	12,550	10,301	13,241	11,406
50,800	50,850	10,884	8,635	11,433	9,740	53,800	53,850	11,724	9,475	12,327	10,580	56,800	56,850	12,564	10,315	13,257	11,420
50,850	50,900	10,898	8,649	11,447	9,754	53,850	53,900	11,738	9,489	12,342	10,594	56,850	56,900	12,578	10,329	13,272	11,434
50,900	50,950	10,912	8,663	11,461	9,768	53,900	53,950	11,752	9,503	12,358	10,608	56,900	56,950	12,592	10,343	13,288	11,448
50,950	51,000	10,926	8,677	11,475	9,782	53,950	54,000	11,766	9,517	12,373	10,622	56,950	57,000	12,606	10,357	13,303	11,462
<b>51,000</b>						<b>54,000</b>						<b>57,000</b>					
51,000	51,050	10,940	8,691	11,489	9,796	54,000	54,050	11,780	9,531	12,389	10,636	57,000	57,050	12,620	10,371	13,319	11,476
51,050	51,100	10,954	8,705	11,503	9,810	54,050	54,100	11,794	9,545	12,404	10,650	57,050	57,100	12,634	10,385	13,334	11,490
51,100	51,150	10,968	8,719	11,517	9,824	54,100	54,150	11,808	9,559	12,420	10,664	57,100	57,150	12,648	10,399	13,350	11,504
51,150	51,200	10,982	8,733	11,531	9,838	54,150	54,200	11,822	9,573	12,435	10,678	57,150	57,200	12,662	10,413	13,365	11,518
51,200	51,250	10,996	8,747	11,545	9,852	54,200	54,250	11,836	9,587	12,451	10,692	57,200	57,250	12,676	10,427	13,381	11,532
51,250	51,300	11,010	8,761	11,559	9,866	54,250	54,300	11,850	9,601	12,466	10,706	57,250	57,300	12,690	10,441	13,396	11,546
51,300	51,350	11,024	8,775	11,573	9,880	54,300	54,350	11,864	9,615	12,482	10,720	57,300	57,350	12,704	10,455	13,412	11,560
51,350	51,400	11,038	8,789	11,587	9,894	54,350	54,400	11,878	9,629	12,497	10,734	57,350	57,400	12,718	10,469	13,427	11,574
51,400	51,450	11,052	8,803	11,601	9,908	54,400	54,450	11,892	9,643	12,513	10,748	57,400	57,450	12,732	10,483	13,443	11,588
51,450	51,500	11,066	8,817	11,615	9,922	54,450	54,500	11,906	9,657	12,528	10,762	57,450	57,500	12,746	10,497	13,458	11,602
51,500	51,550	11,080	8,831	11,629	9,936	54,500	54,550	11,920	9,671	12,544	10,776	57,500	57,550	12,760	10,511	13,474	11,616
51,550	51,600	11,094	8,845	11,643	9,950	54,550	54,600	11,934	9,685	12,559	10,790	57,550	57,600	12,774	10,525	13,489	11,630
51,600	51,650	11,108	8,859	11,657	9,964	54,600	54,650	11,948	9,699	12,575	10,804	57,600	57,650	12,788	10,539	13,505	11,644
51,650	51,700	11,122	8,873	11,671	9,978	54,650	54,700	11,962	9,713	12,590	10,818	57,650	57,700	12,802	10,553	13,520	11,658
51,700	51,750	11,136	8,887	11,685	9,992	54,700	54,750	11,976	9,727	12,606	10,832	57,700	57,750	12,816	10,567	13,536	11,672
51,750	51,800	11,150	8,901	11,699	10,006	54,750	54,800	11,990	9,741	12,621	10,846	57,750	57,800	12,830	10,581	13,551	11,686
51,800	51,850	11,164	8,915	11,713	10,020	54,800	54,850	12,004	9,755	12,637	10,860	57,800	57,850	12,844	10,595	13,567	11,700
51,850	51,900	11,178	8,929	11,727	10,034	54,850	54,900	12,018	9,769	12,652	10,874	57,850	57,900	12,858	10,609	13,582	11,714
51,900	51,950	11,192	8,943	11,741	10,048	54,900	54,950	12,032	9,783	12,668	10,888	57,900	57,950	12,872	10,623	13,598	11,728
51,950	52,000	11,206	8,957	11,755	10,062	54,950	55,000	12,046	9,797	12,683	10,902	57,950	58,000	12,886	10,637	13,613	11,742
<b>52,000</b>						<b>55,000</b>						<b>58,000</b>					
52,000	52,050	11,220	8,971	11,769	10,076	55,000	55,050	12,060	9,811	12,699	10,916	58,000	58,050	12,900	10,651	13,629	11,756
52,050	52,100	11,234	8,985	11,784	10,090	55,050	55,100	12,074	9,825	12,714	10,930	58,050	58,100	12,914	10,665	13,644	11,770
52,100	52,150	11,248	8,999	11,800	10,104	55,100	55,150	12,088	9,839	12,730	10,944	58,100	58,150	12,928	10,679	13,660	11,784
52,150	52,200	11,262	9,013	11,815	10,118	55,150	55,200	12,102	9,853	12,745	10,958	58,150	58,200	12,942	10,693	13,675	11,798
52,200	52,250	11,276	9,027	11,831	10,132	55,200	55,250	12,116	9,867	12,761	10,972	58,200	58,250	12,956	10,707	13,691	11,812
52,250	52,300	11,290	9,041	11,846	10,146	55,250	55,300	12,130	9,881	12,776	10,986	58,250	58,300	12,970	10,721	13,706	11,826
52,300	52,350	11,304	9,055	11,862	10,160	55,300	55,350	12,144	9,895	12,792	11,000	58,300	58,350	12,984	10,735	13,722	11,840
52,350	52,400	11,318	9,069	11,877	10,174	55,350	55,400	12,158	9,909	12,807	11,014	58,350	58,400	12,998	10,749	13,737	11,854
52,400	52,450	11,332	9,083	11,893	10,188	55,400	55,450	12,172	9,923	12,823	11,028	58,400	58,450	13,012	10,763	13,753	11,868
52,450	52,500	11,346	9,097	11,908	10,202	55,450	55,500	12,186	9,937	12,838	11,042	58,450	58,500	13,026	10,777	13,768	11,882
52,500	52,550	11,360	9,111	11,924	10,216	55,500	55,550	12,200	9,951	12,854	11,056	58,500	58,550	13,040	10,791	13,784	11,896
52,550	52,600	11,374	9,125	11,939	10,230	55,550	55,600	12,214	9,965	12,869	11,070	58,550	58,600	13,054	10,805	13,799	11,910
52,600	52,650	11,388	9,139	11,955	10,244	55,600	55,650	12,228	9,979	12,885	11,084	58,600	58,650	13,068	10,819	13,815	11,924
52,650	52,700	11,402	9,153	11,970	10,258	55,650	55,700	12,242	9,993	12,900	11,098	58,650	58,700	13,082	10,833	13,830	11,938
52,700	52,750	11,416	9,167	11,986	10,272	55,700	55,750	12,256	10,007	12,916	11,112	58,700	58,750	13,096	10,847	13,846	11,952
52,750	52,800	11,430	9,181	12,001	10,286	55,750	55,800	12,270	10,021	12,931	11,126	58,750	58,800	13,110	10,861	13,861	11,966
52,800	52,850	11,444	9,195	12,017	10,300	55,800	55,850	12,284	10,035	12,947	11,140	58,800	58,850	13,124	10,875		

1999 Tax Table—Continued

If line 39 (taxable income) is—		And you are—				If line 39 (taxable income) is—		And you are—				If line 39 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—						Your tax is—						Your tax is—			
<b>59,000</b>						<b>62,000</b>						<b>65,000</b>					
59,000	59,050	13,180	10,931	13,939	12,036	62,000	62,050	14,020	11,771	14,869	12,876	65,000	65,050	14,937	12,611	15,799	13,716
59,050	59,100	13,194	10,945	13,954	12,050	62,050	62,100	14,034	11,785	14,884	12,890	65,050	65,100	14,952	12,625	15,814	13,730
59,100	59,150	13,208	10,959	13,970	12,064	62,100	62,150	14,048	11,799	14,900	12,904	65,100	65,150	14,968	12,639	15,830	13,744
59,150	59,200	13,222	10,973	13,985	12,078	62,150	62,200	14,062	11,813	14,915	12,918	65,150	65,200	14,983	12,653	15,845	13,758
59,200	59,250	13,236	10,987	14,001	12,092	62,200	62,250	14,076	11,827	14,931	12,932	65,200	65,250	14,999	12,667	15,861	13,772
59,250	59,300	13,250	11,001	14,016	12,106	62,250	62,300	14,090	11,841	14,946	12,946	65,250	65,300	15,014	12,681	15,876	13,786
59,300	59,350	13,264	11,015	14,032	12,120	62,300	62,350	14,104	11,855	14,962	12,960	65,300	65,350	15,030	12,695	15,892	13,800
59,350	59,400	13,278	11,029	14,047	12,134	62,350	62,400	14,118	11,869	14,977	12,974	65,350	65,400	15,045	12,709	15,907	13,814
59,400	59,450	13,292	11,043	14,063	12,148	62,400	62,450	14,132	11,883	14,993	12,988	65,400	65,450	15,061	12,723	15,923	13,828
59,450	59,500	13,306	11,057	14,078	12,162	62,450	62,500	14,146	11,897	15,008	13,002	65,450	65,500	15,076	12,737	15,938	13,842
59,500	59,550	13,320	11,071	14,094	12,176	62,500	62,550	14,162	11,911	15,024	13,016	65,500	65,550	15,092	12,751	15,954	13,856
59,550	59,600	13,334	11,085	14,109	12,190	62,550	62,600	14,177	11,925	15,039	13,030	65,550	65,600	15,107	12,765	15,969	13,870
59,600	59,650	13,348	11,099	14,125	12,204	62,600	62,650	14,193	11,939	15,055	13,044	65,600	65,650	15,123	12,779	15,985	13,884
59,650	59,700	13,362	11,113	14,140	12,218	62,650	62,700	14,208	11,953	15,070	13,058	65,650	65,700	15,138	12,793	16,000	13,898
59,700	59,750	13,376	11,127	14,156	12,232	62,700	62,750	14,224	11,967	15,086	13,072	65,700	65,750	15,154	12,807	16,016	13,912
59,750	59,800	13,390	11,141	14,171	12,246	62,750	62,800	14,239	11,981	15,101	13,086	65,750	65,800	15,169	12,821	16,031	13,926
59,800	59,850	13,404	11,155	14,187	12,260	62,800	62,850	14,255	11,995	15,117	13,100	65,800	65,850	15,185	12,835	16,047	13,940
59,850	59,900	13,418	11,169	14,202	12,274	62,850	62,900	14,270	12,009	15,132	13,114	65,850	65,900	15,200	12,849	16,062	13,954
59,900	59,950	13,432	11,183	14,218	12,288	62,900	62,950	14,286	12,023	15,148	13,128	65,900	65,950	15,216	12,863	16,078	13,968
59,950	60,000	13,446	11,197	14,233	12,302	62,950	63,000	14,301	12,037	15,163	13,142	65,950	66,000	15,231	12,877	16,093	13,982
<b>60,000</b>						<b>63,000</b>						<b>66,000</b>					
60,000	60,050	13,460	11,211	14,249	12,316	63,000	63,050	14,317	12,051	15,179	13,156	66,000	66,050	15,247	12,891	16,109	13,996
60,050	60,100	13,474	11,225	14,264	12,330	63,050	63,100	14,332	12,065	15,194	13,170	66,050	66,100	15,262	12,905	16,124	14,010
60,100	60,150	13,488	11,239	14,280	12,344	63,100	63,150	14,348	12,079	15,210	13,184	66,100	66,150	15,278	12,919	16,140	14,024
60,150	60,200	13,502	11,253	14,295	12,358	63,150	63,200	14,363	12,093	15,225	13,198	66,150	66,200	15,293	12,933	16,155	14,038
60,200	60,250	13,516	11,267	14,311	12,372	63,200	63,250	14,379	12,107	15,241	13,212	66,200	66,250	15,309	12,947	16,171	14,052
60,250	60,300	13,530	11,281	14,326	12,386	63,250	63,300	14,394	12,121	15,256	13,226	66,250	66,300	15,324	12,961	16,186	14,066
60,300	60,350	13,544	11,295	14,342	12,400	63,300	63,350	14,410	12,135	15,272	13,240	66,300	66,350	15,340	12,975	16,202	14,080
60,350	60,400	13,558	11,309	14,357	12,414	63,350	63,400	14,425	12,149	15,287	13,254	66,350	66,400	15,355	12,989	16,217	14,094
60,400	60,450	13,572	11,323	14,373	12,428	63,400	63,450	14,441	12,163	15,303	13,268	66,400	66,450	15,371	13,003	16,233	14,108
60,450	60,500	13,586	11,337	14,388	12,442	63,450	63,500	14,456	12,177	15,318	13,282	66,450	66,500	15,386	13,017	16,248	14,122
60,500	60,550	13,600	11,351	14,404	12,456	63,500	63,550	14,472	12,191	15,334	13,296	66,500	66,550	15,402	13,031	16,264	14,136
60,550	60,600	13,614	11,365	14,419	12,470	63,550	63,600	14,487	12,205	15,349	13,310	66,550	66,600	15,417	13,045	16,279	14,150
60,600	60,650	13,628	11,379	14,435	12,484	63,600	63,650	14,503	12,219	15,365	13,324	66,600	66,650	15,433	13,059	16,295	14,164
60,650	60,700	13,642	11,393	14,450	12,498	63,650	63,700	14,518	12,233	15,380	13,338	66,650	66,700	15,448	13,073	16,310	14,178
60,700	60,750	13,656	11,407	14,466	12,512	63,700	63,750	14,534	12,247	15,396	13,352	66,700	66,750	15,464	13,087	16,326	14,192
60,750	60,800	13,670	11,421	14,481	12,526	63,750	63,800	14,549	12,261	15,411	13,366	66,750	66,800	15,479	13,101	16,341	14,206
60,800	60,850	13,684	11,435	14,497	12,540	63,800	63,850	14,565	12,275	15,427	13,380	66,800	66,850	15,495	13,115	16,357	14,220
60,850	60,900	13,698	11,449	14,512	12,554	63,850	63,900	14,580	12,289	15,442	13,394	66,850	66,900	15,510	13,129	16,372	14,234
60,900	60,950	13,712	11,463	14,528	12,568	63,900	63,950	14,596	12,303	15,458	13,408	66,900	66,950	15,526	13,143	16,388	14,248
60,950	61,000	13,726	11,477	14,543	12,582	63,950	64,000	14,611	12,317	15,473	13,422	66,950	67,000	15,541	13,157	16,403	14,262
<b>61,000</b>						<b>64,000</b>						<b>67,000</b>					
61,000	61,050	13,740	11,491	14,559	12,596	64,000	64,050	14,627	12,331	15,489	13,436	67,000	67,050	15,557	13,171	16,419	14,276
61,050	61,100	13,754	11,505	14,574	12,610	64,050	64,100	14,642	12,345	15,504	13,450	67,050	67,100	15,572	13,185	16,434	14,290
61,100	61,150	13,768	11,519	14,590	12,624	64,100	64,150	14,658	12,359	15,520	13,464	67,100	67,150	15,588	13,199	16,450	14,304
61,150	61,200	13,782	11,533	14,605	12,638	64,150	64,200	14,673	12,373	15,535	13,478	67,150	67,200	15,603	13,213	16,465	14,318
61,200	61,250	13,796	11,547	14,621	12,652	64,200	64,250	14,689	12,387	15,551	13,492	67,200	67,250	15,619	13,227	16,481	14,332
61,250	61,300	13,810	11,561	14,636	12,666	64,250	64,300	14,704	12,401	15,566	13,506	67,250	67,300	15,634	13,241	16,496	14,346
61,300	61,350	13,824	11,575	14,652	12,680	64,300	64,350	14,720	12,415	15,582	13,520	67,300	67,350	15,650	13,255	16,512	14,360
61,350	61,400	13,838	11,589	14,667	12,694	64,350	64,400	14,735	12,429	15,597	13,534	67,350	67,400	15,665	13,269	16,527	14,374
61,400	61,450	13,852	11,603	14,683	12,708	64,400	64,450	14,751	12,443	15,613	13,548	67,400	67,450	15,681	13,283	16,543	14,388
61,450	61,500	13,866	11,617	14,698	12,722	64,450	64,500	14,766	12,457	15,628	13,562	67,450	67,500	15,696	13,297	16,558	14,402
61,500	61,550	13,880	11,631	14,714	12,736	64,500	64,550	14,782	12,471	15,644	13,576	67,500	67,550	15,712	13,311	16,574	14,416
61,550	61,600	13,894	11,645	14,729	12,750	64,550	64,600	14,797	12,485	15,659	13,590	67,550	67,600	15,727	13,325	16,589	14,430
61,600	61,650	13,908	11,659	14,745	12,764	64,600	64,650	14,813	12,499	15,675	13,604	67,600	67,650	15,743	13,339	16,605	14,444
61,650	61,700	13,922	11,673	14,760	12,778	64,650	64,700	14,828	12,513	15,690	13,618	67,650	67,700	15,758	13,353	16,620	14,458
61,700	61,750	13,936	11,687	14,776	12,792	64,700	64,750	14,844	12,527	15,706	13,632	67,700	67,750	15,774	13,367	16,636	14,472
61,750	61,800	13,950	11,701	14,791	12,806	64,750	64,800	14,859	12,541	15,721	13,646	67,750	67,800	15,789	13,381	16,651	14,486
61,800	61,850	13,964</															

1999 Tax Table—Continued

If line 39 (taxable income) is—		And you are—				If line 39 (taxable income) is—		And you are—				If line 39 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—						Your tax is—						Your tax is—			
<b>68,000</b>						<b>71,000</b>						<b>74,000</b>					
68,000	68,050	15,867	13,451	16,729	14,556	<b>71,000</b>	<b>71,050</b>	16,797	14,291	17,659	15,396	<b>74,000</b>	<b>74,050</b>	17,727	15,131	18,589	16,236
68,050	68,100	15,882	13,465	16,744	14,570	<b>71,050</b>	<b>71,100</b>	16,812	14,305	17,674	15,410	<b>74,050</b>	<b>74,100</b>	17,742	15,145	18,604	16,250
68,100	68,150	15,898	13,479	16,760	14,584	<b>71,100</b>	<b>71,150</b>	16,828	14,319	17,690	15,424	<b>74,100</b>	<b>74,150</b>	17,758	15,159	18,620	16,264
68,150	68,200	15,913	13,493	16,775	14,598	<b>71,150</b>	<b>71,200</b>	16,843	14,333	17,705	15,438	<b>74,150</b>	<b>74,200</b>	17,773	15,173	18,635	16,278
68,200	68,250	15,929	13,507	16,791	14,612	<b>71,200</b>	<b>71,250</b>	16,859	14,347	17,721	15,452	<b>74,200</b>	<b>74,250</b>	17,789	15,187	18,651	16,292
68,250	68,300	15,944	13,521	16,806	14,626	<b>71,250</b>	<b>71,300</b>	16,874	14,361	17,736	15,466	<b>74,250</b>	<b>74,300</b>	17,804	15,201	18,666	16,306
68,300	68,350	15,960	13,535	16,822	14,640	<b>71,300</b>	<b>71,350</b>	16,890	14,375	17,752	15,480	<b>74,300</b>	<b>74,350</b>	17,820	15,215	18,682	16,320
68,350	68,400	15,975	13,549	16,837	14,654	<b>71,350</b>	<b>71,400</b>	16,905	14,389	17,767	15,494	<b>74,350</b>	<b>74,400</b>	17,835	15,229	18,697	16,334
68,400	68,450	15,991	13,563	16,853	14,668	<b>71,400</b>	<b>71,450</b>	16,921	14,403	17,783	15,508	<b>74,400</b>	<b>74,450</b>	17,851	15,243	18,713	16,348
68,450	68,500	16,006	13,577	16,868	14,682	<b>71,450</b>	<b>71,500</b>	16,936	14,417	17,798	15,522	<b>74,450</b>	<b>74,500</b>	17,866	15,257	18,728	16,362
68,500	68,550	16,022	13,591	16,884	14,696	<b>71,500</b>	<b>71,550</b>	16,952	14,431	17,814	15,536	<b>74,500</b>	<b>74,550</b>	17,882	15,271	18,744	16,376
68,550	68,600	16,037	13,605	16,899	14,710	<b>71,550</b>	<b>71,600</b>	16,967	14,445	17,829	15,550	<b>74,550</b>	<b>74,600</b>	17,897	15,285	18,759	16,390
68,600	68,650	16,053	13,619	16,915	14,724	<b>71,600</b>	<b>71,650</b>	16,983	14,459	17,845	15,564	<b>74,600</b>	<b>74,650</b>	17,913	15,299	18,775	16,404
68,650	68,700	16,068	13,633	16,930	14,738	<b>71,650</b>	<b>71,700</b>	16,998	14,473	17,860	15,578	<b>74,650</b>	<b>74,700</b>	17,928	15,313	18,790	16,418
68,700	68,750	16,084	13,647	16,946	14,752	<b>71,700</b>	<b>71,750</b>	17,014	14,487	17,876	15,592	<b>74,700</b>	<b>74,750</b>	17,944	15,327	18,806	16,432
68,750	68,800	16,099	13,661	16,961	14,766	<b>71,750</b>	<b>71,800</b>	17,029	14,501	17,891	15,606	<b>74,750</b>	<b>74,800</b>	17,959	15,341	18,821	16,446
68,800	68,850	16,115	13,675	16,977	14,780	<b>71,800</b>	<b>71,850</b>	17,045	14,515	17,907	15,620	<b>74,800</b>	<b>74,850</b>	17,975	15,355	18,837	16,460
68,850	68,900	16,130	13,689	16,992	14,794	<b>71,850</b>	<b>71,900</b>	17,060	14,529	17,922	15,634	<b>74,850</b>	<b>74,900</b>	17,990	15,369	18,852	16,474
68,900	68,950	16,146	13,703	17,008	14,808	<b>71,900</b>	<b>71,950</b>	17,076	14,543	17,938	15,648	<b>74,900</b>	<b>74,950</b>	18,006	15,383	18,868	16,488
68,950	69,000	16,161	13,717	17,023	14,822	<b>71,950</b>	<b>72,000</b>	17,091	14,557	17,953	15,662	<b>74,950</b>	<b>75,000</b>	18,021	15,397	18,883	16,502
<b>69,000</b>						<b>72,000</b>						<b>75,000</b>					
69,000	69,050	16,177	13,731	17,039	14,836	<b>72,000</b>	<b>72,050</b>	17,107	14,571	17,969	15,676	<b>75,000</b>	<b>75,050</b>	18,037	15,411	18,899	16,516
69,050	69,100	16,192	13,745	17,054	14,850	<b>72,050</b>	<b>72,100</b>	17,122	14,585	17,984	15,690	<b>75,050</b>	<b>75,100</b>	18,052	15,425	18,914	16,530
69,100	69,150	16,208	13,759	17,070	14,864	<b>72,100</b>	<b>72,150</b>	17,138	14,599	18,000	15,704	<b>75,100</b>	<b>75,150</b>	18,068	15,439	18,930	16,544
69,150	69,200	16,223	13,773	17,085	14,878	<b>72,150</b>	<b>72,200</b>	17,153	14,613	18,015	15,718	<b>75,150</b>	<b>75,200</b>	18,083	15,453	18,945	16,558
69,200	69,250	16,239	13,787	17,101	14,892	<b>72,200</b>	<b>72,250</b>	17,169	14,627	18,031	15,732	<b>75,200</b>	<b>75,250</b>	18,099	15,467	18,961	16,572
69,250	69,300	16,254	13,801	17,116	14,906	<b>72,250</b>	<b>72,300</b>	17,184	14,641	18,046	15,746	<b>75,250</b>	<b>75,300</b>	18,114	15,481	18,976	16,586
69,300	69,350	16,270	13,815	17,132	14,920	<b>72,300</b>	<b>72,350</b>	17,200	14,655	18,062	15,760	<b>75,300</b>	<b>75,350</b>	18,130	15,495	18,992	16,600
69,350	69,400	16,285	13,829	17,147	14,934	<b>72,350</b>	<b>72,400</b>	17,215	14,669	18,077	15,774	<b>75,350</b>	<b>75,400</b>	18,145	15,509	19,007	16,614
69,400	69,450	16,301	13,843	17,163	14,948	<b>72,400</b>	<b>72,450</b>	17,231	14,683	18,093	15,788	<b>75,400</b>	<b>75,450</b>	18,161	15,523	19,023	16,628
69,450	69,500	16,316	13,857	17,178	14,962	<b>72,450</b>	<b>72,500</b>	17,246	14,697	18,108	15,802	<b>75,450</b>	<b>75,500</b>	18,176	15,537	19,038	16,642
69,500	69,550	16,332	13,871	17,194	14,976	<b>72,500</b>	<b>72,550</b>	17,262	14,711	18,124	15,816	<b>75,500</b>	<b>75,550</b>	18,192	15,551	19,054	16,656
69,550	69,600	16,347	13,885	17,209	14,990	<b>72,550</b>	<b>72,600</b>	17,277	14,725	18,139	15,830	<b>75,550</b>	<b>75,600</b>	18,207	15,565	19,069	16,670
69,600	69,650	16,363	13,899	17,225	15,004	<b>72,600</b>	<b>72,650</b>	17,293	14,739	18,155	15,844	<b>75,600</b>	<b>75,650</b>	18,223	15,579	19,085	16,684
69,650	69,700	16,378	13,913	17,240	15,018	<b>72,650</b>	<b>72,700</b>	17,308	14,753	18,170	15,858	<b>75,650</b>	<b>75,700</b>	18,238	15,593	19,100	16,698
69,700	69,750	16,394	13,927	17,256	15,032	<b>72,700</b>	<b>72,750</b>	17,324	14,767	18,186	15,872	<b>75,700</b>	<b>75,750</b>	18,254	15,607	19,116	16,712
69,750	69,800	16,409	13,941	17,271	15,046	<b>72,750</b>	<b>72,800</b>	17,339	14,781	18,201	15,886	<b>75,750</b>	<b>75,800</b>	18,269	15,621	19,131	16,726
69,800	69,850	16,425	13,955	17,287	15,060	<b>72,800</b>	<b>72,850</b>	17,355	14,795	18,217	15,900	<b>75,800</b>	<b>75,850</b>	18,285	15,635	19,147	16,740
69,850	69,900	16,440	13,969	17,302	15,074	<b>72,850</b>	<b>72,900</b>	17,370	14,809	18,232	15,914	<b>75,850</b>	<b>75,900</b>	18,300	15,649	19,162	16,754
69,900	69,950	16,456	13,983	17,318	15,088	<b>72,900</b>	<b>72,950</b>	17,386	14,823	18,248	15,928	<b>75,900</b>	<b>75,950</b>	18,316	15,663	19,178	16,768
69,950	70,000	16,471	13,997	17,333	15,102	<b>72,950</b>	<b>73,000</b>	17,401	14,837	18,263	15,942	<b>75,950</b>	<b>76,000</b>	18,331	15,677	19,193	16,782
<b>70,000</b>						<b>73,000</b>						<b>76,000</b>					
70,000	70,050	16,487	14,011	17,349	15,116	<b>73,000</b>	<b>73,050</b>	17,417	14,851	18,279	15,956	<b>76,000</b>	<b>76,050</b>	18,347	15,691	19,209	16,796
70,050	70,100	16,502	14,025	17,364	15,130	<b>73,050</b>	<b>73,100</b>	17,432	14,865	18,294	15,970	<b>76,050</b>	<b>76,100</b>	18,362	15,705	19,224	16,810
70,100	70,150	16,518	14,039	17,380	15,144	<b>73,100</b>	<b>73,150</b>	17,448	14,879	18,310	15,984	<b>76,100</b>	<b>76,150</b>	18,378	15,719	19,240	16,824
70,150	70,200	16,533	14,053	17,395	15,158	<b>73,150</b>	<b>73,200</b>	17,463	14,893	18,325	15,998	<b>76,150</b>	<b>76,200</b>	18,393	15,733	19,255	16,838
70,200	70,250	16,549	14,067	17,411	15,172	<b>73,200</b>	<b>73,250</b>	17,479	14,907	18,341	16,012	<b>76,200</b>	<b>76,250</b>	18,409	15,747	19,271	16,852
70,250	70,300	16,564	14,081	17,426	15,186	<b>73,250</b>	<b>73,300</b>	17,494	14,921	18,356	16,026	<b>76,250</b>	<b>76,300</b>	18,424	15,761	19,286	16,866
70,300	70,350	16,580	14,095	17,442	15,200	<b>73,300</b>	<b>73,350</b>	17,510	14,935	18,372	16,040	<b>76,300</b>	<b>76,350</b>	18,440	15,775	19,302	16,880
70,350	70,400	16,595	14,109	17,457	15,214	<b>73,350</b>	<b>73,400</b>	17,525	14,949	18,387	16,054	<b>76,350</b>	<b>76,400</b>	18,455	15,789	19,317	16,894
70,400	70,450	16,611	14,123	17,473	15,228	<b>73,400</b>	<b>73,450</b>	17,541	14,963	18,403	16,068	<b>76,400</b>	<b>76,450</b>	18,471	15,803		

1999 Tax Table—Continued

If line 39 (taxable income) is—		And you are—				If line 39 (taxable income) is—		And you are—				If line 39 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—						Your tax is—						Your tax is—			
<b>77,000</b>						<b>80,000</b>						<b>83,000</b>					
77,000	77,050	18,657	15,971	19,519	17,076	80,000	80,050	19,587	16,811	20,486	17,916	83,000	83,050	20,517	17,651	21,566	18,756
77,050	77,100	18,672	15,985	19,534	17,090	80,050	80,100	19,602	16,825	20,504	17,930	83,050	83,100	20,532	17,665	21,584	18,770
77,100	77,150	18,688	15,999	19,550	17,104	80,100	80,150	19,618	16,839	20,522	17,944	83,100	83,150	20,548	17,679	21,602	18,784
77,150	77,200	18,703	16,013	19,565	17,118	80,150	80,200	19,633	16,853	20,540	17,958	83,150	83,200	20,563	17,693	21,620	18,798
77,200	77,250	18,719	16,027	19,581	17,132	80,200	80,250	19,649	16,867	20,558	17,972	83,200	83,250	20,579	17,707	21,638	18,812
77,250	77,300	18,734	16,041	19,596	17,146	80,250	80,300	19,664	16,881	20,576	17,986	83,250	83,300	20,594	17,721	21,656	18,826
77,300	77,350	18,750	16,055	19,612	17,160	80,300	80,350	19,680	16,895	20,594	18,000	83,300	83,350	20,610	17,735	21,674	18,840
77,350	77,400	18,765	16,069	19,627	17,174	80,350	80,400	19,695	16,909	20,612	18,014	83,350	83,400	20,625	17,749	21,692	18,854
77,400	77,450	18,781	16,083	19,643	17,188	80,400	80,450	19,711	16,923	20,630	18,028	83,400	83,450	20,641	17,763	21,710	18,868
77,450	77,500	18,796	16,097	19,658	17,202	80,450	80,500	19,726	16,937	20,648	18,042	83,450	83,500	20,656	17,777	21,728	18,882
77,500	77,550	18,812	16,111	19,674	17,216	80,500	80,550	19,742	16,951	20,666	18,056	83,500	83,550	20,672	17,791	21,746	18,896
77,550	77,600	18,827	16,125	19,689	17,230	80,550	80,600	19,757	16,965	20,684	18,070	83,550	83,600	20,687	17,805	21,764	18,910
77,600	77,650	18,843	16,139	19,705	17,244	80,600	80,650	19,773	16,979	20,702	18,084	83,600	83,650	20,703	17,819	21,782	18,924
77,650	77,700	18,858	16,153	19,720	17,258	80,650	80,700	19,788	16,993	20,720	18,098	83,650	83,700	20,718	17,833	21,800	18,938
77,700	77,750	18,874	16,167	19,736	17,272	80,700	80,750	19,804	17,007	20,738	18,112	83,700	83,750	20,734	17,847	21,818	18,952
77,750	77,800	18,889	16,181	19,751	17,286	80,750	80,800	19,819	17,021	20,756	18,126	83,750	83,800	20,749	17,861	21,836	18,966
77,800	77,850	18,905	16,195	19,767	17,300	80,800	80,850	19,835	17,035	20,774	18,140	83,800	83,850	20,765	17,875	21,854	18,980
77,850	77,900	18,920	16,209	19,782	17,314	80,850	80,900	19,850	17,049	20,792	18,154	83,850	83,900	20,780	17,889	21,872	18,994
77,900	77,950	18,936	16,223	19,798	17,328	80,900	80,950	19,866	17,063	20,810	18,168	83,900	83,950	20,796	17,903	21,890	19,008
77,950	78,000	18,951	16,237	19,813	17,342	80,950	81,000	19,881	17,077	20,828	18,182	83,950	84,000	20,811	17,917	21,908	19,022
<b>78,000</b>						<b>81,000</b>						<b>84,000</b>					
78,000	78,050	18,967	16,251	19,829	17,356	81,000	81,050	19,897	17,091	20,846	18,196	84,000	84,050	20,827	17,931	21,926	19,036
78,050	78,100	18,982	16,265	19,844	17,370	81,050	81,100	19,912	17,105	20,864	18,210	84,050	84,100	20,842	17,945	21,944	19,050
78,100	78,150	18,998	16,279	19,860	17,384	81,100	81,150	19,928	17,119	20,882	18,224	84,100	84,150	20,858	17,959	21,962	19,064
78,150	78,200	19,013	16,293	19,875	17,398	81,150	81,200	19,943	17,133	20,900	18,238	84,150	84,200	20,873	17,973	21,980	19,078
78,200	78,250	19,029	16,307	19,891	17,412	81,200	81,250	19,959	17,147	20,918	18,252	84,200	84,250	20,889	17,987	21,998	19,092
78,250	78,300	19,044	16,321	19,906	17,426	81,250	81,300	19,974	17,161	20,936	18,266	84,250	84,300	20,904	18,001	22,016	19,106
78,300	78,350	19,060	16,335	19,922	17,440	81,300	81,350	19,990	17,175	20,954	18,280	84,300	84,350	20,920	18,015	22,034	19,120
78,350	78,400	19,075	16,349	19,937	17,454	81,350	81,400	20,005	17,189	20,972	18,294	84,350	84,400	20,935	18,029	22,052	19,134
78,400	78,450	19,091	16,363	19,953	17,468	81,400	81,450	20,021	17,203	20,990	18,308	84,400	84,450	20,951	18,043	22,070	19,148
78,450	78,500	19,106	16,377	19,968	17,482	81,450	81,500	20,036	17,217	21,008	18,322	84,450	84,500	20,966	18,057	22,088	19,162
78,500	78,550	19,122	16,391	19,984	17,496	81,500	81,550	20,052	17,231	21,026	18,336	84,500	84,550	20,982	18,071	22,106	19,176
78,550	78,600	19,137	16,405	19,999	17,510	81,550	81,600	20,067	17,245	21,044	18,350	84,550	84,600	20,997	18,085	22,124	19,190
78,600	78,650	19,153	16,419	20,015	17,524	81,600	81,650	20,083	17,259	21,062	18,364	84,600	84,650	21,013	18,099	22,142	19,204
78,650	78,700	19,168	16,433	20,030	17,538	81,650	81,700	20,098	17,273	21,080	18,378	84,650	84,700	21,028	18,113	22,160	19,218
78,700	78,750	19,184	16,447	20,046	17,552	81,700	81,750	20,114	17,287	21,098	18,392	84,700	84,750	21,044	18,127	22,178	19,232
78,750	78,800	19,199	16,461	20,061	17,566	81,750	81,800	20,129	17,301	21,116	18,406	84,750	84,800	21,059	18,141	22,196	19,246
78,800	78,850	19,215	16,475	20,077	17,580	81,800	81,850	20,145	17,315	21,134	18,420	84,800	84,850	21,075	18,155	22,214	19,260
78,850	78,900	19,230	16,489	20,092	17,594	81,850	81,900	20,160	17,329	21,152	18,434	84,850	84,900	21,090	18,169	22,232	19,274
78,900	78,950	19,246	16,503	20,108	17,608	81,900	81,950	20,176	17,343	21,170	18,448	84,900	84,950	21,106	18,183	22,250	19,288
78,950	79,000	19,261	16,517	20,123	17,622	81,950	82,000	20,191	17,357	21,188	18,462	84,950	85,000	21,121	18,197	22,268	19,302
<b>79,000</b>						<b>82,000</b>						<b>85,000</b>					
79,000	79,050	19,277	16,531	20,139	17,636	82,000	82,050	20,207	17,371	21,206	18,476	85,000	85,050	21,137	18,211	22,286	19,316
79,050	79,100	19,292	16,545	20,154	17,650	82,050	82,100	20,222	17,385	21,224	18,490	85,050	85,100	21,152	18,225	22,304	19,330
79,100	79,150	19,308	16,559	20,170	17,664	82,100	82,150	20,238	17,399	21,242	18,504	85,100	85,150	21,168	18,239	22,322	19,344
79,150	79,200	19,323	16,573	20,185	17,678	82,150	82,200	20,253	17,413	21,260	18,518	85,150	85,200	21,183	18,253	22,340	19,358
79,200	79,250	19,339	16,587	20,201	17,692	82,200	82,250	20,269	17,427	21,278	18,532	85,200	85,250	21,199	18,267	22,358	19,372
79,250	79,300	19,354	16,601	20,216	17,706	82,250	82,300	20,284	17,441	21,296	18,546	85,250	85,300	21,214	18,281	22,376	19,386
79,300	79,350	19,370	16,615	20,232	17,720	82,300	82,350	20,300	17,455	21,314	18,560	85,300	85,350	21,230	18,295	22,394	19,400
79,350	79,400	19,385	16,629	20,252	17,734	82,350	82,400	20,315	17,469	21,332	18,574	85,350	85,400	21,245	18,309	22,412	19,414
79,400	79,450	19,401	16,643	20,270	17,748	82,400	82,450	20,331	17,483	21,350	18,588	85,400	85,450	21,261	18,323	22,430	19,428
79,450	79,500	19,416	16,657	20,288	17,762	82,450	82,500	20,346	17,497	21,368	18,602	85,450	85,500	21,276	18,337	22,448	19,442
79,500	79,550	19,432	16,671	20,306	17,776	82,500	82,550	20,362	17,511	21,386	18,616	85,500	85,550	21,292	18,351	22,466	19,456
79,550	79,600	19,447	16,685	20,324	17,790	82,550	82,600	20,377	17,525	21,404	18,630	85,550	85,600	21,307	18,365	22,484	19,470
79,600	79,650	19,463	16,699	20,342	17,804	82,600	82,650	20,393	17,539	21,422	18,644	85,600	85,650	21,323	18,379	22,502	19,484
79,650	79,700	19,478	16,713	20,360	17,818	82,650	82,700	20,408	17,553	21,440	18,658	85,650	85,700	21,338	18,393	22,520	19,498
79,700	79,750	19,494	16,727	20,378	17,832	82,700	82,750	20,424	17,567	21,458	18,672	85,700	85,750	21,354	18,407	22,538	19,512
79,750	79,800	19,509	16,741	20,396	17,846	82,750	82,800	20,439	17,581	21,476	18,686	85,750	85,800	21,369	18,421	22,556	19,526
79,800	79,850	19,525</															



1999 Tax Table—Continued

If line 39 (taxable income) is—		And you are—				If line 39 (taxable income) is—		And you are—				If line 39 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—						Your tax is—						Your tax is—			
<b>86,000</b>						<b>89,000</b>						<b>92,000</b>					
86,000	86,050	21,447	18,491	22,646	19,596	89,000	89,050	22,377	19,331	23,726	20,436	92,000	92,050	23,307	20,171	24,806	21,362
86,050	86,100	21,462	18,505	22,664	19,610	89,050	89,100	22,392	19,345	23,744	20,450	92,050	92,100	23,322	20,185	24,824	21,377
86,100	86,150	21,478	18,519	22,682	19,624	89,100	89,150	22,408	19,359	23,762	20,464	92,100	92,150	23,338	20,199	24,842	21,393
86,150	86,200	21,493	18,533	22,700	19,638	89,150	89,200	22,423	19,373	23,780	20,478	92,150	92,200	23,353	20,213	24,860	21,408
86,200	86,250	21,509	18,547	22,718	19,652	89,200	89,250	22,439	19,387	23,798	20,494	92,200	92,250	23,369	20,227	24,878	21,424
86,250	86,300	21,524	18,561	22,736	19,666	89,250	89,300	22,454	19,401	23,816	20,509	92,250	92,300	23,384	20,241	24,896	21,439
86,300	86,350	21,540	18,575	22,754	19,680	89,300	89,350	22,470	19,415	23,834	20,525	92,300	92,350	23,400	20,255	24,914	21,455
86,350	86,400	21,555	18,589	22,772	19,694	89,350	89,400	22,485	19,429	23,852	20,540	92,350	92,400	23,415	20,269	24,932	21,470
86,400	86,450	21,571	18,603	22,790	19,708	89,400	89,450	22,501	19,443	23,870	20,556	92,400	92,450	23,431	20,283	24,950	21,486
86,450	86,500	21,586	18,617	22,808	19,722	89,450	89,500	22,516	19,457	23,888	20,571	92,450	92,500	23,446	20,297	24,968	21,501
86,500	86,550	21,602	18,631	22,826	19,736	89,500	89,550	22,532	19,471	23,906	20,587	92,500	92,550	23,462	20,311	24,986	21,517
86,550	86,600	21,617	18,645	22,844	19,750	89,550	89,600	22,547	19,485	23,924	20,602	92,550	92,600	23,477	20,325	25,004	21,532
86,600	86,650	21,633	18,659	22,862	19,764	89,600	89,650	22,563	19,499	23,942	20,618	92,600	92,650	23,493	20,339	25,022	21,548
86,650	86,700	21,648	18,673	22,880	19,778	89,650	89,700	22,578	19,513	23,960	20,633	92,650	92,700	23,508	20,353	25,040	21,563
86,700	86,750	21,664	18,687	22,898	19,792	89,700	89,750	22,594	19,527	23,978	20,649	92,700	92,750	23,524	20,367	25,058	21,579
86,750	86,800	21,679	18,701	22,916	19,806	89,750	89,800	22,609	19,541	23,996	20,664	92,750	92,800	23,539	20,381	25,076	21,594
86,800	86,850	21,695	18,715	22,934	19,820	89,800	89,850	22,625	19,555	24,014	20,680	92,800	92,850	23,555	20,395	25,094	21,610
86,850	86,900	21,710	18,729	22,952	19,834	89,850	89,900	22,640	19,569	24,032	20,695	92,850	92,900	23,570	20,409	25,112	21,625
86,900	86,950	21,726	18,743	22,970	19,848	89,900	89,950	22,656	19,583	24,050	20,711	92,900	92,950	23,586	20,423	25,130	21,641
86,950	87,000	21,741	18,757	22,988	19,862	89,950	90,000	22,671	19,597	24,068	20,726	92,950	93,000	23,601	20,437	25,148	21,656
<b>87,000</b>						<b>90,000</b>						<b>93,000</b>					
87,000	87,050	21,757	18,771	23,006	19,876	90,000	90,050	22,687	19,611	24,086	20,742	93,000	93,050	23,617	20,451	25,166	21,672
87,050	87,100	21,772	18,785	23,024	19,890	90,050	90,100	22,702	19,625	24,104	20,757	93,050	93,100	23,632	20,465	25,184	21,687
87,100	87,150	21,788	18,799	23,042	19,904	90,100	90,150	22,718	19,639	24,122	20,773	93,100	93,150	23,648	20,479	25,202	21,703
87,150	87,200	21,803	18,813	23,060	19,918	90,150	90,200	22,733	19,653	24,140	20,788	93,150	93,200	23,663	20,493	25,220	21,718
87,200	87,250	21,819	18,827	23,078	19,932	90,200	90,250	22,749	19,667	24,158	20,804	93,200	93,250	23,679	20,507	25,238	21,734
87,250	87,300	21,834	18,841	23,096	19,946	90,250	90,300	22,764	19,681	24,176	20,819	93,250	93,300	23,694	20,521	25,256	21,749
87,300	87,350	21,850	18,855	23,114	19,960	90,300	90,350	22,780	19,695	24,194	20,835	93,300	93,350	23,710	20,535	25,274	21,765
87,350	87,400	21,865	18,869	23,132	19,974	90,350	90,400	22,795	19,709	24,212	20,850	93,350	93,400	23,725	20,549	25,292	21,780
87,400	87,450	21,881	18,883	23,150	19,988	90,400	90,450	22,811	19,723	24,230	20,866	93,400	93,450	23,741	20,563	25,310	21,796
87,450	87,500	21,896	18,897	23,168	20,002	90,450	90,500	22,826	19,737	24,248	20,881	93,450	93,500	23,756	20,577	25,328	21,811
87,500	87,550	21,912	18,911	23,186	20,016	90,500	90,550	22,842	19,751	24,266	20,897	93,500	93,550	23,772	20,591	25,346	21,827
87,550	87,600	21,927	18,925	23,204	20,030	90,550	90,600	22,857	19,765	24,284	20,912	93,550	93,600	23,787	20,605	25,364	21,842
87,600	87,650	21,943	18,939	23,222	20,044	90,600	90,650	22,873	19,779	24,302	20,928	93,600	93,650	23,803	20,619	25,382	21,858
87,650	87,700	21,958	18,953	23,240	20,058	90,650	90,700	22,888	19,793	24,320	20,943	93,650	93,700	23,818	20,633	25,400	21,873
87,700	87,750	21,974	18,967	23,258	20,072	90,700	90,750	22,904	19,807	24,338	20,959	93,700	93,750	23,834	20,647	25,418	21,889
87,750	87,800	21,989	18,981	23,276	20,086	90,750	90,800	22,919	19,821	24,356	20,974	93,750	93,800	23,849	20,661	25,436	21,904
87,800	87,850	22,005	18,995	23,294	20,100	90,800	90,850	22,935	19,835	24,374	20,990	93,800	93,850	23,865	20,675	25,454	21,920
87,850	87,900	22,020	19,009	23,312	20,114	90,850	90,900	22,950	19,849	24,392	21,005	93,850	93,900	23,880	20,689	25,472	21,935
87,900	87,950	22,036	19,023	23,330	20,128	90,900	90,950	22,966	19,863	24,410	21,021	93,900	93,950	23,896	20,703	25,490	21,951
87,950	88,000	22,051	19,037	23,348	20,142	90,950	91,000	22,981	19,877	24,428	21,036	93,950	94,000	23,911	20,717	25,508	21,966
<b>88,000</b>						<b>91,000</b>						<b>94,000</b>					
88,000	88,050	22,067	19,051	23,366	20,156	91,000	91,050	22,997	19,891	24,446	21,052	94,000	94,050	23,927	20,731	25,526	21,982
88,050	88,100	22,082	19,065	23,384	20,170	91,050	91,100	23,012	19,905	24,464	21,067	94,050	94,100	23,942	20,745	25,544	21,997
88,100	88,150	22,098	19,079	23,402	20,184	91,100	91,150	23,028	19,919	24,482	21,083	94,100	94,150	23,958	20,759	25,562	22,013
88,150	88,200	22,113	19,093	23,420	20,198	91,150	91,200	23,043	19,933	24,500	21,098	94,150	94,200	23,973	20,773	25,580	22,028
88,200	88,250	22,129	19,107	23,438	20,212	91,200	91,250	23,059	19,947	24,518	21,114	94,200	94,250	23,989	20,787	25,598	22,044
88,250	88,300	22,144	19,121	23,456	20,226	91,250	91,300	23,074	19,961	24,536	21,129	94,250	94,300	24,004	20,801	25,616	22,059
88,300	88,350	22,160	19,135	23,474	20,240	91,300	91,350	23,090	19,975	24,554	21,145	94,300	94,350	24,020	20,815	25,634	22,075
88,350	88,400	22,175	19,149	23,492	20,254	91,350	91,400	23,105	19,989	24,572	21,160	94,350	94,400	24,035	20,829	25,652	22,090
88,400	88,450	22,191	19,163	23,510	20,268	91,400	91,450	23,121	20,003	24,590	21,176	94,400	94,450	24,051	20,843	25,670	22,106
88,450	88,500	22,206	19,177	23,528	20,282	91,450	91,500	23,136	20,017	24,608	21,191	94,450	94,500	24,066	20,857	25,688	22,121
88,500	88,550	22,222	19,191	23,546	20,296	91,500	91,550	23,152	20,031	24,626	21,207	94,500	94,550	24,082	20,871	25,706	22,137
88,550	88,600	22,237	19,205	23,564	20,310	91,550	91,600	23,167	20,045	24,644	21,222	94,550	94,600	24,097	20,885	25,724	22,152
88,600	88,650	22,253	19,219	23,582	20,324	91,600	91,650	23,183	20,059	24,662	21,238	94,600	94,650	24,113	20,899	25,742	22,168
88,650	88,700	22,268	19,233	23,600	20,338	91,650	91,700	23,198	20,073	24,680	21,253	94,650	94,700	24,128	20,913	25,760	22,183
88,700	88,750	22,284	19,247	23,618	20,352	91,700	91,750	23,214	20,087	24,698	21,269	94,700	94,750	24,144	20,927	25,778	22,199
88,750	88,800	22,299	19,261	23,636	20,366	91,750	91,800	23,229	20,101	24,716	21,284	94,750	94,800	24,159	20,941	25,796	22,214
88,800	88,850	22,315</															

1999 Tax Table—Continued

If line 39 (taxable income) is—		And you are—				If line 39 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—						Your tax is—			
<b>95,000</b>						<b>98,000</b>					
95,000	95,050	24,237	21,011	25,886	22,292	98,000	98,050	25,167	21,851	26,966	23,222
95,050	95,100	24,252	21,025	25,904	22,307	98,050	98,100	25,182	21,865	26,984	23,237
95,100	95,150	24,268	21,039	25,922	22,323	98,100	98,150	25,198	21,879	27,002	23,253
95,150	95,200	24,283	21,053	25,940	22,338	98,150	98,200	25,213	21,893	27,020	23,268
95,200	95,250	24,299	21,067	25,958	22,354	98,200	98,250	25,229	21,907	27,038	23,284
95,250	95,300	24,314	21,081	25,976	22,369	98,250	98,300	25,244	21,921	27,056	23,299
95,300	95,350	24,330	21,095	25,994	22,385	98,300	98,350	25,260	21,935	27,074	23,315
95,350	95,400	24,345	21,109	26,012	22,400	98,350	98,400	25,275	21,949	27,092	23,330
95,400	95,450	24,361	21,123	26,030	22,416	98,400	98,450	25,291	21,963	27,110	23,346
95,450	95,500	24,376	21,137	26,048	22,431	98,450	98,500	25,306	21,977	27,128	23,361
95,500	95,550	24,392	21,151	26,066	22,447	98,500	98,550	25,322	21,991	27,146	23,377
95,550	95,600	24,407	21,165	26,084	22,462	98,550	98,600	25,337	22,005	27,164	23,392
95,600	95,650	24,423	21,179	26,102	22,478	98,600	98,650	25,353	22,019	27,182	23,408
95,650	95,700	24,438	21,193	26,120	22,493	98,650	98,700	25,368	22,033	27,200	23,423
95,700	95,750	24,454	21,207	26,138	22,509	98,700	98,750	25,384	22,047	27,218	23,439
95,750	95,800	24,469	21,221	26,156	22,524	98,750	98,800	25,399	22,061	27,236	23,454
95,800	95,850	24,485	21,235	26,174	22,540	98,800	98,850	25,415	22,075	27,254	23,470
95,850	95,900	24,500	21,249	26,192	22,555	98,850	98,900	25,430	22,089	27,272	23,485
95,900	95,950	24,516	21,263	26,210	22,571	98,900	98,950	25,446	22,103	27,290	23,501
95,950	96,000	24,531	21,277	26,228	22,586	98,950	99,000	25,461	22,117	27,308	23,516
<b>96,000</b>						<b>99,000</b>					
96,000	96,050	24,547	21,291	26,246	22,602	99,000	99,050	25,477	22,131	27,326	23,532
96,050	96,100	24,562	21,305	26,264	22,617	99,050	99,100	25,492	22,145	27,344	23,547
96,100	96,150	24,578	21,319	26,282	22,633	99,100	99,150	25,508	22,159	27,362	23,563
96,150	96,200	24,593	21,333	26,300	22,648	99,150	99,200	25,523	22,173	27,380	23,578
96,200	96,250	24,609	21,347	26,318	22,664	99,200	99,250	25,539	22,187	27,398	23,594
96,250	96,300	24,624	21,361	26,336	22,679	99,250	99,300	25,554	22,201	27,416	23,609
96,300	96,350	24,640	21,375	26,354	22,695	99,300	99,350	25,570	22,215	27,434	23,625
96,350	96,400	24,655	21,389	26,372	22,710	99,350	99,400	25,585	22,229	27,452	23,640
96,400	96,450	24,671	21,403	26,390	22,726	99,400	99,450	25,601	22,243	27,470	23,656
96,450	96,500	24,686	21,417	26,408	22,741	99,450	99,500	25,616	22,257	27,488	23,671
96,500	96,550	24,702	21,431	26,426	22,757	99,500	99,550	25,632	22,271	27,506	23,687
96,550	96,600	24,717	21,445	26,444	22,772	99,550	99,600	25,647	22,285	27,524	23,702
96,600	96,650	24,733	21,459	26,462	22,788	99,600	99,650	25,663	22,299	27,542	23,718
96,650	96,700	24,748	21,473	26,480	22,803	99,650	99,700	25,678	22,313	27,560	23,733
96,700	96,750	24,764	21,487	26,498	22,819	99,700	99,750	25,694	22,327	27,578	23,749
96,750	96,800	24,779	21,501	26,516	22,834	99,750	99,800	25,709	22,341	27,596	23,764
96,800	96,850	24,795	21,515	26,534	22,850	99,800	99,850	25,725	22,355	27,614	23,780
96,850	96,900	24,810	21,529	26,552	22,865	99,850	99,900	25,740	22,369	27,632	23,795
96,900	96,950	24,826	21,543	26,570	22,881	99,900	99,950	25,756	22,383	27,650	23,811
96,950	97,000	24,841	21,557	26,588	22,896	99,950	100,000	25,771	22,397	27,668	23,826
<b>97,000</b>						<div style="border: 1px solid black; border-radius: 50%; padding: 20px; width: fit-content; margin: 0 auto;"> <p><b>\$100,000 or over — use the Tax Rate Schedules</b></p> </div>					
97,000	97,050	24,857	21,571	26,606	22,912						
97,050	97,100	24,872	21,585	26,624	22,927						
97,100	97,150	24,888	21,599	26,642	22,943						
97,150	97,200	24,903	21,613	26,660	22,958						
97,200	97,250	24,919	21,627	26,678	22,974						
97,250	97,300	24,934	21,641	26,696	22,989						
97,300	97,350	24,950	21,655	26,714	23,005						
97,350	97,400	24,965	21,669	26,732	23,020						
97,400	97,450	24,981	21,683	26,750	23,036						
97,450	97,500	24,996	21,697	26,768	23,051						
97,500	97,550	25,012	21,711	26,786	23,067						
97,550	97,600	25,027	21,725	26,804	23,082						
97,600	97,650	25,043	21,739	26,822	23,098						
97,650	97,700	25,058	21,753	26,840	23,113						
97,700	97,750	25,074	21,767	26,858	23,129						
97,750	97,800	25,089	21,781	26,876	23,144						
97,800	97,850	25,105	21,795	26,894	23,160						
97,850	97,900	25,120	21,809	26,912	23,175						
97,900	97,950	25,136	21,823	26,930	23,191						
97,950	98,000	25,151	21,837	26,948	23,206						

\* This column must also be used by a qualifying widow(er).

# 1999 Tax Rate Schedules



Use **only** if your taxable income (Form 1040, line 39) is \$100,000 or more. If less, use the **Tax Table**. Even though you cannot use the Tax Rate Schedules below if your taxable income is less than \$100,000, all levels of taxable income are shown so taxpayers can see the tax rate that applies to each level.

## Schedule X—Use if your filing status is **Single**

If the amount on Form 1040, line 39, is: Over—	<i>But not over—</i>	Enter on Form 1040, line 40	<i>of the amount over—</i>
\$0	\$25,750	..... 15%	\$0
25,750	62,450	<b>\$3,862.50 + 28%</b>	<b>25,750</b>
62,450	130,250	<b>14,138.50 + 31%</b>	<b>62,450</b>
130,250	283,150	<b>35,156.50 + 36%</b>	<b>130,250</b>
283,150	.....	<b>90,200.50 + 39.6%</b>	<b>283,150</b>

## Schedule Y-1—Use if your filing status is **Married filing jointly** or **Qualifying widow(er)**

If the amount on Form 1040, line 39, is: Over—	<i>But not over—</i>	Enter on Form 1040, line 40	<i>of the amount over—</i>
\$0	\$43,050	..... 15%	\$0
43,050	104,050	<b>\$6,457.50 + 28%</b>	<b>43,050</b>
104,050	158,550	<b>23,537.50 + 31%</b>	<b>104,050</b>
158,550	283,150	<b>40,432.50 + 36%</b>	<b>158,550</b>
283,150	.....	<b>85,288.50 + 39.6%</b>	<b>283,150</b>

## Schedule Y-2—Use if your filing status is **Married filing separately**

If the amount on Form 1040, line 39, is: Over—	<i>But not over—</i>	Enter on Form 1040, line 40	<i>of the amount over—</i>
\$0	\$21,525	..... 15%	\$0
21,525	52,025	<b>\$3,228.75 + 28%</b>	<b>21,525</b>
52,025	79,275	<b>11,768.75 + 31%</b>	<b>52,025</b>
79,275	141,575	<b>20,216.25 + 36%</b>	<b>79,275</b>
141,575	.....	<b>42,644.25 + 39.6%</b>	<b>141,575</b>

## Schedule Z—Use if your filing status is **Head of household**

If the amount on Form 1040, line 39, is: Over—	<i>But not over—</i>	Enter on Form 1040, line 40	<i>of the amount over—</i>
\$0	\$34,550	..... 15%	\$0
34,550	89,150	<b>\$5,182.50 + 28%</b>	<b>34,550</b>
89,150	144,400	<b>20,470.50 + 31%</b>	<b>89,150</b>
144,400	283,150	<b>37,598.00 + 36%</b>	<b>144,400</b>
283,150	.....	<b>87,548.00 + 39.6%</b>	<b>283,150</b>

---

## Your Rights as a Taxpayer

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The first part of this section explains some of your most important rights as a taxpayer. The second part explains the examination, appeal, collection, and refund processes.

### Declaration of Taxpayer Rights

**Protection of your rights.** IRS employees will explain and protect your rights as a taxpayer throughout your contact with us.

**Privacy and confidentiality.** The IRS will not disclose to anyone the information you give us, except as authorized by law. You have the right to know why we are asking you for information, how we will use it, and what happens if you do not provide requested information.

**Professional and courteous service.** If you believe that an IRS employee has not treated you in a professional, fair, and courteous manner, you should tell that employee's supervisor. If the supervisor's response is not satisfactory, you should write to your IRS District Director or Service Center Director.

**Representation.** You may either represent yourself or, with proper written authorization, have someone else represent you in your place. Your representative must be a person allowed to practice before the IRS, such as an attorney, certified public accountant, or enrolled agent. If you are in an interview and ask to consult such a person, then we must stop and reschedule the interview in most cases.

You can have someone accompany you at an interview. You may make sound recordings of any meetings with our examination, appeal, or collection personnel, provided you tell us in writing 10 days before the meeting.

**Payment of only the correct amount of tax.** You are responsible for paying only the correct amount of tax due under the law—no more, no less. If you cannot pay all of your tax when it is due, you may be able to make monthly installment payments.

**Help with unresolved tax problems.** See *How To Get More Information*.

**Appeals and judicial review.** If you disagree with us about the amount of your tax liability or certain collection actions, you have the right to ask the Appeals Office to review your case. You may also ask a court to review your case.

**Relief from certain penalties and interest.** The IRS will waive penalties when allowed by law if you can show you acted reasonably and in good faith or relied on the incorrect advice of an IRS employee. We will waive interest that is the result of certain errors or delays caused by an IRS employee.

### Examinations, Appeals, Collections, and Refunds

#### Examinations (Audits)

We accept most taxpayers' returns as filed. If we inquire about your return or select it for examination, it does not suggest that you are dishonest. The inquiry or examination may or may not result in more tax. We may close your case without change; or, you may receive a refund.

The process of selecting a return for examination usually begins in one of two ways. First, we use computer programs to identify returns that may have incorrect amounts. These programs may be based on information returns, such as Forms 1099 and W-2, on studies of past examinations, or on certain issues identified by compliance projects. Second, we use information from outside sources that indicates that a return may have incorrect amounts. These sources may include newspapers, public records, and individuals. If we determine that the information is accurate and reliable, we may use it to select a return for examination.

Publication 556, *Examination of Returns, Appeal Rights, and Claims for Refund*, explains the rules and procedures that we follow in examinations. The following sections give an overview of how we conduct examinations.

**By mail.** We handle many examinations and inquiries by mail. We will send you a letter with either a request for more information or a reason why we believe a change to your return

may be needed. You can respond by mail or you can request a personal interview with an examiner. If you mail us the requested information or provide an explanation, we may or may not agree with you, and we will explain the reasons for any changes. Please do not hesitate to write to us about anything you do not understand.

**By interview.** If we notify you that we will conduct your examination through a personal interview, or you request such an interview, you have the right to ask that the examination take place at a reasonable time and place that is convenient for both you and the IRS. If our examiner proposes any changes to your return, he or she will explain the reasons for the changes. If you do not agree with these changes, you can meet with the examiner's supervisor.

**Repeat examinations.** If we examined your return for the same items in either of the 2 previous years and proposed no change to your tax liability, please contact us as soon as possible so we can see if we should discontinue the examination.

#### Appeals

If you do not agree with the examiner's proposed changes, you can appeal them to the Appeals Office of the IRS. Most differences can be settled without expensive and time-consuming court trials. Your appeal rights are explained in detail in both Publication 5, *Your Appeal Rights and How To Prepare a Protest If You Don't Agree*, and Publication 556, *Examination of Returns, Appeal Rights, and Claims for Refund*.

If you do not wish to use the Appeals Office or disagree with its findings, you may be able to take your case to the U.S. Tax Court, U.S. Court of Federal Claims, or the U.S. District Court where you live. If you take your case to court, the IRS will have the burden of proving certain facts if you kept adequate records to show your tax liability, cooperated with the IRS, and meet certain other conditions. If the court agrees with you on most issues in your case, and finds that our position was largely unjustified, you may be able to recover some of your administrative and litigation costs. You will not be eligible to

recover these costs unless you tried to resolve your case administratively, including going through the appeals system, and you gave us the information necessary to resolve the case.

#### Collections

Publication 594, *The IRS Collection Process*, explains your rights and responsibilities regarding payment of federal taxes. It describes:

- What to do when you owe taxes. It describes what to do if you get a tax bill and what to do if you think your bill is wrong. It also covers making installment payments, delaying collection action, and submitting an offer in compromise.
- IRS collection actions. It covers liens, releasing a lien, levies, releasing a levy, seizures and sales, and release of property.

Publication 1660, *Collection Appeal Rights*, explains your collection appeal rights for liens, levies, seizures, and installment agreement terminations.

**Innocent spouse relief.** Generally, both you and your spouse are responsible, jointly and individually, for paying the full amount of any tax, interest, or penalties due on your joint return. However, you may not have to pay the tax, interest, and penalties related to your spouse (or former spouse).

New tax law changes make it easier to qualify for innocent spouse relief and add two other ways for you to get relief. For more information, see Publication 971, *Innocent Spouse Relief*, and Form 8857, *Request for Innocent Spouse Relief (And Separation of Liability and Equitable Relief)*.

#### Refunds

You may file a claim for refund if you think you paid too much tax. You must generally file the claim within 3 years from the date you filed your original return or 2 years from the date you paid the tax, whichever is later. The law generally provides for interest on your refund if it is not paid within 45 days of the date you filed your return or claim for refund. Publication 556, *Examination of Returns, Appeals Rights, and Claims for Refund*, has more information on refunds.

## How To Get More Information

You can order free publications and forms, ask tax questions, and get more information from the IRS in several ways. By selecting the method that is best for you, you will have quick and easy access to tax help.

This section describes several ways you can get free tax help from the IRS and from community volunteers (during the regular filing season).

**Free tax services.** To find out what services are available, get Publication 910, *Guide to Free Tax Services*. It contains a list of free tax publications and an index of tax topics. It also describes other free tax information services, including tax education and assistance programs and a list of TeleTax topics.



### Personal computer.

With your personal computer and modem, you can access the IRS on the Internet at [www.irs.gov](http://www.irs.gov). While visiting our Web Site, you can select:

- *Frequently Asked Tax Questions* (located under *Taxpayer Help & Ed*) to find answers to questions you may have.
- *Forms & Pubs* to download forms and publications or search for forms and publications by topic or keyword.
- *Fill-in Forms* (located under *Forms & Pubs*) to enter information while the form is displayed and then print the completed form.
- *Tax Info For You* to view Internal Revenue Bulletins published in the last few years.
- *Tax Regs in English* to search regulations and the Internal Revenue Code (under *United States Code (USC)*).
- *Digital Dispatch* and *IRS Local News Net* (both located under *Tax Info For Business*) to receive our electronic newsletters on hot tax issues and news.
- *Small Business Corner* (located under *Tax Info For Business*) to get information on starting and operating a small business.

You can also reach us with your computer using File Transfer Protocol at [ftp.irs.gov](ftp://ftp.irs.gov)



**TaxFax Service.** Using the phone attached to your fax machine, you can receive forms and instructions by calling **703-368-9694**. Follow the directions from the prompts. When you order forms, enter the catalog number for the form you need. The items you request will be faxed to you.



**Phone.** Many services are available by phone.

- *Ordering forms, instructions, and publications.* Call **1-800-829-3676** to order current and prior year forms, instructions, and publications.
- *Asking tax questions.* Call the IRS with your tax questions at **1-800-829-1040**.
- *TTY/TDD equipment.* If you have access to TTY/TDD equipment, call **1-800-829-4059** to ask tax questions or to order forms and publications.
- *TeleTax topics.* Call **1-800-829-4477** to listen to pre-recorded messages covering various tax topics. You can also check on the status of your 1999 refund using TeleTax's Refund Information service.

**Evaluating the quality of our telephone services.** To ensure that IRS representatives give accurate, courteous, and professional answers, we evaluate the quality of our telephone services in several ways.

- A second IRS representative sometimes monitors live telephone calls. That person only evaluates the IRS assistant and does not keep a record of any taxpayer's name or tax identification number.
- We sometimes record telephone calls to evaluate IRS assistants objectively. We hold these recordings no longer than one week and use them only to measure the quality of assistance.
- We value our customers' opinions. Throughout this year, we will be surveying our customers for their opinions on our service.



**Walk-in.** You can walk in to many post offices, libraries, and IRS offices to pick up certain forms, instructions, and publications. Also, some libraries and IRS offices have:

- An extensive collection of products available to print from a CD-ROM or photocopy from reproducible proofs.
- The Internal Revenue Code, regulations, Internal Revenue Bulletins, and Cumulative Bulletins available for research purposes.



**Mail.** You can send your order for forms, instructions, and publications to the Distribution Center nearest to you and receive a response within 10 workdays after your request is received. Find the address that applies to your part of the country.

- **Western part of U.S.:**  
Western Area Distribution Center  
Rancho Cordova, CA 95743-0001
- **Central part of U.S.:**  
Central Area Distribution Center  
P.O. Box 8903  
Bloomington, IL 61702-8903
- **Eastern part of U.S. and foreign addresses:**  
Eastern Area Distribution Center  
P.O. Box 85074  
Richmond, VA 23261-5074



**CD-ROM.** You can order IRS Publication 1796, *Federal Tax Products on CD-ROM*, and obtain:

- Current tax forms, instructions, and publications.
- Prior-year tax forms, instructions, and publications.
- Popular tax forms which may be filled-in electronically, printed out for submission, and saved for recordkeeping.
- Internal Revenue Bulletins.

The CD-ROM can be purchased from National Technical Information Service (NTIS) by calling **1-877-233-6767** or on the Internet at [www.irs.gov/cdorders](http://www.irs.gov/cdorders). The first release is available in mid-

December and the final release is available in late January.

IRS Publication 3207, *Small Business Resource Guide*, is an interactive CD-ROM that contains information important to small businesses. It is available in mid-February. You can get one free copy by calling **1-800-829-3676**.

**Written tax questions.** You can send your written tax questions to your IRS District Director. You should get an answer in about 30 days. If you do not have the address, you can get it by calling **1-800-829-1040**. (Do not send tax questions with your return.)

**Braille tax materials.** Braille tax materials are available for review from Regional Libraries for the Visually Impaired in conjunction with the National Library Service for the Blind and Physically Handicapped. To locate your nearest library, write to:

National Library Service for the Blind and Physically Handicapped  
Library of Congress  
1291 Taylor St., NW  
Washington, DC 20542

Braille materials currently available for review include this publication, Publication 334, *Tax Guide for Small Business*, and Forms 1040, 1040A, and 1040EZ and their instructions.

**Assistance with your return.** Assistors are available in many IRS offices throughout the country to help you prepare your own return. To find the location of the IRS office nearest you, look in the phone book under "United States Government, Internal Revenue Service" or call **1-800-829-1040**. If you want help with your tax return, you should bring in your tax package, Forms W-2 and 1099, and any other information (such as a copy of last year's return) that will help the assistant to help you.

At all IRS offices you can also get tax forms, publications, and help with questions about IRS notices or bills.

**Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE).** Free help from volunteers is available in most communities. After completing IRS training, these volunteers help prepare basic tax returns for taxpayers with special needs, including low-income people, persons with disabilities, the elderly, and non-English-speaking people. At

some of these offices, you can file your tax return electronically. See *IRS e-file* in chapter 1 for information on electronic filing.

Call the IRS for the location of the volunteer assistance site near you. Or, for the location of an American Association of Retired Persons (AARP) Tax-Aide site in your community, call 1-888-AARPNOW or visit their Internet Web Site at [www.aarp.org/taxaide/home.htm](http://www.aarp.org/taxaide/home.htm).

**Help with unresolved tax issues.** If you have attempted to deal with an IRS problem unsuccessfully, you should contact your Taxpayer Advocate.

The Taxpayer Advocate represents your interests and concerns within the IRS by protecting your rights and resolving problems that have not been fixed through normal channels. While Taxpayer Advocates can-

not change the tax law or make a technical tax decision, they can clear up problems that resulted from previous contacts and ensure that your case is given a complete and impartial review.

To contact your Taxpayer Advocate:

- Call the Taxpayer Advocate's toll-free number: 1-877-777-4778.

- Call the IRS toll-free number (1-800-829-1040).

- Call, write, or fax the Taxpayer Advocate office in your area.

- Call 1-800-829-4059 if you are a TTY/TDD user.

For more information, get Publication 1546, *The Taxpayer Advocate Service of the IRS*.

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