



2007 VITA/TCE

Publication 678

Volunteer Student Guide

(for use in preparing Tax Year 2007 Returns)

Coming together to strengthen communities through free volunteer tax return preparation programs

For the most up to date tax products, information and other training options such as Link & Learn Taxes visit www.irs.gov.

IRS
Department of the Treasury
Internal Revenue Service
www.irs.gov
Publication 678 (Rev. 2007)
Catalog Number 61206C

Technical Updates

Tax law changes implemented after this product was published may cause various forms, tables, and worksheets to change. The supplemental changes (if any) are normally available in mid-December on www.irs.gov (keyword: Community Network).

Technical updates are also conveyed in Volunteer Quality Alerts during the filing season on www.irs.gov. Also, consult your course facilitator and/or site coordinator.

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.

IRS
Department of the Treasury
Internal Revenue Service
www.irs.gov

Confidentiality Statement

All tax information received from taxpayers in your volunteer capacity is strictly confidential and should not, under any circumstances, be disclosed to unauthorized individuals and should be properly safeguarded.

All persons, scenarios and addresses appearing in this product are fictitious. Any resemblance to persons living or dead is purely coincidental.

Table of Contents

Basic Course

Introduction and Administrative Guidelines

Intermediate Course

Introduction and Administrative Guidelines

Advanced Course

Introduction and Administrative Guidelines

Military/International Course

Introduction and Administrative Guidelines

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308

WAGE AND INVESTMENT DIVISION

November 9, 2007

Welcome Volunteers!

First, let me thank you for agreeing to serve as a volunteer. Assisting taxpayers in a volunteer site is a rewarding and valuable experience for thousands of volunteers every year. Your work directly impacts communities by increasing the financial stability of individuals and families across the country.

I encourage you to actively participate in the training exercises. This hands-on experience will ensure you leave with the skills needed for preparing accurate tax returns.

This course is unlike many classes you've taken because it's open book and there's no need to memorize everything. Instead, this training relies on role play scenarios and demonstrations to enhance your learning experience.

Since it's important we all ***Keep An Eye On Quality***, your training will include demonstrations of quality tools such as *Form 13614, Intake and Interview Sheet*, and *Form 8158, Quality Review Checklist*. You'll find these tools and practice exercises will clearly define your role and give you a good idea of what to expect while working at a site. To supplement your training, *Publication 4012, VITA/TCE Resource Guide* is a useful reference tool that contains helpful charts, exhibits and interview tips.

Additionally, your instructors will talk with you about safeguarding taxpayer information. This is especially important as the IRS and our partners want to guarantee taxpayer privacy is always protected.

As we continue to improve the training process. I welcome your suggestions and ideas for enhancing these materials and your overall training experience. Provide your feedback using the forms in your training kit or by sending it directly to this address:

Internal Revenue Service
Stop 45-WI – VITA/TCE Training
401 West Peachtree Street, NW
Atlanta, GA 30308

Enjoy your class! I know you will be a success. Again, thank you for volunteering!

Sincerely,

Julieta D. Garcia
Acting Director,
Stakeholder Partnerships,
Education & Communication

STUDENT NOTES

Important Tax Law Changes for 2007

Standard Deduction Amount Increased. The standard deduction has increased to:

- **$10,700**—Married filing jointly or qualifying widow(er),
- **$7,850**—Head of household, and
- **$5,350**—Single or married filing separately.

Limit on Itemized Deductions Increased. Taxpayers with an adjusted gross income above a certain amount may lose part of their itemized deductions. In 2007, this phase out begins at **$156,400** (**$78,200** if married filing separately).

Exemption Amount Increased. The amount each taxpayer can deduct for each exemption increased to **$3,400.**

Phaseout of Personal Exemption Amount. Taxpayers with an adjusted gross income above a certain amount may lose part of their deductions for personal exemptions. In 2007, the phaseout begins at:

- **$117,300** for married filing separately,
- **$156,400** for single individuals,
- **$195,500** for head of household, and
- **$234,600** for married filing jointly and qualifying widow(er)s.

Standard Business-Related Mileage. The standard mileage rate for the cost of operating a car, van, pickup, or panel truck in 2007 is **48.5** cents per mile for all business miles driven.

Medical and Move-Related Mileage. For 2007, the standard mileage rate for the cost of operating a vehicle for medical reasons or as part of a deductible move is **20** cents per mile driven.

Charitable Contributions. New record-keeping requirements for cash contributions: Regardless of the amount, no deduction is allowable unless the taxpayer keeps documentation in the form of a cancelled check, bank copy of check, bank statement with date, amount, and name of charity noted, or written communication from the charity with date and amount included.

Earned Income Credit (EIC) Amounts Increased. For 2007, the maximum credits are:

- **$4,716**—Two or more qualifying children,
- **$2,853**—One qualifying child, and
- **$428**—No children.

Earned Income Amount Increased. To be eligible for a full or partial credit, the taxpayer must have an earned income of at least $1 but less than:

- **$37,783** (**$39,783** if married filing jointly) and two or more qualifying children,
- **$33,241** (**$35,241** if married filing jointly) and one qualifying child, and
- **$12,590** (**$14,590** if married filing jointly) with no qualifying children.

Investment Income Amount Increased. Taxpayers whose investment income is more than **$2,900** cannot claim EIC.

Nontaxable Combat Pay Election Extended. Taxpayers may elect to have nontaxable combat pay included in their earned income when figuring the earned income credit for 2007. This election was previously due to expire at the end of 2006 but was extended through 2007.

Earned Income Amount for Additional Child Tax Credit. For 2007, the minimum earned income used to figure the additional child tax credit increased to **$11,750.**

Social Security and Medicare Taxes. For Social Security tax, the maximum amount of 2007 wages subject to the tax has increased to **$97,500.** For Medicare tax, all wages are subject to the tax.

Income Limits Increased for Hope and Lifetime Learning Credits. For 2007, the amount of the Hope and Lifetime Learning credit is phased out for taxpayers whose modified adjusted gross income (MAGI) is between **$47,000** and **$57,000** (**$94,000** and **$114,000** for a joint return). Taxpayers cannot claim an education credit if their MAGI is **$57,000** or more (**$114,000** or more for a joint return).

Income Limits Increased for Student Loan Interest Deduction. For 2007, the amount of student loan interest deduction is phased out if your modified adjusted gross income (MAGI) is between $55,000 and $70,000 (between $110,000 and $140,000 if married filing jointly). You cannot take the deduction if your MAGI if over $70,000 ($140,000 if filing jointly).

Deductible Long-Term Care Premium Limits Increased. For 2007, the maximum amount of qualified long-term care premiums includable as medical expenses has increased. Qualified long-term care premiums up to the amounts shown below can be included as medical expenses on Form 1040, Schedule A.

- **$290**—Age 40 or under
- **$550**—Age 41 to 50
- **$1,110**—Age 51 to 60
- **$2,950**—Age 61 to 70
- **$3,680**—Age 71 and over

Note: The limit on premiums is for each person.

Income Limits Increased for Education Savings Bond Interest Exclusion. For 2007, the amount of the interest exclusion is phased out for taxpayers—married filing jointly or qualifying widow(er)s—whose modified adjusted gross income (MAGI) is between **$98,400** and **$128,400.** If the MAGI is **$128,400** or more, no deduction is allowed. For all other filing statuses, the interest exclusion is phased out for taxpayers whose MAGI is between **$65,600** and **$80,600.** If the MAGI is **$80,600** or more, no deduction is allowed.

Self-Employment Tax. The maximum amount of net earnings subject to the Social Security part of the self-employment tax has increased to **$97,500.**

Modified Adjusted Gross Income (AGI) Limit for Traditional IRA Contributions Increased. If a taxpayer is covered by a retirement plan at work, the deduction for contributions to a traditional IRA is reduced (phased out) if the modified AGI is:

- More than **$83,000** but less than **$103,000** for married couples filing a joint return or qualifying widow(er)s,
- More than **$52,000** but less than **$62,000** for a single individual or head-of-household return, or
- Less than **$10,000** for married couples filing separate returns.

If you live with your spouse or file a joint return and the spouse is covered by a plan at work and you are not, your deduction is phased out if your AGI is more than $156,000 but less than $166,000. The credit is not allowed if AGI is $166,000 or more.

Modified AGI Limit for Retirement Savings Contribution Credit Increased. For 2007 the taxpayer may be able to claim the credit if modified AGI not more than:

- **$52,000** for married filing jointly,
- **$39,000** for head-of-household, and
- **$26,000** for single, married filing separately, or qualifying widow(er)s.

Mortgage Insurance Premium Deduction. Premiums that taxpayers pay or accrue for "qualified mortgage insurance" during 2007 in connection with home acquisition debt on a qualified home are deductible as an itemized deduction. The deduction is subject to limitations due to income. The expense will be claimed in the "Interest You Paid" section of Schedule A.

Foreign Earned Income and Housing Exclusion. Certain taxpayers can exclude income earned in foreign countries. For 2007, the maximum exclusion amount increased to **$85,700.** The base housing amount has increased to **$37.57** per day or **$13,712** for the entire calendar year.

Foreign Tax Credit. Some income categories have been eliminated for tax years beginning after 2006. Income that previously fell in those categories will now either be passive or general limitation income.

Expired Tax Benefits. The following tax benefits related to Hurricanes Katrina, Rita, and Wilma have expired and will not apply in 2007:

- Tax-favored treatment of qualified hurricane distributions from eligible retirement plans
- Increased limits and delayed repayment on loans from qualified employer plans
- Special rules regarding support provided for individuals due to displacements
- Increased limits and expanded definition of qualified education expenses for Hope and lifetime learning credits
- Additional exemption for housing-displaced individuals
- Nonbusiness debt exclusion

Additional Expired Tax Benefits.

- The Qualified Electric Vehicle Credit cannot be claimed for any vehicle purchased after 2006.
- The Claim for Refund of Federal Telephone Excise Tax was only for tax year 2006. Your 2006 tax return can be amended to claim this refund. Taxpayers who qualified but had no other filing requirements can still file 1040EZ-T (2006).

Note: At the time this publication went to print, Congress was considering legislation that may not be referenced above. If such legislation is passed that might impact these training materials, a supplement will be issued. You can visit www.**irs.gov** for current information.

INTRODUCTION AND ADMINISTRATIVE GUIDELINES

Welcome to the Tax Year 2007 Volunteer Income Tax Assistance (VITA) and the Tax Counseling for the Elderly (TCE) Programs. We're glad you decided to take advantage of this challenging, yet rewarding experience as an important player in the tax administration process.

INTRODUCTION AND OBJECTIVES

This **course** is designed to guide you through the basics of tax law and tax return preparation. You will learn the answers to frequently asked questions and how to assist taxpayers in filing an accurate and complete return.

After completing this course, you should be able to:

- Solicit appropriate information from the taxpayer to complete an accurate tax return.
- Determine if the taxpayer must/should file a return.
- Accurately fill out Forms 1040, 1040A, and 1040EZ.
- Accurately answer questions about filing a tax return.
- Accurately and appropriately select and fill out additional forms and schedules that should accompany each return.
- Find answers to any questions regarding filing a tax return.
- Test and become certified to be a volunteer tax return preparer.

In this **lesson** you will learn about:

- The course of study as presented in this book and the associated workbook, test, and reference books.
- Important information about the VITA/TCE program and your role in it.
- The approved VITA/TCE process for preparing tax returns.

After completing this lesson you should be able to describe:

- The major features of this course's materials.
- The major components of the VITA/TCE process.
- The rights and responsibilities of a volunteer.
- Resources to assist the volunteer.

ALERT

This lesson covers administrative matters that impact all volunteers. It is part of the basic, intermediate, advanced, and military/international courses.

ALERT

We encourage you to reinforce the tax law training in this course at your own pace using the online course **(Link and Learn Taxes)** at www.**irs.gov** (keyword: volunteer training).

THE COURSE

There are five courses presented in this publication. They are Basic, Intermediate, Advanced, Military, and International.

- **Basic** – This course covers the completion of wage earner type returns.
- **Intermediate** – This course covers completion of returns from wage earners, those who receive pension income, and more complex Forms 1040. It requires completion of the Basic course.
- **Advanced** – This course covers the completion of the full scope of returns. It requires completion of the Basic and Intermediate courses.
- **Military** – This course covers the full scope of returns presented by members of the Armed Forces, Reserve and National Guard. It requires completion of the Basic and Intermediate courses.
- **International** – This course covers the completion of returns for taxpayers (non-Military) living outside the United States and assisted by volunteers working at United States Embassies and Consulates or other areas. It requires completion of the Basic and Intermediate courses.

Training Kit

Your training kit contains the materials you need to become a certified volunteer tax return preparer as follows:

- Student Text (Publication 678)
- Comprehensive Problems and Exercises (Publication 678-W)
- Test (Form 6744)
- Volunteer Resource Guide (Publication 4012—for use in the classroom and at the site)
- VITA/TCE Plastic Bag, (Publication 1278)
- Course Evaluation Form 13222

It is very important that you assist only with returns, forms, and supporting schedules for which you have been trained and certified. If you go beyond your training, you risk making errors and causing difficulties for those you wish to help. Refer taxpayers with very complex returns, or with portions of returns that are beyond the scope of your training, to seek assistance from a paid professional tax preparer.

There are separate training supplements available for the following categories of taxpayers:

- Foreign Students and Scholars—Publication 678-FS
- Tax Issues for Puerto Rico—Publication 678-PR

Draft Copies of Forms

Forms imprinted in this publication were current as of the "draft as of date" shown on each product. Final copies of the products can be found at www.**irs.gov** and may have supplemental changes. The charts and exhibits can be found in Publication 17 and the tax return instruction booklets (in most cases). **Be sure to compare the final forms with those in this publication. If there are differences, then make sure you understand the reasons for the changes before helping taxpayers with their returns.**

Lesson Features

- **Introduction and Objectives.** Each lesson or segment contains a brief introductory statement and a list of objectives.
- **Interview, Quality Review, and Reference Tools.** Each lesson of this training manual will include tips on how to conduct a thorough interview using Form 13614. Each lesson will also highlight the importance of conducting a strong quality review on each aspect of the return and the whole return. The reference material in Publication 4012 is highlighted in each lesson. Publication 17 should also be used. You should refer to these publications with every return you prepare. Use all these important tools to take the guesswork out of return preparation.
- **Sidebar Features.** Sidebar features appear in the outer margins (left and right) of the text. These boxed features emphasize important points presented in the lesson or provide additional related information.
  - **Potential Pitfalls** point out commonly made errors and indicate ways to avoid these errors.
  - **Alert!** identifies pending legislation, tax law changes, or tax form changes that were expected but not enacted or in final form when this publication went to print.
- **Exercises and Exhibits.** The exercises and problems in the lessons and Publication 678-W (included in your training kit) allow you to apply the knowledge gained in each lesson. The information in this course can be reinforced using the web-based volunteer training—Link and Learn Taxes at www.**irs.gov.**

  The exhibits are numbered consecutively within each lesson. Many of the exercises contain exhibits of blank forms, or parts of forms, that you must complete.
- **Summing Up This Section, Segment, or Lesson.** This feature in each lesson provides a summary of the main points covered in the lesson. The summaries provide a comprehensive overview of the lesson content.

Testing and Certification

VITA/TCE training includes a certification process. Volunteers working in the programs as tax preparers, instructors, quality reviewers, and electronic return transmitters must become certified by passing a test. The tests for all courses are open book with all references and resource materials available to the volunteer. Volunteers are expected to complete the test on their own. Taking the test in groups or with outside assistance could prove to be a disservice to the taxpayer.

Volunteers who do not pass the test may review the course material and retake the test in Form 6744. If volunteers do not achieve the minimum required score on the Test or the Retest, they are encouraged to participate in the program in another capacity such as greeting/screening, publicity/communication, or resource acquisition.

Volunteers may test at any time. However, they must complete and pass the IRS test before teaching others how to complete tax returns, prepare tax returns, transmit tax returns, or conduct quality reviews on completed returns.

Note: All VITA/TCE volunteers who teach tax law, prepare tax returns, conduct quality reviews, and/or act as the Electronic Return Originator (ERO) transmitting and correcting for transmission returns must be certified by passing the IRS test for the 2007 tax law.

This includes all law and tax professionals, IRS employees, and volunteers in any required capacity.

Link and Learn Taxes at www.**irs.gov** (keyword: volunteer training) can provide you immediate test results, online certification, and retesting if necessary.

Course Evaluations

Evaluations are an important part of our continuing efforts to improve the training offered to volunteers. We appreciate feedback as it is a vital contribution to the success of the program.

A course evaluation form is included in your kit. It's helpful to take notes during the course for ease in completing the evaluation. The evaluation will be taken up at the end of class by the facilitator.

The evaluations are anonymous. They will not be read by the facilitator. They are sent to a vendor who provides reports on areas of training needing improvement.

The Lessons and the Return Forms

Exhibits 1, 2, and 3 that follow will help you to correlate the information presented in the course to the three tax return forms—Form 1040, 1040A, and 1040EZ.

Exhibit 1

Form **1040** Department of the Treasury—Internal Revenue Service
U.S. Individual Income Tax Return 2007 (99) IRS Use Only—Do not write or staple in this space.

For the year Jan. 1–Dec. 31, 2007, or other tax year beginning , 2007, ending , 20 — OMB No. 1545-0074

Label (See instructions on page 16.) **Use the IRS label.** Otherwise, please print or type.

LABEL HERE

Your first name and initial | Last name | **Your social security number**

If a joint return, spouse's first name and initial | La… | **Spouse's social security number**

Home address (number and street). If you have a P.O… | You **must** enter your SSN(s) above.

City, town or post office, state, and ZIP code. If you have a foreign address, see page 16.

Introduction and Administrative Guidelines and Lesson 14 – Finishing the Return

Checking a box below will not change your tax or refund.

Presidential Election Campaign ▶ Check here if you, or your spouse if filing jointly, want $3 to go to this fund (see page 16) ▶ ☐ **You** ☐ **Spouse**

Filing Status

Check only one box.

1 ☐ Single
2 ☐ Married fi…
3 ☐ Married filing separately. Enter spouse's SSN above and full name here. ▶
4 ☐ Head of household (with qualifying person). (See page 17.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶
5 ☐ Qualifying widow(er) with dependent child (see page 17)

Lesson 2 – Filing Status and Filing Requirement

Exemptions

6a ☐ **Yourself.** If someone can claim you as a dependent, **do not** check box 6a
b ☐ **Spouse**
c **Dependents:**

(1) First name Last name	(2) Dependent's social security number	(3) Dependent's relationship to you	(4) ✓ if qualifying child for child tax credit (see page 19)
			☐
			☐
			☐
			☐

Lesson 1 – Taxpayer Identification Numbers and Exemptions

If more than four dependents, see page 19.

d Total number of exemptions claimed

Boxes checked on 6a and 6b
No. of children on 6c who:
- lived with you
- did not live with you due to divorce or separation (see page 20)

Dependents on 6c not entered above
Add numbers on lines above ▶

Income

Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld.

If you did not get a W-2, see page 23.

Enclose, but do not attach, any payment. Also, please use **Form 1040-V.**

7 Wages, salaries, tips, etc. Attach Form(s) W-2 — 7
8a **Taxable** interest. Attach Schedule B if required — 8a
b **Tax-exempt** interest. **Do not** include on line 8a — 8b
9a Ordinary dividends. Attach Schedule B if required — 9a
b Qualified dividends (see page 23) — 9b
10 Taxable refunds, credits, or offsets of state and local income taxes (see page 24) — 10
11 Alimony received — 11
12 Business income or (loss). Attach Schedule C or C-EZ — 12
13 Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐ — 13
14 Other gains or (losses). Attach Form 4797 — 14
15a IRA distributions — 15a — b Taxable amount (see page 25) — 15b
16a Pensions and annuities — 16a — b Taxable amount (see page 26) — 16b
17 Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E — 17
18 Farm income or (loss). Attach Schedule F — 18
19 Unemployment compensation — 19
20a Social security benefits — 20a — b Taxable amount (see page 27) — 20b
21 Other income. List type and amount (see page 29) — 21
22 Add the amounts in the far right column for lines 7 through 21. This is your **total income** ▶ — 22

Lesson 3 – Income

Lesson 12 – Sale of Home

Lesson 12 – Sale of Stock

Lesson 13 – Sale of Home

Lesson 11 – Pensions

Adjusted Gross Income

23 Educator expenses (see page XX) — 23
24 Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ — 24
25 Health savings account deduction. Attach Form 8889 — 25
26 — 26
27 …edule SE — 27
28 Self-employed SEP, SIMPLE, and qualified plans — 28
29 Self-employed health insurance deduction (see page 29) — 29
30 Penalty on early withdrawal of savings — 30
31a Alimony paid b Recipient's SSN ▶ — 31a
32 IRA deduction (see page 31) — 32
33 Student loan interest deduction (see page 33) — 33
34 Tuition and fees deduction. Attach Form 8917 — 34
35 Domestic production activities deduction. Attach Form 8903 — 35
36 Add lines 23 through 31a and 32 through 35 — 36
37 Subtract line 36 from line 22. This is your **adjusted gross income** ▶ — 37

Lesson 10 – Adjustments to Income

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see page 80. Cat. No. 11320B Form **1040** (2007)

Exhibit 1 continued

Form 1040 (2007) Page **2**

Tax and Credits

38 Amount from line 37 (adjusted gross income) . . . 38

39a Check if: { ☐ **You** were born before January 2, 1943, ☐ Blind. } **Total boxes checked ▶ 39a**
{ ☐ **Spouse** was born before January 2, 1943, ☐ Blind. }

Lesson 9 – Miscellaneous Credit

b If your spouse itemizes on a separate return or you were a dual-status alien, see page 34 and check here ▶39b

Standard Deduction for—

- People who checked any box on line 39a or 39b **or** who can be claimed as a dependent, see page 34.
- All others:

Single or Married filing separately, $5,350

Married filing jointly or Qualifying widow(er), $10,700

Head of household, $7,850

40 **Itemized deductions** (from Schedule A) **or** your **standard deduction** (see left margin) . . 40

41 Subtract line 40 from line 38 . . . 41

42 If line 38 is $117,300 or less, multiply $3,400 by the total number of exemptions claimed on line 6d. If line 38 is over $117,300, see the worksheet on page XX . . .

Lesson 4 – Deductions and Tax Computation

43 **Taxable income.** Subtract line 42 from line 41. If line 42 is more than line 41, enter -0-

44 **Tax** (see page 36). Check if any tax is from: **a** ☐ Form(s) 8814 **b** ☐ Form 4972 **c** ☐ Form(s) 888

45 **Alternative minimum tax** (see page 39). Attach Form 6251 . . .

46 Add lines 44 and 45 . . . ▶ 46

47 Credit for child and dependent care expenses. Attach Form 2441 47

48 Credit for the elderly or the disabled. Attach Schedule R .

Lesson 7 – Child and Dependent Care Credit

49 Education credits. Attach Form 8863 . . .

50 Residential energy credits. Attach Form 5695 . . . 50

Lesson 8 – Education Credits

51 Foreign tax credit. Attach Form 1116 if required . 51

52 Child tax credit (see page XX). Attach Form 8901 if required 52

Lesson 6 – Child Tax Credit

53 Retirement savings contributions credit. Attach Form 8880. 53

54 Credits from: **a** ☐ Form 8396 **b** ☐ Form 8859 **c** ☐ Form 8839 54

55 Other credits: **a** ☐ Form 3800 **b** ☐ Form 8801 **c** ☐ Form______ 55

Lesson 9 – Miscellaneous Credits

56 Add lines 47 through 55. These are your **total credits** . . . 56

57 Subtract line 56 from line 46. If line 56 is more than line 46, enter -0- . . . ▶ 57

Other Taxes

58 Self-employment tax. Attach Schedule SE . . . 58

59 Unreported social security and Medicare tax from: **a** ☐ Form 4137 **b** ☐ Form 8919 59

60 Additional tax on IRAs, other qualified retirement plans, etc. Attach Form 5329 if required .

61 Advance earned income credit payments from Form(s) W-2, box 9 . . .

62 Household employment taxes. Attach Schedule H . . .

63 Add lines 57 through 62. This is your **total tax** . . . ▶

Lesson 3 – Income
Lesson 11 – Pensions

Payments

64 Federal income tax withheld from Forms W-2 and 1099 . . 64

65 2007 estimated tax payments and amount applied from 2006 return 65

Lesson 14 – Finishing the Return

If you have a qualifying child, attach Schedule EIC.

66a **Earned income credit (EIC)** . . . 66a

b Nontaxable combat pay election ▶ 66b

Lesson 5 – Earned Income Credit

67 Excess social security and tier 1 RRTA tax withheld (see page 60) 67

68 Additional child tax credit. Attach Form 8812 . . . 68

69 Amount paid with request for extension to file (see page 60) 69

Lesson 6 – Child Tax Credit

70 Payments from: **a** ☐ Form 2439 **b** ☐ Form 4136 **c** ☐ Form 8885 . 70

71 Refundable credit for prior year minimum tax from Form 8801, line 27 71

72 Add lines 64, 65, 66a, and 67 through 71. These are your **total payments** . . . ▶ 72

Refund

Direct deposit? See page 61 and fill in 74b, 74c, and 74d, or Form 8888.

73 If line 72 is more than line 63, subtract line 63 from line 72. This is the amount you **overpaid** 73

74a Amount of line 73 you want **refunded to you.** If Form 8888 is attached, check here ▶ ☐

▶ b Routing number ▶ c Type: ☐ Checking ☐ Savings

▶ d Account number

Lesson 14 – Finishing the Return

75 Amount of line 73 you want **applied to your 2008 estimated tax** ▶ 75

Amount You Owe

76 **Amount you owe.** Subtract line 72 from line 63. For details on how to pay, see page 62 ▶ 76

77 Estimated tax penalty (see page 62) . . . 77

Third Party Designee

Do you want to allow another person to discuss this return with the IRS (see page 63)? ☐ **Yes.** Complete the following. ☐ **No**

Designee's name ▶ **Lesson 14 – Finishing the Return**) Personal identification number (PIN) ▶

Sign Here

Joint return? See page 17.
Keep a copy for your records.

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.

Your signature | Date | Your occupation | Daytime phone number ( )

Lesson 14 – Finishing the Return

Spouse's signature. If a joint return, **both** must sign. | Date | Spouse's occupation

Paid Preparer's Use Only

Preparer's signature ▶ | Date | Check if self-employed ☐ | Preparer's SSN or PTIN

Firm's name (or yours if self-employed), address, and ZIP code ▶

Lesson 14 – Finishing the Return

Enter your SIDN here

Form **1040** (2007)

Exhibit 2

Form **1040A** Department of the Treasury—Internal Revenue Service

U.S. Individual Income Tax Return (99) 2007

IRS Use Only—Do not write or staple in this space.

OMB No. 1545-0074

Introduction and Administrative Guidelines and Lesson 14 – Finishing the Return

Label (See page 18.)

LABEL HERE

Use the IRS label. Otherwise, please print or type.

Your first name and initial | Last name | **Your social security number**

If a joint return, spouse's first name and initial | Last name | **Spouse's social security number**

Home address (number and street). If you have a P.O. box, see page

City, town or post office, state, and ZIP code. If you have a foreign address, see page 18.

▲ You **must** enter your SSN(s) above. ▲

Presidential Election Campaign ▶ Check here if you, or your spouse if filing jointly, want $3 to go to this fund (see page 18) ▶

Checking a box below will not change your tax or refund. ☐ **You** ☐ **Spouse**

Filing status Check only one box.

Lesson 2 – Filing Status and Filing Requirement

1 ☐ Single

2 ☐ Married filing jo

3 ☐ Married filing se full name here.

4 ☐ Head of household (with qualifying person). (See page 19.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶

5 ☐ Qualifying widow(er) with dependent child (see page 20)

Exemptions

6a ☐ **Yourself.** If someone can claim you as a dependent, **do not** check box 6a.

b ☐ **Spouse**

Lesson 1 – Taxpayer Identification Numbers and Exemptions

c **Dependents:**

If more than six dependents, see page 21.

(1) First name Last name	**(2)** Dependent's social security number	**(3)** Dependent's relationship to you	(4) ✓ if qualifying child for child tax credit (see page 21)
			☐
			☐
			☐
			☐
			☐
			☐

Boxes checked on 6a and 6b

No. of children on 6c who:

• lived with you

• did not live with you due to divorce or separation (see page 22)

Dependents on 6c not entered above

d Total number of exemptions claimed.

Add numbers on lines above ▶

Income

Attach Form(s) W-2 here. Also attach Form(s) 1099-R if tax was withheld.

If you did not get a W-2, see page 24.

Enclose, but do not attach, any payment.

Lesson 3 – Income

7 Wages, salaries, tips, etc. Attach Form(s) W-2. 7

8a **Taxable** interest. Attach Schedule 1 if required. 8a

b **Tax-exempt** interest. **Do not** include on line 8a. 8b

9a Ordinary dividends. Attach Schedule 1 if required. 9a

b Qualified dividends (see page 25). 9b

10 Capital gain distributions (see page 25). 10

11a IRA distributions. 11a | 11b Taxable amount (see page 25). 11b

12a Pensions and annuities. 12a | 12b Taxable amount (see page 26). 12b

13 Unemployment compensation and Alaska Permanent Fund dividends. 13

14a Social security benefits. 14a | 14b Taxable amount (see page 28). 14b

15 Add lines 7 through 14b (far right column). This is your **total income.** ▶ 15

Adjusted gross income

Lesson 10 – Adjustments

16 Educator expenses (see page 28). 16

17 IRA deduction (see page 28). 17

18 Student loan interest deduction (see page 31). 18

19 Tuition and fees deduction. Attach Form 8917. 19

20 Add lines 16 through 19. These are your **total adjustments.** 20

21 Subtract line 20 from line 15. This is your **adjusted gross income.** ▶ 21

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see page 58. Cat. No. 11327A Form **1040A** (2007)

Exhibit 2 continued

Form 1040A (2007) Page **2**

Tax, credits, and payments

Standard Deduction for—
- People who checked any box on line 23a or 23b **or** who can be claimed as a dependent, see page 32.
- All others:

Single or Married filing separately, $5,350

Married filing jointly or Qualifying widow(er), $10,700

Head of household, $7,850

22 Enter the amount from line 21 (adjusted gross income). 22

23a Check if: ☐ **You** were born before January 2, 1943, ☐ Blind; ☐ **Spouse** was born before January 2, 1943, ☐ Blind — **Total boxes checked** ▶ 23a ☐

b If you are married filing separately and your spouse itemizes deductions, see page 32 and check here ▶ 23b ☐

24 Enter your **standard deduction** (see left margin).

25 Subtract line 24 from line 22. If line 24 is more than line 22, enter -0-.

26 If line 22 is $117,300 or less, multiply $3,400 by the total number of exemption claimed on line 6d. If line 22 is over $117,300, see the worksheet on page 32. 26

27 Subtract line 26 from line 25. If line 26 is more than line 25, enter -0-. This is your **taxable income.** ▶ 27

28 **Tax,** including any alternative minimum tax (see page 32).

29 Credit for child and dependent care expenses. Attach Schedule 2. 29

30 Credit for the elderly or the disabled. Attach Schedule 3. 30

31 Education credits. Attach Form 8863. 31

32 Child tax credit (see page 37). Attach Form 8901 if required. 32

33 Retirement savings contributions credit. Attach Form 8880. 33

34 Add lines 29 through 33. These are your **total credits.**

35 Subtract line 34 from line 28. If line 34 is more than line 28, enter -

36 Advance earned income credit payments from Form(s) W-2, box

37 Add lines 35 and 36. This is your **total tax.**

If you have a qualifying child, attach Schedule EIC.

38 Federal income tax withheld from Forms W-2 and 1099. 38

39 2007 estimated tax payments and amount applied from 2006 return. 39

40a **Earned income credit (EIC).** 40a

b Nontaxable combat pay election. 40b

41 Additional child tax credit. Attach Form 8812. 41

42 Add lines 38, 39, 40a, and 41. These are your **total payments.** ▶ 42

Lesson 4 – Deductions and Tax Computation

Lesson 7 – Child and Dependent Care

Lesson 8 – Education Credit

Lesson 6 – Child Tax Credit

Lesson 9 – Miscellaneous Credits

Lesson 3 – Income
Lesson 5 – Earned Income Credit
Lesson 14 – Finishing the Return

Lesson 5 – Earned Income Credit

Lesson 6 – Child Tax Credit

Refund

Direct deposit? See page 53 and fill in 44b, 44c, and 44d or Form 8888.

43 If line 42 is more than line 37, subtract line 37 from line 42. This is the amount you **overpaid.**

44a Amount of line 43 you want **refunded to you.** If Form 8888 is attached, check here ▶ ☐ 44a

▶ b Routing number ▶ c Type: ☐ Checking ☐ Savings

▶ d Account number

45 Amount of line 43 you want **applied to your 2008 estimated tax.** 45

Lesson 14 – Finishing the Return

Amount you owe

46 **Amount you owe.** Subtract line 42 from line 37. For details on h to pay, see page 54.

47 Estimated tax penalty (see page 54). 47

Lesson 14 – Finishing the Return

Third party designee

Do you want to allow another person to discuss this return with the IRS (see page 55)? ☐ **Yes.** Complete the following. ☐ **No**

Designee's name ▶ no. ▶ ( ) Personal identification number (PIN) ▶

Lesson 14 – Finishing the Return

Sign here

Joint return? See page 18.

Keep a copy for your records.

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 accurately list all amounts and sources of income I received during the tax year. Declaration of preparer (other than the taxpayer) is based on all information of which the preparer has any knowledge.

Your signature | Date | Your occupation | Daytime phone number

Spouse's signature. If a joint return, **both** must sign. | Date | Spouse's occupatio

Lesson 14 – Finishing the Return

Paid preparer's use only

Preparer's signature | Date | Check if self-employed ☐ | Preparer's SSN or PTIN

Firm's name (or yours if self-employed), address, and ZIP code | EIN | Phone no. ( )

Lesson 14 – Finishing the Return

Enter your SIDN here

Printed on recycled paper Form **1040A** (2007)

Exhibit 3

Form **1040EZ**

Department of the Treasury—Internal Revenue Service

Income Tax Return for Single and Joint Filers With No Dependents (99) **2007**

OMB No. 1545-0074

Introduction and Administrative Guidelines and Lesson 14 – Finishing the Return

Label

(See page 11.)

Use the IRS label. Otherwise, please print or type.

LABEL HERE

Your first name and initial | Last name | **Your social security number**

If a joint return, spouse's first name and initial | Last name | **Spouse's social security number**

Home address (number and street). If you have a P.O. box, see pa

City, town or post office, state, and ZIP code. If you have a foreign address, see page 11.

▲ You **must** enter your SSN(s) above. ▲

Checking a box below will not change your tax or refund.

Presidential Election Campaign (page 11)

Check here if you, or your spouse if a joint return, want $3 to go to this fund . . . . ▶ ☐ **You** ☐ **Spouse**

Income

Attach Form(s) W-2 here.

Enclose, but do not attach, any payment.

Lesson 3 – Income

1 Wages, salaries, and tips. This should be shown in box 1 of your Form(s) W-2. Attach your Form(s) W-2. 1

2 Taxable interest. If the total is over $1,500, you cannot use Form 1040EZ.

3 Unemployment compensation and Alaska Permanent Fund dividends (see page 13). 3

4 Add lines 1, 2, and 3. This is your **adjusted gross income.** 4

5 If someone can claim you (or your spouse if a joint return) as a dependent, check the applicable box(es) below and enter the amount from the worksheet on back.

☐ **You** ☐ **Spouse**

If no one can claim you (or your spouse if a joint return), enter $8,750 if **single;** $17,500 if **married filing jointly.** See back for explanation.

Lesson 2 – Filing Status and Filing Requirement

6 Subtract line 5 from line 4. If line 5 is larger than line 4, enter -0-. This is your **taxable income.**

Lesson 4 – Deductions and Tax Computations

Payments and tax

7 Federal income tax withheld from box 2 of your Form(s) W-2.

8a **Earned income credit (EIC).**

Lesson 5 – Earned Income Credit

b Nontaxable combat pay election. 8b

9 Add lines 7 and 8a. These are your **total payments.**

Lesson 14 – Finishing the Return

10 **Tax.** Use the amount on **line 6 above** to find your tax in the tax table on pages 24–32 of the booklet. Then, enter the tax from the table on this line. 10

Refund

Have it directly deposited! See page 18 and fill in 11b, 11c, and 11d or Form 8888.

11a If line 9 is larger than line 10, subtract line 10 from line 9. This is your **refund.** If Form 8888 is attached, check here ▶ ☐

Lesson 14 – Finishing the Return

▶ b Routing number ▶ c Type: ☐ Checking ☐ Savings

▶ d Account number

Amount you owe

12 If line 10 is larger than line 9, subtract line 9 from line 10. This is the **amount you owe.** For details on how to pay, see page 19.

Lesson 14 – Finishing the Return

Third party designee

Do you want to allow another person to discuss this return with the IRS (see page 20)? ☐ **Yes.** Complete the following. ☐ **No**

Designee's name ▶ Phone no. ▶ ( )

Lesson 14 – Finishing the Return

Sign here

Joint return? See page 11.

Keep a copy for your records.

Under penalties of perjury, I declare that I have examined this return, and to the best of my knowledge and belief, it is true, correct, and accurately lists all amounts and sources of income I received during the tax year. Declaration of preparer (other than the taxpayer) is based on all information of which the preparer has any knowledge.

Yo | Date | Your occupation | Daytime phone number ( )

Lesson 14 – Finishing the Return

Spouse's signature. If a joint return, **both** must sign. | Date | Spouse's occupation

Paid preparer's use only

Preparer's signature ▶ | Date | Check if self-employed ☐ | Preparer's SSN or PTIN

Enter your SIDN here

Firm's name (or yours if self-employed), address, and ZIP code ▶ | EIN | Phone no. ( )

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see page 22. Cat. No. 11329W Form **1040EZ** (2007)

Intake and Interview

The two most important aspects of the return preparation process are a comprehensive conversation/interview with the taxpayer and the use of all the tools available to interpret and apply the tax law accurately.

The starting point of the process is the Intake and Interview Sheet, Form 13614, or an approved alternative form, or software interview worksheet. Please take a moment to familiarize yourself with Form 13614, shown in Publication 4012. This form will be used throughout the training manual to complete exercises and problems on tax return preparation. An Intake and Interview Sheet or electronic alternative should be used at all sites to engage customers in the process of preparing their returns.

Note: Partners may use forms provided in the TaxWise® software in lieu of IRS Form 13614 or partner-developed intake and interview sheet. When choosing this option, to ensure all required questions are asked, the volunteer preparer must use the following TaxWise® forms:

1. Main Information Sheet, Interview Sheet (Interview Questions)
2. Dependent Worksheet (Dependent Exemption Eligibility Due Diligence Worksheet)
3. Unmarried Head of Household Worksheet (Head of Household Worksheet), and
4. Earned Income Credit Worksheet found in TaxWise® software

Partners choosing this method should provide the TaxWise® forms for use during the quality review process.

The Five-Step Interview Process

As you become experienced with interviewing taxpayers, you will develop your own interview approach which should encompass the five steps found in the 5-step Interview Process chart shown in Publication 4012.

During the interview you should:

- Review each taxpayer's response to the critical intake questions.
- Ask if they are uncertain about any responses. Ask probing questions to clarify—status, relationships, technical tax law points, etc.
- Explain the tax preparation process and encourage them to ask questions throughout the interview.
- Use the intake sheet along with the Interview Tips and charts in Publication 4012 to probe for accurate and complete information.

If you are not shown the video about the interview process (Publication 4475), ask your instructor how you can obtain a copy.

Screening and Probing Interviews

To complete accurate returns, you must ask questions about the taxpayer and, if needed, the taxpayer's family. Involving the taxpayer in the entire process creates a learning experience for both you and the taxpayer and provides the best opportunity to prepare an accurate return. Volunteers must gather sufficient information to establish identity, filing status, dependents, income, adjustments, deductions, credits, and direct deposit information. Using an integrated approach of significant taxpayer involvement, standard intake questions, decision tree application, use of Form 13614, Intake and Interview Sheet (or partner-developed or software tool which captures the same information), use of the reference materials (Publication 4012 and Publication 17) as well as the quality review process will deliver an accurate, quality return. You should not assume that prior year information or general information provided by the taxpayer is complete.

During the interview process, the taxpayer may become defensive or upset with so many questions; even so, continue to ask for the information you need to accurately complete the return. However, deal with the taxpayer's emotional state:

- If silent ("Tell me more about . . .").
- If upset (paraphrase or define any terms that may be unfamiliar to the taxpayer).
- Check your own comfort level.
- Respond to any misunderstandings.
- Continue with effective questioning and active listening.
- Allow adequate response time.
- Avoid making assumptions.

Critical Intake Documents—Proof of Identity, Income, etc.

A critical component of the intake process is in confirming that the taxpayer has the required documentation and he or she is the person reflected on the documentation. The three steps in this process include:

- **Review Income/Reporting Documents.** The taxpayer must provide information depicting the taxpayer's income sources such as wage and earning statements (Form W-2), and investment income (Forms 1099, etc.) as discussed in Lesson 3, Income.
- **Confirm Taxpayer's Identity.** The taxpayer should provide proof of identity in order to receive tax preparation services. One may be valid picture identification—a United States driver's license or state identification card, school photo, military identification card, passport, or visa. Additional forms of identification are discussed later in Lesson 1.

- **Confirm Taxpayer Identification Number(s).** Each person listed on the taxpayer's return must be identified by a taxpayer identification number. This includes the taxpayer, the taxpayer's spouse (if married), and any dependents claimed on the return. The taxpayer identification number (TIN) will be a social security number (SSN), an individual taxpayer identification number (ITIN), or an adoption individual taxpayer identification number (ATIN). All are discussed in detail in Lesson 1.

The taxpayer's return cannot be prepared without the above information. If the taxpayer has the required proofs of identity, income reporting documents, taxpayer identification number(s) and the taxpayer's income is within the scope of the program, a more intensive, probing interview is required to complete an accurate return.

In those instances where the taxpayer appears to qualify for VITA/TCE assistance but does not have all the required documentation (W-2s, TINs, etc.), you may provide guidance, as explained in Lessons 1 and 3, for acquiring the missing or incomplete documentation. If the taxpayer has the required documentation but his or her tax situation is outside the scope of the VITA/TCE programs and/or your VITA/TCE certification, you should courteously restate the scope of the program and encourage the taxpayer to seek services elsewhere. The Site Coordinator may help provide additional assistance.

Quality Return Process

The IRS has an ongoing initiative to improve and/or enhance the quality of returns prepared at VITA/TCE sites. An accurate return is the most important aspect of providing quality service to the taxpayer; it establishes credibility and integrity in the program and in the volunteer who prepared the return. Throughout this training material you will be introduced to the major components of the VITA/TCE return preparation process, including:

- Understanding and applying tax law.
- Screening and interviewing taxpayers (Intake and Interview Sheet).
- Using references, resources, and tools.
- Conducting quality reviews.

Your ability to prepare an accurate return can be measured in two ways:

1. The testing and certification process is used initially to gauge your understanding of the return preparation process.
2. The results of quality reviews of the returns you prepare demonstrate your proficiency in all aspects of the process.

As discussed in Lesson 14, Finishing the Return, each VITA/TCE site must have an on-site Quality Review Process. Consult with your site coordinator or sponsor for more information.

Scope of the Program

It is vital for you to assist only with returns, supporting schedules, and forms for which you have been trained and certified. Remember to refer taxpayers with tax situations outside your scope of training, experience, and certification to your site coordinator and/or a paid preparer.

The training resources and tools discussed in this text support the completion of the following returns and attachments:

- Form 1040, United States Individual Income Tax Return, and 1040 Schedules—A, B, C–EZ, D, EIC, R, & SE
- Form 1040A, United States Individual Income Tax Return, and 1040A Schedules 1, 2, 3, and EIC
- Form 1040EZ, Income Tax Return for Single and Joint Filers with No Dependents
- Form 1040V, Payment Voucher
- Form1040-ES, Estimated Tax for Individuals
- Form 2441, Child and Dependent Care Credit
- Form 8812, Additional Child Tax Credit
- Form 8863, Education Credits
- Form 8880, Credit for Qualified Retirement Savings Contributions

The training does not address the more complex tax laws associated with the following forms and schedules:

- Form 1040 Schedule C, Profit or Loss from Business
- Form 1040 Schedule E, Supplemental Income or Loss (exception: Military/International Course)
- Form 1040X, Amended United States Individual Income Tax Return
- Form 2106, Employee Business Expenses (exception: Military/International Course)
- Form 3903, Moving Expenses (exception: Military/International Course)
- Form 8888 Direct Deposit of Refund
- Form 5695 Residential Energy Credit
- Form 8910 Alternative Motor Vehicle Credit

Every year, thousands of volunteers assist millions of people in preparing and filing their tax returns. These volunteers have certain protections under the Volunteer Protection Act of 1997, Public Law 105-19 (42 United States Code sections 14501 et seq.). The Act applies to volunteers who perform services for nonprofit organizations or governmental entities and receive no compensation other than reasonable reimbursement or allowance for expenses actually incurred, or any other things of value in lieu of compensation not to exceed $500 per year. The term “volunteer” includes those serving as director, officer, trustee, or direct service volunteer. Consult your site coordinator for a copy of the Act or you may obtain a copy through an Internet search engine by typing Volunteer Protection Act of 1997 in the search box.

Standards of Conduct

As a VITA/TCE volunteer, you accept the responsibility to provide quality service and to uphold the ethical standards of the program. You sign an agreement to adhere to these standards:

- Treat all taxpayers professionally, with courtesy and respect.
- Safeguard the confidentiality of taxpayer information.
- Apply the tax laws equitably and accurately to the best of your ability.
- Prepare only the returns within the scope of your training, for example, Basic or Advanced.
- Exercise reasonable care in the use and protection of equipment and supplies.
- **Do not** solicit business from taxpayers you assist or use knowledge you gained about them for any direct or indirect personal benefit for you or any other individual or organization.
- **Do not** accept payment from the taxpayer for services provided. **Note:** You may receive compensation from your site sponsor.

Note: Only paid preparers should accept payment for preparing a tax return. Paid preparers are legally liable under federal law for the returns they prepare; VITA/TCE volunteers are not. This means you cannot accept payment of any kind for preparing a federal tax return or for providing any other tax-related assistance.

Privacy and Confidentiality

The VITA/TCE programs and the volunteers working in them share a responsibility to ensure the public trust and to guarantee to the fullest extent possible the confidentiality of all personal information received in the course of working with taxpayers. In an age where personal information can be manipulated so easily, the responsibility to protect the information you receive during tax return preparation is even more important.

Taxpayers who use the VITA/TCE services provide significant personal information which is a prime target for identity theft. The volunteers, partners, and sponsors of VITA/TCE programs have established an outstanding standard of privacy and confidentiality over 35 years of public service. You have accepted the responsibility to continue this tradition of excellence and public trust.

Taxpayers will trust that all the information you receive from them is protected from disclosure. To maintain this trust:

- **Do not** share any personal information with anyone who does not have a need to know. Examples of "need to know" would include: obtaining guidance on return completion or tax law interpretation, quality review of completed returns, and/or electronic return transmission.
- **Do not** retain taxpayers' documents for a follow-up visit. All tax returns should be prepared at the site with the taxpayer present. When the taxpayer does not have all the information necessary (like a missing W-2 or cost information for stock sold) to complete the return, all documents should be returned to the taxpayer with an invitation to return with everything when it is available.

Note: Due to the use of dedicated space and increased physical security, military VITA sites are exempt from this standard. VITA sites located on military installations and staffed by military volunteers can retain taxpayer data for subsequent visits to prepare returns. This exception does not remove the "need to know" standard. Privacy and confidentiality standards are required of all sites.

ALERT

Do not solicit or accept payment for the services you provide. During an interview on a local television news program, a taxpayer complained that she had been improperly charged a fee by a VITA/TCE participant to have her tax return prepared. She found out through the IRS that VITA/TCE participants were supposed to prepare tax returns for free.

Program Integrity

Do not prepare a tax return when you suspect an individual is not providing truthful information.

You are completely authorized as a volunteer preparer to not prepare a return. Some individuals may attempt to defraud the government by filing false tax returns. If you have any question at all about the validity of the information provided by a taxpayer or are uncomfortable with a taxpayer situation, discuss your concern with your site coordinator or other individual in charge of the site. Together, you can make the decision to diplomatically explain the confusion or concern, if possible, or simply refer the taxpayer to a paid tax preparer.

Volunteer Site Credentials

The VITA/TCE Wallet Card, Form 13645, was created to acknowledge the accomplishment of certified volunteers as well as to assist internal and external stakeholders with identifying certified volunteers. Your site coordinator or instructor may provide you a wallet card when you pass the IRS test. If you are provided with a Wallet Card, you should bring it to the tax preparation site for identification purposes.

Do not prepare returns outside the scope of your training and certification.

Site Identification Number (SIDN)

Each paper or electronically filed return should be identified with the appropriate site identification number (SIDN) to ensure that all volunteer-prepared returns are readily identifiable by the Internal Revenue Service. The SIDN on the return allows your site to receive much deserved credit for your work and its impact on your local community. The statistics captured by the SIDN enable the IRS to demonstrate the contributions of the VITA/TCE programs.

Your SIDN is an 8-digit number preceded by the letter S that must be entered on all returns you prepare (Forms 1040, 1040A, and 1040EZ)—both paper and electronic. Your site coordinator provides this number with other necessary guidelines for completing the return.

The SIDN should appear in the preparer's SSN/PTIN field in the paid preparer's section and will be discussed in detail in Lesson 14, Finishing the Return.

RESOURCES

The following tools and resources are available to assist you in filing an accurate and complete return.

e-file Software

A major initiative of the IRS is to encourage taxpayers to file their returns electronically—e-file. Those VITA/TCE partners that electronically file clients' returns eliminate simple math errors and other omissions by using the software. Additionally, electronically filing certifies IRS receipt of the return and, if a refund is due, speeds receipt of any refund due. The e-filing software is available free to qualifying VITA/TCE sponsors. Consult your sponsor for additional information. All volunteers should be aware that they must inform all taxpayers who e-file their return, that they will not receive a tax package in the mail the following year. Forms and publications may be accessed via the Internet at: HYPERLINK "http://www.irs.gov/formspubs"www.irs.gov/formspubs.

Key Technical Reference Materials

At a minimum, all VITA/TCE sites must have reference material available for each volunteer. When you arrive at the tax preparation site, reference materials should be located at each workstation. You will receive Publication 4012 and Publication 17 with your training material. You are encouraged to annotate your copies and use them as an integral part of each tax return service you deliver. Throughout this course, your instructor will refer to various forms, publications, worksheets, and instructions that will be useful during training and while assisting taxpayers. Although not required, it is suggested that each site maintain a technical research library—paper or electronic.

Take advantage of the resources at your disposal to deliver accurate and quality service to the customer: Publication 4012, Publication 17, the Intake and Interview Sheet, the instructions for forms and schedules, and where available, the return preparation software diagnostics.

- **The Volunteer Resource Guide** (Publication 4012) is designed to assist you in preparing an accurate return whether paper or electronic. The tax law, decision trees, and interview tips contained in the publication are drawn from your training materials, Publication 17, and the forms' instructions. It is customized to accompany the VITA/TCE programs and is designed to assist you in preparing an accurate return by providing tips for asking the right questions.

  The Guide is divided into three tabbed sections. The White Tab Section includes tax preparation reference materials and decision charts for both paper and electronic filers. The Yellow Tab section contains step-by-step procedures for e-file software users. The Blue Tab section provides specific information for users of the Web-based e-file software users.

  Another useful component of Publication 4012 is a list of contact numbers and Web sites frequently used by volunteers as well as a list of questions frequently asked by taxpayers.

- **Your Federal Income Tax for Individuals** (Publication 17) provides detailed explanations and examples of tax law topics including those typically seen at volunteer sites. It is a comprehensive tax resource guide for individual taxpayers. The topics are arranged in the same order as the items are shown on the returns.

Site and Technical Resources

- **The Intake and Interview Sheet** (Form 13614) is the starting point for your interview and conversation to assess the taxpayers' tax situations—filing status, number of exemptions, income, adjustments, deductions, credits, etc.

  Your site coordinator can obtain Form 13614 from the IRS. Form 13614 can be downloaded from www.**irs.gov** and photocopied as needed.

  Your volunteer organization may have developed its own interview tool or form or you may use the return preparation software worksheets to assist you in a comprehensive interview and conversation with the taxpayer.

- **Instruction Booklets for Forms 1040, 1040A and 1040EZ** provide line-by-line directions for completing each of the tax return forms—Form 1040, 1040A, and 1040EZ—and the applicable schedules and worksheets associated with each form.
- **Tax Information Publication** (Publication 1194) is a compilation of the most frequently requested tax information publications. The publications referenced in this training material (i.e., Publication 596, *Earned Income Credit;* Publication 972, *Child Tax Credit;* Publication 501, *Exemptions, Standard Deduction, and Filing Information*) are generally included in the two-volume set of Publication 1194.
- **Volunteer Hotline Access 1-800-829-8482** *(volunteers only)* is for telephonic VITA/TCE tax assistance. This volunteer-only hotline is operational during the filing season. When calling, identify yourself as a VITA/TCE volunteer.
- **1040 Central at** www.**irs.gov** is your electronic source for tax forms, information, and updates.
- **Volunteer Quality Alerts** are messages which provide tax law updates and other helpful tips to volunteers throughout the filing season. Visit www.**irs.gov** (keyword: Volunteer Quality Alerts).
- **Volunteer Coordinator's Handbook** (Publication 1084) contains an overview on the establishment and management of a volunteer site. It includes policies, procedures, roles and responsibilities, management tools, and tips designed to ensure consistency and quality in the delivery of VITA/TCE services.

- **IRS Guide to Free Tax Services** (Publication 910) provides an expanded index to the information publications that are available. This is an invaluable research aid to help locate the publication in which an answer to the question may be found. The topical index is cross-referenced to the numerical listing of informational publications.
- **Volunteer e-file Administrator Guide** (Publication 3189) provides guidance on IRS standards for volunteer sites, administrative procedures in using return preparation software, and samples of the types of documents needed to successfully operate a volunteer e-file site.
- **Handbook for Authorized IRS e-file Providers** (Publication 1345) contains the requirements for participating in the IRS e-file program. Most items of relevance to volunteer sites from this publication are also contained in Publication 3189 mentioned above.
- **Equipment and Supplies** required at the tax preparation site may be provided by the IRS. Consult your sponsor or site coordinator for specific information about available property, use restrictions, and security and maintenance requirements.

A Property Loan Agreement (Form 13632) must be signed by individuals and/or organizations that receive government property. All equipment remains the property of the government and may not be used for commercial purposes.

Commercial and/or certain personal uses of the property may terminate the Property Loan Agreement. Recipients of government property must certify that the equipment will be used for volunteer electronic tax return preparation and filing. It may also be used for related activities associated with supporting the volunteer program as listed in the Agreement.

Sites that file paper returns should use the VITA/TCE overprinted forms (Form 1040, 1040A, and 1040EZ) furnished by the IRS. These forms can be ordered in the fall of the year and are modified to accommodate the site identification number in the paid preparer's only use portion of the form.

This section is intended to serve as a reference. It does not constitute legal guidance. For additional guidance, contact your Site Coordinator or sponsor.

▶▶ Summing Up This Lesson ◀◀

The goal of the Volunteer Programs is to assist taxpayers in filing a timely and accurate tax return while upholding the integrity of the VITA/TCE program. Key points to remember:

- ▶ Know your rights and responsibilities.
- ▶ Uphold the quality and ethical standards of the VITA/TCE programs.
- ▶ Prepare returns within the scope of the VITA/TCE programs and for which you have been certified.
- ▶ Always interview the taxpayer—don't assume that prior year information or information written on the Intake and Interview Sheet is correct.
- ▶ Use the fact-gathering tools, such as the Intake and Interview Sheet (Form 13614), and decision trees.
- ▶ Use government-furnished equipment as stated in the property loan agreement.
- ▶ Use Publication 4012 and Publication 17 when assisting taxpayers.
- ▶ Consult with other more experienced volunteers or your site coordinator when necessary.
- ▶ Help is available from the IRS. Call the Volunteer Hotline during the filing season and use the IRS technical resources and tools.
- ▶ Do not misuse government property or charge taxpayers for the services you provide as a VITA/TCE volunteer. (A taxpayer filed a complaint with the IRS that a VITA/TCE participant had charged her a fee for preparing her tax return. The Department of the Treasury's Office of Investigation was notified and subsequently identified another taxpayer who stated her tax return was prepared for a fee by the same person. The taxpayers' copies of their tax returns confirmed that the tax returns had been prepared on a government computer and had been electronically stamped as having been prepared by the VITA/TCE programs.)
- ▶ Complete the Self-Assessment on page 1 of your Volunteer Resource Guide (Publication 4012) to determine if you have everything you need to provide top quality professional service before assisting taxpayers.

Taxpayer Identification Numbers and Exemptions

Lesson 1

Introduction and Objectives

In this lesson you will learn about the types of taxpayer identification numbers and how to determine whether an individual can be claimed as a dependent. The lesson will build on the information in the Introduction and Administrative Guidelines regarding critical intake questions and probing interviews.

After completing this lesson you should be able to:

- Explain the importance of the taxpayer identification number (TIN).
- Identify the three types of taxpayer identification numbers.
- Define the terms "personal" and "dependency exemption".
- Apply the tests to determine whether an individual can be claimed as a dependent on a taxpayer's tax return.

Alert

This lesson contains basic tax law and is required training for all volunteers.

Potential Pitfalls

The tax law and a taxpayer's tax situation changes from year to year. Avoid filing an erroneous return or delaying the taxpayer's refund—validate verbal and written information provided by the taxpayer using interview tips and decision trees discussed in this training and included in your (Publication 4012) Volunteer Resource Guide.

Intake and Interview Process—Form 13614 Taxpayer Identification Numbers and Exemptions

Use **Form 13614, Intake and Interview Sheet,** to engage the taxpayer in preparing an accurate return. Use the Intake and Interview Sheet as a starting point for comprehensive interaction with the taxpayer, in combination with all the source documents provided by the taxpayer, to ensure quality and accuracy on each return.

Confirm each item on Form 13614 (or similar tool used at the site) to make sure you and the taxpayer have considered all the necessary information. Ensure that all the questions and issues have been addressed. If items are incorrect or incomplete, revisit the issue and make corrections to the return, as needed.

Excerpt from Form 13614

Part I: Taxpayer Information

1. Your First Name	M.I.	Last Name	2. SSN or ITIN
3. Date of Birth (mm/dd/yyyy)	4. US Citizen or Resident Alien ☐ Yes ☐ No	5. Legally Blind ☐ Yes ☐ No	6. Totally and Permanently Disabled ☐ Yes ☐ No
7. Spouse's First Name	M.I.	Last Name	8. SSN or ITIN
9. Date of Birth (mm/dd/yyyy)	10. US Citizen or Resident Alien ☐ Yes ☐ No	11. Legally Blind ☐ Yes ☐ No	12. Totally and Permanently Disabled ☐ Yes ☐ No

To ensure the accurate reporting of the taxpayer's information, confirm the name, date of birth, and taxpayer identification number. If filing a joint return, include the spouse's information.

Refer to the chart on Determination of Residency Status in the Volunteer Resource Guide, Tab A (Who Must File/Which Form?) to determine if the taxpayer is a United States citizen/resident or a nonresident alien. If it is determined that the taxpayer is a nonresident alien, volunteers should refer them to the site coordinator, unless they have been trained and certified to prepare tax returns (Forms 8843, 1040NR, or 1040NR-EZ) for nonresident aliens.

ALERT

Always validate the taxpayer's identity and confirm the accuracy of all TINs submitted on the return by viewing social security cards and/or ITIN and ATIN documentation.

TAXPAYER IDENTIFICATION AND SUPPORTING DOCUMENTS

Based on information in the Introduction and Administrative Guidelines regarding the intake process and the importance of confirming the taxpayer's identity and supporting documents, you should have the following information:

- Proof of identity and taxpayer identification number(s)
- Birth dates of all individuals to appear on the return
- Wage and earning statements (for example, Form W-2 or Form W-2G)
- Interest and dividend statements (Form(s) 1099)
- A copy of last year's federal and state returns (if available)
- Documentation supporting a claim to a dependency exemption (for example, Form 8332 or Form 2120)
- Day care provider's identifying number and receipts (if applicable)
- Bank routing and account numbers for direct deposit
- Social security number printed on an original document from the Social Security Administration

POTENTIAL PITFALLS

Processing delays (and a refund delay, if applicable) will result from submitting incorrect information on the return.

At a minimum, you will need the above information to get started. Due to the extreme importance of the taxpayer identification number (TIN), a more detailed discussion follows.

TAXPAYER IDENTIFICATION NUMBERS

For tax purposes, all individuals appearing on a tax return must have a taxpayer identification number (TIN). The TIN can be a social security number (SSN), an individual taxpayer identification number (ITIN), or an adoption taxpayer identification number (ATIN).

Social Security Number (SSN)

Each year thousands of returns are delayed in processing or credit/deductions are disallowed because names and SSNs listed on the returns do not match the Social Security Administration's (SSA) records. The SSA issues SSNs on social security cards.

To minimize processing delays (and a potential refund delay), ask the taxpayer to show you the social security card (either the original or a copy) for each individual listed on the return. Then, verify the accuracy of the SSN and the spelling of the individual's name by ensuring that the information on the tax return matches the social security card. An original letter or document from the SSA showing the SSN is an acceptable substitute for the social security card.

If the taxpayer, the taxpayer's spouse, or dependent(s) are not eligible for an SSN, they will need either an ATIN or ITIN from the IRS. These numbers should be entered on the return wherever an SSN is required.

For federal tax purposes, the most important rule to remember is that the name on the tax return must match the records on file with the SSA or with the Internal Revenue Service ITIN Unit. Use the name in the same order as it appears on the social security card or ITIN letter. Refer to Social Security Cards and Determining the Last Name of Taxpayer to Use in Tax Preparation Software Chart in the Volunteer Resource Guide, Tab 1 (Starting TaxWise®).

Adoption Taxpayer Identification Number (ATIN)

During the adoption process, the taxpayer may not have been able to obtain an existing or a new SSN for the child. If the taxpayer is eligible to claim the child as a dependent and does not have the child's SSN, then the taxpayer will need to provide an ATIN to claim the child as a dependent and (if eligible) to claim the child care credit.

Form W-7A, Application for Taxpayer Identification Number for Pending United States Adoptions, should be filed with the IRS if the following are true:

1. The child lives with the taxpayer and was placed with him or her by a legal adoption agency.
2. The taxpayer cannot get the child's existing SSN after attempting to by reasonable means; or the SSA will not provide an SSN because the adoption is not final.
3. The taxpayer is eligible to claim the child as a dependent on his or her tax return.
4. The taxpayer cannot get an ITIN for the child.

Individual Taxpayer Identification Number (ITIN)

The IRS issues an ITIN to nonresident or resident aliens who are required to have a United States taxpayer identification number but who do not have, and are not eligible to obtain, an SSN.

> **ALERT**
> ITINs are issued by the IRS for federal tax purposes only.

An ITIN is issued for federal tax purposes only. **It does not entitle the individual to social security benefits or the earned income credit.** The ITIN creates no inference concerning the taxpayer's immigration status or right to work in the United States.

Who Needs an ITIN?

Federal law requires individuals with United States income, regardless of immigration status, to file a United States tax return. If a taxpayer must file a United States tax return or can be listed on a United States tax return as a spouse or dependent, he or she must have a TIN.

For most individuals their taxpayer identification number is an SSN. If the taxpayer is a foreign person who does not have, and is not eligible to obtain, an SSN, he or she uses an ITIN.

The instructions for **Form W-7, Application for IRS Individual Taxpayer Identification Number,** contain detailed information about individuals who need an ITIN and how to complete and submit Form W-7 to the IRS to obtain one. See page M-1-2 for information about resident and nonresident aliens. Examples of individuals who need an ITIN include:

- Nonresident aliens filing a United States tax return and not eligible for an SSN;
- United States resident aliens (based on days present in the United States) filing a United States tax return and not eligible for an SSN;
- Dependents or spouses of a United States citizen or resident alien and not eligible for an SSN;
- Dependents or spouses of a nonresident alien visa holder.

Proof of Identity and Foreign Status for ITIN

An original or a certified copy of an **unexpired** passport are acceptable documents for both identity and foreign status. In lieu of a passport, the IRS will accept certified or notarized copies (two or more) of certain identifying documents, such as:

- National identification card (must show photo, name, current address, date of birth, and expiration date),
- United States or foreign driver's license,
- United States state identification card,
- United States or foreign military identification card,
- United States Citizenship and Immigration Services (USCIS) photo identification,
- Medical records for dependents under the age of 14 (under age 18 if a student),
- Civil birth certificate,
- Foreign voter registration card,
- School records for dependents under age 14 (under age 18 if a student).

ALERT

Do not make any annotation on earning statements (Form W-2) that do not match the ITIN or SSN provided by the taxpayer.

Assisting Taxpayers with No ITIN

You may assist taxpayers who visit your site in need of an ITIN. In those instances, you can assist them only by preparing their return and returning the completed return to them for submission to the IRS along with a properly completed Form W-7. Acceptance agents are available throughout the country to assist taxpayers with the proper completion of Form W-7.

The ITIN is a nine-digit number that begins with the number 9 and is formatted like an SSN (9NN-NN-NNNN). The fourth and fifth digits of the ITIN are in the range of 70–89. When using TaxWise® software, a temporary taxpayer identification number is required to complete a return for a taxpayer who does not have an ITIN. Instructions for establishing a temporary number are in Tab 1–Publication 4012, *Volunteer Resource Guide*.

Upon completing the return package using TaxWise®, you must completely cross out in ink the TIN on each form reflecting the temporary number and give the package to the taxpayer so that he or she can mail the package to the address shown in the instructions for Form W-7.

To prevent processing delays due to the separation of the forms or returns in a family package (multiple Form W-7), stagger the forms and staple the package together to show the entire package as a family pack.

Volunteers should refer taxpayers who need assistance completing Form W-7 to the site coordinator unless they have been trained in the completion of the form or an authorized acceptance agent is present to provide assistance.

Note: An ITIN acceptance agent (AA) has entered into a contract with the IRS to act on behalf of an ITIN applicant. AAs complete Form W-7/W-7SP and authenticate the supporting documentation. The AA completes a certificate of accuracy, which is attached to the W-7/W-7SP application, and then forwards the application, certificate, and the federal tax return to the Austin Service Center (AUSC) for processing. Certified acceptance agents are required to attach the tax return unless they file under an exception. Call 1-800-829-1040 or go to www.**irs.gov** and search acceptance agents for an AA referral listing.

Potential Pitfalls

Taxpayers may need assistance with returns with SSN/ ITIN mismatches; you may prepare and file the return electronically.

Assisting Taxpayers with an ITIN

In general, ITIN-eligible taxpayers should file Form W-7 and supply documentation that will establish foreign status and identity to receive an ITIN. You may complete their return using electronic filing software. **Do not** electronically transmit the return. The taxpayer must send the return along with Form W-7 and proof of identity documents to the address listed on Form W-7.

When a taxpayer seeks assistance with valid ITINs and there is no ITIN/SSN mismatch (described below), you may e-file or mail the taxpayer's return if his or her tax situation is within the scope of the Volunteer Income Tax Assistance Program. The return will not require special processing.

ALERT

Incorrect SSN/ITIN Usage

The incorrect use of SSNs/ITINs can lead to delays in a taxpayer receiving a refund. There are two types of incorrect usage:

- Using an SSN/ ITIN that was not assigned to the taxpayer (i.e., using some other person's SSN/ITIN)
- Usage of a correct SSN/ITIN by more than one taxpayer (i.e., two taxpayers filing separately and claiming the same dependents)

ASSISTING TAXPAYERS WITH MISMATCHED ITINS/SSNS

Taxpayers may seek your assistance with earning statements (Form(s) W-2) and/or reporting documents (Form(s) 1099) reflecting an SSN and an ITIN as their taxpayer identification number—an ITIN/SSN mismatch. You can assist the taxpayer with the return. You must not, however, change the information on Form W-2. As of January 1, 2007, programming changes allow the IRS e-file system to accept these returns electronically.

Prior to completing the return, you should confirm the taxpayer's identity as previously stated. For ITIN holders, an original or a copy of their ITIN card or letter issued by the IRS must be provided.

The taxpayer's ITIN number should be entered on the return and not the SSN appearing on the Form W-2.

ITIN ASSISTANCE FROM THE IRS—FOR VOLUNTEERS

Specific procedures for assisting taxpayers with the ITIN application process are published on www.**irs.gov** (keyword: volunteer ITIN procedures). Publication 1915, *Understanding Your IRS ITIN,* and Form W-7 instructions are also available on the Web.

▶▶ Summing Up Taxpayer Identification Numbers ◀◀

- ▶ Without all the required supporting documentation (for example, Form W-2, proof of identity, Form(s) 1099, and child care information), you cannot prepare the taxpayer's return.
- ▶ Each person listed on the taxpayer's return must be identified by a valid taxpayer identification number (TIN)—the taxpayer, the taxpayer's spouse (if married), and any dependents.
- ▶ The TIN can be a social security number (SSN), an individual taxpayer identification number (ITIN), or an adoption taxpayer identification number (ATIN).
- ▶ Check the accuracy of each TIN (especially SSNs) as well as the spelling of the name associated with the number by reviewing the official document issued by the prescribing agency.
- ▶ If eligible, an ATIN may be used to identify a child being adopted by the taxpayer who does not have an SSN.
- ▶ Taxpayers who visit your site with a valid ITIN or ITIN/SSN mismatch issues should submit the return to the appropriate IRS campus either by mail or electronically.
- ▶ Specific procedures for assisting the taxpayer with the ITIN application process are published on www.**irs.gov** (keyword: volunteer ITIN procedures). Publication 1915, *Understanding Your IRS ITIN,* and Form W-7 instructions are also available on the Web.

PERSONAL AND DEPENDENCY EXEMPTIONS

Exemptions reduce the taxpayer's taxable income. Generally, the deduction for each exemption is $3,400 in 2007. There are two types of exemptions: personal exemptions and exemptions for dependents. While each is worth the same amount, different rules apply to each type.

Excerpt from Form 13614

Part II. Family and Dependent Information – Do not include you or your spouse.

Print the name of everyone who lived in your home and outside your home that you supported during the year.

Name (first, last) (a)	Date of Birth mm/dd/yyyy (b)	Social Security Number or ITIN (c)	Relationship to you (son, daughter, etc.) (d)	Number of months person lived with you in 2007 (e)	US Citizen, Resident of US, Canada or Mexico (yes or no) (f)	Is the dependent a full time student born before 1989? (yes or no) (g)

To ensure the accurate reporting of the taxpayer's dependency information, complete columns (a) through (g) for each person listed on the return as a dependent. The taxpayer's return cannot be prepared without this information.

Part III. Filing Status & Dependency Determination

Based on the interview, the filing status of the taxpayer is: ☐ Single ☐ MFJ ☐ MFS* ☐ HOH ☐ QW

*Spouse Name ______________________________ Social Security Number ______________________

☐ Yes ☐ No 1. Did you provide more than 50% of the support for the dependents claimed?

☐ Yes ☐ No 2. Can anyone else claim any of these dependents on their income tax return?

☐ Yes ☐ No 3. Were any of these dependents permanently and totally disabled in 2007?

☐ Yes ☐ No 4. Did any of these dependents file a joint return for 2007?

_____________ 5. Based on the interview, how many individuals qualify as dependents for this return?

Probe to ensure that the taxpayer is entitled to claim the dependency exemption for individuals listed on the return.

PERSONAL EXEMPTIONS

Generally, a taxpayer may claim a personal exemption for himself or herself. If filing a joint return or in certain other circumstances, a taxpayer may claim an exemption for a spouse.

The Taxpayer's Personal Exemption

A personal exemption (a $3,400 reduction in taxable income) can be claimed by the taxpayer unless the taxpayer is eligible to be claimed as a dependent on another person's return. If this is true, the taxpayer cannot claim an exemption, even if the other taxpayer does not actually claim the person as a dependent.

POTENTIAL PITFALLS

Avoid claiming exemptions for nonqualifying individuals, thus incorrectly reducing the taxpayer's taxable income. Use tools in the Dependency/Exemptions tab in Publication 4012 to avoid this common error.

ALERT

Interview each taxpayer to confirm his or her marital status on December 31 of each year using the tools in Publication 4012.

Exemption for a Spouse

The taxpayer's spouse can be claimed as a personal exemption on the return if the following conditions are met:

- The taxpayers must be considered married on December 31, 2007. State or local laws determine the validity of a marriage.
- The taxpayer's spouse cannot be claimed as a dependent on another person's tax return (even if the other taxpayer does not claim the taxpayer's spouse as a dependent).
- The taxpayer files a joint return with the spouse or the taxpayer files a separate return and the spouse has no gross income.

Personal Exemptions—Divorced, Deceased, or Separated Taxpayers

If a taxpayer's spouse died during the year and the taxpayer did not remarry by December 31, he or she can generally claim the personal exemption for the deceased spouse. This exemption can be claimed only if the taxpayer was not divorced or legally separated from his or her spouse on the date of death and would have been able to claim the exemption if the spouse had not died.

INTERVIEW TIPS—PERSONAL EXEMPTIONS

Refer to the Personal Exemptions Chart in the Volunteer Resource Guide, Tab C, (Exemptions/Dependents) for a set of interview questions to assist you in applying the rules for personal exemptions. In some cases, the question may reference topics that will be discussed later.

DEPENDENCY EXEMPTIONS

The term "dependent" means a qualifying child or a qualifying relative. Each dependency exemption for a qualifying relative and/or qualifying child reduces the taxpayer's taxable income by $3,400.

A taxpayer can claim an exemption for a qualifying child or qualifying relative only if these three tests are met:

1. **Dependent Taxpayer Test**

   If a taxpayer can be claimed as a dependent by another person, he or she cannot claim anyone else as a dependent. Even if the taxpayer has a qualifying child or qualifying relative, he or she cannot claim that person as a dependent.

2. **Joint Return Test**

   Generally, a taxpayer cannot claim a dependency exemption for a married person filing a joint return, unless the joint return is being filed to claim a refund and there would be no tax liability for either spouse if separate returns were filed.

3. **Citizen or Resident Test**

   A taxpayer cannot claim a person as a dependent unless that person is a United States citizen, United States resident alien, United States national, or a resident of Canada or Mexico for some part of the year.

   Refer to the chart on Determination of Residency Status in the Volunteer Resource Guide, Tab A (Who Must File/Which Form?) to determine if the taxpayer is a United States citizen/resident or nonresident alien. If it is determined that the taxpayer is a nonresident alien, volunteers should refer those taxpayers to the site coordinator, unless they have been trained and certified to prepare returns (Forms 8843, 1040NR, or 1040NR-EZ) for nonresident aliens.

   However, there is an exception for certain adopted children. If the taxpayer is a United States citizen or United States national who has legally adopted a child who is not a United States citizen, United States resident alien, or United States national, but who has lived with the taxpayer as a member of the taxpayer's household for the entire year, then dependency can be claimed.

   A United States national is an individual who, although not a United States citizen, owes his or her allegiance to the United States. United States nationals include American Samoans and Northern Mariana Islanders who chose to become United States nationals instead of United States citizens.

QUALIFYING CHILD DEPENDENCY TESTS

To be a "qualifying child," the person must meet the following tests:

1. **Relationship Test**

   A child must be the taxpayer's:

   - Son, daughter, stepchild, eligible foster child, or a descendant (i.e., grandchild) of any of them; or
   - Brother, sister, half brother, half sister, stepbrother, stepsister, or a descendant (i.e., niece or nephew) of any of them.
   - Adopted child
   - Eligible foster child

2. **Age Test**

   A child must be:

   - Under age 19 at the end of the year,
   - A full-time student under age 24 at the end of the year, or
   - Permanently and totally disabled at any time during the year, regardless of age.

3. **Residency Test**

   A child must have lived with the taxpayer for more than half of the year. There are exceptions for temporary absences, children who were born or died during the year, kidnapped children, and children of divorced or separated parents.

4. **Support Test**

   A child does not qualify if he or she has provided more than half of his or her own support for the year. This test is different from the support test to be a qualifying relative, which is described later.

5. **Special Test for a Qualifying Child of More Than One Person**

   If a child meets the relationship, age, residency, and support tests to be a qualifying child of more than one person, only one person can actually treat the child as a qualifying child.

   If the taxpayer and another person have the same qualifying child, the taxpayer and the other person may decide who will treat the child as a qualifying child. That person can take all of the following tax benefits (if eligible for each benefit) based on the qualifying child:

   - Dependency exemption
   - Head of household
   - Child tax credit
   - Earned income credit
   - Child and dependency care expenses credit
   - Exclusion from income for dependent care benefits

   The other person cannot take any of these benefits based on the qualifying child. Thus, the benefits cannot be divided between the taxpayer and the other person. If the taxpayer and the other person cannot agree on who will claim the child, and more than one person files a return claiming the same child, the IRS will use the tiebreaker rule. (Refer to the Tiebreaker Rule Chart in the Volunteer Resource Guide, Tab C—Exemptions/Dependency.)

QUALIFYING RELATIVE DEPENDENCY TESTS

To be a "qualifying relative," the person must meet the following tests:

1. **Qualifying Child Test**

   A child is not the taxpayer's qualifying relative if the child is the taxpayer's qualifying child or the qualifying child of another taxpayer.

2. **Member of Household or Relationship Test**

   A person must either live with the taxpayer all year as a member of the taxpayer's household, or be related to the taxpayer in one of the following ways:

   - Child, stepchild, eligible foster child, legally adopted child, or a descendant of any of them (i.e., grandchild)
   - Brother, sister, half brother, half sister, stepbrother, or stepsister

- Father, mother, grandparent, or other direct ancestor, but not a foster parent
- Stepfather or stepmother
- Son or daughter of taxpayer's brother or sister
- Brother or sister of taxpayer's father or mother
- Son-in-law, daughter-in-law, father-in-law, mother-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.

A person does not meet this test if at any time during the year the relationship between the taxpayer and that person violates local law.

A cousin only meets this test if he or she lived with the taxpayer all year as a member of the taxpayer's household. A cousin is a descendant of a brother or sister of the taxpayer's mother or father.

3. **Gross Income Test**

   Generally, a taxpayer cannot claim a person who has a gross income of $3,400 or more.

   Gross income is all income in the form of money, property, and services that is not exempt from tax.

   For purposes of the gross income test, do not include the income for services performed at a sheltered workshop if the individual was permanently and totally disabled at any time during the year. The main reason for the person's presence at the workshop must be due to the availability of medical care and the income must come from activities at the workshop that are incident to this medical care.

   A sheltered workshop is a school that provides special instruction or training designed to alleviate the disability of the individual and is operated by certain tax-exempt organizations or by a state, a United States possession, a political subdivision of a state or a United States possession, the United States, or the District of Columbia.

4. **Support Test**

   Generally, a taxpayer must provide more than half of a person's total support during the calendar year to claim a qualifying relative as a dependent.

DEPENDENTS

The Dependents Worksheet (Exhibit 1) from Form 1040 Instructions will be used to teach this portion of the course. All volunteers are encouraged to use the worksheet in Form 1040 or Form 1040A Instructions or the interview tips included in Publication 4012 when applying the dependency rules. The information in Step 3—child tax credit—will be discussed in Lesson 6.

Line 6c—Dependents

Dependents and Qualifying Child for Child Tax Credit

Follow the steps below to find out if a person qualifies as your dependent, qualifies you to take the child tax credit, or both. If you have more than four dependents, attach a statement to your return with the required information.

Step 1 Do You Have a Qualifying Child?

Relationship Test

A qualifying child is a child who is your...

Son, daughter, stepchild, foster child, brother, sister, stepbrother, stepsister, or a descendant of any of them (for example, your grandchild, niece, or nephew)

AND

was ...

Under age 19 at the end of 2007

or

Under age 24 at the end of 2007 and a student (see page 17)

or

Any age and permanently and totally disabled (see page 17)

Age Test

AND

Support Test

who...

Did not provide over half of his or her own support for 2007 (see Pub. 501)

AND

Residency Test

who...

Lived with you for more than half of 2007. If the child did not live with you for the required time, see *Exception to time lived with you* on page 17.

CAUTION *If the child meets the conditions to be a qualifying child of any other person (other than your spouse if filing jointly) for 2007, see* Qualifying child of more than one person *on page 17.*

1. Do you have a child who meets the conditions to be your qualifying child?

   ☐ **Yes.** Go to Step 2. ☐ **No.** Go to Step 4 on page 16.

Step 2 Is Your Qualifying Child Your Dependent?

Citizen or Resident Test

1. Was the child a U.S. citizen, U.S. national, U.S. resident alien, or a resident of Canada or Mexico? If the child was adopted, see *Exception to citizen test* on page 17.

   ☐ **Yes.** Continue

   ☐ **No.** STOP You cannot claim this child as a dependent. Go to Form 1040, line 7.

2. Was the child married?

   ☐ **Yes.** See *Married person* on page 17.

   ☐ **No.** Continue

3. Could you, or your spouse if filing jointly, be claimed as a dependent on someone else's 2007 tax return? See Steps 1, 2, and 4.

   ☐ **Yes.** You cannot claim any dependents. Go to Step 3.

   ☐ **No.** You can claim this child as a dependent. Complete Form 1040, line 6c, columns (1) through (3) for this child. Then, go to Step 3.

Step 3 Does Your Qualifying Child Qualify You for the Child Tax Credit?

See Lesson 6

1. Was the child under age 17 at the end of 2007?

   ☐ **Yes.** Continue

   ☐ **No.** STOP This child is not a qualifying child for the child tax credit. Go to Form 1040, line 7.

2. Was the child a U.S. citizen, U.S. national, or U.S. resident alien? If the child was adopted, see *Exception to citizen test* on page 17.

   ☐ **Yes.** This child is a qualifying child for the child tax credit. If this child is your dependent, check the box on Form 1040, line 6c, column (4). Otherwise, you must complete and attach Form 8901.

   ☐ **No.** STOP This child is not a qualifying child for the child tax credit. Go to Form 1040, line 7.

Step 4 Is Your Qualifying Relative Your Dependent?

Relationship Test

A qualifying relative is a person who is your...

Son, daughter, stepchild, foster child, or a descendant of any of them (for example, your grandchild)

or

Brother, sister, or a son or daughter of either of them (for example, your niece or nephew)

or

Father, mother, or an ancestor or sibling of either of them (for example, your grandmother, grandfather, aunt, or uncle)

or

Stepbrother, stepsister, stepfather, stepmother, son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law

Member of Household

or

Any other person (other than your spouse) who lived with you all year as a member of your household if your relationship did not violate local law. If the person did not live with you for the required time, see *Exception to time lived with you* on page 17

AND

Not a Qualifying Child

who was not...

A qualifying child (see Step 1) of any taxpayer for 2007 (see Pub. 501 if the child lived in Canada or Mexico)

AND

Gross Income

who...

Had gross income of less than $3,400 in 2007. If the person was permanently and totally disabled, see *Exception to gross income test* on page 17

AND

Support

For whom you provided...

Over half of his or her support in 2007. But see the special rule for *Children of divorced or separated parents* that begins on this page, *Multiple support agreements* on page 17, and *Kidnapped child* on page 17.

1. Does any person meet the conditions to be your qualifying relative?

   ☐ **Yes.** Continue ↓ ☐ **No.** STOP Go to Form 1040, line 7.

2. Was your qualifying relative a U.S. citizen, U.S. national, U.S. resident alien, or a resident of Canada or Mexico? If your qualifying relative was adopted, see *Exception to the citizen test* on page 17.

   Citizen or Resident

   ☐ **Yes.** Continue ↓ ☐ **No.** STOP You cannot claim this person as a dependent. Go to Form 1040, line 7.

3. Was your qualifying relative married?

   ☐ **Yes.** See *Married person* on page 17. ☐ **No.** Continue ↓

4. Could you, or your spouse if filing jointly, be claimed as a dependent on someone else's 2007 tax return? See Steps 1, 2, and 4.

   ☐ **Yes.** STOP You cannot claim any dependents. Go to Form 1040, line 7.

   ☐ **No.** You can claim this person as a dependent. Complete Form 1040, line 6c, columns (1) through (3). Do not check the box on Form 1040, line 6c, column (4).

Definitions and Special Rules

Adopted child. An adopted child is always treated as your own child. An adopted child includes a child lawfully placed with you for legal adoption.

Adoption taxpayer identification numbers (ATINs). If you have a dependent who was placed with you for legal adoption and you do not know his or her SSN, you must get an ATIN for the dependent from the IRS. See Form W-7A for details.

Children of divorced or separated parents. A child will be treated as being the qualifying child or qualifying relative of his or her noncustodial parent (the parent with whom the child lived for the lesser part of 2007) if all of the following conditions apply.

1. The parents are divorced, legally separated, separated under a written separation agreement, or lived apart at all times during the last 6 months of 2007.
2. The child received over half of his or her support for 2007 from the parents (without regard to the rules on *Multiple support agreements* on page 17). Support of a child received from a parent's spouse is treated as provided by the parent.
3. The child is in custody of one or both of the parents for more than half of 2007.
4. Either of the following applies.

a. The custodial parent signs Form 8332 or a substantially similar statement that he or she will not claim the child as a dependent for 2007, and the noncustodial parent attaches the form or statement to his or her return. If the divorce decree or separation agreement went into effect after 1984, the noncustodial parent can attach certain pages from the decree or agreement instead of Form 8332. See *Post-1984 decree or agreement* on page 17.

b. A pre-1985 decree of divorce or separate maintenance or written separation agreement between the parents provides that the noncustodial parent can claim the child as a dependent, and the noncustodial parent provides at least $600 for support of the child during 2007.

If conditions (1) through (4) apply, only the noncustodial parent can claim the child for purposes of the dependency exemption (line 6c) and the child tax credits (lines 52 and 68). However, this special rule does not apply to head of household filing status, the credit for child and dependent care expenses, the exclusion for dependent care benefits, or the earned income credit. See Pub. 501 for details.

Post-1984 decree or agreement. The decree or agreement must state all three of the following.

1. The noncustodial parent can claim the child as a dependent without regard to any condition, such as payment of support.
2. The other parent will not claim the child as a dependent.
3. The years for which the claim is released.

The noncustodial parent must attach all of the following pages from the decree or agreement.

- Cover page (include the other parent's SSN on that page).
- The pages that include all the information identified in (1) through (3) above.
- Signature page with the other parent's signature and date of agreement.

CAUTION *You must attach the required information even if you filed it with your return in an earlier year.*

Exception to citizen test. If you are a U.S. citizen or U.S. national and your adopted child lived with you all year as a member of your household, that child meets the citizen test.

Exception to gross income test. If your relative (including a person who lived with you all year as a member of your household) is permanently and totally disabled (defined on this page), certain income for services performed at a sheltered workshop may be excluded for this test. For details, see Pub. 501.

Exception to time lived with you. A person is considered to have lived with you for all of 2007 if the person was born or died in 2007 and your home was this person's home for the entire time he or she was alive. Temporary absences for special circumstances, such as for school, vacation, medical care, military service, or detention in a juvenile facility, count as time lived with you. Also see *Children of divorced or separated parents* that begins on page 16 or *Kidnapped child* below.

Foster child. A foster child is any child placed with you by an authorized placement agency or by judgment, decree, or other order of any court of competent jurisdiction.

Kidnapped child. If your child is presumed by law enforcement authorities to have been kidnapped by someone who is not a family member, you may be able to take the child into account in determining your eligibility for head of household or qualifying widow(er) filing status, the deduction for dependents, child tax credit, and the earned income credit (EIC). For details, use TeleTax topic 357 (see page 81) or see Pub. 501 (Pub. 596 for the EIC).

Married person. If the person is married, you cannot claim that person as your dependent if he or she files a joint return. But this rule does not apply if the return is filed only as a claim for refund and no tax liability would exist for either spouse if they had filed separate returns. If the person meets this exception, go to Step 2, question 3, on page 15 (for a qualifying child) or Step 4, question 4, on page 16 (for a qualifying relative). If the person does not meet this exception, go to Step 3 on page 15 (for a qualifying child) or Form 1040, line 7 (for a qualifying relative).

Multiple support agreements. If no one person contributed over half of the support of your relative (including a person who lived with you all year as a member of your household) but you and another person(s) provided more than half of your relative's support, special rules may apply that would treat you as having provided over half of the support. For details, see Pub. 501.

Permanently and totally disabled. A person is permanently and totally disabled if, at any time in 2007, the person cannot engage in any substantial gainful activity because of a physical or mental condition and a doctor has determined that this condition has lasted or can be expected to last continuously for at least a year or can be expected to lead to death.

Qualifying child of more than one person. If the child is the qualifying child of more than one person, only one person can claim the child as a qualifying child for all of the following tax benefits, unless the special rule for *Children of divorced or separated parents* beginning on page 16 applies.

1. Dependency exemption (line 6c).
2. Child tax credits (lines 52 and 68).
3. Head of household filing status (line 4).
4. Credit for child and dependent care expenses (line 47).
5. Exclusion for dependent care benefits (Form 2441, Part III).
6. Earned income credit (lines 66a and 66b).

No other person can take any of the six tax benefits listed above unless he or she has a different qualifying child. If you and any other person claim the child as a qualifying child, the IRS will apply the following rules.

- If only one of the persons is the child's parent, the child will be treated as the qualifying child of the parent.
- If two of the persons are the child's parents, the child will be treated as the qualifying child of the parent with whom the child lived for the longer period of time in 2007. If the child lived with each parent for the same amount of time, the child will be treated as the qualifying child of the parent who had the higher adjusted gross income (AGI) for 2007.
- If none of the persons are the child's parent, the child will be treated as the qualifying child of the person who had the highest AGI for 2007.

Example. Your daughter meets the conditions to be a qualifying child for both you and your mother. If you and your mother both claim tax benefits based on the child, the rules above apply. Under these rules, you are entitled to treat your daughter as a qualifying child for any of the six tax benefits listed above for which you otherwise qualify. Your mother would not be entitled to take any of the six tax benefits listed above unless she has a different qualifying child.

If you will be claiming the child as a qualifying child, go to Step 2 on page 15. Otherwise, stop; you cannot claim any benefits based on this child. Go to Form 1040, line 7.

Social security number. You must enter each dependent's social security number (SSN). Be sure the name and SSN entered agree with the dependent's social security card. Otherwise, at the time we process your return, we may disallow the exemption claimed for the dependent and reduce or disallow any other tax benefits (such as the child tax credit) based on that dependent. If the name or SSN on the dependent's social security card is not correct, call the Social Security Administration at 1-800-772-1213. For details on how your dependent can get an SSN, see page 12. If your dependent will not have a number by the date your return is due, see *What if You Cannot File on Time?* on page 6.

If your dependent child was born and died in 2007 and you do not have an SSN for the child, you can attach a copy of the child's birth certificate instead and enter "Died" in column (2).

Student. A student is a child who during any part of 5 calendar months of 2007 was enrolled as a full-time student at a school, or took a full-time, on-farm training course given by a school or a state, county, or local government agency. A school includes a technical, trade, or mechanical school. It does not include an on-the-job training course, correspondence school, or school offering courses only through the Internet.

Summary of the Rules for Claiming an Exemption for a Dependent

Refer to the Overview of the Rules for Claiming an Exemption for a Dependent Chart in the Volunteer Resource Guide, Tab C (Exemptions/Dependents).

Gross Income

Generally, a person cannot be a **qualifying relative** if the person had gross income of $3,400 or more. There is no gross income test in determining whether a person is a **qualifying child.**

Gross income is all taxable income in the form of money, goods, property, and services. It includes all unemployment compensation and certain scholarships. It does not include welfare benefits or nontaxable social security benefits.

Support Test

The support test required to determine if an individual is a "qualifying child" is **different** from the support test required for an individual to be a "qualifying relative." For an individual to be considered a qualifying relative, the taxpayer must have provided more than half the individual's total support for the entire year. An individual can be a qualifying child, however, as long as the individual did not provide more than half of his or her own support for the entire year. There is **no requirement** that the taxpayer provide more than half of a **qualifying child's** support.

Alert

Notice the difference between the support test for a qualifying child and the support test for a qualifying relative.

The worksheet for determining support (Exhibit 4) is available in Publication 17 to assist you in determining whether the taxpayer provided more than 50 percent of an individual's support.

Similarly, to determine if an individual provided over half of his or her own support (qualifying child test), compare the individual's contributions to his or her own support to the entire amount of support the individual received from all sources.

Some support items, such as food and rent, will benefit more than one member of a household. Divide the value of these support items among the number of household members that benefit.

Capital items (e.g., furniture, appliances, automobiles) should be included if they are solely for the dependent's own use or benefit.

Sources of Support Information

You will be asking the taxpayer some very personal questions when conducting this test. If the taxpayer becomes uncomfortable, explain that the information is necessary to help determine whether an individual is a dependent.

You may need to ask the taxpayer about the individual's own sources of support, for example:

- Income received (taxable and nontaxable),
- Savings accounts (amounts both spent and saved),
- Borrowed amounts, such as student loans and car loans,
- Tax-exempt income, including social security benefits and life insurance proceeds, and
- Nontaxable pensions, gifts, and tax-exempt interest.

Do not include in support any amounts that are:

- paid from the individual's own funds for income taxes and social security taxes,
- paid as life insurance premiums,
- not spent, such as amounts put in savings or invested, or
- scholarships received by full-time students.

The taxpayer should be prepared to discuss how much "total support" he or she provided toward the following for the individuals they wish to claim as dependents:

- Food, clothing, and shelter (at fair rental value)
- Education and recreation expenses
- Medical and dental care
- Transportation and other items solely for the individual's benefit, such as furniture, appliances, or automobiles

State benefit payments, such as Temporary Assistance for Needy Families (TANF), food stamps, and housing, are considered support provided by the state and not a parent or guardian.

Exercise 1—Determining Support

Traci needs help to determine whether her mother meets the support test. Each individual's contributions are shown in the table below.

Traci's contributions to her mother's support	Expenses paid for by her mother
Food—$1,500	Rent—$2,400
Medical bills—$500	Recreation—$300
	Clothes—$150
	Transportation—$100
	Life insurance—$400
	Television set—$200

A. What is the total support for Traci's mother?

B. How much financial support did Traci provide?

C. How much did Traci's mother contribute toward her own support?

D. Did Traci provide more than 50 percent of her mother's support?

Show your work below:

Funds Belonging to the Person You Supported

1. Enter the 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	**1.**	________
2. Enter the amount on line 1 that was used for the person's support	**2.**	________
3. Enter the amount on line 1 that was used for other purposes	**3.**	________
4. Enter the total amount in the person's savings and other accounts at the end of the year	**4.**	________
5. Add lines 2 through 4. (This amount should equal line 1.)	**5.**	________

Expenses for Entire Household (where the person you supported lived)

6. Lodging (complete line 6a or 6b):		
6a. Enter the total rent paid	**6a.**	________
6b. Enter the fair rental value of the home. If the person you supported owned the home, also include this amount in line 21.	**6b.**	________
7. Enter the total food expenses	**7.**	________
8. Enter the total amount of utilities (heat, light, water, etc. not included in line 6a or 6b)	**8.**	________
9. Enter the total amount of repairs (not included in line 6a or 6b)	**9.**	________
10. Enter the total of other expenses. Do not include expenses of maintaining the home, such as mortgage interest, real estate taxes, and insurance.	**10.**	________
11. Add lines 6a through 10. These are the total household expenses	**11.**	________
12. Enter total number of persons who lived in the household	**12.**	________

Expenses for the Person You Supported

13. Divide line 11 by line 12. This is the person's share of the household expenses	**13.**	________
14. Enter the person's total clothing expenses	**14.**	________
15. Enter the person's total education expenses	**15.**	________
16. Enter the person's total medical and dental expenses not paid for or reimbursed by insurance	**16.**	________
17. Enter the person's total travel and recreation expenses	**17.**	________
18. Enter the total of the person's other expenses	**18.**	________
19. Add lines 13 through 18. This is the total cost of the person's support for the year	**19.**	________

Did the Person Provide More Than Half of His or Her Own Support?

20. Multiply line 19 by 50% (.50)	**20.**	________
21. Enter the amount from line 2, plus the amount from line 6b if the person you supported owned the home. This is the amount the person provided for his or her own support	**21.**	________

22. Is line 21 more than line 20?

☐ **No.** You meet the support test for this person to be your qualifying child. If this person also meets the other tests to be a qualifying child, stop here; do not complete lines 23–26. Otherwise, go to line 23 and fill out the rest of the worksheet to determine if this person is your qualifying relative.

☐**Yes.** You do not meet the support test for this person to be either your qualifying child or your qualifying relative. **Stop here.**

Did You Provide More Than Half?

23. Enter the 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.	**23.**	________
24. Add lines 21 and 23	**24.**	________
25. Subtract line 24 from line 19. This is the amount you provided for the person's support	**25.**	________

26. Is line 25 more than line 20?

☐ **Yes.** You meet the support test for this person to be your qualifying relative.

☐**No.** You do not meet the support test for this person to be your qualifying relative. You cannot claim an exemption for this person unless you can do so under a multiple support agreement or the support test for children of divorced or separated parents. See *Multiple Support Agreement* or *Support Test for Children of Divorced or Separated Parents.*

Exercise 2—Critical Definitions

Match each term with its definition by entering the number of the term in the box next to the corresponding definition. Refer to the Glossary to review the definitions of these terms.

Terms:		Definitions:
1. Gross income	☐	Exemptions allowed to taxpayers for a qualifying child and/or qualifying relative
2. Dependency exemptions	☐	Dollar amount that can be deducted from an individual's total income, thereby reducing the taxable income
3. Gross income test	☐	A method to determine qualifying relative status, in which the person's gross income must be less than $3,400
4. Exemption amount	☐	All taxable income in the form of money, goods, property, and services

MULTIPLE SUPPORT AGREEMENT

In a situation where no one person contributes over one-half of the support of an individual, the individual still may be a qualifying relative of a taxpayer if:

- Over one-half of such individual's support was received from two or more persons each of whom would have been able to claim the individual as a dependent except for the over 50 percent support test,
- The taxpayer contributed over 10 percent of such individual's support,
- Each person who contributed over 10 percent of the individual's support (other than the taxpayer) signs a statement waiving his or her rights to claim the individual as a dependent, and
- The taxpayer attaches a **Form 2120, Multiple Support Declaration,** to his or her tax return for the year the dependency exemption is taken.

Example 1—Completing a Multiple Support Declaration (Form 2120)

Henry E. and Harold S. Loras each provided more than 10 percent of the total support of their mother, Angela S. Loras. Neither one of the brothers individually provided more than 50 percent of their mother's support. Together, however, Henry and Harold provided more than 50 percent of their mother's support. They decided that Henry would claim the dependency exemption for this tax year. Henry must complete and attach Form 2120 (Exhibit 5) to his return.

Exhibit 5 **Henry's Form 2120**

Form **2120**
(Rev. October 2005)
Department of the Treasury
Internal Revenue Service

Multiple Support Declaration

▶ **Attach to Form 1040 or Form 1040A.**

OMB No. 1545-0074

Attachment Sequence No. **114**

Name(s) shown on return	Your social security number
Henry E. Loras	**000 00 0000**

During the calendar year **2007**, the eligible persons listed below each paid over 10% of the support of:

Angela S. Loras (my mother)

Name of your qualifying relative

I have a signed statement from each eligible person waiving his or her right to claim this person as a dependent for any tax year that began in the above calendar year.

Eligible person's name	Social security number
Harold S. Loras	**000 00 0000**

123 MAIN ST Anytown, USA 00000

Address (number, street, apt. no., city, state, and ZIP code)

CHILDREN OF DIVORCED OR SEPARATED PARENTS

A child of divorced or separated parents or parents who lived apart during the last six months of the year will generally be considered the qualifying child of the parent with whom the child shared the same principal abode for the greater part of the year (the custodial parent). However, the child will be considered the qualifying child or qualifying relative of the noncustodial parent (i.e., the parent who is not the custodial parent) if the following requirements are met:

- The child receives over half of his or her support during the calendar year from his or her parents who are either divorced or legally separated under a decree of divorce or separate maintenance; who are separated under a written separation agreement; or who lived apart at all times during the last six months of the calendar year.
- The decree of divorce or separate maintenance or written separation agreement applicable to the taxable year provides that the noncustodial parent shall be entitled to the dependency exemption (and if the decree or agreement was executed before January 1, 1985, the noncustodial parent provided at least $600 of support for the child during the calendar year), or the custodial parent has signed a **Form 8332, Release of Claim to Exemption for Child of Divorced or Separated Parents** (Exhibit 6), allowing the noncustodial parent to claim the exemption.

The noncustodial parent will not be entitled to the dependency exemption, however, if a multiple support agreement has been executed that gives the exemption to someone other than the noncustodial parent.

Example 2

Ellen M. and Richard A. Stonehill were divorced in 2004. Together, they provided over half of the support of their two children in 2007. Their children, Lisa and Jay, were in the custody of one or both parents for more than half of the year. Richard was the custodial parent because the children shared the same principal abode with their father for the greater part of the year.

Since the divorce occurred after 1984 and Richard and Ellen had agreed that Ellen would claim the dependency exemptions for the children, Richard should execute and sign Form 8332 and Ellen will be allowed to claim the dependency exemption regardless of how much support she provided. Exhibit 6 shows a completed Form 8332 for Ellen.

Exhibit 6 **Ellen's Form 8332**

Form **8332**
(Rev. September 2007)
Department of the Treasury
Internal Revenue Service

Release of Claim to Exemption for Child of Divorced or Separated Parents

► **Attach to noncustodial parent's return each year exemption is claimed.**

OMB No. 1545-0074
Attachment Sequence No. **115**

Name of noncustodial parent claiming exemption: **Ellen Stonehill**
Noncustodial parent's social security number (SSN) ► **000 00 0000**

Part I **Release of Claim to Exemption for Current Year**

I agree not to claim an exemption for **Lisa Stonehill**
Name(s) of child (or children)

for the tax year 20**07**.

Richard Stonehill — Signature of custodial parent releasing claim to exemption
000 00 0000 — Custodial parent's SSN
03/26/2008 — Date

Note. If you choose not to claim an exemption for this child (or children) for future tax years, also complete Part II.

COMPLETING THE EXEMPTIONS SECTION OF THE TAX RETURN

A tax identification number, generally a social security number, is required for all dependents listed on a return. Otherwise, the return may be processed without the benefit of the dependency exemption, which may result in an increased tax or decreased refund for the taxpayer.

The Exemptions section of Form 1040A and Form 1040 are the same (as shown in Exhibit 7). The exemption amount is included in the standard deduction on Form 1040EZ.

Exemptions

If more than four dependents, see page 19.

6a	☑ **Yourself.** If someone can claim you as a dependent, **do not** check box 6a				**Boxes checked on 6a and 6b** 2
b	☑ **Spouse**				**No. of children on 6c who:**
c	**Dependents:** (1) First name Last name	(2) Dependent's social security number	(3) Dependent's relationship to you	(4) ✓ if qualifying child for child tax credit (see page 19)	• **lived with you** 1
	James Nicholson	000 00 3333	son	☑	• **did not live with you due to divorce or separation (see page 20)**
				☐	**Dependents on 6c not entered above**
				☐	
				☐	
d	Total number of exemptions claimed				**Add numbers on lines above ▶** 3

Exemptions are claimed on lines 6a through 6d of Form 1040 and Form 1040A. First, enter the taxpayer's personal exemption on line 6a. Then, if applicable, enter the exemption for the taxpayer's spouse on line 6b. Enter the total of lines 6a and 6b on the line in the right-hand margin.

Enter any dependency exemptions on line 6c. In column 3, enter the specific relationship for each dependent, such as son, daughter, or grandchild. If you use the word "child," there may be a delay in the processing of the return.

Check column 4 if the taxpayer's dependent is also a qualifying child for the child tax credit. The child tax credit is discussed in detail in a later lesson.

Total the line 6c exemptions on the three right-hand-margin lines, which include:

- Children who lived with the taxpayer,
- Children who did not live with the taxpayer as a result of divorce or separation, and
- Other dependents not entered on the lines above.

Indicate the total number of exemptions (personal and dependency) in line 6d.

Directions

Read the following scenarios and then use Publication 4012, Volunteer Resource Guide and other references to determine the best answer to the following questions.

1. Jessica has been raising her son, Jim, alone since her husband died 5 years ago. In 2007, Jessica earned $25,000. Jim, who lives with Jessica, is a U.S. citizen, single, and does not provide more than half of his own support. He was 19 on Sept 17, 2007. Jim is not a full-time student and is not disabled. He worked for a short time at a fast food place and made about $1,800. All are U.S. citizens and have SSNs.

Question: Is Jim the qualifying child or qualifying relative of Jessica?

a. Jim meets the requirements for being her qualifying relative.

b. Jim is Jessica's qualifying child since he is her son.

2. Bob and Judy live together, they are not married. They have 1 child together, Katie, who is age 4. Bob, Judy and Katie are U.S. citizens and have SSNs. Katie did not provide her own support and Katie lived with her parents all year. Bob's AGI is $18,500 and Judy's AGI is $14,000. Neither Bob nor Judy can be claimed as a dependent by any other taxpayer. They did not have any investment income. Bob pays day care for Katie so he and Judy can work. Bob pays over half of the costs of maintaining the home.

Question: What can Bob and Judy claim on their return based on the qualifying child, Katie?

a. Only Bob can claim Katie as a dependent.

b. Only Judy can claim Katie as a dependent.

c. Katie is the qualifying child for both Bob and Judy. They agree that Bob should claim Katie. He can claim the dependency exemption, head of household filing status, Child Tax Credit, dependent care credit, and Earned Income Credit.

d. Judy can claim the dependency exemption, Child Tax Credit, and EIC for Katie and Bob can claim head of household and the dependent care credit.

3. Mary and Ralph got a divorce in 2002. They have one child together, Amy, who lives with Mary. All are U.S. citizens and have SSNs. Mary and Ralph provide more than half of Amy's support. Mary's AGI is $31,000 and Ralph's AGI is $39,000. Amy is 12 and single. The divorce decree does not state who can claim the child.

Question: Who may claim Amy as a qualifying child and the tax benefits?

a. Ralph says he can claim Amy as a dependent and the other benefits.

b. Ralph and Mary need to choose who can claim Amy as a dependent and any other benefits.

c. Mary signed a Form 8332 to give the dependency exemption to Ralph. He can claim Amy as a dependent and the child tax credit. Mary can use Amy to claim the earned income credit, head of household, and child and dependent care credit on the condition she meets the requirements for those specific benefits.

d. Neither Ralph nor Mary can claim Amy as a dependent or any of the other benefits.

4. Phil wants to know if he can claim his daughter, Mariah, as a dependent on his 2007 tax return. Phil is a widower who works full-time and made $35,000 in 2007. He supports his daughter, who lives with him in California. Phil's parents live with him. His parents always file a joint return to pay tax on their pension income, investment income, and Social Security benefits. Everyone in Phil's family is a U.S. citizen and has a SSN. Mariah is 16 years old. In 2007, she earned $10,000 from her hit single "The Grass is Green and the Sky is Blue" which she sold only on the Internet. She put all $10,000 in a college savings account. Phil's AGI is $35,000. Phil's parents' AGI is $42,321.

Question: If Phil and his parents both claim Mariah as a dependent on their returns, who would be entitled based on the tie-breaker rule?

a. Phil can claim Mariah as a dependent. Under the tie-breaker rule, the parent is able to treat the child as a qualifying child.

b. Phil's parents would be entitled to claim Mariah since their AGI is higher.

5. Larry has lived with his girlfriend, Carla, and her 4-year-old son Billy since November 2006. Larry is not Billy's father, but he worked and provided the main support for both Carla and Billy in 2007. Larry's earnings totaled $31,000. Carla stays home and takes care of Billy. She worked part-time and made $4,000. All three are U.S. citizens, all three have SSNs, no one files a joint return, and Billy's father is deceased.

   Question: Choose the best answer that accurately explains who can claim Billy and related benefits for 2007.

   a. Carla can claim Billy as a dependent and let Larry claim head of household based on Billy.

   b. Larry cannot claim Billy as a dependent or any other related benefits. Billy is the qualifying child of Carla and therefore he does not meet the "not a qualifying child test" under the rules for qualifying relative.

   c. Larry is eligible to claim Billy since he provided his support.

Answers to the questions above.

1. a. Qualifying relative since Jim does not meet the rules for qualifying child. He is 19, not a full time student, and not disabled.
2. c. Katie is the qualifying child for both Bob and Judy. They can decide who will claim Katie and all the benefits.
3. c. Since Mary signed the 8332, the dependency exemption for Amy and the child tax credit is given to Ralph, the non-custodial parent. However, Mary can use Amy to claim the earned income credit, head of household, and child and dependent care credit assuming she otherwise qualifies for them.
4. a. Phil wins the tie-breaker rule since he is Mariah's parent.
5. b. Since Billy is the qualifying child of Carla, this prevents Larry from claiming Billy as a qualifying relative.

Exercise 3—Exemptions

A. Janice is 18 years old and a full-time student. She can be claimed as a dependent on her parents' tax return. Janice will file Form 1040EZ to report income from her summer job. Can Janice claim a personal exemption for herself on her return? ______________________________

B. Tom Brown supports his wife's uncle, Jim (her mother's brother), who lives in another city. Jim has no gross income for the calendar year. The Browns file a joint return. Can the Browns claim Jim as a dependent if all other tests are met?______________________________

C. Ruth filed a joint return with her husband whom she married in November. They claimed two personal exemptions on their return. Ruth had no income; her husband had $10,600 income. Can Ruth's father, who supported her and paid for the wedding, claim her as a dependent on his return? __________

D. Joe is 65 years old and lives with his son and daughter-in-law. In 2007, Joe's taxable pension income was $4,700. Can Joe's son and daughter-in-law claim a dependency exemption for Joe if all other tests are met? ____________________

E. Randy's son, Paul, earned $4,300 last year. Paul is 18 years old and started college in September 2007. He is a full-time student. Does Paul's earned income of $4,300 preclude Randy from claiming Paul as a dependent? ________________

F. Mrs. Wiley has three children: Mark, Tim, and Mary. Each child contributes toward Mrs. Wiley's support. Mark provides 45 percent; Tim, 35 percent; and Mary, 10 percent.

1. Which, if any, of her children can claim a dependency exemption for Mrs. Wiley under a multiple-support agreement? ______________________________

2. If Mark is to claim the dependency exemption, who must sign a statement waiving his or her right to claim Mrs. Wiley as a dependent? ____________________

G. Under the terms of Peter's pre-1985 divorce decree, Peter can claim the exemption for his child. He provided $700 toward the child's support. Can Peter claim the child's exemption even if the child's mother is the custodial parent for the tax year? ______________________________

Exercise 1—Determining Support

A. $5,150 ($1,500 + $500 + $2,400 + $300 + $150 + $100 + $200) Note that life insurance premiums are not considered support.

B. $2,000 ($1,500 + $500)

C. $3,150 ($2,400 + $300 + $150 + $100 + $200) Note that life insurance premiums are not considered support.

D. No, because the total support for Traci's mother is $5,150 and Traci provided only $2,000.

Exercise 2—Critical Definitions

Order of the answers in the definition boxes: 2, 4, 3, 1

Exercise 3—Exemptions

A. No. Janice's parents are claiming her as a dependent.

B. Yes. Mrs. Brown's uncle passes the relationship test for a qualifying relative.

C. No, because Ruth filed a joint return with her spouse.

D. No, because Joe's income exceeded $3,400 (the exemption amount for tax year 2007).

E. No. As long as Paul does not provide over half of his own support for the year, the amount of Paul's gross income is not taken into account in determining whether Paul is a qualifying child. Paul cannot be a qualifying relative because his gross income exceeds the exemption amount ($3,400 for 2007).

F.1. Mark and Tim must decide who will claim the exemption. Mary is not eligible since she did not provide more than 10 percent of the support.

F.2. Tim must sign. Mary's signature is not required on the waiver since she is not eligible to take the exemption. Mark must maintain Tim's signed statement and documentation of the support provided by all parties with his tax records.

G. Yes. Peter provided at least $600 in support, and the terms of his pre-1985 divorce decree grant him the exemption.

QUALITY REVIEW (QR)—TAXPAYER IDENTIFICATION NUMBERS AND EXEMPTIONS

Use **Form 8158, Quality Review Sheet,** or an approved alternative form to review all returns prepared. Apply the quality review tools in combination with the Interview and Intake Sheet and all the source documents to the returns you prepare to ensure quality and accuracy for every taxpayer.

Excerpts from Form 8158

Yes	No	
☐	☐	**Names and social security numbers (SSN) or individual taxpayer identification numbers (ITIN)** on the return match the intake sheet and supporting documents.

Yes	No	
☐	☐	**Dependency exemptions** on the return were determined based on the interview with the taxpayer and the intake and interview sheet.

Consider each box on the Quality Review Sheet that applies to the taxpayer's situation to confirm that all the necessary questions and issues have been addressed. If items are incorrect or incomplete, revisit the issue and make corrections to the return, as needed.

To ensure accurate reporting, verify that the names and taxpayer identification numbers match the intake sheet and supporting documents.

To ensure accurate reporting, verify that the dependency exemption information matches the intake sheet.

▶▶ Summing Up Exemptions ◀◀

- Exemptions reduce the taxpayer's taxable income. Generally, the deduction for each exemption is $3,400 in 2007.
- There are two types of exemptions: personal exemptions and exemptions for dependents. While each is worth the same amount, different rules apply to each type.
- Generally, one personal exemption is claimed by the taxpayer, and if the taxpayer is married, one exemption is claimed by his or her spouse.
- A personal exemption (a $3,400 reduction in taxable income) can be claimed by the taxpayer unless the taxpayer is eligible to be claimed as a dependent on another person's return.
- If a taxpayer is divorced or legally separated on December 31, 2007, he or she cannot claim an exemption for his or her (former) spouse.
- For dependency exemptions, use the worksheet in Form 1040 Instructions and tools in Publication 4012, *Volunteer Resource Guide,* to avoid filing errors and processing delays.
- Different tests apply to determine if an individual is a qualifying child or a qualifying relative.
- If the taxpayer wants to take a dependency exemption, review each dependency test to make sure the dependent qualifies.

STOP

Military/International students continue.

All others go to Lesson 2, page 2-1.

STUDENT NOTES

MILITARY MATTERS

In this segment we will address the unique exemption situations you may encounter when assisting members of the United States armed forces with their tax returns. At the end of this lesson you will be able to:

- Explain how to obtain an SSN for children born abroad,
- Determine whether a service member's spouse and/or dependents are nonresident aliens or resident aliens,
- Determine whether a United States service member is entitled to claim the personal exemption for a spouse who is a nonresident aliens,
- Apply the dependency tests to determine whether a service member can be claimed as a dependent, and
- Apply the dependency tests to determine whether an individual can be claimed as a dependent by a service member.

CHILDREN BORN ABROAD OBTAINING AN SSN

Military families who wish to apply for a social security number for a child born overseas should begin the process by first contacting their base legal office or United States embassy officials to obtain a Report of Birth Abroad. This document serves as proof of United States citizenship and can be used in the future.

To register the birth of a child born abroad, the parents should bring the child to the embassy/consulate office along with the following documents:

- The child's original birth certificate
- The parents' marriage certificate
- Any divorce decree or death certificate (original documents required) from any previous marriage

While applying for the Report of Birth Abroad, parents should also apply for a social security number and passport for their child. The SSN will be mailed directly to the taxpayer. The process takes several months. Without a social security number, the parents will not be able to claim the child as a dependent or take advantage of credits such as the earned income tax credit or the child tax credit, even if all of the other prerequisites are met.

DETERMINING RESIDENCY STATUS

Most members of the Armed Forces are United States citizens or resident aliens. However, occasionally you may have questions about the residency status of a service member or a service member's spouse and dependents.

For United States tax purposes, a nonresident alien is an individual who is not a citizen or resident of the United States. A nonresident alien generally must pay tax only on income received from sources within the United States. Filing status, eligibility for tax credits, and other matters are affected by an individual's residency status.

Once you've determined that a taxpayer is an alien (not a United States citizen), you must then determine his or her alien status for tax purposes. An alien falls into one of the following categories:

1. Resident: A taxpayer is considered a resident alien of the United States for tax purposes if he or she meets either the green card test or the substantial presence test for the calendar year.
2. Nonresident: An alien who does not meet the requirements to be a resident alien.
3. Dual status: A taxpayer can be both a nonresident and resident alien during the same year. This usually occurs in the year that he or she arrives or departs from the United States.

Placement in the correct category is crucial in determining what income to report and which tax return to file. Nonresident aliens must file **Form 1040NR, United States Nonresident Income Tax Return**.

Resident aliens generally are taxed on their worldwide income, the same as United States citizens. Therefore, resident aliens should use the same tax forms (Form 1040, Form 1040A, and Form 1040EZ) as United States citizens.

RESIDENCY STATUS TESTS

An individual is considered to be a United States resident alien if he or she meets either of these two tests:

- The green card test
- The substantial presence test

An individual who does not meet one of these two tests is considered to be a nonresident alien.

Green Card Test

When individuals are issued green cards by the United States Citizenship and Immigration Services (USCIS), they generally become lawful, permanent residents of the United States and are considered to have met the green card test. The green card is an alien registration card that indicates that the individual has been granted the privilege, according to immigration laws, of residing permanently in the United States as an immigrant.

This resident status continues indefinitely unless it is taken away from the individual or is administratively or judicially determined to have been abandoned.

Substantial Presence Test

Individuals who do not have green cards may still qualify as resident aliens if they meet the requirements of the substantial presence test for the calendar year. To meet this test, an individual must be physically present in the United States on at least:

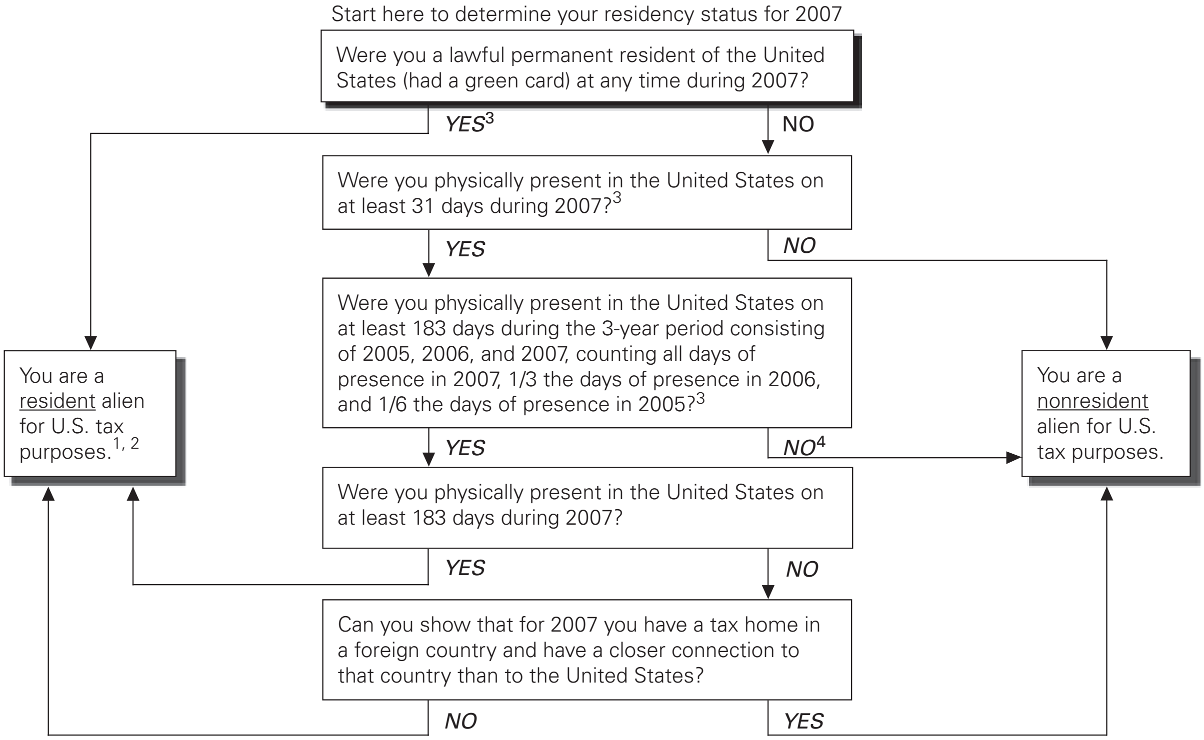
1. 31 days during the current year, and
2. 183 days during the 3-year period that includes the current year and the two years immediately before that, counting:
   - All the days he or she was present in the current year (2007), and
   - 1/3 of the days he or she was present in the first year before the current year (2006), and
   - 1/6 of the days he or she was present in the second year before the current year (2005).

To correctly apply the substantial presence test, it is necessary to define the term "United States." For tax purposes, the United States includes the following:

- All 50 states and the District of Columbia
- The territorial waters of the United States
- The seabed and subsoil of those submarine areas that are adjacent to the United States territorial waters and over which the United States has exclusive rights under international law to explore and exploit natural resources

The term does not include United States possessions and territories or United States air space.

Exhibit M-1-1. Nonresident Alien or Resident Alien?



1 If this is your first or last year of residency, you may have a dual status for the year. See Dual-Status Aliens in Publication 519.
2 In some circumstances you may still be considered a nonresident alien under an income tax treaty between the U.S. and your country. Check the provisions of the treaty carefully.
3 See Days of Presence in the United States in Publication 519 for days that do not count as days of presence in the United States.
4 If you meet the substantial presence test for 2008, you may be able to choose treatment as a U.S. resident alien for part of 2007. For details, see Substantial Presence Test under Resident Aliens and First-Year Choice under Dual-Status Aliens in Publication 519.

Example 1

Sergeant Paul Kingman and his wife, Gabriella, were married at the end of 2007. She lived in the United States for 120 days in 2007 (from September to December) as a nonresident alien. She was in the United States for 120 days in each of the years 2005 and 2006. To determine if she meets the substantial presence test for 2007, total the following:

- The full 120 days of presence in 2007
- 40 days in 2006 (1/3 of 120)
- 20 days in 2005 (1/6 of 120)

Since the total for the 3-year period is 180 days, Gabriella is not considered to be a resident under the substantial presence test for 2007.

Exceptions to the Substantial Presence Test

There are exceptions to the substantial presence test that may affect the resident or nonresident alien spouse of a service member. An individual is treated as present in the United States on the day the individual is physically present in the country. However, you should not count the days an individual:

- Regularly commutes to work in the United States from a residence in Canada or Mexico,
- Is in the United States for less than 24 hours when in transit between two places outside the United States,
- Is unable to leave the United States because of a medical condition that developed while he or she was in the United States, or
- Was an exempt individual.

Regular Commuters from Canada or Mexico

For the purposes of the substantial presence test, the term "commute" means to travel to work and return home within a 24-hour period. Individuals are considered to commute regularly if they commute to work in the United States on more than 75 percent of the workdays during their working period.

Workdays are the days on which they work in the United States or Canada or Mexico. Working period is the period beginning with the first day in 2007 in which an individual is physically present in the United States to work.

The working period for individuals whose work requires them to be present in the United States on a seasonal or cyclical basis begins on the first day of the season or cycle on which they are present in the United States to work.

The period ends on the last day of the season or cycle on which they are in the United States to work. Thus, an individual may have more than one working period in 2007, and the working periods may begin in one calendar year and end in the following calendar year.

Exempt Individual

For the substantial presence test, do not count days for which an individual is exempt. The term "exempt individual" does not refer to someone exempt from United States tax, but to anyone in the following categories:

- An individual temporarily present in the United States as a foreign government-related individual,
- A teacher or trainee, temporarily present in the United States under a J or a Q visa, who substantially complies with the requirements of the visa,
- A student, temporarily present in the United States under an F, J, M, or Q visa, who substantially complies with the requirements of the visa, or
- A professional athlete temporarily in the United States to compete in a charitable sports event.

Choosing Residency Status

Aliens who do not meet the green card test or the substantial presence test for 2006 or 2007, and did not choose to be treated as residents for part of 2005, but will meet the substantial presence test for 2008, can choose to be treated as United States residents for part of 2007. To make this choice, the individual must have been:

- Present in the United States for at least 31 consecutive days in 2007, and
- Present in the United States for at least 75 percent of the days, beginning with the first day of the 31-day period in 2007 and ending with the last day of 2007.

As a general rule most alien enlistees in the Armed Forces are resident aliens. In peacetime all enlistees in the Armed Services must be United States citizens or permanent residents of the United States.

Alien enlistees will generally be classified as resident aliens if they are:

- Enlisting voluntarily, and
- Have been granted permanent residency in the United States.

The United States has treaty agreements with certain nations that allow a very limited number of their citizens to retain their nonresident alien status. Alien enlistees in this category should seek advice from their base legal officer. Other aliens who are present in the United States merely because of military assignments and who have residences outside the United States are nonresident aliens.

Choice to Treat Nonresident Spouse As a Resident

Remember, a nonresident alien spouse may choose to be treated as a resident alien if all the following conditions are met:

- The nonresident alien spouse must be married to a United States citizen or resident alien at the end of the tax year.
- Both spouses must choose to treat the alien spouse as a resident alien.
- One of the spouses must be a United States citizen or resident alien on the last day of the tax year.

A statement signed by both spouses must be attached to the joint return for the first tax year for which the choice applies. The statement should contain:

1. A declaration that one spouse was a nonresident alien and the other spouse was a United States citizen or resident alien on the last day of the tax year and that the nonresident alien spouse chooses to be treated as a United States resident for the entire tax year, and
2. The name, address, and taxpayer identification number of each spouse.

Once a nonresident alien chooses to be treated as a resident, the choice applies to all later tax years unless one of the following situations occurs:

- Revocation by either spouse
- Death of either spouse
- Legal separation
- Inadequate records

If the choice is ended for any of these reasons, neither spouse can make a choice for any future year.

Choice to Treat Nonresident Spouse As a Nonresident

If the choice is made to treat the nonresident spouse as a nonresident for tax purposes, the following rules apply:

- The nonresident alien spouse cannot file a joint return.
- The nonresident alien spouse is generally not eligible for certain credits, such as the earned income credit or the education credits.

Continuing with rules that apply when the choice is made to treat the nonresident spouse as a nonresident:

The spouse who is a United States citizen or resident may claim an exemption for the nonresident alien spouse if the nonresident alien has no gross income for United States tax purposes and is not another United States taxpayer's dependent. Check the box on line 6b of Form 1040 or Form 1040A.

The nonresident alien spouse does not have to file a federal income tax return if he or she had no United States source income. Nonresident alien spouses do not have to report any income from sources outside the United States as long as they remain nonresident aliens.

ALERT

Generally, dual-status aliens should be referred to a military legal assistance officer or paid tax professional.

DUAL-STATUS ALIENS

An alien may be both a nonresident and resident alien during the same tax year. The most common dual-status tax years are the years of arrival and departure. Dual-status aliens are taxed on income from all sources for the part of the year they are resident aliens. They are taxed on income from United States sources only for the time they are nonresident aliens.

Dual-status aliens must file Form 1040 and mark it "Dual-Status Return" if they are resident aliens on the last day of the tax year. If they are **nonresident** aliens at the end of the year, they must file Form 1040NR and mark it "Dual-Status Return."

In either case, they must attach a separate statement to explain their income and compute the tax for the other part of their dual-status year. Dual-status aliens must either itemize their allowable deductions or claim zero deductions because dual-status aliens cannot use the standard deduction.

UNDOCUMENTED ALIENS

In addition to dual-status aliens, you may encounter undocumented aliens who wish to file tax returns. Typically, undocumented aliens who meet the substantial presence test are considered resident aliens for tax purposes. Although undocumented aliens are not eligible for a social security number because they do not have legal work authorization, they are eligible for an ITIN, which enables them to file a tax return.

As a volunteer preparer, you may encounter the following common scenario that often causes processing problems for the IRS:

An undocumented alien "acquires" (buys or trades) a social security number to provide to an employer. The employer hires the alien and gives the alien a Form W-2 at the end of the year with the invalid SSN. The alien then files a tax return with his or her ITIN listed as his or her identification number. This causes a processing problem for the IRS. The refund may be delayed until the issue can be resolved.

PERSONAL EXEMPTIONS—FOREIGN SPOUSE

Taxpayers who file a joint return may claim their spouses as personal exemptions. On a married filing separately return, the taxpayer may claim his or her spouse as a personal exemption only if the spouse had no gross income.

The same rules apply to military personnel who reside in the United States or who live abroad.

However, special filing rules apply to taxpayers who wish to claim personal exemptions for spouses who are nonresident aliens. These rules apply to service members whether they live in the United States or overseas.

There are no special rules for service members who are married to United States resident aliens; they can claim the standard personal exemptions for their spouses.

There are two ways service members who are married to nonresident aliens can claim the personal exemptions for their spouses:

- If the spouse chooses to be treated as a nonresident alien for tax purposes, the exemption can be claimed on a married filing separately return.
- If the spouse chooses to be treated as a United States resident alien for tax purposes, the exemption can be claimed on a joint return (the spouse does not have to be from Canada or Mexico to make this choice).

Married Filing Separately Return

In order for a nonresident alien spouse to be claimed as a personal exemption on a service member's married filing separately return, the spouse:

- Must not have any gross income for United States tax purposes,
- Cannot be the dependent of another United States taxpayer, and
- Must have an individual taxpayer identification number (ITIN)

DEPENDENCY TESTS—MILITARY PERSONNEL

Review the information in the base lesson closely before proceeding.

A taxpayer can take one exemption for each dependent who meets all qualifying child and/or qualifying relative dependency tests.

The dependency tests apply in the same way to United States service members who wish to claim dependency exemptions or who may be claimed as a dependent on someone else's return. However, you may encounter unique issues regarding the application of the support test and the citizen/resident tests to members of the military, specifically those overseas. The remainder of this topic discusses the two tests in detail.

Armed Forces Member As a Dependent

If you recall, for an individual to be a qualifying relative, the taxpayer must have provided more than 50 percent of the individual's support for the entire year, including food, lodging, clothing, education, recreation, transportation, and medical and dental care. To be a qualifying child, the individual must not have provided more than half of his or her own support for the year.

Individuals who have been in the Armed Forces for the entire year generally cannot be claimed as dependents on another taxpayer's return because the support test will not have been met.

However, individuals in the Armed Forces for part of the year can often be claimed as dependents if they meet all dependency tests. When determining whether the support test has been met, remember to take into account all amounts that service members receive from the Armed Forces.

Similarly, individuals who are appointed to one of the Armed Forces academies and reside at the academy all year cannot be claimed as dependents. However, an appointee at the academy for only part of the year may qualify as a dependent if all the tests are met.

Armed Forces Member Claiming a Dependent

Members of the military can claim an exemption for their dependents if the dependency tests are met. Further, a member of the military can authorize an allotment from his or her pay for the support of dependents. The allotment amount provided by the military member is used to determine which taxpayer provides more than half of the dependent's support.

If an allotment is used to support persons other than those the military member names, the military member can claim exemptions for them if they otherwise qualify as the military member's dependent.

Example

Army Sergeant Jeff Banks authorizes an allotment for his widowed mother.

She uses the money to support herself and Jeff's 10-year-old sister. If that amount provides more than half of each individual's support, Jeff can claim an exemption for each of them, if they otherwise qualify, even though he only authorized the allotment for his mother.

CITIZEN OR RESIDENT TEST

Earlier, you learned about the citizen/resident test. The requirements are exactly the same for dependents of members of the military. To meet the citizen/resident test, the dependent must generally be a United States citizen, a United States national, a United States resident, or a resident of Canada or Mexico for some part of the tax year.

Children

Children are usually citizens or residents of the country of their parents. This often holds true even if both parents are not citizens of the same country.

For example, if a service member is married to a nonresident alien in a foreign country, and their child is born in that country, the child may be entitled to United States citizenship. In most instances, the United States parent will register the child with the United States embassy or consulate closest to where they live.

Adopted Children

Service members who legally adopt a child who is not a United States citizen or resident can claim the child as a dependent if the other dependency tests are met. The following must be true for the tax year:

- The child is a member of the taxpayer's household.
- The service person's home is the child's main home.
- The service person is a citizen or national of the United States.
- The adopted child must have a TIN (SSN, ATIN, or ITIN).

▶▶ Summing Up This Military Segment ◀◀

- ▶ Armed Forces personnel should contact their base legal office or United States embassy for assistance with tax matters and other matters such as obtaining SSNs and filing their tax return.
- ▶ An individual's tax situation is impacted by his or her alien status.
- ▶ Aliens can choose to be a part-year resident alien.
- ▶ Special rules apply to military personnel who wish to claim a personal exemption for a nonresident alien spouse.
- ▶ Nonresident aliens must have an ITIN.
- ▶ The support test and citizen/resident test for military personnel require some special considerations.
- ▶ Children born abroad may be entitled to United States citizenship even if one of the parents is a nonresident alien.

STUDENT NOTES

Filing Status and Filing Requirements

Lesson 2

Introduction and Objectives

In this lesson you will learn how to determine the correct filing status to use when completing a tax return. You will also learn how to establish whether there is a filing requirement and which tax form to use. You must choose the correct filing status before you can determine if there is a filing requirement. The filing status is also used to determine whether the taxpayer is eligible to claim certain deductions and credits.

After completing this lesson you should be able to:

- Apply the requirements for each of the five filing statuses.
- Determine who must file.
- Determine who should file.
- Select the appropriate tax form to use.

Alert

This lesson contains basic tax law and is required training for all volunteers.

Intake and Interview Process—Form 13614 (Filing Status and Filing Requirements)

Use **Form 13614, Intake and Interview Sheet,** or approved equivalent form to engage the taxpayer in preparing an accurate return. Use the Intake and Interview Sheet as a starting point for a comprehensive interaction with the taxpayer, in combination with all the source documents provided by the taxpayer, to ensure quality and accuracy on each return.

Confirm each item on the Form 13614 (or similar approved tool used at your site) to make sure you and the taxpayer have considered all the necessary information. Ensure that all questions and issues have been addressed. If items are incorrect or incomplete, revisit the issue and make corrections to the return, as needed.

Excerpt from Form 13614

Part I: Taxpayer Information

16. **On December 31, 2007:**

a. Were you: ☐ Single ☐ Legally Married ☐ Separated ☐ Divorced ☐ Widowed

b. If married, were you living together (with your husband/wife) **on/after June 30, 2007?** ☐ Yes ☐ No

c. Was your spouse deceased? If yes, provide the date of death.__________________ (mm/dd/yyyy)

Part III. Filing Status & Dependency Determination

Based on the interview, the filing status of the taxpayer is: ☐ Single ☐ MFJ ☐ MFS* ☐ HOH ☐ QW

*Spouse Name ______________________________ Social Security Number _____________________

To accurately determine the filing status, verify the taxpayer's marital status. Using Publications 4012 and/or 17, confirm that the appropriate decision tree, interview tips, and informational charts were used to determine filing status.

Filing Status

There are five filing statuses:

1. Single
2. Married filing jointly
3. Married filing separately
4. Head of household
5. Qualifying widow(er) with dependent child

In general, a taxpayer's filing status depends on whether he or she is considered unmarried or married. Determining the appropriate filing status is critical to the accuracy of the taxpayer's return.

Single

A taxpayer is considered single if, on the last day of the year, any of the following is true:

- The taxpayer was never married.
- The taxpayer was legally separated, according to state law, under a decree of divorce or separate maintenance.
- The taxpayer was widowed before January 1, 2007, and did not remarry in 2007.

However, the taxpayer may be able to use another filing status that will give a lower tax.

See Head of Household and Qualifying Widow(er) with Dependent Child, later.

Married Filing a Joint Return

Taxpayers may use the married filing jointly status if they are married. A marriage means only a legal union between a man and a woman as husband and wife. They are considered married if, on the last day of the year, one of the following applies:

- They are married and live together as husband and wife.
- They live together in a common-law marriage recognized in the state where they now live or in the state where the common-law marriage began.

- They are married and live apart but are not legally separated under a decree of divorce or separate maintenance.
- They are separated under an interlocutory (not final) divorce decree.
- The taxpayer's spouse died during the year and the taxpayer has not remarried.

If taxpayers file a joint return, combine the husband's and wife's tax items (for example, income) on the same return. Both the husband and wife must sign the return and both are responsible for any tax owed on that return. Taxpayers can choose the married filing jointly status even if only one spouse has income.

Taxpayers filing a joint return generally have a lower tax than their combined tax for any other filing status.

Married Filing a Separate Return

Taxpayers who are married may choose to file separately. The husband and wife report their own incomes and deductions on separate returns. Taxpayers may choose the married filing separately status even if one spouse has no income.

If the taxpayers live in a community property state, they must follow state law to determine their separate income. For more information, see Publication 555, *Community Property*.

If a married couple files separately and one spouse itemizes deductions, the other spouse must also itemize deductions because he or she cannot take the standard deduction. See Lesson 4 for more information on itemized deductions.

Taxpayers filing separate returns generally have a higher tax than when filing jointly. Occasionally, however, separate returns may result in a lower tax. If you think this might be the case, compute the tax liability for (a) married filing jointly and (b) married filing separately. Choose the filing status that results in the lower tax.

When a married taxpayer files separately, the taxpayer must show his or her spouse's social security number in the label section. Also, the spouse's full name must be entered on line 3 in the space provided opposite the married filing separately check box.

Potential Pitfalls

A common-law marriage is recognized for federal tax purposes if the marriage is recognized by the state where the taxpayers now live or in the state in which the common-law marriage was entered. Legal advice may be required to determine if a common-law marriage exists.

Alert

If a taxpayer files a joint return, he or she cannot amend it to file separately after the due date for filing the tax return.

Alert

A taxpayer who would normally file a married filing separately return may qualify for the head of household filing status. See rules for head of household and married persons living apart with dependent children.

HEAD OF HOUSEHOLD

Generally, taxpayers who file under the head of household filing status have a lower tax than if they file as single. If taxpayers qualify, they should use the head of household status instead of the single status.

Head of Household Qualifications

> **ALERT**
>
> The taxpayer cannot file as head of household for a person who is a qualifying relative only because he or she lived with the taxpayer for the whole year or because the taxpayer may claim him or her as a dependent under a multiple support agreement.

Taxpayers may claim head of household status if both of the following qualifications are met:

1. The taxpayer must be unmarried (single, widowed, divorced, or legally separated) on the last day of the year, or meet the tests for married persons living apart with dependent children (explained later in this lesson).
2. The taxpayer must have paid more than half the cost of keeping up a home that was the main home for more than half the year (except for temporary absences) of any of the following:
   - The taxpayer's qualifying child who lived with the taxpayer but does not have to be claimed as a dependent by the taxpayer.
   - The taxpayer's child who lived with the taxpayer and is not a qualifying child but is the taxpayer's dependent.
   - Only the relatives listed at the end of this discussion who lived with the taxpayer and were the taxpayer's dependents.

     Exception: The taxpayer may claim head of household filing status if the taxpayer's parent can be claimed as a dependent, even if the parent does not live with the taxpayer. However, the taxpayer must pay more than half the cost of maintaining the parent's home for the entire year.

"Child" includes:

- The taxpayer's child or stepchild (whether by blood or adoption), foster child, sibling or stepsibling, or a descendant of one of these.

"Relative" includes:

- Child who is not a qualifying child,
- Parent, grandparent,
- Brother, sister, stepbrother, stepsister,
- Half brother, half sister,
- Stepmother, stepfather,
- Mother-in-law, father-in-law,
- Brother-in-law, sister-in-law,
- Son-in-law, daughter-in-law,
- Uncle, aunt, nephew, or niece.

"Relative" does not include cousins and more distant relatives.

Married Persons Living Apart with Dependent Children

Some married taxpayers who live apart from their spouses may be considered unmarried for tax purposes. If so, these taxpayers are permitted to file as head of household and receive the benefit of lower tax amounts.

A married taxpayer can file as head of household if:

- The taxpayer files a separate return;
- The taxpayer paid more than half the cost of keeping up his or her home for the year;
- The taxpayer's spouse did not live in the home during the last six months of the year;
- The taxpayer's home was the main home of the taxpayer's child, stepchild, adopted, or foster child for more than half of the year; and
- The taxpayer is entitled to claim the child, stepchild, adopted child, or foster child as a dependent, unless one of the following exceptions for divorced or separated parents applies:
  - The taxpayer signed a statement allowing the noncustodial parent to claim the child as a dependent, or
  - The noncustodial parent provided at least $600 for the child's support and can claim the dependent under a pre-1985 agreement.

Keeping Up the Home

The taxpayer must pay more than half the cost of keeping up the home. The cost of keeping up a home includes payments for rent, mortgage principal and interest, real estate taxes, insurance on the home, repairs, utilities, domestic help, and food eaten in the home. Welfare payments are not considered amounts that the taxpayer furnishes to keep up a home.

The home must have been the main home for more than half the year except for temporary absences. Temporary absences include those for school, vacation, illness, business, or military service.

You can determine whether the taxpayer paid more than half of the cost of keeping up a home by using the worksheet shown on following page.

Exhibit 1

> **ALERT**
> When determining the amount that the taxpayer furnishes in keeping up the home, do not include welfare payments.

Cost of Keeping Up a Home

Keep for Your Records

	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

Review the "Who Is a Qualifying Person for Filing as Head of Household" chart in the Volunteer Resource Guide, Tab B. This chart may help you decide who is eligible to claim head of household filing status. The Caution at the top of the chart is referring to the pages in Publication 17.

Reporting Head of Household Filing Status

Taxpayers must enter the name of the person who qualifies them for the head of household status. If the person is a dependent, enter the dependent's name on line 6c of the exemption section of the tax return. If the qualifying child is not claimed as a dependent, enter the name of the nondependent person on line 4 in the filing status section of the tax return.

Example 1

Darlisa is divorced and provided over half the cost of keeping up a home. Her five-year-old daughter, Jayla Smith, lived with her for seven months last year. Darlisa does not claim Jayla as a dependent; her ex-husband does.

Darlisa may use head of household status. Darlisa must write Jayla's name in the space on Form 1040 or 1040A, on line 4. See Exhibit 2.

Exhibit 2 Darlisa's Form 1040A, page 1

Filing status Check only one box.	1 ☐ Single 2 ☐ Married filing jointly (even if only one had income) 3 ☐ Married filing separately. Enter spouse's SSN above and full name here. ►	4 ☒ Head of household (with qualifying person). (See page 19.) If the qualifying person is a child but not your dependent, enter this child's name here. ► Jayla Smith 5 ☐ Qualifying widow(er) with dependent child (see page 20)

PRACTICE SCENARIOS FOR HEAD OF HOUSEHOLD FILING STATUS

1. Abner and Alice were divorced in 2002. They have two children who live with Alice. Their divorce decree specifies that Abner may claim the dependency exemptions for the two children in odd numbered years (2003, 2005, 2007, etc.) and Alice may claim the dependency exemptions in even numbered years (2002, 2004, 2006 etc.) In 2007 Abner claims the children's exemptions as qualifying children under the rule for children of divorced or separated parents.

Question: Can Abner claim head of household based on these two children in 2007?

2. Luke and Laura separated in February 2007 and lived apart for the rest of the year. They do not have a written separation agreement and are not yet divorced. Their 6-year-old daughter Lucy lived with Luke all year. Luke and Laura will not file a joint tax return. Luke paid more than half the cost of keeping up his home. Luke claims Lucy's exemption because he is the custodial parent.

Question: Can Luke claim HOH filing status?

3. Carlos supports his parents and pays more than half the cost of keeping up their home in Mexico. Carlos claims his parents as dependents on his 2007 tax return. Carlos has never married.

Question: Can Carlos claim HOH filing status?

4. Jeffrey has lived with his girlfriend Janice and her son John for five years. Jeffrey is not related to John and cannot claim him as a dependent. Jeffrey pays all of the cost of keeping up the home where they all live. No one else lives in the household, and Jeffrey does not keep up a home for his parents.

Question: Can Jeffrey claim HOH filing status?

5. Craig and Colleen never married, but they have lived together for four years. They have one child, Carrie, who is 8 years old. Carrie is a qualifying child for both Craig and Colleen. They agreed that Colleen would claim Carrie as a dependent.

Question: Can Craig claim HOH based on his qualifying child Carrie?

QUALIFYING WIDOW(ER) WITH DEPENDENT CHILD

A widow or widower, with one or more dependent children, may be able to use the **qualifying widow(er)** with a dependent child filing status. This filing status yields the lowest tax rate (the same tax for married filing jointly).

If the taxpayer's spouse died during 2005 or 2006 and the taxpayer did not remarry before the end of 2007, the taxpayer may be able to file as a qualifying widow(er) with a dependent child. To qualify, the taxpayer must:

- Have been entitled to file a joint return for the year the spouse died (it does not matter whether or not a joint return was actually filed),
- Have a child, adopted child, or stepchild who qualifies as the taxpayer's dependent for the year, and
- Have furnished over half the cost of keeping up a home that was the main home of the child for the entire year.

An adopted child includes a child lawfully placed with the taxpayer by an authorized placement agency for legal adoption.

Social Security survivor benefits received on behalf of the child are considered to be amounts furnished by the child, not by the parent.

In the year a taxpayer's spouse dies, if the taxpayer does not remarry, he or she can use the married filing jointly filing status or married filing separately filing status and can claim an exemption for the deceased spouse. For two years after the year of death, the taxpayer may file as a qualifying widow(er) with dependent child, but may not claim an exemption for the deceased spouse. After the second year following the year of death, the taxpayer can no longer use the qualifying widow(er) filing status. The taxpayer may use either the head of household or single filing status, depending on his or her situation at this point in time.

The following chart may help you decide which filing status to use for a taxpayer with a qualifying dependent if the spouse is deceased and the taxpayer has not remarried.

Exhibit 3

Filing Status After Death of Spouse		
Tax Year	Filing Status	Exemption for Deceased Spouse?
1. Year of death	Married (joint)	Yes
	OR	
	Married (separate)	Yes[1]
2. First year after death	Qualifying widow(er)[2]	No
3. Second year after death	Qualifying widow(er)[2]	No
4. After the second year after death	Head of household[3]	No
	OR	
	Single	No

[1] Only if spouse had no income.

[2] With a qualifying dependent who is a son, daughter, stepson, or stepdaughter.

[3] With a qualifying child or qualifying relative.

You may find the flowchart (Determination of Filing Status) shown in the Volunteer Resource Guide, Tab 2, helpful in determining the correct filing status. It has some of the same questions as shown in the Interview Tips on the following page of the Volunteer Resource Guide.

TaxWise® Hints

When using TaxWise® to prepare a tax return, you will need to have the social security number of anyone who qualifies the taxpayer for head of household filing status and is not the taxpayer's dependent.

For qualifying widow(er) filing status, you must enter the year of death of the deceased spouse.

For married filing separately status, you will need the spouse's full name and social security number.

Quality Review (QR)—Filing Status and Filing Requirements

Use **Form 8158, Quality Review Sheet,** or your site's approved equivalent form to review all returns prepared. Apply the quality review tools in combination with the Intake/Interview Sheet and all the source documents to the returns you prepare to assure quality and accuracy for every taxpayer.

Excerpt from Form 8158

Yes	No	
☐	☐	**Filing status** on the return was determined based on the interview with the taxpayer and the intake and interview sheet.

Consider each box on the Quality Review Sheet that applies to your taxpayer's situation to confirm that all the necessary questions and issues have been addressed. If items are incorrect or incomplete, revisit the issue and make corrections to the return, as needed.

To accurately determine the filing status, verify the taxpayer's marital status. Using Publications 4012 and/or 17, confirm that the appropriate decision tree, interview tips, and informational charts were used to determine filing status.

▶▶ Summing Up Filing Status ◀◀

When completing their tax returns, taxpayers should choose one of the five filing statuses for which they qualify.

1. Single

2. Married filing jointly*

3. Married filing separately

4. Head of household

5. Qualifying widow(er) with dependent child*

*Filing status 2 and 5 yield the same (lowest) tax.

Filing status is indicated on lines 1 through 5 of Forms 1040A and 1040. Selecting the correct filing status is one of the most important aspects of completing a tax return because the filing status factors in how much tax will be due. Remember that filing status requirements do not change, regardless of the tax form used. If a taxpayer is qualified to use more than one filing status, choose the one that will result in the lowest tax.

Answers to Practice Scenarios for Head of Household Filing Status

1. No. The non-custodial parent cannot claim head of household filing status. If Abner has another qualifying relative for HOH purposes, then he may claim HOH based on the other person.

2. Yes. Although Luke is still legally married, he meets all the requirements to be “considered unmarried”.

3. Yes. Carlos’ parents are qualifying persons for HOH filing status.

4. No. Janice nor her son John are qualifying persons for Jeffrey for HOH purposes

5. No. Because Colleen claims Carrie as a dependent, only Colleen may claim HOH based on Carrie.

Exercises

1. Kay and Fred were married in 2006. They are not divorced, but have lived apart all of 2007. They are not legally separated under a decree of divorce or separate maintenance. They have no children. Can they use the married filing jointly status?

 ____

2. Jerry does not know which filing status to use. You ask if he is married. He answers that he got divorced in December but supported his wife all year and has not remarried. Can Jerry and his ex-wife file a joint return? ______________

3. Ginger is single and paid more than half the cost of keeping up her home. Her grandmother lived with her all year. Ginger claims her grandmother as a dependent. What is Ginger's filing status? ______________

4. Craig is single and lives alone. He paid over half the cost of maintaining a home for his father for the entire year. He claims his father as a dependent. What is Craig's filing status? ______________

5. Rhonda is single and lives alone. She paid over half the cost of maintaining a separate home for her father. She cannot claim her father as a dependent. What is Rhonda's filing status?

 ____

6. Mrs. Calvin tells you that she is divorced and that her 21-year-old, unmarried son lived with her all year. She paid for their rent and food and provided over half of her son's total support. She cannot claim her son as a dependent because he earned $4,000 and is not a student. Her son used his earnings to pay for his car, clothing, and entertainment. Can Mrs. Calvin file as head of household? ______________

7. Kathy lived with her unemployed roommate, Sandra, for the entire year. Kathy had to pay more than half of the cost of keeping up their apartment. Can Kathy file as head of household? ______________

8. Jack has lived apart from his wife for several years. Their children live with his wife, but Jack pays over half the children's support. What filing status can Jack use? ______

9. Lily left her husband in August 2007. She took her children with her. She supported the children during all of 2007 and will claim them as dependents. Lily will not file a joint return with her husband. Which filing status should Lily use in 2007? ______________

10. Rose and her husband separated in October 2007 but were still married on December 31, 2007. What filing status can she use?

 ____

11. Dick's wife died in 2005. Dick has not remarried. Dick provides all of the support for his two dependent children. What will be Dick's filing status for 2008? ______________

Exercise 1

Yes

Exercise 2

No

Exercise 3

Head of household

Exercise 4

Head of household

Exercise 5

Single

Exercise 6

No, the son is too old to be a qualifying child and has too much income for his mother to be entitled to claim him as an exemption.

Exercise 7

No; Sandra, a nonrelated person, qualifies as a dependent (as a qualifying relative) because she lived in the household the entire year and met the other tests but did not qualify Kathy for head of household filing status.

Exercise 8

Married filing jointly or married filing separately

Exercise 9

Married filing separately; she lived with her husband during part of the last six months of 2007.

Exercise 10

Either married filing jointly or married filing separately

Exercise 11

Head of household; he could claim qualifying widower for 2006 and 2007 only.

WHO MUST FILE

ALERT

Even if you do not otherwise have to file a return, you should file one to get a refund of any federal income tax withheld. You should also file if you are eligible for the earned income tax credit or the health coverage tax credit.

To decide who must file a tax return, you will need to know the individual's:

- Filing status,
- Age,
- Gross income,

and if:

- Special taxes might be owed on different types of income,
- Some of the income is excludable or exempt,
- The individual can be claimed as a dependent on another's tax return,
- The individual is blind, or
- The individual received advance earned income credit payments.

You may not be familiar with some of the terms used in the list. These terms will be explained in later lessons. For now, concentrate on learning how to use the charts and checklists.

POTENTIAL PITFALLS

If a checklist or chart indicates that a person must file a return, he or she should do so even if no tax is owed. If a minor child must file a return but cannot do so, the child's parent or guardian must complete and sign a return for the child.

How to Use the Charts and Flowcharts

You will use a set of charts shown in the Volunteer Resource Guide, Tab A, "Who Must File," to determine who must file. An individual who cannot be claimed as a dependent on another taxpayer's return will use *Chart A—For Most People*. Based on the individual's circumstances, a person who can be claimed as a dependent on another taxpayer's return will use one of the other charts. *Chart C—Other Situations When You Must File* should be reviewed for every individual. Page numbers within the charts refer to pages in the Form 1040 Instructions.

ALERT

When determining gross income for the taxpayers' filing requirements, always use the amount reported in box 2 of Form 1099-B (do not apply cost basis to this amount).

DEPENDENTS WHO MUST OR SHOULD FILE A RETURN—CHECKLIST

The dependents listed in the following checklist must or should file a return.

Exhibit 4

Checklist—Children and Other Dependents
■ A married dependent with at least $5 of income whose spouse itemizes deductions on a separate return on Form 1040 must file a return.
■ A dependent with at least $400 of net self-employment income must file a return. **Self-employment income** is earned income from a trade, business, farming, or profession that is not paid by an employer. For example, seamstresses and lawncare workers who work for themselves (and not for someone else) are considered self-employed.
■ A dependent who is not required to file but had income tax withheld should file a return to get a refund.
■ A dependent who has to pay a tax, such as tax on tips, must file a return.
■ If a taxpayer can be claimed as a dependent by another person, the taxpayer cannot claim any dependents on the tax return whether or not actually claimed by the other person.

OTHER SITUATIONS

Remember to review the *Chart C—Other Situations for When You Must File* chart after you use the other charts.

WHO SHOULD FILE A RETURN?

The charts noted previously in this lesson may indicate that an individual does not have to file a tax return. However, in these instances, individuals *should* file a return:

- To claim a refund of withheld taxes
- To claim an earned income credit
- To claim the additional child tax credit
- To qualify for the health coverage tax credit

HELPING THOSE WHO DON'T NEED TO FILE

The Reduce Unnecessary Filing Program (RUF) is intended to help certain individuals determine their need to file a federal income tax return. Use **Form 9452, Filing Assistance Program Worksheet**, to help potential unnecessary filers determine whether or not they need to file.

Thank you for helping to save time and effort for your VITA and TCE clients and for helping to reduce the cost to all taxpayers of processing unnecessary returns by helping your clients with Form 9452 and related materials, as needed.

TAXWISE® HINTS

After completing the tax return, refer back to the Main Information screen and select the appropriate tax form, which TaxWise® will indicate in the first field on the Main Information Sheet.

▶▶ SUMMING UP FILING REQUIREMENTS ◀◀

Use the charts provided in this section to determine who *must* and who *should* file a tax return.

Exercises

12. Emily is married and has one dependent child. She has not lived with her husband since May and is the head of household. She is under 65 and not blind. Her gross income from wages is $15,000. Is she required to file a tax return? ________________

13. Larry and Zelda are married but will not file a joint return. Both are under 65 and not blind. Larry's gross income from wages is $30,150. Zelda's gross income is $3,500.

A. Is Larry required to file? ______________________________

B. Is Zelda required to file? ______________________________

Exercise 12

Yes

Exercise 13

A. Yes

B. Yes

WHICH FORM TO USE?

FORM 1040EZ

Form 1040EZ is for single and joint filers with no dependents. The form instructions booklet has a worksheet for taxpayers who can be claimed as dependents.

ALERT

Form 1040EZ should not be used by taxpayers who are age 65 or older or blind.

FORM 1040A

Form 1040A is a two-page form. Page 1 of the form shows the filing status, exemptions, income, and adjusted gross income. Page 2 of the form shows the standard deduction, exemption amount, taxable income, tax, credits, payments, amount owed or refund due, and signature. Form 1040A may have four schedules. Use **Schedule 1** to report interest and/or dividend income that is more than $1,500. Use **Schedule 2** to report child and dependent care expenses and to figure the credit. Claim the credit for the elderly or the disabled on **Schedule 3.** This credit is explained in Lesson 9. If the taxpayer can take the earned income credit and has a qualifying child, use **Schedule EIC** to give information about that child. Schedule EIC is discussed and illustrated in Lesson 5.

FORM 1040

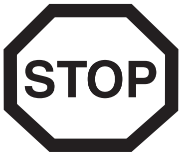
Form 1040 is a two-page form. Page 1 of the form shows the filing status, exemptions, income, and adjusted gross income. Page 2 shows the standard deduction or itemized deductions, the exemption amount, taxable income, tax, credits, other taxes, payments, and the amount owed or refund due.

IRS E-FILE

IRS *e-file* offers quick and easy alternatives to traditional paper returns. These options include filing electronically through an authorized tax professional, a personal computer, or a volunteer site. For those expecting a refund, these options offer direct deposit to a bank account. For those with a balance due, paying is made easier with the option of payment by Electronic Funds Withdrawal from their bank account.

Why *e-file?* Because IRS *e-file* makes filing faster and more accurate and gets the taxpayers their refund in half the usual time—even faster with direct deposit!

As a volunteer, you should become familiar with this option as there will be occasions when you are called upon to answer questions from taxpayers regarding it. You may even have the opportunity to volunteer at a VITA or TCE site that has been set up to offer electronic tax filing. If so, you will receive additional specialized training on using return preparation software and other procedures unique to this type of site.



Military/International students continue.

All others go to Lesson 3, page 3-1.

FILING STATUS ISSUES

Lesson 2
Military and International

INTRODUCTION AND OBJECTIVES

This lesson will explain additional factors to consider in selecting the married filing jointly and head of household filing status for taxpayers who are United States citizens or resident aliens.

At the end of this segment, you will be able to:

- Determine the correct filing status for resident aliens, and
- Explain how to treat a nonresident alien's spouse as a resident.

MARRIED NONRESIDENTS FILING JOINTLY

In order to file married filing jointly, the taxpayers must be married by the last day of the tax year and agree to file a joint return. However, a joint return generally cannot be made if either spouse is a nonresident alien at any time during the tax year (Publication 17).

Treating a Nonresident Spouse as a United States Resident

If, at the end of the tax year, the taxpayer is married and one spouse is a United States citizen or a resident alien and the other spouse is a nonresident alien, the taxpayer can elect to treat the nonresident spouse as a United States resident. This includes situations in which one spouse is a nonresident alien at the beginning of the tax year, but a resident alien at the end of the year, and the other spouse is a nonresident alien at the end of the year.

If this choice is made, the taxpayer and spouse are treated for income tax purposes as residents for the entire tax year. For example, neither the taxpayer nor the spouse can claim tax treaty benefits as a resident of a foreign country for a tax year for which the choice is in effect. Taxpayers must file a joint income tax return for the year the choice is made, but the taxpayer and spouse can file joint or separate returns in later years.

Example 1

Debra Green, a U.S. citizen for all of tax year 2007, is married to Charles, a nonresident alien. Debra and Charles make the choice to treat Charles as a resident alien by attaching a statement to their joint return for 2007. Debra and Charles must report their worldwide income in 2007 and later years unless the choice is ended or suspended. Although they must file a joint return for 2007, they can file joint or separate returns for later years.

Example 2

Jim and Judy Adams are married and both are nonresident aliens. In June 2007, Jim became a resident alien and remained a resident for the rest of the year. Jim and Judy both choose to be treated as resident aliens by attaching a statement to the 2007 joint return. Jim and Judy must report their worldwide income in 2007 and later years unless the choice is ended or suspended. They must file a joint return for 2007, but they can file either joint or separate returns for later years.

THE "CHOICE" DECLARATION

A statement containing the following information must be signed by both spouses and attached to the joint return for the first tax year for which the choice applies:

1. A declaration that one spouse was a nonresident alien and the other spouse a United States citizen or resident alien on the last day of the tax year, and that the taxpayer and spouse chose to be treated as United States residents for the entire tax year
2. The name, address, and social security number or ITIN of each spouse (if one spouse died, the name and address of the person making the choice for the deceased spouse)

The choice can also be made by filing a joint amended return. Publication 54 contains specifics on this option.

Suspending the Choice

The choice to be treated as a resident alien does not apply to any later tax year if neither spouse is a United States citizen or resident alien at any time during the tax year.

Example 3

Dick Brown was a resident alien on December 31, 2004, and married to Judy, a nonresident alien. They chose to treat Judy as a resident alien and filed joint returns for tax years 2004 and 2005. On January 10, 2006, Dick became a nonresident alien. Judy had remained a nonresident alien throughout the period. Dick and Judy can file joint or separate returns for 2006. However, since neither Dick nor Judy is a resident alien at any time during 2007, their choice is suspended for that year. If either has U.S. source income or foreign source income effectively connected with a U.S. trade or business in 2007, they must file separate returns as nonresident aliens. If Dick becomes a resident alien again in 2008, their choice is no longer suspended.

Ending the Choice

Once made, the choice to be treated as a resident applies to all later years unless suspended or ended in one of the ways shown below. If the choice is ended for any of these reasons, neither spouse can make a choice in any later tax year.

Revocation	• Either spouse can revoke the choice for any tax year.
	• The revocation must be made by the due date for filing the tax return for that year.
	• The spouse who revokes must attach a signed statement declaring that the choice is being revoked. If the spouse revoking the choice does not have to file a return and does not file a claim for refund, send the statement to the Internal Revenue Service Center where the last joint return was filed.
	• The statement revoking the choice must include the following:
	  • The name, address, and social security number (or taxpayer identification number) of each spouse
	  • The name and address of any person who is revoking the choice for a deceased spouse
	  • A list of any states, foreign countries, and possessions that have community property laws in which either spouse is domiciled or where real property is located from which either spouse receives income

Death	• The death of either spouse ends the choice, beginning with the first tax year following the year the spouse died. • If the surviving spouse is a U.S. citizen or resident and is entitled to the joint tax rates as a surviving spouse, the choice will not end until the close of the last year for which these joint rates may be used. • If both spouses die in the same tax year, the choice ends on the first day after the close of the tax year in which the spouses died.
Divorce or Legal Separation	• A divorce or legal separation ends the choice as of the beginning of the tax year in which the legal separation occurs.
Inadequate records	• The Internal Revenue Service can end the choice for any tax year that either spouse has failed to keep adequate books, records, and other information necessary to determine the correct income tax liability, or to provide adequate access to those records.

Head of Household

In general, in order to claim head of household status, the taxpayer must:

1. Be unmarried or considered unmarried on the last day of the year,
2. Have paid more than half the cost of keeping up a home for the year, and
3. Have a qualifying person in the home for more than half the year.

These general rules are discussed in the basic text and in more detail in Publication 17

Special Rule

For head of household purposes, “the taxpayer is considered unmarried if his or her spouse was a nonresident alien at any time during the year, and the taxpayer does not choose to treat his or her spouse as a resident alien.” All of the other qualifications for head of household must also be met.

Example 4

Raul is in the U.S. Army in Japan. His wife and children live with him and he is able to claim the children as dependents. Raul’s wife (a citizen of Japan) chooses not to be treated as a resident alien. Even though Raul is married, he can claim head of household status because of the rule above. If Raul had not passed all of the other qualifications for head of household, he would have to file as a married person (either as married filing separately or married filing jointly).

▶▶ Summing Up This Military and International Segment ◀◀

▶ The taxpayer may be considered unmarried if the spouse was a nonresident alien at any time during the year and the taxpayer does not choose to treat the spouse as a resident alien.

INCOME

Lesson 3

INTRODUCTION AND OBJECTIVES

In this lesson you will learn to distinguish between taxable and nontaxable income. You will also learn where to report the different types of income. In addition, you will learn to make income entries on Forms 1040, 1040A, and 1040EZ.

After completing this lesson you should be able to:

- Determine what is taxable and nontaxable income.
- Determine where to report income on Forms 1040, 1040A, and 1040EZ.
- Identify who can file Schedule C-EZ.
- Identify who must file Schedule SE.

ALERT

This lesson contains tax law and information relating to all levels of training. Your course facilitator will only teach the information required to assist taxpayers you will serve.

INTAKE AND INTERVIEW PROCESS FORM 13614—INCOME

Use **Form 13614, Intake and Interview Sheet,** to engage the taxpayer in preparing an accurate return. Use the Intake and Interview Sheet as a starting point for a comprehensive interaction with the taxpayer, in combination with all the source documents provided by the taxpayer, to ensure quality and accuracy on each return.

Confirm each item on Form 13614 (or similar approved alternative tool used at the site) to make sure you and the taxpayer have considered all the necessary information. Ensure that all questions and issues have been addressed. If items are incorrect or incomplete, revisit the issue and make corrections to the return, as needed.

Excerpt from Form 13614

Part IV. Income – **In 2007, did you (or your spouse) receive:**

☐ Yes	☐ No	1.	Wages or Salary (include W-2s for all jobs worked during the year)
☐ Yes	☐ No	2.	Disability income
☐ Yes	☐ No	3.	Interest/Dividends from: checking or savings account, bonds, CDs, or brokerage account
☐ Yes	☐ No	4.	State tax refund (may be taxable if you itemized last year)
☐ Yes	☐ No	5.	Alimony income
☐ Yes	☐ No	6.	Tip income
☐ Yes	☐ No	7.	Pension and/or IRA distribution
☐ Yes	☐ No	8.	Unemployment (1099-G)
☐ Yes	☐ No	9.	Social Security or Railroad Retirement Benefits (1099-SSA or RRB)
☐ Yes	☐ No	10.	Self Employment Income - business, farm, hobby **(1099-Misc or any earned income not reported on W-2)**
☐ Yes	☐ No	11.	Other Income such as gambling winnings, awards, prizes and Jury Duty pay, etc.

To ensure accurate reporting of income, verify that the taxpayer's wages are accurate and that all income from Form(s) W-2 and other income documents, such as Form(s) 1099, have been included. Confirm that all income received by the taxpayer has been discussed and shown on the return, if required.

Taxpayers may arrive at the VITA/TCE site without all of the Form(s) 1099 that they should have received. In some of these cases, a taxpayer may not have his or her copy of a Form 1099 available but knows the reportable income amount. In these cases, report the income on the appropriate line of the return as explained in this lesson and subsequent income lessons. If a taxpayer cannot accurately determine the reportable income amount, advise him or her to contact the payer of the income to get the missing information.

What is Income?

All income is taxable if it is not specifically excluded by law. The Income section of Form 1040 lists possible sources of income. It includes both earned and unearned income. Examples are wages, salaries, and tips; interest earnings; dividends; taxable refunds and credits from state and local income taxes; alimony; business earnings; unemployment compensation; pensions; and income from other sources.

Taxable and Nontaxable Income

Taxable income is any income that is subject to tax. It must be reported on a tax return, unless the amount is so small that the individual is not required to file a return.

A list of types of taxable and nontaxable income can be found in Publication 4012, Income Tab.

Nontaxable income is income that is exempt from tax. If a return must be filed, some types of nontaxable income will be shown on the return but will not be added into the amount of income subject to tax.

Example 1

Robert received the following income: wages, interest, child support, alimony, inheritance, workers' compensation, and lottery winnings.

The wages, interest, alimony, and lottery winnings are taxable income and will appear on Robert's tax return.

Child support, inheritance, and workers' compensation are nontaxable income and will not appear on Robert's tax return.

Exercise 1

Indicate whether the income listed is taxable or nontaxable.

Type of Income	Nontaxable	Taxable
1. Wages	________	________
2. Dividends from stock	________	________
3. Veterans' disability benefits	________	________
4. Child support	________	________
5. Credit union dividends	________	________
6. Cash bonuses	________	________
7. Inheritances	________	________
8. Tips	________	________
9. Worker's compensation	________	________

WHERE TO REPORT INCOME

Taxpayers can report only wages, salaries, tips, unemployment compensation, qualified state tuition program payments, Alaska Permanent Fund dividends, taxable scholarship and fellowship grants, and interest income of $1,500 or less on Form 1040EZ.

In addition to the types of income that can be reported on Form 1040EZ, ordinary and qualified dividends, capital gains distribution, interest income greater than $1,500, IRA distributions, pension and annuity income, and taxable social security and equivalent railroad retirement benefits can be reported on Form 1040A.

These and all other types of income can be reported on Form 1040.

EARNED INCOME

Wages and Salaries

The total of wages, salaries, tips, and taxable scholarships and fellowships are reported on Form 1040 or 1040A, line 7 or 1040EZ, line 1.

Wages, salaries, and tips are primary examples of earned income received for services performed. Wages and salaries are compensation received. Tips are money and goods received as a gratuity by food servers, maids, porters, etc.

POTENTIAL PITFALLS

Volunteers should be alert to the following possible indications of fraudulent activity:

- Forms W-2 that are typed, handwritten, or have noticeable corrections
- Form W-2 from a firm in the area that is different from other Forms W-2 issued by the same firm
- Suspicious person accompanying the taxpayer and observed on other occasions
- Multiple refunds directed to the same address or P.O. Box
- Employment or earnings that are a basis for refundable credits but are not well documented
- Similar returns (e.g., same amount of refund, or same number of dependents, or same number of Forms W-2)

Form W-2

Form W-2, Wages and Tax Statement, shown in Exhibit 1, reports the employee's earned income for the year. Employers should issue Form W-2 to every employee and a copy to the Social Security Administration.

Box 1, Wages, tips, and other compensation, shows the amount of payments received in cash, goods and services, bonuses, supplemental unemployment benefits, awards, and taxable employee benefits. This amount should be included on the return.

An individual taxpayer or a couple filing jointly might have one or more Forms W-2 from various employers. When the taxpayer and/or spouse receive Forms W-2 from their employers, add the amounts from box 1 of each Form W-2 and report the total amount on the return.

Generally, if a **household employee** earned less than $1,500 a year while working in the employer's home, the employer is not required to provide the taxpayer with a Form W-2, but the income must be included on Form 1040 or 1040A, line 7, or Form 1040EZ, line 1. However, a Form W-2 is required if the employer withheld federal income taxes.

If a taxpayer does not get a Form W-2, or if the one he or she gets is not correct, the taxpayer will have to contact his or her employer as soon as possible. Only an employer can issue a Form W-2 or a Form W-2c.

In the event that the employer prepared an incorrect W-2, a **Form W-2c, Corrected Wage and Tax Statement,** should be issued. Use the Form W-2c amounts on the return. Be sure to attach the Form W-2c to the taxpayer's return.

All wage, salary, and tip income must be reported on the return, even if the employee did not receive a Form W-2.

If the taxpayer does not receive a Form W-2 by January 31, he or she should first contact the employer and find out if or when the Form W-2 was mailed. If, after a reasonable amount of time, the Form W-2 still has not been received, the taxpayer should contact the IRS for assistance at 1-800-829-1040, but not before February 15.

If the taxpayer does not receive Form W-2 by the due date of the return, he or she should file a **Form 4852, Substitute for Form W-2, Wage and Tax Statement** or **Form 1099-R, Distributions from Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, Etc.**

The taxpayer should keep a copy of Form 4852 for his or her records and file a copy with the Social Security Administration to ensure proper social security credit.

a Employee's social security number XXX-XX-XXXX	OMB No. 1545-0008	**Safe, accurate, FAST! Use** IRS e-file. Visit the IRS website at *www.irs.gov/efile*.

b Employer identification number (EIN) XX-XXXXXXX	**1** Wages, tips, other compensation $15,000	**2** Federal income tax withheld $1,500
c Employer's name, address, and ZIP code Allen Company 11 Avert Street You City, State, Zip Code	**3** Social security wages $15,000	**4** Social security tax withheld $930
	5 Medicare wages and tips $15,000	**6** Medicare tax withheld $218
	7 Social security tips	**8** Allocated tips
d Control number	**9** Advance EIC payment	**10** Dependent care benefits
e Employee's first name and initial Last name Suff. Douglas Brown 12 Harvard Street Your City, State, Zip Code	**11** Nonqualified plans	**12a** See instructions for box 12 Code
	13 Statutory employee / Retirement plan / Third-party sick pay	**12b** Code
	14 Other	**12c** Code
		12d Code
f Employee's address and ZIP code		

15 State Employer's state ID number	**16** State wages, tips, etc.	**17** State income tax	**18** Local wages, tips, etc.	**19** Local income tax	**20** Locality name

Form **W-2** **Wage and Tax Statement** 2007

Department of the Treasury—Internal Revenue Service

Copy B—To Be Filed With Employee's FEDERAL Tax Return.
This information is being furnished to the Internal Revenue Service.

Form 1099-MISC

Taxpayers with earnings reported on **Form 1099-MISC, Miscellaneous Income,** shown in Exhibit 2, may be considered self-employed. These amounts are reported on Schedule C-EZ or Schedule C. Net losses and profits are reported on Form 1040, line 12. Self-employment income is discussed later in this lesson. Some employers misclassify employees as independent contractors and report their earnings on Form 1099-MISC, box 7. Taxpayers who believe they have been misclassified should contact the IRS.

☐ CORRECTED (if checked)

PAYER'S name, street address, city, state, ZIP code, and telephone no. Oakdale Company 345 Oakwood Drive Your City, State, Zip Code	1 Rents $ 2 Royalties $ 3 Other income $	OMB No. 1545-0115 **2007** Form **1099-MISC** **4 Federal income tax withheld** $	**Miscellaneous Income** **Copy B** **For Recipient**
PAYER'S federal identification number XX-XXXXXXX / RECIPIENT'S identification number XXX-XX-XXXX	5 Fishing boat proceeds $	6 Medical and health care payments $	
RECIPIENT'S name Shelton Wagner	7 Nonemployee compensation $ 7,000	8 Substitute payments in lieu of dividends or interest $	This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported.
Street address (including apt. no.) 897 Wabash Street City, state, and ZIP code Your City, State, Zip Code	9 Payer made direct sales of $5,000 or more of consumer products to a buyer (recipient) for resale ► ☐ 11	10 Crop insurance proceeds $ 12	
Account number (see instructions)	13 Excess golden parachute payments $	14 Gross proceeds paid to an attorney $	
15a Section 409A deferrals $ / 15b Section 409A income $	16 State tax withheld $ $	17 State/Payer's state no.	18 State income $ $

Form **1099-MISC** (keep for your records) Department of the Treasury - Internal Revenue Service

Tip Income

All tip income is taxable. Individuals who receive **$20 or more per month in tips,** while working one job, must report their tip income to their employer. Tips that are reported to employers are included with wages on Form W-2, box 1. If the taxpayer received tip income of $20 or more in a month and did not report all of those tips to the employer, he or she must report the social security and medicare taxes on the unreported tips as additional tax on Form 1040. **Form 4137, Social Security and Medicare Tax on Unreported Tip Income,** should be used to compute and report the additional tax.

> **POTENTIAL PITFALLS**
>
> If the taxpayer fails to report tip income to the employer, as required, the taxpayer may be subject to a penalty equal to 50% of the social security and medicare taxes owed on unreported tips.

Individuals who receive **less than $20 per month in tips,** while working one job, do not have to report their tip income to their employer. Additionally, noncash tips (for example, tickets or passes) do not have to be reported to the employer. Tips of less than $20 per month or noncash tips are not subject to social security and medicare taxes. However, this tip income is subject to federal income taxes and must be reported on Form 1040 or Form 1040A, line 7, or Form 1040EZ, line 1.

Allocated tips are tips an employer assigns to an employee. They are in addition to the tips the employee reported to the employer. The taxpayer may have allocated tips if he or she worked in a restaurant, cocktail lounge, or similar business that must allocate tips to employees.

Allocated tips are shown separately on Form W-2, box 8. They are not included in the amount in box 1. The taxpayer must report allocated tips on his or her tax return unless either of the following exceptions applies:

- The taxpayer kept a daily tip record or other evidence that is as credible and as reliable as a daily tip record, as required. (See Publication 531, *Reporting Tip Income.*)
- The taxpayer's tip record is incomplete, but it shows that his or her actual tips were more than the tips reported to his or her employer plus the allocated tips.

If either exception applies, report actual tips on the return. Do not report the allocated tips.

If the taxpayer is required to report allocated tips on the return, the amount on Form W-2, box 8, should be added to the amount in box 1. The total is reported on Form 1040, line 7. Allocated tips cannot be reported on Form 1040A or 1040EZ, and are subject to social security and medicare taxes. Form 4137 should be used to compute and report the additional tax.

The taxpayer should keep a copy of Form 4137 as substantiation of contributions to social security.

Unreported Social Security and Medicare Tax

If you are an employee and your employer did not withhold social security and medicare tax, see the instructions for line 59, Form 1040 and Form 8919.

Example 2

Fred works as a repairman during the week and as a barber on alternate Saturdays. His tips are less than $20 in any month, and he does not report them to his employer. The amounts from box 1 on his Forms W-2 show income of $23,500 (repairman) and $1,950 (barber). His unreported tip income was $200.

Fred will report $25,650 on Form 1040A, line 7. This is the total of his Forms W-2, box 1, income and his unreported tip income ($23,500 plus $1,950 plus $200).

If Fred reported his tip income to his employer, the tips would be included in Form W-2, box 1. The amount in box 1 of that Form W-2 would be $2,150 ($1,950 plus $200). Fred would still enter $25,650 on line 7, Form 1040, ($23,500 plus $2,150).

Scholarships and Fellowships

Some scholarships and fellowships may be partially taxable. If the taxpayer received a Form W-2 for the scholarship or fellowship, add the amount in box 1 to any other Form W-2, box 1 amounts. Enter the total on Form 1040 or 1040A, line 7 or Form 1040EZ, line 1.

POTENTIAL PITFALLS

The following individuals cannot file Form 1040A or 1040EZ; they must file Form 1040:
(1) Individuals who received $20 or more in tips in any month, while working for one employer, and who did not report the full amount to the employer. (These tips are subject to social security and medicare tax.)
(2) Taxpayers whose Form W-2 has an amount entered in box 8, *Allocated tips,* that they must report as income. For more information, see Publication 531, *Reporting Tip Income.*

Scholarship or fellowship money used for tuition and fees to enroll at or attend an educational institution or fees, books, supplies, and equipment required for courses at the educational institution is nontaxable. Amounts used for room and board do not qualify for the exclusion and therefore are taxable.

Even if the taxpayer did not receive a Form W-2 for the scholarship or fellowship, the taxable portion of the scholarship or fellowship must be reported. Add the taxable portion to other Form W-2, box 1, amounts and unreported tip income. Enter the total on Form 1040 or 1040A, line 7, or Form 1040EZ, line 1. Write "SCH" and the amount not reported on Form W-2 in the space to the left of line 7 or line 1, whichever applies.

Refer to Scholarship/Fellowship TIP in Publication 4012.

Exercise 2

A. Mike worked two jobs. He was a quality inspector during the week and a bartender on the weekends. He reported all of his tip income ($3,000) to his employer. His Forms W-2, box 1, showed income of $21,000 (quality inspector) and $8,250 (bartender). What amount will Mike report on his Form 1040A, line 7? ____________________

B. John works as a food server in an expensive restaurant. He tells you that he did not report his tip income of $18,100 to his employer. Can John file Form 1040A? ____________________

C. Randy had several employers during the tax year. On February 3, 2008, he comes into the VITA site to have his return prepared. He tells you that he has not received the Form W-2 for XYZ Inc. What should you tell Randy? ____________________

____

Potential Pitfalls

Some savings and loans, credit unions, cooperative banks, and mutual savings banks call their distributions "dividends." These "dividends" are really interest and are reported as interest. True dividends are different and will be discussed later in this lesson.

Interest Income

Money earns interest when it:

- Is deposited in accounts in banks, savings and loans, and credit unions;
- Is used to buy certificates of deposit or bonds; or
- Is lent to another person or business.

Interest income is considered unearned income. Money, not a person, is working to earn the income.

Taxable Interest Income

Savings Accounts

Interest is reported in the year that it is credited to the taxpayer's account and is available for withdrawal by the taxpayer. The taxpayer should report all interest received during the year, even if the interest is not entered in the taxpayer's passbook.

United States Savings Bonds

Interest on United States savings bonds is earned in one of two ways:

- Some bonds are issued at a "discount," and the interest earned equals the increase in the bond's value over a period of time.
- Some bonds pay interest at stated intervals of time.

Series EE and Series I Bonds. Series EE bonds are the most common type. They are issued at a discount; this means that the purchase price is less than the face value (the amount shown on the bond). The interest is the difference between the purchase price and the amount received when the bonds are redeemed (cashed in).

Series I bonds were first offered in 1998. They are issued at face value with a maturity period of 30 years. Interest on these bonds is paid when the bond is redeemed.

Taxpayers can choose one of two ways to report interest income from these bonds:

- Report the increase in value when the bond is cashed in or when the bond matures, whichever is earlier.
- Report the increase in the bond's value each year.

Generally, taxpayers must use the same method for all Series EE and Series I bonds they own.

If a United States savings bond is issued in the names of co-owners, such as the taxpayer and child, or the taxpayer and spouse, interest on the bond is generally taxable to the co-owner who purchased the bond. To determine who is responsible for paying the tax on a bond, see the table below.

Exhibit 3

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.

Example 3

Barbara owns a $500 U.S. Series EE savings bond. She paid $250 for the bond. When the bond matures, Barbara will receive $500. At the end of the first year, the bond was worth $265.

Barbara can report interest income in one of two ways:

- She can report $250 of interest income when the bond matures. This is the difference between the $500 value at maturity and the $250 she paid for the bond. Barbara would report interest income only once, at maturity.
- She can report $15 of interest income at the end of the first year. This is the increase in value at the end of the year ($265 minus $250). Barbara would report interest income each year until maturity.

Excludable Interest on United States Savings Bonds. Taxpayers may be able to exclude from income all or part of the interest received from certain qualified United States savings bonds. The taxpayer must have paid for qualified higher education expenses the same year the bonds are cashed. The bonds must be either Series EE bonds issued after 1989 or Series I bonds in the taxpayer's name or, if married, the taxpayer's name or spouse's name. The individual in whose name the bonds were issued must have been 24 years of age or older before the bonds were issued. The taxpayer cannot file married filing separately.

Qualified higher education expenses include tuition and fees paid to an eligible educational institution for the bond owner, the bond owner's spouse, or the bond owner's dependent for whom the bond owner claims an exemption. An eligible educational institution is any college, university, vocational school, or other postsecondary educational institution eligible to participate in a student aid program administered by the Department of Education.

Qualified expenses include any **contribution** to a qualified state tuition program or to a Coverdell ESA. (For more information, see **Publication 970, Tax Benefits for Higher Education**.)

Use **Form 8815, Exclusion of Interest from Series EE and I United States Savings Bonds Issued After 1989 (For Filers with Qualified Higher Education Expenses),** to report the exclusion of interest income. The excludable amount is transferred from Form 8815 to Form 1040, Schedule B or Form 1040A, Schedule 1, Part I, line 3.

Series HH Bonds. The interest on these bonds is paid twice a year. Report the interest on these bonds in the year in which it is received.

Other United States Obligations. Interest on other United States obligations, such as United States Treasury notes and bonds, is fully taxable when received.

Savings Certificates, Money Market Certificates, and Other Deferred Interest Accounts

Interest that is paid at fixed intervals of one year or less is included in taxable income when it is received or when the taxpayer could receive it (that is, when it is credited to the account, even if it is not withdrawn) without paying a substantial penalty. If an account matures in one year or less and provides a single interest payment at maturity, include the interest in taxable income when the account matures and the interest is received.

Example 4

Duane has a six-month certificate of deposit (CD) that matures in January 2008. He will receive $75 in interest income.

Duane will report the interest income on the certificate of deposit on his 2008 tax return. It matures in one year or less with a single interest payment at maturity.

Certificates of Deposit with Maturities of More Than One Year

If interest on a CD is deferred for more than one year, the taxpayer must include a part of the interest in income each year. The taxpayer should receive Form 1099-INT, stating the amount to report.

Example 5

Deborah has a two-year CD that pays interest every three months. She bought the CD on March 1, 2007. It matures on February 28, 2009.

For 2007, Deborah reports the interest income earned from March through December. For 2008, she will report 12 months of interest. For 2009, she will report two months of interest.

Original Issue Discount. Long-term obligations that pay no interest before maturity are considered to be issued at a discount. **Original Issue Discount (OID)** is the amount by which the principal amount (redemption price at maturity) of a long-term debt instrument, such as a bond or note, exceeds its issue price. Taxpayers generally report a portion of the OID each year until the obligation matures.

Example 6

Roger purchased a $1,000 U.S. Treasury zero coupon bond for $350. When the bond matures, Roger will receive $1,000. He will receive no interest income until the bond matures many years later.

The difference between the redemption amount ($1,000) and the issue price ($350) is the OID ($650). Each year until maturity, Roger must recognize part of the OID as taxable interest income.

Interest on Insurance Proceeds

Life insurance proceeds may include interest. Taxpayers can receive life insurance policy benefits paid upon the death of the insured either in a lump sum or in installments. Generally, if the payments are received in installments, the portion that is interest must be included in the taxpayer's income. However, if the insured individual died before October 23, 1986, and was the taxpayer's spouse, the first $1,000 of interest income received each year is not taxed if the payments are received in installments. This exclusion does not apply if proceeds are left on deposit with the insurance company and only interest is paid.

Life insurance dividends generally are not taxable. These dividends may be used to reduce life insurance premiums due, purchase additional paid-up insurance, or earn interest. In general, the interest earned on life insurance dividends is taxable when it is credited to the taxpayer's account.

Coverdell ESA

Contributions to a Coverdell education savings account (ESA) are not deductible. Amounts in the ESA grow (tax deferred) until they are distributed. Generally, if the beneficiary has qualified education expenses that are greater than the distribution during the year, then no tax is due.

If the taxpayer received Form 1099-Q, showing a distribution from a Coverdell ESA, ask the taxpayer if the funds were used for qualified education expenses. Coverdell ESA qualified education expenses include elementary, secondary, and postsecondary (higher) education expenses.

If the entire amount of the distribution was spent on qualified elementary and secondary expenses, the distribution is tax-free. Tax-free distributions are not reported. If the taxpayer paid for qualified higher (postsecondary) education expenses, the taxpayer may be eligible for the Hope Credit or Lifetime Learning Credit, whichever may be more beneficial.

Refer the taxpayer/beneficiary to a tax professional and/or **Publication 970, Tax Benefits for Higher Education,** if:

- The funds were not used for qualified education expenses;
- The distribution is more than the amount spent for qualified expenses;
- Part or all of the distribution is taxable and earnings must be computed; or
- The taxpayer/beneficiary received other education benefits such as a distribution from a qualified tuition program, employer-provided educational assistance, or a scholarship, or used United States Savings Bonds to pay for qualified education expenses.

If any amount needs to be reported as other income, report it on Form 1040, line 21. Additional tax may be due. Use Part II of **Form 5329, Additional Taxes on Qualified Plans (including IRAs) and Other Tax Favored Accounts,** to figure any additional tax.

TAX-EXEMPT INTEREST

Certain types of interest are exempt from federal income tax. Bonds issued by the following entities generally pay **tax-exempt interest:**

- State and political subdivisions (county or city)
- District of Columbia
- United States possessions and political subdivisions

Examples of tax-exempt bonds are those issued by:

- Port authorities
- Toll-road commissions
- Utility service authorities
- Community redevelopment agencies
- Qualified volunteer fire departments
- Amounts indicated on broker statements as tax-exempt interest or dividends

Although tax-exempt interest is not taxable, the taxpayer must report all tax-exempt interest on Form 1040, 1040A, or 1040EZ.

Form 1099-INT

Interest income is reported to the taxpayer on **Form 1099-INT, Interest Income,** shown in Exhibit 4. Financial institutions also send a copy of Form 1099-INT to the IRS.

Box 1 shows taxable interest income from various institutions.

Some taxpayers withdraw funds from a time deposit before the maturity date of the account and, therefore, incur an interest penalty. The early withdrawal penalty is reported on Form 1099-INT in box 2. Report the total interest earned, shown in Form 1099-INT, box 1 on Form 1040, line 8a. Do not subtract the penalty from the total interest. The early withdrawal penalty is an adjustment to income and is entered on Form 1040, line 30, in the Adjusted Gross Income section on page 1.

Box 3 shows United States savings bond and Treasury obligations interest. Be sure to ask the taxpayer about this interest income. The amount shown on Form 1099-INT may be too high if the taxpayer was not the original owner of the bond or if the taxpayer has reported the interest income each year as it was earned.

Some Forms 1099-INT will have entries in box 4, indicating that federal income tax has been withheld from the interest paid. Be sure to include the amount shown in box 4 with other tax withheld on Form 1040, Form 1040A or Form 1040EZ.

Exhibit 4 **Form 1099-INT**

☐ CORRECTED (if checked)

PAYER'S name, street address, city, state, ZIP code, and telephone no.

Sterling Bank
125 Tyler Drive
Your City, State, Zip Code

Payer's RTN (optional)

OMB No. 1545-0112

2007

Form **1099-INT**

Interest Income

1 Interest income $ 100

2 Early withdrawal penalty $

PAYER'S federal identification number: XX-XXXXXXX

RECIPIENT'S identification number: XXX-XX-XXXX

3 Interest on U.S. Savings Bonds and Treas. obligations $ 50

Copy B

For Recipient

This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported.

RECIPIENT'S name

Madison Morris

Street address (including apt. no.)

465 Wells Street

City, state, and ZIP code

Your City, State, Zip Code

Account number (see instructions)

4 Federal income tax withheld $

5 Investment expenses $

6 Foreign tax paid $

7 Foreign country or U.S. possession

8 Tax-exempt interest $

9 Specified private activity bond interest $

Form **1099-INT** (keep for your records) Department of the Treasury - Internal Revenue Service

Form 1099-OID

Form 1099-OID, Original Issue Discount, reports the amount of original issue discount income that a taxpayer should report as income for the year. Financial institutions/brokerages also send a copy of Form 1099-OID to the IRS.

Box 1 shows the amount of interest (OID) for the year if the taxpayer bought the obligation at its original issue and held the issue all year.

Box 2 shows regular interest paid on the obligation other than the OID income.

Generally, if a Form 1099-OID was received, you report the entire amount in boxes 1 and 2 of the Form 1099-OID as interest income. If the taxpayer needs to report the OID in an amount less than the amount shown on the Form 1099-OID, referral should be made to a professional paid preparer.

Reporting Interest Income

If the taxpayer files Form **1040EZ**, taxable interest income is reported on line 2. Form 1040EZ filers should report tax-exempt interest by writing “TEI” and the amount of tax-exempt interest on line 2, as shown in the example below. Do not include tax-exempt interest in the *Dollars / Cents* portion of line 2. If the taxpayer’s interest income is more than $1,500, he or she cannot file Form 1040EZ.

Example 7

Jennifer received taxable interest income of $65 and tax-exempt interest income of $23. She would report her interest income on Form 1040EZ, line 2 “TEI $23” as shown in the exhibit below.

Exhibit 5 **Jennifer’s 1040EZ**

Income	1	Wages, salaries, and tips. This should be shown in box 1 of your Form(s) W-2. Attach your Form(s) W-2.	1	
Attach Form(s) W-2 here.	2	Taxable interest. If the total is over $1,500, you cannot use Form 1040EZ. **TEI $23**	2	**65**
Enclose, but do not attach, any payment.	3	Unemployment compensation and Alaska Permanent Fund dividends (see page 13).	3	
	4	Add lines 1, 2, and 3. This is your **adjusted gross income.**	4	
	5	If someone can claim you (or your spouse if a joint return) as a dependent, check the applicable box(es) below and enter the amount from the worksheet on back. ☐ **You** ☐ **Spouse** If no one can claim you (or your spouse if a joint return), enter $8,750 if **single;** $17,500 if **married filing jointly.** See back for explanation.	5	
	6	Subtract line 5 from line 4. If line 5 is larger than line 4, enter -0-. This is your **taxable income.** ▶	6	

Taxpayers who file Forms 1040 or 1040A report taxable interest income on line 8a and tax-exempt interest on line 8b.

If the taxpayer files Form 1040 or Form 1040A and:

- Has interest income of more than $1,500,
- Wants to claim an exclusion for savings bond interest in the same year that he or she paid for qualified higher education expenses, or
- Receives a Form 1099-INT for tax-exempt interest,

Form 1040, Schedule B, or Form 1040A, Schedule 1, Part I must be completed, before making an entry on line 8a or 8b.

If the tax-exempt interest is shown on a Form 1099-INT, and a Schedule B or Schedule 1 must be filed, the taxpayer must include tax-exempt interest on Schedule B or Schedule 1. It should be reported on line 1, but it should not be included in the total on line 2. Instead, under the last entry on line 1, a subtotal of all interest listed should be made. Below the subtotal, the taxpayer should write “tax-exempt interest” and show the amount. Subtract it from the subtotal, and enter the result on line 2.

On Schedule B or Schedule 1, Part I, list the interest payers’ names and the various amounts received for each form, even if there are two or more forms from the same source.

Exercise 3

A. Randy and Ann have three Forms 1099-INT: Epping National Bank, $62; Epping Credit Union, $178; and Brenton Savings and Loan, $760.

1. How much interest income will be reported on Form 1040A, Schedule 1? ____________________

2. How much interest income will be reported on Form 1040A, line 8a?____________________

B. Catherine received $398 interest income this year. She files Form 1040EZ. How much interest income is reported on her return, and where is it reported? ____________________

____

C. Emily and Andrew file a joint return on Form 1040. They have the following interest income: City Savings and Loan (joint), $320; Third National Bank (Andrew), $100; U.S. Series HH savings bonds (joint), $45; and Welder's Credit Union (Emily), $30.

How much interest is reported on their Form 1040, and where is it reported? ____________________

Dividend Income and Other Corporate Distributions

Dividends are payments made by corporations to shareholders. Dividends can also be paid through partnerships, estates, or trusts.

There are several types of corporate distributions, including ordinary and qualified dividends, capital gain distributions, nontaxable distributions, stock dividends, and others. Ordinary dividends are paid out of the earnings and profits of a corporation and are ordinary income to you. Qualified dividends are the ordinary dividends received in tax years beginning after 2002 that are subject to the same 5 percent or 15 percent maximum tax rate that applies to net capital gains. Most dividends are paid in cash. Some dividends, however, are paid in property, services, or additional shares of stock. Only **ordinary and qualified dividends** can be reported on Form 1040A. Any other dividends or distributions received are reported on Form 1040. Taxpayers with dividend income may not use Form 1040EZ. Other types of dividends and distributions include the following:

- **Dividend reinvestment**—Through dividend reinvestment, instead of receiving cash (a dividend check), some stockholders ask the corporation to use their dividends to purchase more shares of the corporation's stock. The shareholders "reinvest" their dividends. The dividend is taxable at the time it would be paid if it were in cash. See Alert.

ALERT

Taxpayers who enter into dividend reinvestment programs need to maintain a total of the value of all shares of stock purchased with reinvested dividends as an increase to their cost basis in the related share of stock. This will avoid their paying a capital gain tax when the shares of stock purchased with after-tax dividends are sold.

- Mutual funds (regulated investment companies) and real estate investment trusts (REITs) pass capital gains to their investors in the form of capital gain distributions. These distributions should not be confused with capital gains or losses that occur when an owner of a mutual fund or other capital asset sells shares in a fund or other capital asset. For more information on capital gains and losses, see Lesson 12, Sale of Stock.
- Nondividend distributions can be made in the form of a return of capital or a tax-free distribution of additional shares of stock or stock rights. A return of capital is a return of some or all of an investment in the stock of a company. A return of capital reduces the basis of the stock and is not taxed until the basis in the stock is fully recovered. Once the basis of the stock has been reduced to zero, any further return of capital is a capital gain. A tax-free distribution of additional shares of stock or stock rights does not affect the basis in the stock but will be taxed as a capital gain when the shares issued are sold.
- **Stock dividends**—Stock dividends increase the taxpayer's number of shares in the company. Generally, stock dividends are not taxable.

Other types of nontaxable dividends are:

- Exempt-interest dividends paid by mutual funds (listed on Form 1040, line 8b)
- Dividends on insurance policies, as long as they do not exceed the total of all net premiums paid by the taxpayer
- Dividends on veterans' insurance
- Certain patronage dividends

Reporting Dividends and Capital Gain Distributions

The payer reports dividends and certain other distributions on **Form 1099-DIV, Dividends and Distributions.**

Ordinary dividends are reported in Form 1099-DIV, box 1a (see exhibit 6). Add the amounts in box 1a from all the Forms 1099-DIV the taxpayer received. If the total is:

- $1,500 or less, enter the total on Form 1040 or 1040A, line 9a.
- over $1,500, complete Form 1040, Schedule B, Part II or Form 1040A, Schedule 1, Part II. Transfer the result to Form 1040 or 1040A, line 9a.

On Schedule B or Schedule 1, enter the payer's name and the amount received for each Form 1099-DIV, even if the same corporation used separate forms to report more than one distribution. If the taxpayer has a substitute Form 1099-DIV from a brokerage firm, it may show a total for dividends received. Enter the brokerage firm as the payer of the dividends, and enter the total dividend amount. Do not list the dividends individually.

Some taxpayers receive dividend income from shares that the husband and wife own jointly. If they file a joint return, enter the total dividend in the appropriate place on the return. If they file separate tax returns, divide the dividend by two. Report half on the husband's return and half on the wife's return.

Qualified Dividends. Report qualified dividends (Form 1099 DIV, box 1b) on Form 1040 or Form 1040A, line 9b. Do not include any of the following on line 9b:

- Qualified dividends received as a nominee (A nominee is a person who receives, in his or her name, income that actually belongs to someone else.)
- Dividends on stock for which the holding period was not met
- Dividends on any share of stock to the extent that there is an obligation to make related payments for positions in substantially similar or related property
- Payments in lieu of dividends, but only if it is known or reason to have known that the payments are not qualified dividends

See Chapter 1 of **Publication 550** for further details.

If qualified dividends are reported, tax must be figured by completing the Qualified Dividends and Capital Gain Tax Worksheet in the Forms 1040 or 1040A instructions.

Capital gain distributions reported in Form 1099-DIV, box 2a, are treated as long-term capital gains, regardless of how long the taxpayer holds the shares. If, in addition to a capital gain distribution, the taxpayer has a capital gain or loss resulting from the disposition of a capital asset reported on Schedule D, the capital gain distribution is entered on line 13 of Schedule D. If a Schedule D is not required, the capital gain distribution is entered directly on Form 1040, line 13 with a check in the box next to line 13. If a capital gain distribution is reported, tax must be computed by completing the *Qualified Dividends and Capital Gain Tax Worksheet* unless there is a loss reported on line 21 of Schedule D and there are not any qualified dividends.

Capital gain distributions occur when a mutual fund (regulated investment company) sells assets for more than their cost, and the realized capital gain is distributed to the fund's shareholders. This should not be confused with a capital gain that occurs when the owner of a mutual fund or a capital asset sells shares in the fund or the asset for more than the cost and realizes a capital gain. For more information on capital gains and losses, see Lesson 12, Sale of Stock.

Payers report capital gain distributions in Form 1099-DIV, box 2a (see Exhibit 6). Taxpayers can report capital gain distributions directly on Form 1040 or Form 1040A if:

- The only amounts the taxpayer has to report on Schedule D are capital gain distributions (box 2a), and
- The taxpayer does not have any unrecaptured Section 1250 gain (box 2b), Section 1202 gain (box 2c), and 28 percent collectibles (box 2d).

☐ CORRECTED (if checked)

PAYER'S name, street address, city, state, ZIP code, and telephone no. Fairfield Investment Co. 34 Irvine Drive Your City, State, Zip Code	**1a** Total ordinary dividends $ 200 **1b** Qualified dividends $ 200	OMB No. 1545-0110 **2007** Form **1099-DIV**	**Dividends and Distributions**
	2a Total capital gain distr. $	**2b** Unrecap. Sec. 1250 gain $	**Copy B** **For Recipient**
PAYER'S federal identification number XX-XXXXXXX — RECIPIENT'S identification number XXX-XX-XXXX			
RECIPIENT'S name Jordan Knox	**2c** Section 1202 gain $	**2d** Collectibles (28%) gain $	This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported.
	3 Nondividend distributions $	**4 Federal income tax withheld** $	
Street address (including apt. no.) 255 Chapman Street		**5** Investment expenses $	
City, state, and ZIP code Your City, State, Zip Code	**6** Foreign tax paid $	**7** Foreign country or U.S. possession	
Account number (see instructions)	**8** Cash liquidation distributions $	**9** Noncash liquidation distributions $	

Form **1099-DIV** (keep for your records) Department of the Treasury - Internal Revenue Service

If the taxpayer does not meet the requirements to report the capital gain distribution directly on Form 1040 or Form 1040A, a Schedule D, *Capital Gains and Losses,* must be filed. If a Schedule D is not required, the capital gains distributions can be reported directly on of Form 1040, line 13, or Form 1040A, line 10. Capital gains distributions are not reported on Form 1040EZ.

If capital gains distributions are reported directly on Form 1040 or Form 1040A, use the *Qualified Dividend and Capital Gain Tax Worksheet* from either the Form 1040 or 1040A instruction booklet to compute the tax.

The volunteer should be careful not to ignore other boxes on the Form 1099-DIV.

- Box 4, Federal income tax withheld. Be sure to include this amount on the appropriate line for Federal income tax withheld of Form 1040 or 1040A.
- Box 5, Investment expenses. If the taxpayer files Form 1040 and itemizes deductions on Schedule A, report the amount from box 5 as a miscellaneous itemized deduction subject to the 2 percent-of-adjusted-gross-income limit. (See Itemized Deductions Section in Lesson 4.)
- Box 6, Foreign tax paid. If the taxpayer has an entry in box 6, see Lesson 9 for the proper treatment of the tax. The taxpayer may be able to claim the foreign tax credit or take a deduction on his or her Form 1040, Schedule A, under taxes paid.

A capital gain distribution is reported on a Schedule D when the taxpayer has more than capital gain distributions to report. Taxpayers should be referred to a tax professional if there are entries on Form 1099-DIV boxes 2b, 2c, 2d, 8, or 9. Capital gain distributions are always treated as long-term capital gains, regardless of how long the taxpayer holds the shares, and are reported on line 13 of Schedule D.

GAMBLING WINNINGS

Taxpayers must include gambling winnings as income on Form 1040, line 21. If the taxpayers itemize their deductions on Form 1040, Schedule A, they can deduct gambling losses they had during the year, **but only up to the amount of their winnings.**

Taxpayers must keep an accurate diary or similar record of their losses and winnings. The diary should contain at least the following information:

1. Date and type of specific wager or waging activity
2. Name and address or location of the gambling establishment
3. Names of other persons present with the taxpayer at the gambling establishment
4. Amount(s) the taxpayer won or lost

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

Form W-2G. Taxpayers may receive a **Form W-2G, Certain Gambling Winnings,** showing the amount of their gambling winnings and any tax withheld from those winnings. Include the amount from box 1 on Form 1040, line 21. Include the amount shown in box 2 on Form 1040 as federal income tax withheld.

UNEMPLOYMENT COMPENSATION

Unemployment compensation includes benefits to unemployed individuals that a state or the District of Columbia paid from the Federal Unemployment Trust Fund. It is reported to the recipient on **Form 1099-G, Certain Government Payments.** All unemployment compensation is taxable. Transfer the amount in box 1 of Form 1099-G (see Exhibit 7) to Form 1040, line 19 or Form 1040A, line 13, or Form 1040EZ, line 3.

Supplemental benefits provided from an employer's fund to which the employee did not contribute are sometimes thought of as unemployment benefits also. They are reported to the employee on Form W-2. Include them on Form 1040 or 1040A, line 7, or on Form 1040EZ, line 1.

☐ VOID ☐ CORRECTED

PAYER'S name, street address, city, state, ZIP code, and telephone no. Georgia Department of Revenue 76 Butter Street Atlanta, GA 30345		1 Unemployment compensation $ 4,000.00 2 State or local income tax refunds, credits, or offsets $	OMB No. 1545-0120 **2007** Form **1099-G**	**Certain Government Payments**
PAYER'S federal identification number XX-XXXXXXX	RECIPIENT'S identification number XXX-XX-XXXX	3 Box 2 amount is for tax year	4 Federal income tax withheld $ 400.00	**Copy C** **For Payer**
RECIPIENT'S name Clark Fisk		5 ATAA payments $	6 Taxable grants $	For Privacy Act and Paperwork Reduction Act Notice, see the **2007 General Instructions for Forms 1099, 1098, 5498, and W-2G.**
Street address (including apt. no.) 87 Bluefield Avenue City, state, and ZIP code New York, NY 10001		7 Agriculture payments $	8 Check if box 2 is trade or business income ▶ ☐	
Account number (see instructions)				

Form **1099-G** Department of the Treasury - Internal Revenue Service

STOP

Stop here for the basic course.
Go to Lesson 4, page 4-1.

All others continue.

STATE AND LOCAL TAX REFUNDS

Taxpayers who receive a refund of state or local taxes may receive a **Form 1099-G, Certain Government Payments** (see Exhibit 7). If the taxpayer claimed the standard deduction on the 2006 return and received a refund of 2006 state or local tax, the taxpayer does not have to include the refund in taxable income for tax year 2007. However, if the taxpayer itemized deductions **and** received a state or local tax refund, the taxpayer may have to include part or all of the refund in taxable income in 2007. Use the *State and Local Income Tax Refund Worksheet*—line 10 in the Form 1040 instruction booklet—to determine what part of the refund, if any, is taxable. Enter the taxable portion of state and local refunds on Form 1040, line 10.

POTENTIAL PITFALLS

If the state or local income tax refund reflects any deductions, credits, or payments for years other than 2006, refer the taxpayer to a tax professional.

Alimony Received

Alimony or separate maintenance payments made under a court decree are taxable income to the person receiving them. They are reported on Form 1040, line 11. The person making the payments deducts them on Form 1040, as an adjustment to gross income. When an entry is made for alimony paid, TaxWise® requires the social security number of the person receiving the alimony.

Child support payments are not alimony. The person making the payments cannot deduct them. The person receiving child support payments does not have to include them in income.

Cancelled Debts

Generally, if a debt is cancelled or forgiven, other than as a gift or bequest, you must include the cancelled amount in your income. You have no income if the cancelled amount is considered a gift to you. A debt includes any indebtedness for which you are liable or which is attached to property you hold.

If a federal government agency, financial institution, or credit union cancels or forgives a debt of $600 or more you owe, you will receive a **Form 1099-C, Cancellation of Debt.** The amount of the cancelled debt will be shown in box 2.

Additional information on cancelled debts and exceptions to the inclusion of the cancelled debt in income can be found in Publication 525, *Taxable and Nontaxable Income,* and Publication 908, *Bankruptcy Tax Guide.*

Disabled Taxpayers Working at a Sheltered Workshop

Generally, a taxpayer may need to include the income for services performed at a sheltered workshop.

However, for purpose of the gross income test for a dependent, the income is not included as gross income.

Additional information can be found in Publication 501, *Exemptions, Standard Deduction, and Filing Information* and Publication 525, *Taxable and Nontaxable Income.*

Early Distributions from Qualified Retirement Plans

Part of pension and annuities income may be taxable. To discourage the use of retirement and/or pension funds for purposes other than normal retirement, the law imposes additional taxes on early distributions of the taxable part of those funds.

An early distribution from qualified retirement plans and nonqualified annuity contracts is a distribution made before the taxpayer reaches age 59½. These distributions may be subject to an additional tax of 10 percent. This tax applies to the part of the distribution that you must include in gross income. It does not apply to any part of a distribution that is tax-free, such as amounts that represent a return of the taxpayer's cost or that were rolled over to another retirement plan.

For this purpose, a qualified retirement plan is:

- A qualified plan, including a qualified cash or deferred arrangement (CODA) under Internal Revenue Code section 401(k),
- A qualified employee annuity plan,
- A tax-sheltered annuity plan (403(b) plan), or
- An eligible state or local government Section 457 deferred compensation plan (to the extent that any distribution is attributable to amounts the plan received in a direct transfer or rollover from one of the other plans listed here).

If a taxpayer must pay this tax, report it on Form 5329, *Additional Taxes on Qualified Plans (Including IRAs) and Other Favored Accounts.* However, taxpayers do not have to file Form 5329 if they owe only the tax on early distributions, and their Form 1099-R correctly shows a "1" in box 7. Instead, enter 10 percent of the taxable part of the distribution on page 2 of Form 1040 on line 60 of the "Other Taxes" section, and write "No" under the "Other Taxes" heading to the left of line 60.

Exceptions to additional tax. Certain early distributions are excepted from the early distribution tax. If the payer knows that an exception applies to the early distribution, and Form 1099-R, box 7 shows code 2, 3, or 4, then the taxpayer does not have to report the distribution on Form 5329. If an exception applies but distribution code 1 (early distribution, no known exception) is shown in box 7, the taxpayer must file Form 5329. Enter the taxable amount of the distribution shown in Form 1099-R, on box 2a, Form 5329, line 1. On line 2, enter the amount that can be excluded and the exception number shown in the Form 5329 instructions.

General exceptions. The tax does not apply to distributions that are:

- Made as part of a series of substantially equal periodic payments (made at least annually) for the taxpayer's life or the joint lives of the taxpayer and the taxpayer's designated beneficiary;
- Made because the taxpayer is totally and permanently disabled;
- Made on or after the death of the plan participant or contract holder;
- Made to members of the National Guard and Reserves called to active duty more than 179 days during the period after September 11, 2001, and before December 31, 2007; or

ALERT ⚠

If distribution code "1" is incorrectly shown on Form 1099-R for a distribution received when a taxpayer was 59½ or older, include that distribution on Form 5329. Enter exception "11" on line 2.

- Made to qualified public safety employees who participate in government pension plans with a Deferred Retirement Option Plan and who are over the age of 50 and retire early.

See Publications 575, Pension and Annuity Income and Publication 590, Individual Retirement Arrangements (IRAs) for more information.

Income from Business

Business income or loss is reported first on Form 1040, Schedule C, *Profit or Loss from Business,* or Schedule C-EZ, *Net Profit from Business,* and then transferred to Form 1040, line 12. Taxpayers who must file a Schedule C should see a professional tax preparer.

Generally, if a taxpayer receives a Form 1099-MISC with an amount of $400 or more in box 7, Nonemployee Compensation, it should be reported as self-employment income on Schedule C or C-EZ. (Exception may include medical subject, Americorps income, hobby income not undertaken for profit, and in rare cases newspaper carriers under age 18 and household employees with earnings under $1,500).

VITA and TCE volunteers who have received training on this topic, at the discretion of the site coordinator, may assist self-employed individuals who qualify to use Schedule C-EZ, shown in Exhibit 8.

Who Can Use Schedule C-EZ

Potential Pitfalls

Many taxpayers erroneously report amounts from Form 1099-MISC, *Miscellaneous Income,* with wages or other income. This income should instead be reported on Schedule C or C-EZ and on Schedule SE, *Self-Employment Tax.* If the income is reported incorrectly, IRS may later issue a notice of proposed tax increase for the self-employment income and tax.

A taxpayer can use Schedule C-EZ only if he or she:

- Had business expenses on $5,000 or less,
- Uses the cash method of accounting,
- Did not have an inventory at any time during the year,
- Did not have a net loss from his or her business,
- Had only one business as a sole proprietor, or is a statutory employee,
- Had no employees during the year,
- Is not required to file Form 4562, *Depreciation and Amortization,* for this business (see the instructions for Schedule C, line 13, to find out if the taxpayer must file),
- Does not deduct expenses for business use of his or her home, and
- Does not have prior year unallowed passive activity losses from this business.

Completing Schedule C-EZ

Schedule C-EZ has three parts:

Part I: General Information

Part II: Figure Your Net Profit

Part III: Information on Your Vehicle

Part I: General Information

Part I is used to determine whether or not the taxpayer is eligible to use this form instead of Schedule C for reporting self-employment income. If all the criteria are met, the taxpayer then completes Part I.

Line B, Principal Business Code, is determined by looking at the code list in the Instructions for Schedule C, Profit or Loss from Business or in the 1040 instruction booklet.

Line D, Employer ID Number, is a number that the Internal Revenue Service supplies to businesses and other professional activities. If the taxpayer does not have one, the space should be left blank. The taxpayer cannot use the taxpayer's social security number.

Part II: Figure Your Net Profit

Gross receipts are all receipts from a trade or business, including income reported on a Form 1099-MISC, *Miscellaneous Income,* box 7, Nonemployee Compensation. All items of taxable income actually or constructively received during the year are included. Gross receipts are entered on line 1, Schedule C or C-EZ.

> **ALERT**
> The 2007 rate for business use of your vehicle is 48.5 cents per mile.

If the taxpayer is a statutory employee, check the box next to line 1 of Schedule C-EZ. Then report the amount shown in box 1 of the taxpayer's Form W-2 in box 1 of Schedule C-EZ. Examples of statutory employees include full-time life insurance salespeople, certain agent or commission drivers, traveling salespeople, and certain homemakers. The statutory employee checkbox in box 13 of the taxpayer's Form W-2 should be checked.

Total expenses include the total amount of all deductible business expenses actually paid during the year. Examples of these expenses include advertising, car and truck expenses, commissions, insurance, interest, legal and professional services and fees, office expense, rent or lease expense, repairs and maintenance, supplies, taxes, travel, 50 percent of business meals and entertainment, and utilities (including telephone). Total expenses of $5,000 or less are entered on line 2.

If the taxpayer uses his or her car or truck for business purposes, he or she can deduct expenses related to using the car or truck. To determine the amount of car and truck expenses that can be deducted, the taxpayer must use either the standard mileage rate or actual car expenses.

Standard Mileage Rate. If the taxpayer can and does choose to use the standard mileage rate, business miles are multiplied by the applicable mileage rate and added to the deductible parking and tolls. Car expenses using the standard mileage rate are computed as follows:

  Business miles incurred during the year × **48.5¢** per mile
\+ Parking and tolls incurred while on business

Actual Car Expenses. If the taxpayer chooses to use the actual car expenses, only the business portion of the expenses is deductible. Deductible expenses under the actual method are computed as follows:

1. Compute the percentage of business use:

$$\frac{\text{Business miles}}{\text{Total miles}} = \text{percent of business use}$$

2. Determine the deductible expenses:

  (percent of business use × total actual expenses)
\+ Parking and tolls incurred while on business

Note: If taxpayers depreciate their car or truck, or their total expenses are more than $5,000, they cannot use Schedule C-EZ and should be referred to a professional tax preparer.

Subtract line 2 from line 1, and enter the net amount on line 3 to determine the net profit or loss.

If line 3 shows a profit, transfer this amount to Form 1040, line 12, and to Schedule SE, line 2 (except statutory employees). Attach Schedule C-EZ to Form 1040 in the correct sequence.

If line 3 is zero, show zero amount on Form 1040, line 12.

If line 3 shows a loss, the taxpayer cannot use Schedule C-EZ and should be referred to a professional tax preparer.

Part III: Information on Your Vehicle

Part III should be completed if the taxpayer is claiming car and truck expenses in Part II.

SCHEDULE C-EZ (Form 1040)

Department of the Treasury
Internal Revenue Service

Net Profit From Business

(Sole Proprietorship)

▶ Partnerships, joint ventures, etc., must file Form 1065 or 1065-B.
▶ Attach to Form 1040, 1040NR, or 1041. ▶ See instructions on back.

OMB No. 1545-0074

2007

Attachment Sequence No. **09A**

Name of proprietor	Social security number (SSN)
Coe Curry	XXX XX XXXX

Part I General Information

You May Use Schedule C-EZ Instead of Schedule C Only If You:

- Had business expenses of $5,000 or less.
- Use the cash method of accounting.
- Did not have an inventory at any time during the year.
- Did not have a net loss from your business.
- Had only one business as either a sole proprietor or statutory employee.

And You:

- Had no employees during the year.
- Are not required to file **Form 4562,** Depreciation and Amortization, for this business. See the instructions for Schedule C, line 13, on page C-4 to find out if you must file.
- Do not deduct expenses for business use of your home.
- Do not have prior year unallowed passive activity losses from this business.

A Principal business or profession, including product or service
Hair Salon

B Enter code from pages C-8, 9, & 10 ▶ 1 1 2 1 1 1

C Business name. If no separate business name, leave blank.

D Employer ID number (EIN), if any

E Business address (including suite or room no.). Address not required if same as on page 1 of your tax return.
2525 Clemson Lane

City, town or post office, state, and ZIP code
Your City, State, Zip Code

Part II Figure Your Net Profit

1	**Gross receipts. Caution.** If this income was reported to you on Form W-2 and the "Statutory employee" box on that form was checked, see **Statutory Employees** in the instructions for Schedule C, line 1, on page C-3 and check here . . . . ▶ ☐	1	25,000
2	**Total expenses** (see instructions). If more than $5,000, you **must** use Schedule C	2	1,400
3	**Net profit.** Subtract line 2 from line 1. If less than zero, you **must** use Schedule C. Enter on both **Form 1040, line 12,** and **Schedule SE, line 2,** or on **Form 1040NR, line 13.** (Statutory employees **do not** report this amount on Schedule SE, line 2. Estates and trusts, enter on Form 1041, line 3.)	3	23,600

Part III Information on Your Vehicle. Complete this part only if you are claiming car or truck expenses on line 2.

4 When did you place your vehicle in service for business purposes? (month, day, year) ▶ 01 / 01 / 2007.

5 Of the total number of miles you drove your vehicle during 2007, enter the number of miles you used your vehicle for:

a Business 10,000 **b** Commuting (see instructions) 15,000 **c** Other

6 Do you (or your spouse) have another vehicle available for personal use? . . . . ☐ Yes ☑ No

7 Was your vehicle available for personal use during off-duty hours? . . . . ☑ Yes ☐ No

8a Do you have evidence to support your deduction? . . . . ☑ Yes ☐ No

b If "Yes," is the evidence written? . . . . ☑ Yes ☐ No

For Paperwork Reduction Act Notice, see page 2. Cat. No. 14374D **Schedule C-EZ (Form 1040) 2007**

ALERT ⚠

Statutory employees have social security and medicare tax withheld and do not owe self-employment tax. See Schedule C instructions for details.

Self-Employment Tax

Self-employment tax is a social security tax for persons who work for themselves. It is similar to the social security tax and medicare tax withheld from employees' wages.

Special exemptions from self-employment tax may apply to members of the clergy, members of certain religious sects, and certain nonclergy church employees.

The tax is computed on Schedule SE and transferred to Form 1040 to be added to other taxes owed. Schedule SE is attached to Form 1040.

Who Must File Schedule SE

A taxpayer must file Schedule SE (see Exhibit 9) if he or she has:

- Net earnings from self-employment of $400 or more, other than church employee income (line 4 of Short Schedule SE), or
- Church employee income of $108.28 or more (line 5a of Long Schedule SE).

Exception: If the only self-employment income was from earnings as a minister, member of a religious order, or Christian Science practitioner, and the taxpayer has filed **Form 4361, Application for Exemption From Self-Employment Tax for Use by Ministers, Members of Religious Orders and Christian Science Practitioners,** and has received IRS approval not to be taxed on these earnings, he or she does not have to file Schedule SE. Instead, write "Exempt—Form 4361" on the self-employment tax line of Form 1040.

Most taxpayers will need to complete only Section A of Schedule SE, also known as the Short Schedule SE. Follow the chart on the form to determine whether the taxpayer qualifies to file the short form. Anyone who does not qualify and who must file the long form should be referred to a professional tax preparer.

If the taxpayer qualifies for the short form, enter the net profit from Schedule C-EZ, line 3, on lines 2 and 3 of the Schedule SE.

Follow the instructions on the form to determine net earnings from self-employment on line 4 and the self-employment tax on line 5.

Enter the amount from line 5 on the line for self-employment tax on page 2 of Form 1040.

Deduction of Self-Employment Tax

Self-employed people may claim an adjustment to income of one-half of the social security and medicare taxes they pay.

Enter the amount from Schedule SE, line 6, on page 1, line 27 of Form 1040 as an adjustment to gross income.

SCHEDULE SE (Form 1040) Department of the Treasury Internal Revenue Service (99)	**Self-Employment Tax** ▶ **Attach to Form 1040.** ▶ **See Instructions for Schedule SE (Form 1040).**	OMB No. 1545-0074 **2007** Attachment Sequence No. **17**
Name of person with **self-employment** income (as shown on Form 1040) **Coe Curry**	Social security number of person with **self-employment** income ▶	**XXX XX XXXX**

Who Must File Schedule SE

You must file Schedule SE if:

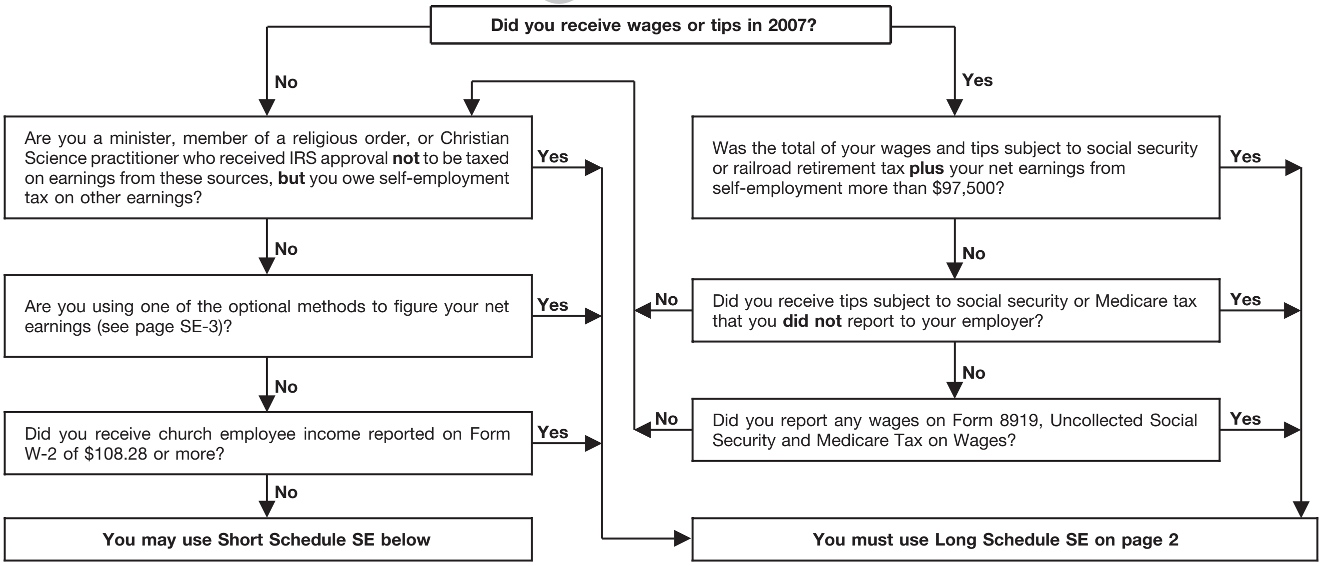
- You had net earnings from self-employment from **other than** church employee income (line 4 of Short Schedule SE or line 4c of Long Schedule SE) of $400 or more, **or**
- You had church employee income of $108.28 or more. Income from services you performed as a minister or a member of a religious order **is not** church employee income (see page SE-1).

Note. Even if you had a loss or a small amount of income from self-employment, it may be to your benefit to file Schedule SE and use either "optional method" in Part II of Long Schedule SE (see page SE-3).

Exception. If your only self-employment income was from earnings as a minister, member of a religious order, or Christian Science practitioner **and** you filed Form 4361 and received IRS approval not to be taxed on those earnings, **do not** file Schedule SE. Instead, write "Exempt–Form 4361" on Form 1040, line 58.

May I Use Short Schedule SE or Must I Use Long Schedule SE?

Note. Use this flowchart **only if** you must file Schedule SE. If unsure, see Who Must File Schedule SE, above.



Section A—Short Schedule SE. Caution. Read above to see if you can use Short Schedule SE.

1	Net farm profit or (loss) from Schedule F, line 36, and farm partnerships, Schedule K-1 (Form 1065), box 14, code A	1	
2	Net profit or (loss) from Schedule C, line 31; Schedule C-EZ, line 3; Schedule K-1 (Form 1065), box 14, code A (other than farming); and Schedule K-1 (Form 1065-B), box 9, code J1. Ministers and members of religious orders, see page SE-1 for amounts to report on this line. See page SE-3 for other income to report	2	23,600
3	Combine lines 1 and 2	3	23,600
4	**Net earnings from self-employment.** Multiply line 3 by 92.35% (.9235). If less than $400, **do not** file this schedule; you do not owe self-employment tax ▶	4	21,795
5	**Self-employment tax.** If the amount on line 4 is: • $97,500 or less, multiply line 4 by 15.3% (.153). Enter the result here and on **Form 1040, line 58.** • More than $97,500, multiply line 4 by 2.9% (.029). Then, add $12,090 to the result. Enter the total here and on **Form 1040, line 58**	5	3335
6	**Deduction for one-half of self-employment tax.** Multiply line 5 by 50% (.5). Enter the result here and on **Form 1040, line 27** — 6 — 1,668		

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 11358Z **Schedule SE (Form 1040) 2007**

> **POTENTIAL PITFALLS**
>
> Form 1099-R reports pension income, IRA distribution, not earned income. Form 1099-R amounts are not included on line 7 of Form 1040. They are reported on Form 1040A, lines 12a and 12b, or Form 1040, lines 16a and 16b. You will learn how to report pensions in Lesson 11, *Pensions*.

CAPITAL GAINS AND LOSSES

Both the sale of stock and the sale of a home are reported on Form 1040, line 13. The amount entered on Form 1040, line 13, is transferred from Form 1040, Schedule D, *Capital Gains and Losses.* See Lesson 12, Sale of Stock, and Lesson 13, Sale of Home, for more information about these types of sales.

SALE OF BUSINESS PROPERTY

The sale or involuntary conversion of business property is reported on Form 1040, line 14. If taxpayers are reporting the sale of business property, they should be referred to a professional tax preparer.

PENSION AND ANNUITY INCOME

Generally, payers of pension and annuity income send Form 1099-R to the recipients. The total pension or annuity income is reported on Form 1040, line 16a, or Form 1040A, line 12a; the taxable portion is reported on Form 1040, line 16b, or Form 1040A, line 12b. If all of the pension or annuity is taxable, make an entry on line 16b or 12b only.

For more information on pension and annuity income, see Lesson 11, Pensions.

RENTS, ROYALTIES, PARTNERSHIPS, S CORPORATIONS, ESTATES, AND TRUSTS

Income from rental property, royalties, partnerships, S corporations, estates, and/or trusts is reported on Form 1040, line 17. See the Military sections of this lesson for more information.

FARM INCOME

Farm income is reported on Form 1040, line 18. Advise taxpayers with farm income to see a professional tax preparer.

TAXWISE® HINTS

- When entering wages for the taxpayer, you have the following three choices:

  Go to line 7 and click F9 (Link),

  Click the right mouse button and select "Link," or

  Click on Add Form and select "W-2"

- Enter all information into TaxWise® **exactly** as it appears on Forms W-2, 1099, etc.

- When entering self-employment income from Form 1099-MISC, select the parent form (Form Schedule C or C-EZ) and then link to Form 1099-MISC.

Note: TaxWise® automatically rounds numbers.

QUALITY REVIEW (QR)—INCOME

Use **Form 8158, Quality Review Sheet** or an approved alternative form to review all returns prepared. Apply the quality review tools, in combination with the Intake and Interview Sheet and all the source documents, to the returns you prepare to ensure quality and accuracy for every taxpayer.

Consider each box on the Quality Review Sheet that applies to the taxpayer's situation. Confirm that all the necessary questions and issues have been addressed. If items are incorrect or incomplete, revisit the issue and make corrections to the return, as needed.

Excerpt from Form 8158

Yes	No	
☐	☐	All **income** indicated on the intake/interview sheet, taxpayer's interview and/or supporting documents are included on the return.

To ensure accurate reporting of income, verify that the taxpayer's wages are accurate and that all income from Form(s) W-2 and other income documents, such as Form(s) 1099, have been included. Confirm that all income received by the taxpayer has been discussed and shown on the return, if required.

▶▶ Summing Up This Lesson ◀◀

▶ Interest income

▶ Dividend income

▶ Capital gain distributions

▶ Unemployment compensation

Use Form 1040, Schedule B or Form 1040A, Schedule 1 to report:

▶ Interest and/or dividend income over $1,500, and

▶ Interest from Series I and/or Series EE savings bonds, issued after 1989, that is excluded from taxable income. Report any early withdrawal penalties on Form 1040 as an adjustment to income. Do not subtract penalties from interest income.

Report capital gain distributions directly on Form 1040, line 13 or Form 1040A, line 10 if the taxpayer is not required to file Schedule D.

State and local tax refunds are included in taxable income if:

▶ The taxpayer itemized deductions, and

▶ Received a tax benefit by including the state and local tax in itemized deductions.

Alimony payments are taxable income to the person receiving these payments. The person making these payments can subtract them as an adjustment to income.

Business income or loss is generally beyond the scope of VITA or TCE. However, in some cases, trained volunteers may help self-employed taxpayers who qualify to use Schedule C-EZ.

Taxpayers with net self-employment income of $400 or more must complete Schedule SE to compute self-employment tax.

Some nontaxable income is reported but is not included in taxable income:

▶ Tax-exempt interest

▶ Nontaxable portions of IRA distributions, including rollovers

Other income, such as prizes, awards, lottery winnings, and jury duty pay, is reported on Form 1040, line 21, including the amount and description.

Volunteers should refer taxpayers with any of the following items to professional tax preparers:

▶ Sales of business property

▶ Farm income

Exercise 1

1. Taxable
2. Taxable
3. Nontaxable
4. Nontaxable
5. Taxable
6. Taxable
7. Nontaxable
8. Taxable
9. Nontaxable

Exercise 2

A. Mike will report $29,250 on line 7. The tip income is included in the $8,250.

B. No; John must file Form 1040 to pay social security and Medicare tax on his tip income.

C. Randy should be advised to contact the employer and request that a Form W-2 be issued or reissued. If after waiting a reasonable amount of time, it still has not been received, Randy should contact the IRS (but not before February 15).

Exercise 3

A. 1. None

2. $1,000

B. $398 is reported on Form 1040EZ, line 2.

C. $495 is reported on Form 1040, line 8a.

Military/International students continue.

All others go to Lesson 4, page 4-1.

STUDENT NOTES

INCOME

INTRODUCTION AND OBJECTIVES

This segment discusses whether to include specific items in gross income. You should be aware, however, that certain items related to moving or travel expenses generally must be accounted for even if they are not considered income.

This lesson includes information about the combat zone exclusion. For additional tax benefits, see *Tax Options for Combat Zone Participants* in Lesson M-14, Finishing the Return.

After completing this lesson you should be able to:

- Determine which items received by Armed Forces members are includable in gross income.
- Determine if an amended return must be filed for a taxpayer who received medical separation pay.
- Determine who qualifies for exclusion of pay from income because of service in a combat zone.
- Identify qualifying items of military pay received for service in a combat zone.

FORM W-2

Includable military income will generally be the amount shown in box 1 of Form W-2, *Wage and Tax Statement*. **If this amount differs from the last Leave and Earnings Statement for 2007, advise the person to contact his or her local accounting and finance or payroll office for an explanation.**

The wages shown in box 1 of the 2007 Form W-2 should not include military pay excluded from an individual's income under the combat zone exclusion provisions. Wages excluded based on combat zone exclusion will be reflected in box 12 with Code Q. Tax exempt earned income, basic allowance for subsistence (BAS), basic allowance for housing (BAH), and certain in-kind allowances are no longer reported in box 12 of Form W-2.

INCLUDABLE INCOME

Members of the Armed Forces receive many different types of pay and allowances. Some are includable in gross income while others are excludable from gross income. Includable items are subject to tax and must be reported on the taxpayer's tax return. Excludable items are not subject to tax but may have to be shown on the tax return. The following items are includable in gross income, **unless** the pay is for service in a combat zone declared by an executive order of the President or an area designated as an area in Direct Support of Combat Zone.

Table 1 – Includable Income

Basic pay	• Active duty • Attendance at a designated service school • Back wages • CONUS COLA • Drills • Reserve training • Active duty for training/ annual training	**Bonuses**	• Career status • Enlistment* • Officer • Overseas extension • Reenlistment*
		Other payments	• Accrued leave • High deployment per diem • Personal money allowances paid to high-ranking officers • Student loan repayment from programs such as the Department of Defense Educational Loan Repayment Program when year's service (requirement) is not attributable to a combat zone
Special pay	• Aviation career incentives • Career sea • Diving duty • Foreign duty (outside the 48 contiguous states and the District of Columbia) • Foreign language proficiency • Hardship duty • Hostile fire or imminent danger • JAG Continuation pay • Medical and dental officers • Nuclear-qualified officers • Optometry • Pharmacy • Special duty assignment pay • Veterinarian	**Incentive pay**	• Submarine • Flight • Hazardous duty • High altitude/Low altitude (HALO)

* Enlistment and reenlistment bonuses fall under the category of taxable income. Income tax will be withheld from these entitlements before they are paid to the service member. Income tax is withheld at a flat rate of 27 percent as bonuses are treated as supplemental wages. Service members will not need to account for enlistment and reenlistment bonuses separately when preparing their tax returns as the payments and withholdings will be reflected on their Form W-2. If a service member feels this information is incorrect, he or she will need to contact the local accounting and finance or payroll office.

A reenlistment bonus may be tax-free if the voluntary extension or reenlistment occurs in a month the service member served in a combat zone.

EXCLUDABLE INCOME

The following qualified military benefits do not have to be reported as income on Form 1040, 1040A, or 1040EZ. The exclusion applies whether the item is furnished in kind or is a reimbursement or allowance. The personal use of a vehicle cannot be excluded from gross income as a qualified military benefit.

Table 2–Excludable Income

Living allowances	• BAH (Basic Allowance for Housing). You can deduct mortgage interest and real estate taxes on your home even if you pay these expenses with your BAH. • BAS (Basic Allowance for Subsistence) • Housing and cost-of-living allowances abroad whether paid by the U.S. government or by a foreign government • OHA (Overseas Housing Allowance)	**Combat zone pay**	• Compensation for active service while in a combat zone or Direct Support area or a qualified hazardous duty area. Note: Limited amount for officers
		Family allowances	• Certain educational expenses for dependents • Emergencies • Evacuation to a place of safety • Separation
		Death allowances	• Burial services • Death gratuity payments to eligible survivors • Travel of dependents to burial site
Moving allowances	• Dislocation • Military base realignment and closure benefit paid after November 11, 2003 (the exclusion may be limited—see Publication 3). • Move-in housing • Moving household and personal items • Moving trailers or mobile homes • Storage • Temporary lodging and temporary lodging expenses	**Other payments**	• Defense counseling • Disability, including payments received for injuries incurred as a direct result of a terrorist or military action • Group term life insurance • Professional education • ROTC educational and subsistence allowances • Survivor and retirement protection plan premiums • Uniform allowances • Uniforms furnished to enlisted personnel
Travel allowances	• Annual round trip for dependent students • Leave between consecutive overseas tours • Reassignment in a dependent restricted status • Transportation for you or your dependents during ship overhaul or inactivation • Per diem	**In-kind military benefits**	• Dependent-care assistance program • Legal assistance • Medical/dental care • Commissary/exchange discounts • Space-available travel on government aircraft

Note: If the person you are helping is a member of the Armed Forces and was provided a commuter highway vehicle (such as a van) by his or her employer in 2007, refer the taxpayer to Publication 525, *Taxable and Nontaxable Income,* and to a tax professional.

ALERT

Military separation with disability severance pay—Form W-2 is issued and income is taxable.

Disability separation pay—Paid by the VA—No Form W-2 or 1099-R is issued and the income is non-taxable.

MILITARY SEPARATION WITH DISABILITY SEVERANCE PAY

Service members who have been separated from the service for years of service or medical reasons are given severance pay, which is taxable as wages. If any portion of their pay is subject to medical disability, only the Veteran's Affairs (VA) can make that determination and assign what percentage is attributable to medical disability pension due. This process takes several months and sometimes years. The service member will receive the total "pension," which is taxable, until the VA makes the determination and sends the discharged service member a letter of determination.

Disability compensation is a monetary benefit paid to veterans who are disabled by injury or disease incurred or aggravated during active military service. The service of the veteran must have been terminated through separation or discharge under conditions that were other than dishonorable. Disability compensation varies with the degree of disability and the number of dependents, and is paid monthly. The benefits are not subject to federal or state income tax.

Once the letter of determination is received, any future pension payments will be offset by that percentage and paid directly from the VA. The payments received directly from the VA are not taxable and will not be included in Form W-2. However, the payments received prior to the letter of determination's being issued have already been taxed and the letter also exempts that percentage of pay already received from taxes. The service member needs to file an amended return if a return has already been filed, and attach a copy of the letter of determination to Form 1040X.

The payment of military retirement pay, disability severance pay, and separation incentive payments, known as Special Separation Benefits (SSB) and Voluntary Separation Incentives (VSI), also affect the amount of VA compensation paid.

Example 1

Anita Bennett, an active duty service member, retired in February 2006, with 20 years of service. She receives a service pension in the amount of $3,000 per month. Her 2006 Form 1099-R showed $33,000 in pension income. She filed and claimed $33,000 in pension income on her 2006 tax return. In 2007, the Veterans Administration (VA) determined that, due to her medical condition, she was entitled to VA disabilty pension of 40% from the date of discharge. She received her determination letter from the VA in March 2007. Anita should amend her 2006 tax return to exclude 40% of the pension pay she received in 2006, $13,200 ($33,000 x 40%). She would attach a copy of the letter of determination to the 2006 amended return. The tax return she files in 2007 will also reflect that 40% of her pension income is excluded from taxable income.

COMBAT ZONE EXCLUSION

Members of the United States Armed Forces who serve in a combat zone (defined later) may exclude certain pay from their income. They do not have to receive the pay while in a combat zone, in a hospital, or in the same year they served in a combat zone. However, the entitlement to the pay must have fully accrued in a month during which they served in the combat zone or were hospitalized as a result of wounds, disease, or injury incurred while serving in the combat zone. The following military pay can be excluded from their income:

- Active duty pay earned in any month during which they served in a combat zone
- Imminent danger/hostile fire pay
- A reenlistment bonus if the voluntary extension or reenlistment occurs in a month during which they served in a combat zone
- Pay for accrued leave earned in any month during which they served in a combat zone (The Department of Defense must determine that the unused leave was earned during that period.)
- Pay received for duties as a member of the Armed Forces in clubs, messes, post and station theaters, and other nonappropriated fund activities (The pay must be earned in a month during which they served in a combat zone.)
- Awards for suggestions, inventions, or scientific achievements that members are entitled to because of a submission they made in a month during which they served in a combat zone
- Student loan repayments that are attributable to their period of service in a combat zone

Retirement pay does not qualify for the combat zone exclusion.

Partial (month) service. Members of the United States Armed Forces who serve in a combat zone for one or more days during a particular month are entitled to an exclusion for that entire month.

Combat Zone

A combat zone is any area the President of the United States designates by Executive Order as an area in which the United States Armed Forces are engaging or have engaged in combat. An area usually becomes a combat zone and ceases to be a combat zone on the dates the President designates by Executive Order.

Afghanistan Area. By Executive Order No. 13239, Afghanistan (and airspace above) is designated as a combat zone, beginning September 19, 2001.

Somalia. On June 5, 2007, the Principal Deputy Undersecretary of Defense for Personnel and Readiness certified that all military personnel operating in the airspace above Somalia and on the water in the area of the Somali Basin (coordinates detailed in signed memo) are eligible for all combat zone-related tax benefits due to their service in direct support of military operations in the Afghanistan combat zone. The effective date of this certification is January 1, 2007. This action is in addition to the October 17, 2006 action which similarly designated the land area of Somalia as a Direct Support area.

Yemen Area. Executive Order No. 13239 was extended to include Yemen as a designated combat zone, beginning April 10, 2002.

Kosovo Area. By Executive Order No. 13119 and Public Law 106-21, the following locations (including airspace above) were designated as a combat zone and a qualified hazardous duty area, beginning March 24, 1999:

- Federal Republic of Yugoslavia (Serbia/Montenegro)
- Albania
- The Adriatic Sea
- The Ionian Sea—north of the 39th parallel (including all of the airspace in connection with the Kosovo operation)

Persian Gulf Area. By Executive Order No. 12744, the following locations (and airspace above) were designated as a combat zone, beginning January 17, 1991:

- The Persian Gulf
- The Red Sea
- The Gulf of Oman
- The part of the Arabian Sea that is north of 10 degrees north latitude and west of 68 degrees east longitude
- The Gulf of Aden
- The total land areas of Iraq, Kuwait, Saudi Arabia, Oman, Bahrain, Qatar, and the United Arab Emirates

In addition, the Department of Defense has certified these locations for combat zone tax benefits due to their direct support of military operations, beginning on the listed dates:

In support of Operation Enduring Freedom (Afghanistan combat zone):

- Pakistan, Tajikistan, and Jordan—September 19, 2001 (Direct Support designation terminated December 31, 2005).
- Incirlik Air Base, Turkey—September 21, 2001
- Kyrgyzstan and Uzbekistan—October 1, 2001
- Philippines—January 9, 2002 (applies only to personnel deployed in conjunction with Operation Enduring Freedom—Philippines).
- Yemen—April 10, 2002
- Djibouti—July 1, 2002
- Somalia—on land, effective January 1, 2004; in the air or on the water, effective January 1, 2007.

In support of Operation Iraqi Freedom (Arabian Peninsula Areas combat zone):

- Israel and Turkey—January 1, 2003 (Israel Direct Support designation terminated July 31, 2003.) (Turkey Direct Support designation terminated December 31, 2005.)
- The Mediterranean (Mediterranean Direct Support designation terminated July 31, 2003.)

Qualified Hazardous Duty Area. Beginning November 21, 1995, a qualified hazardous duty area in the former Yugoslavia is treated as if it were a combat zone. The qualified hazardous duty area includes:

- Bosnia and Herzegovina,
- Croatia, and
- Macedonia.
- Syria—January 1, 2004

Members of the Armed Forces deployed overseas away from their permanent duty station in support of operations in a qualified hazardous duty area, or performing qualifying service outside the qualified hazardous duty area, are treated as if they are in a combat zone solely for the purposes of the extension of deadlines discussed in Lesson M-14. These personnel are not entitled to other combat zone tax benefits.

Serving in a Combat Zone

Service in a combat zone includes any periods that military members are absent from duty because of sickness, wounds, or leave. If, as a result of serving in a combat zone, a person becomes a prisoner of war or is missing in action, that person is considered to be serving in the combat zone so long as he or she keeps that status for military pay purposes.

Qualifying Service Outside Combat Zone. Military service outside a combat zone is considered to be performed in a combat zone if:

- The service is in direct support of military operations in the combat zone, and
- The service qualifies a member for special military pay for duty subject to hostile fire or imminent danger.

Military pay received for this service will qualify for the combat zone exclusion if the other requirements are met.

Nonqualifying Presence in Combat Zone. The following military service does not qualify as service in a combat zone:

- Presence in a combat zone while on leave from a duty station located outside the combat zone
- Passage over or through a combat zone during a trip between two points that are outside a combat zone
- Presence in a combat zone solely for a member's personal convenience

Note: Military personnel are considered to be serving in a combat zone if they are either assigned on official temporary duty or on other orders to a combat zone, or they qualify for hostile fire/imminent danger pay while in a combat zone.

Amount of Exclusion

Enlisted Members. Enlisted members, warrant officers, or commissioned warrant officers who serve in a combat zone during any part of a month can exclude all of their military pay for that month from their income. They can also exclude military pay earned while they are hospitalized as a result of wounds, disease, or injury incurred in the combat zone. The exclusion of their military pay while they are hospitalized does not apply to any month that begins more than 2 years after the end of combat activities in that combat zone. Their hospitalization does not have to be in the combat zone.

Officers. Commissioned officers (including limited-duty officers) may exclude their pay according to the rules just discussed. However, the amount of their exclusion is limited to the highest rate of enlisted pay plus the amount of imminent danger/hostile fire pay they received for each month during any part of which they served in a combat zone or were hospitalized as a result of their service there.

Hospitalized While Serving in the Combat Zone. If a member is hospitalized while serving in the combat zone, the wound, disease, or injury causing the hospitalization will be presumed to have been incurred while serving in the combat zone unless there is clear evidence to the contrary.

Example 2

Sergeant Ron Brady is hospitalized for a specific disease after serving in a combat zone for 3 weeks, and the disease for which he is hospitalized has an incubation period of 2 to 4 weeks. The disease is presumed to have been incurred while he was serving in the combat zone. On the other hand, if the incubation period of the disease were one year, the disease would not have been incurred while he was serving in the combat zone.

Hospitalized after Leaving the Combat Zone. In some cases the wound, disease, or injury may have been incurred while serving in the combat zone, even though the member was not hospitalized until after he or she left.

Example 3

Airman Martha Marshall was hospitalized for a specific disease 3 weeks after she left the combat zone. The incubation period of the disease is from 2 to 4 weeks. The disease was considered incurred while serving in the combat zone.

COMMUNITY PROPERTY

The community property states are Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin. Special rules apply to married persons who file separate returns or who were divorced during the tax year and were domiciled in a community property state.

For military personnel in community property states, the key word is "domicile." Domicile describes someone's legal, permanent residence. It is not always where the person presently lives.

Whether an item is subject to community property laws depends on the nature of the payment.

Armed Forces Pay. State community property laws apply to active military pay. Generally, the pay is either separate or community income, based on the marital status and domicile of the couple while the member of the Armed Forces was/is in active military service.

Armed Forces Retired or Retainer Pay. Retired or retainer payments to a member of the Armed Forces may be subject to community property laws.

For more information, see Publication 555, *Community Property*.

Exercise 1

Which of the following should be included in income on Form W-2?

A. Basic Allowance for Subsistence (BAS)

B. Overseas housing allowance

C. Lump sum for accrued leave, paid on separation

D. Foreign language proficiency pay

E. Uniform allowance

F. Foreign duty pay

G. Reenlistment bonus received while a service member was deployed to Qatar

H. Hazardous duty pay

I. Family separation allowance received while a service member was deployed to Italy

Answer: ____

Exercise 2

Sergeant James Wells was medically separated, in November 2006, from active duty military service due to a medical condition that interfered with his ability to perform his military duties. James was entitled to $12,000 in medical separation pay from which he received $8,640, after taxes were withheld. Prior to his separation, he submitted the required documentation to the Veteran's Affairs, applying for disability pay. James filed his tax return in March 2006 and received a $567 refund. In August of 2007 Sergeant Wells received his determination letter from VA, informing him he was entitled to an $800 disability pension per month from the date of his discharge. Sergeant Wells receives 100% VA disability.

A. Does James need to file an amended tax return for 2006?

Answer: ____

B. What amount of pay will James need to exclude from his pay when he files an amended tax return?

Answer: ____

▶ ▶ Summing Up This Military Segment ◀ ◀

You have learned that certain items received by members of the Armed Forces are included in their gross income. Certain other items are specifically excluded by law. Pay for service in a combat zone is not taxed for an enlisted member of the United States military. The amount of income that is not taxed for commissioned officers serving in a combat zone is limited to the highest rate of enlisted pay, plus the amount of imminent danger pay per month.

Exercise 1

C, D, F, and H

Exercise 2

A. Yes

B. $12,000

STUDENT NOTES

Rental Income and Expenses

Lesson 3
Military Segment

Introduction and Objectives

This lesson will explain the rental income reporting requirements for United States citizens, resident aliens and military members. Generally, a taxpayer must include in gross income all amounts received from rental properties, including rental receipts received from the taxpayer's former residence. Both United States citizens and resident aliens must report rental income, regardless whether the rental property is located in the United States or in a foreign country.

At the end of the segment, you will be able to:

- Determine how to report rental income.
- Determine how to report rental expenses.
- Determine how to report rental income when property is used for personal purposes either part of the year or during the entire year.
- Determine how to compute deductible depreciation expense.
- Identify the application of at-risk and passive activity rules.

Note: The information and explanation of this issue is beyond the usual scope of volunteer training. An exception has been made to serve the military and other volunteers living abroad due to limited access to both resources and the professional preparers.

Which Forms to Use

Rental income and expenses are reported on Form 1040, Schedule E, Supplemental Income and Loss, Part I. Additional information on rental income can be found in **Publication 527, Residential Rental Property,** and **Publication 946, How to Depreciate Property.**

Rental Income

Rental income may include other payments in addition to the normal and ordinary rents received. Include in gross rental income advance rent, security deposits, payments for canceling a lease, expenses paid by the tenant, and the fair market value of property or services received in exchange for rental payments. The security deposit is not included when the taxpayer plans to return the deposit at the end of the lease. A taxpayer using the cash basis of accounting reports the income when it is actually received. Taxpayers using the accrual accounting method report the income in the year they are entitled to receive payments.

The deductible rental expenses are reported on Schedule E, Part I, lines 5 through 18 (see Exhibit 1).

Exhibit 1 **Form 1040 Schedule E**

SCHEDULE E (Form 1040)
Department of the Treasury
Internal Revenue Service (99)

Supplemental Income and Loss
(From rental real estate, royalties, partnerships, S corporations, estates, trusts, REMICs, etc.)
▶ Attach to Form 1040, 1040NR, or Form 1041. ▶ See Instructions for Schedule E (Form 1040).

OMB No. 1545-0074
2007
Attachment Sequence No. **13**

Name(s) shown on return | **Your social security number**

Part I **Income or Loss From Rental Real Estate and Royalties** **Note.** If you are in the business of renting personal property, use **Schedule C** or **C-EZ** (see page E-3). If you are an individual, report farm rental income or loss from **Form 4835** on page 2, line 40.

1 List the type and location of each **rental real estate property:**		**2** For each rental real estate property listed on line 1, did you or your family use it during the tax year for personal purposes for more than the greater of: • 14 days **or** • 10% of the total days rented at fair rental value? (See page E-3.)		**Yes**	**No**
A			A		
B			B		
C			C		

Income:		Properties A	Properties B	Properties C		Totals (Add columns A, B, and C.)
3 Rents received	3				3	
4 Royalties received	4				4	
Expenses:						
5 Advertising	5					
6 Auto and travel (see page E-4)	6					
7 Cleaning and maintenance	7					
8 Commissions	8					
9 Insurance	9					
10 Legal and other professional fees	10					
11 Management fees	11					
12 Mortgage interest paid to banks, etc. (see page E-4)	12				12	
13 Other interest	13					
14 Repairs	14					
15 Supplies	15					
16 Taxes	16					
17 Utilities	17					
18 Other (list) ▶	18					

Deductible expenses include any ordinary and necessary expenses, such as expenses for repairs, maintenance, certain operating expenses, and depreciation.

Repairs vs. Improvements. The cost of a repair is a current year deduction; however, the cost of an improvement must be depreciated over the useful life of the improvement. The distinction between a repair and an improvement is that a repair keeps the property in good operating condition, whereas an improvement materially adds to the life or value of the property or adapts it to new uses. The following chart helps illustrate the difference between repairs and improvements.

Improvements	Repairs
Adding a room	Painting
Putting up a fence	Fixing gutters
Putting in plumbing or wiring	Repairing driveways
Replacing hot water tank	Replacing window glass
Appliances	Repairing Appliances
Putting on a new roof	Repairing the roof

Since an improvement is a capital expenditure and must be depreciated, the total cost, including material, labor, and installation, increases the basis of the property. Depreciation will be discussed later in this chapter.

Other Expenses. Some of the other ordinary expenses that may be deducted from gross rental income include salary and wages, utilities, rental of equipment, insurance premiums, interest expense (mortgage interest), advertising, taxes, homeowners association fees, and commissions paid for collecting rental income. If any part of the property tax is for local benefits, such as putting in streets and sidewalks, that portion of the property tax is added to the basis of the property rather than deducted as an ordinary expense. Insurance premiums paid in advance must be prorated over the period covered by the policy by both the cash basis and accrual basis taxpayer. If the rental is a condominium or cooperative, the maintenance fee is deductible. See Publication 527, *Residential Rental Property*, for taxes and interest deductions on cooperatives. Generally, mortgage interest expense is fully deductible. However, if the taxpayer has interest expense other than mortgage interest, refer him or her to the Internal Revenue Service or a tax professional.

Ordinary and necessary travel and transportation expenses attributable to the production of rental income are deductible. If a personal automobile is used, the taxpayer may use the standard mileage rate for business mileage. The standard mileage rate for the year 2007 is 48.5 cents per mile. When the taxpayer is using the standard mileage rate, parking fees and tolls may also be deducted. The standard mileage rate method may be selected on a yearly basis. However, if the taxpayer is changing to actual expense after using the standard mileage method, accelerated depreciation (MACRS) may not be used. In order for the taxpayer to claim depreciation under the actual expense method for transportation expenses, the vehicle must be used more than 50 percent for business, including for the production of rental income. If the travel incurred on behalf of a rental property is into or outside of the United States, the trip may have a dual purpose. Substantiation of the pleasure vs. business purpose and allocation of the expenses may be required. When a tenant does not pay the rent, the cash-basis landlord cannot take a deduction for the unpaid rent, since a deduction can never be taken for a payment that has never been included in income.

Example 1

Sergeant Judson lived in his home through September 2007. He received orders and rented his home out in October. Nine months of the mortgage interest and property taxes would go on his Schedule A, and the other three months would go on Schedule E. Remember, also, that three months of his property insurance is also a deductible item on Schedule E, even though this expense is not deductible when the home is his residence.

Other expenses that are deductible for rental property are cleaning and maintenance, repairs, utilities that are paid for the tenant, legal and professional fees, homeowners association fees, management fees paid to a real estate company or individual to care for the property during the absence, auto and travel expenses to check on the property, long distance phone calls, etc.

SPECIAL ALLOCATION

Special rules apply when rental property is used for personal purposes or as a rental without the intent to make a profit. When the taxpayer is renting part of the property, certain expenses must be divided between rental use and personal use. When figuring the division of expenses, the taxpayer may use any reasonable method. The most common methods used are based on the number of rooms in the dwelling or on the total area of the dwelling.

Example 2

Mary Alma rents one room in her house. The total square footage of her house is 1,000 square feet. The rental room measures 10 feet by 10 feet (100 square feet). She may deduct 10 percent of any allowable expense that benefited the renter. She may deduct 100 percent of any expenses that relate only to the rental portion of the house, such as painting the rented room.

Exercise 1

Mary Alma, in the example above, has the following expenses attributable to the **entire** property:

Taxes	$ 1,000
Utilities	$ 600
Mortgage interest	$ 800
Depreciation	$ 500

Also wallpapering expense of $100 for the tenant's room only.

A. What are the allowable expense deductions on Schedule E?
Answer: ______________________________

B. What are the allowable expense deductions on Schedule A?
Answer: ______________________________

For property changed to rental use in the tax year other than the beginning of the year, the allocation of expenses should be made between the number of days in the year for personal use and the number of days for rental use.

Example 3

John Princeton is transferred overseas and begins renting out his residence on October 1, 2007. For 2007, he may deduct three-twelfths (25 percent) of his yearly expenses, such as taxes, interest, and utilities, as rental expenses.

Vacation Home and Other Dwelling Units. Certain limitations apply to rental expenses for vacation homes or other dwellings that are used by the taxpayer for personal use during the year. A dwelling unit for this purpose includes a house, apartment, condominium, mobile home, boat, or similar property. However, the limitation does not apply to a hotel, motel, an inn, or a similar dwelling unit. The limitation on deductions applies if a dwelling unit is used as a residence during the tax year for personal purposes for greater than:

1. 14 days, or
2. 10 percent of the number of days during the tax year the property is rented at fair market value.

See Publication 527 for a discussion of the limitations.

Use As Home Before or After Renting. If individuals use a dwelling unit as their main home before or after renting it or trying to rent it, they may not have to count the days they use it as their main home as days of personal use.

12 Months or More. If for 12 or more consecutive months, taxpayers rent or try to rent a dwelling unit at a fair rental price, some of the days on which they use the property as their main home are not counted as days of personal use.

Do not count as days of personal use the days individuals used the property as their main home:

1. During the year in which they began renting it or offering it for rent, but before they began renting it or offering it for rent, or
2. During the year in which they stopped renting it or offering it for rent, but after they stopped renting it or offering it for rent.

Example 4

On March 1, 2005, you moved out of the house you had lived in for six years because you accepted a job in another town. You rent your house at a fair rental price from March 15, 2005, to May 14, 2007. On June 1, 2007, you move back to town and move back into your house.

Your use of the house as your main home from January 1 to March 1, 2005, and from June 1 to December 31, 2007, is not counted as personal use.

Since these days are not counted as days of personal use, the limitations on deductions discussed above do not apply.

Depreciation

The cost of property with a useful life of one year or more and used in a trade or business or held for the production of income is recovered by allowing an annual deduction called depreciation. The most common methods for the depreciation are called Accelerated Cost Recovery System (ACRS) for property placed in service after 1980 and before 1987, and Modified ACRS (MACRS) for property placed in service after 1986. Both of these depreciation methods have an alternative method that may be chosen which generally increases the number of years the property is depreciated over and, therefore, decreases the annual deduction. The method used for property placed in service before 1981 is referred to as straight line or declining balance.

Depreciable property includes buildings, machinery, furniture, new appliances, equipment, and vehicles. As discussed earlier, any cost for additions or improvements to the rental property must also be depreciated. Depreciation is allowed or allowable. What this means is, if the taxpayer did not claim depreciation that he or she was entitled to claim in an earlier year, the taxpayer must still reduce his or her basis in the property by the amount of depreciation that was not deducted. The depreciation deduction is determined by considering several factors. These factors are discussed next in this chapter. When the taxpayer is depreciating real property, the value of land is not depreciable.

Basis. The total of the yearly deductions for depreciation can never total more than the cost or other basis of the property. Generally, the cost (purchase price) of the property, including the cost of improvements, is the basis for depreciation. However, if the taxpayer acquired the property rather than purchased it, the basis may be figured differently than using the original cost. An example is an acquisition through inheritance or gift. For further information on the basis of inherited or gifted property, refer to **Publication 551, Basis of Assets.** When property is converted from personal use to rental use, the basis is the lesser of the adjusted basis or fair market value (FMV) at the time of conversion.

Example 5

Jen and Tom purchased a house in 1986 for $85,000. In 2007, they were transferred overseas and decided to rent out their personal residence. The value in 2007 was $125,000. The basis for depreciation is $85,000. Assume that the value of land was excluded in determining the cost of the house.

Adjusted Basis. The basis of property must be increased or decreased to reflect certain adjustments before the depreciation deduction is computed. For example, to the purchase price of a home, add the cost of any improvements, minus any casualty losses or depreciation previously deducted and minus the land value, to find the adjusted basis. Since land can never be depreciated, an allocation between land and building must be done based generally on assessed value. Where property is acquired in a purchase along with a trade-in, the basis must be adjusted.

Example 6

Neil Bates traded in old appliances used for his rental property, with an adjusted basis of $500, and got new appliances, with a fair market value of $2,000. He paid $1,000 in cash. His basis for depreciation in the new appliances is $1,500 (the $500 adjusted basis plus the $1,000 cash).

Placed in Service. For depreciation purpose, property is considered placed in service when it is in a condition or state of readiness and availability for use. However, a depreciation deduction may not be claimed until the property is used in business or for the production of income.

Property Classes and Recovery Periods. The ACRS and MACRS use the class life of depreciable property to determine the recovery period. If property was used as a personal residence before 1987 and converted to rental property after 1986, use the MACRS method to figure depreciation. Under MACRS, tangible property used in a rental activity generally falls into a 5-, 7-, or 27.5-year recovery period.

A home converted in 1998 to a rental property would be depreciated over a recovery period of 27.5 years. A stove also used in this same rental would be assigned a 7-year recovery period. Property, both real and personal, located outside the United States has a longer recovery period. Although the true physical life of the property may be less, under MACRS the recovery period is fixed. MACRS requires that a convention for half-year or mid-quarter be used. Under this special rule, in the year the property is placed in service, the depreciation deduction is prorated. **Publication 946, How to Depreciate Property,** contains tables of depreciation with the conventions already incorporated. Examples of the tables are shown below.

MACRS 5-Year Property

	Half-year convention	Mid-quarter convention			
Year		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	3.68

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

Residential Rental Property (27.5-year)

	Use the column for the month of taxable year placed in service											
Year	1	2	3	4	5	6	7	8	9	10	11	12
1	3.485%	3.182%	2.879%	2.576%	2.273%	1.970%	1.667%	1.364%	1.061%	0.758%	0.455%	0.152%
2	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%
3	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%
4	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%

For property located outside of the United States, the taxpayer must use an alternative method of depreciation under MACRS. Therefore, residential rental property located in a foreign country would be depreciated over a 40-year recovery period. Refer to Publication 946.

Reporting Depreciation

The depreciation deduction is shown on Schedule E, line 20 (see Exhibit 2). Use **Form 4562, Depreciation and Amortization,** only if the taxpayer places an asset in service in the current year, depreciates listed property, or claims a Section 179 expense.

19 Add lines 5 through 18 . . .	19						19	
20 Depreciation expense or depletion (see page E-4)	20						20	
21 Total expenses. Add lines 19 and 20	21							
22 Income or (loss) from rental real estate or royalty properties. Subtract line 21 from line 3 (rents) or line 4 (royalties). If the result is a (loss), see page E-5 to find out if you must file **Form 6198** . .	22							
23 Deductible rental real estate loss. **Caution.** Your rental real estate loss on line 22 may be limited. See page E-5 to find out if you must file **Form 8582.** Real estate professionals must complete line 43 on page 2	23	(	)	(	)	(	)	
24 **Income.** Add positive amounts shown on line 22. **Do not** include any losses							24	
25 **Losses.** Add royalty losses from line 22 and rental real estate losses from line 23. Enter total losses here							25	( )
26 **Total rental real estate and royalty income or (loss).** Combine lines 24 and 25. Enter the result here. If Parts II, III, IV, and line 40 on page 2 do not apply to you, also enter this amount on Form 1040, line 17, or Form 1040NR, line 18. Otherwise, include this amount in the total on line 41 on page 2							26	

For Paperwork Reduction Act Notice, see page E-7 of the instructions. Cat. No. 11344L **Schedule E (Form 1040) 2007**

AT-RISK AND PASSIVE LOSS

Very often rental property shows a net loss because the rental expenses are greater than the rental income. In this situation there are two potential restrictions on how much of the loss can offset other sources of income.

The first restriction is the at-risk rule. This rule provides that taxpayers can claim a loss for no more than they could actually lose from the activity. That is, taxpayers can claim a loss only up to the amount for which they are personally at-risk in the activity. Generally, individuals are considered at-risk for the amount of cash and property contributed to the activity from which they are not protected against personal liability, with the exception of casualty insurance.

Rental activities, by definition of the law, are generally considered to be a passive activity. The passive activity law states that passive activity losses can be deducted only from passive activity income. A passive activity is a trade or business being conducted without the taxpayer materially participating. Material participation may be defined by the regular, continuous, and substantial involvement of the taxpayer in the operation of the trade or business. For rental property, active participation does not require regular, continuous, and substantial involvement. Active participation requires that the taxpayer participate in making management decisions or arranging for others to provide services in a significant and bona fide sense. Management decisions include approving new tenants, setting rental terms, approving capital or repair expenditures, and similar decisions. It is important to understand the difference between active and material participation as it pertains to rentals because of a special $25,000 offset allowed for certain rental losses.

Rental losses up to $25,000 ($12,500 for married taxpayers filing separately and living apart for the entire year) may be used to offset any and all nonpassive income if the taxpayer actively participates in the residential rental activity. The following list is an example of nonpassive income:

- Salaries, wages, commissions, or tips
- Self-employment income from a trade or business in which the taxpayer materially participates (may be partnership, but not limited partnership income)
- Distributive shares of income through pass-through entities (such as S corporations) that is not income from a passive activity
- Portfolio income (gross income from interest, dividends, annuities, or some royalties)

Example 7

Lynn Ferris, a U.S. citizen, lives in Europe and has wages, paid by the U.S. government, of $25,000 and interest income of $100. She rented out her home located in the United States in 2007, and incurred $1,000 in rental loss. Although her sister collects the rent, Lynn makes all of the bottom-line decisions as to whom, and for what amount, the property will be rented. While Lynn is outside of the United States, she pays her sister to manage the property. The rental loss of $1,000 may be offset against her gross income of $25,100 because she is considered to be an active participant in the rental activity.

Phaseout of Offset. The amount allowed to offset nonpassive income is reduced once the taxpayer's adjusted gross income exceeds $100,000 ($50,000 for married filing separately). It is completely phased out when AGI exceeds $150,000 ($75,000 for married filing separately). Refer taxpayers with an AGI over $100,000 to the Internal Revenue Service or a professional preparer.

Reporting Rental Loss

Form 8582, Passive Activity Loss Limitations, is filed to summarize losses and income from all passive activities. Check the instructions for Form 1040 to determine if the taxpayer is required to file Form 8582 when he or she has rental losses. Generally, taxpayers who have only one passive loss generated from a rental activity and an adjusted income of less than $100,000 will not be required to file Form 8582. If any questions arise beyond the scope of this lesson regarding filing Form 8582, refer the taxpayer to the Internal Revenue Service or a tax professional.

Selling Rental Property

The sale of rental property is reported on **Form 4797, Sales of Business Property.** A gain is the amount realized minus the adjusted basis of the property.

Example 8

Pat Drake sold her rental property for $60,000. She had purchased the house for $30,000 and had claimed $10,000 for depreciation. Her gain is $40,000.

The gain is figured as follows:

1. Selling price		$60,000
2. Less selling expenses		0
3. Amount realized		$60,000
4. Basis	$30,000	
5. Less depreciation	$10,000	
6. Adjusted basis	$20,000	$20,000
7. Gain (line 3 minus 6)		$40,000

The gain may be either capital gain or ordinary gain, depending on the depreciation claimed. If part of the property was also used for personal uses, the sale is reported as two separate sales. A loss is the adjusted basis of the property minus the amount realized. A loss for any personal use of property cannot be deducted.

▶▶ Summing Up This Military Segment ◀◀

As a volunteer, you will assist taxpayers who have rental properties. In this lesson you learned what qualified as rental income and rental expenses. You studied how to figure and report the following:

- ▶ The proration needed when the property is used both for personal and rental purposes
- ▶ Depreciation expense
- ▶ Rental losses

Answers

Exercise 1

A. $390 (10% of total expenses of $2,900 = $290 plus $100 for wallpaper)

B. $1,620 (1,800 × .90 = 90% of mortgage interest and taxes)

STUDENT NOTES

WORLDWIDE INCOME

INTRODUCTION AND OBJECTIVES

This lesson will provide insights into the misconception that a United States citizen or resident alien only files a United States tax return if he or she has income from the United States, especially if taxes are paid to another country.

At the end of this segment, you will be able to:

- Define worldwide income and compute the United States dollar value of a foreign currency if given an exchange rate table, and
- Determine when to use average annual exchange figures.

WORLDWIDE INCOME

United States citizens and United States resident aliens are required to file a United States tax return based on their worldwide income. While United States citizens and United States resident aliens living abroad can claim tax benefits, such as the foreign earned income exclusion and the foreign tax credit (later lessons), they have the same filing requirements as United States citizens living in the United States. This applies whether their income is from within or outside the United States. Types of income, such as child support, that would not be taxed in the United States, are generally not taxed if from outside the United States. But, types of income that would be taxable if from within the United States are also taxable if from outside the United States.

You may wish to refer to the lists of taxable and nontaxable income on the applicable pages of the basic Military Section of the text.

Example 1

In 2007, Joe Adams earned $40,000 while working in Austin, Texas, for XYZ Corporation. In September 2007 he transferred to their office in Stuttgart, Germany. While in Germany he earned $30,000. His worldwide wages earned in 2007 would be $70,000. Line 7 of his Form 1040 would show $70,000.

Exercise 1

Marta Brener lives in Mussbach, Germany. Her 2007 income included $22,000 in wages earned in Germany. She earned $3,000 in interest from her U.S. bank and $2,000 unemployment compensation from the state of Iowa. What is Marta's worldwide gross income?

Exercise 2

Mary Carlton lives in Belgium. Her 2007 income included $10,000 in wages from her Belgian employer. She received $2,000 interest from her U.S. bank, $8,000 in alimony payments, and $8,000 in child support payments from her ex-spouse. What is her worldwide gross income?

Exercise 3

Would Marta Brener (Exercise 1) have to file a U.S. tax return for 2007? Would Mary Carlton (Exercise 2) have to file a U.S. tax return for 2007?

Exchange Rates

Another question that you will frequently be asked is "What exchange rate do I use?" The exchange rates of foreign currencies to the United States tax dollar change on a daily basis. **All amounts on the United States tax return must be stated in United States dollars.** Since most taxpayers abroad receive some kind of income in foreign currency, you will find situations when you will need to convert foreign income into United States dollars in order to put these income amounts on the return.

When making a conversion, you should make sure that the exchange rate is stated in foreign currency to one United States dollar. To convert a sum of money into United States dollars, you would **divide** the foreign currency by the exchange rate.

Example 2

If you received 3,000 euros on a day that the exchange rate was 1.7115 euros to U.S. $1, you would have $1,752.85 in equivalent U.S. dollar value (3,000/1.7115 = 1,752.85). To convert a sum of money into U.S. dollars when the currency unit is larger in value, you can use the same process.

Example 3

Caryn received 200 euros on a day that the exchange rate was .5514 euros to US $1. In U.S. dollars, she would have $362.71 (200/.5514 = 362.71).

Exercise 4

Convert the following amounts to U.S. dollars:

A. 36,000 euros (1.7115 exchange rate) ____________

B. 800 euros (.5514 exchange rate) ____________

When to Convert. Now that you have information on how to calculate exchange rates, we need to discuss what exchange rates to use. The exchange rate is determined by the date of the transactions; that is, the date on the check or the date money is credited to the taxpayer's account. If the taxpayer has income that was received evenly throughout the year, he or she can use the average annual exchange rate if the foreign exchange rate was relatively stable during the year. The average annual exchange rate is available from IRS offices throughout the world, generally starting around January 15.

IRS also distributes information to its worldwide offices concerning the quarterly exchange rates for various currencies.

Example 4

Edward Pasco worked in Dallas for Megacorp Incorporated from January until September 2007. On September 29, he was transferred to their Mexico City office where he will be working for 3 years. While in the United States, Edward earned his salary in U.S. dollars. When he moved to Mexico, he was paid in Mexican pesos. Since he did not receive his salary in foreign currency throughout the year, he should not use the annual average exchange rate. He should use the average rates for October, November, and December.

Where to Obtain Exchange Rates

To obtain exchange rates, you can call the IRS international office or the overseas IRS offices. The phone numbers of these offices are listed in Publication 54. You may also contact banks that provide international currency exchange services. Since a taxpayer "should use the rate that most nearly reflects the value of the foreign currency (Publication 54)" at the time he or she receives the income, the taxpayer may use an exchange rate that is different from the rates posted in our worldwide offices if he or she finds it to be a truer representation.

Exercise 5

Deborah Vance lives and works in Manila, Philippines. In 2007 she had the following income: 16,000 Filipino pesos in wages, 1,200 Filipino pesos interest income, and US $500 in interest from her U.S. bank. On June 7, 2007, she sold her car and made a profit of 2,000 Filipino pesos (fully taxable capital gain).

Since these items are fully taxable, what is the total income to be reported on Deborah's U.S. tax return (in U.S. dollars)?

For this exercise assume that the 2007 average annual exchange rate for the Filipino peso is 40.25 pesos to US $1, and the exchange rate for June 7, 2007 was 32.55 pesos to US $1.

Wages ______________________________
Interest ____________________________
Capital gain ________________________
Total 2007 income ___________________

Sometimes, you may get questions on exchanging money when there is "blocked income" or "soft currency." **Questions on these issues should be referred to IRS.** "Blocked income" refers to a situation where a taxpayer cannot convert foreign currency to United States dollars. This is generally due to local law or local government policy. There are special tax rules that exist when there is blocked income that allow taxpayers to choose to put off reporting part of their income. "Soft currency" refers to a situation where a person can convert back to United States dollars only an amount that equals what he or she brought into that country in United States dollars.

▶▶ Summing Up This International Segment ◀◀

- ▶ United States citizens (and resident aliens) are taxed on worldwide income and must file United States tax returns even if all the income is from foreign sources.
- ▶ You have learned how to convert foreign currency to United States dollar equivalent values.
- ▶ Exchange rates used should reflect the closest accurate rate.

WORLDWIDE INCOME

ANSWERS TO EXERCISES

Exercise 1

$27,000

Exercise 2

$20,000

Exercise 3

Yes. Yes.

Exercise 4

A. $21,034.18

B. $1,450.85

Exercise 5

Wages: 16,000.00 ÷ 40.25 = $397.52

Interest: 1,200.00 ÷ 40.25 = $29.81 from Philippines plus $500 interest from U.S. = $529.81

Capital gain: 2,000.00 ÷ 32.55 = $61.44

Total 2007 Income: $988.77

Tax Treaties

Treaty benefits generally are available to residents of the United States. They are generally not available to United States citizens who do not reside in the United States. However, certain treaty benefits and safeguards are available to United States citizens residing in the treaty countries. Some common tax treaty benefits are the following:

Tax Credit Provisions. A United States resident who receives income from a foreign country may be taxed on that income by both the United States and the treaty country. Most treaties allow the taxpayer to take a credit against or deduction from the treaty country's taxes based on the United States tax on the income.

Saving Clauses. United States treaties contain saving clauses that provide that the treaties do not affect the United States taxation of its own citizens and residents. However, most treaties provide exceptions to saving clauses that allow certain provisions of the treaty to be claimed by United States citizens or residents. It is important that you examine the applicable treaty's saving clause to determine if an exception applies.

For more information, consult **Publication 54, Tax Guide for United States Citizens and Resident Aliens Abroad** and **Publication 901, U.S Tax Treaties.**

TD Form 90-22.1

Each United States person who has a financial interest in, or signature authority or other authority over any financial accounts including bank, securities, or other types of financial accounts in a foreign country, may be required to report that relationship each calendar year by filing TD Form 90-22.1 with the Department of the Treasury by June 30. This form is filed separately. For more information, consult the instructions for Form 1040, Schedule B, Part III, Foreign Accounts and Trusts, and the instructions for TD Form 90-22.1.

Foreign Earned Income Exclusion

It is advisable to keep a log of the days in foreign countries and the days spent in the United States to substantiate the physical presence test. This log should be kept with the taxpayer's records.

Canadian Registered Retirement Plans

A pension includes any payment under a pension or other retirement arrangement, including registered retirement savings plans (RRSPs) and (RRIFs) in Canada. Form 8891 is used by United States citizens or residents (a) to report contributions to Canadian RRSPs and RRIFs, (b) to report undistributed earnings in RRSPs and RRIFs, and (c) to report distributions received from RRSPs and RRIFs. A separate Form 8891 must be filed for each RRSP or RRIF for which there is a filing requirement. If the taxpayer and the taxpayer's spouse both must file Form 8891, they each must file a separate Form 8891. For more information consult **Publication 597, Information on the United States-Canada Income Tax Treaty.**

Social Security Benefits

Benefits paid under the Canada Pension Plan (CPP), Quebec Pension Plan (QPP), and Old Age Security (OAS) program to a United States resident are treated as United States social security benefits for United States tax purposes. For more information consult Publication 597 and **Publication 915, Taxation of Social Security Benefits.**

Home Mortgage Interest

Mortgage interest paid on loans secured by the taxpayer's main home and a second home is deductible even if the home is outside of the United States.

Education Credit

Certain educational institutions located outside the United States also participate in the United States Department of Education's Federal Student Aid programs and are eligible educational institutions for education credits. The United States Department of Education Web site has a list of the eligible institutions.

Grants Paid in Foreign Currency

Taxpayers generally must report their foreign income in terms of United States dollars and, with one exception (Fulbright Grant), must pay taxes due on it in United States dollars. However, there are special rules when the income is "blocked income." For more information consult **Publication 54, Tax Guide for United States Citizens and Resident Aliens Abroad.**

Sale of Residence

Members, of the Foreign Service have the same suspension of the 5-year period for ownership and use tests for sale of residence as members of the uniformed services. If members use property partly as a home and partly for business or to produce rental income, the treatment of any gain on the sale depends on whether the business or rental part of the property is part of their home or separate from it. For more information consult **Publication 523, Selling Your Home.**

STUDENT NOTES

SELF-EMPLOYMENT TAX

INTRODUCTION AND OBJECTIVES

This lesson will explain when a self-employed taxpayer living abroad is subject to United States income tax requirements and his or her filing obligations.

At the end of the segment, you will be able to:

- Determine who is a self-employed individual,
- Compute the self-employment tax for a United States citizen or resident abroad, and
- Compute the deduction for self-employment tax.

EMPLOYEE OR SELF-EMPLOYED

A self-employed person is generally one who either:

- Carries on a trade or business as a sole proprietor or independent contractor,
- Is a member of a partnership that carries on a trade or business, or
- Is otherwise in business for himself or herself.

SELF-EMPLOYMENT TAX

The self-employment tax is a social security tax for individuals who work for themselves. It is similar to the social security tax withheld from the pay of wage earners.

Social security benefits are available to individuals who are self-employed just as they are to wage earners. Payments of self-employment tax contribute to an individual's coverage under the social security system.

Income Limits. Individuals must pay self-employment tax if they have net earnings from self-employment of $400 or more a year.

Self-employment tax consists of two parts, social security tax and Medicare tax. For 2007, social security tax is paid on the first $97,500 of net income. The Medicare tax is imposed on the full amount of net earnings.

Note: If a person's self-employment income is $400 or more, he or she must file a return even though the income is below the minimum amount for income tax filing purposes.

Effect of Foreign Earned Income Exclusion. Taxpayers must take all of their earned income into account in figuring their self-employment tax, even though the income is exempt from income tax because of the foreign earned income exclusion.

Example 1

You are in business abroad as a consultant and qualify for the foreign earned income exclusion. Your foreign earned income is $70,000 and business expenses are $20,000, resulting in net earnings of $50,000. You must pay self-employment tax on the net income even though you excluded all of your earned income.

Exemption from United States Self-Employment Tax. The United States may reach agreements with foreign countries to eliminate dual coverage and dual contributions (taxes) to social security systems for the same work. As a general rule, self-employed persons who are subject to dual taxation will be covered only by the social security system of the country where they reside.

For more information, consult Publication 54, *Tax Guide for United States Citizens and Resident Aliens Abroad.*

Which Forms to Use

Form 1040, United States Individual Income Tax Return, is used to report self-employment tax. Both income tax and self-employment tax are due at the same time. **Schedule SE, Self-Employment Tax,** is used to figure the tax. Even if the taxpayer is not otherwise required to file an income tax return, he or she must file both Form 1040 and Schedule SE to pay self-employment tax.

The Schedule SE includes a flowchart to determine if the short or long form is required.

Computing the Self-Employment Tax

Although there are three methods available to compute self-employment tax, VITA volunteers will use only the regular method. Taxpayers who wish to use the other methods should seek professional assistance. There are no limits on who may use the regular method. Most taxpayers use this method.

Under the regular method, the net income from the taxpayer's business or profession is generally the net self-employment earnings from Schedules C, C-EZ, F, and Form 1065, Schedule K-1.

If the taxpayer has more than one trade or business, the net earnings from self-employment are the combined net earnings from each of the businesses. A loss in one business will reduce the income earned in another. Taxpayers must claim all allowable deductions, including depreciation, when figuring their net earnings from self-employment.

Even though the income may be exempt from income tax because of the foreign earned income exclusion, taxpayers must take all of their net earned income into account in figuring their self-employment tax. Refer to Publication 54, *Tax Guide for United States Citizens and Resident Aliens Abroad*, regarding the effect of the foreign earned income exclusion on United States self-employment tax.

Example 2

Susan J. Brown is sole proprietor of a dress shop, Milady Fashions. Her Schedule C shows a net profit of $35,100. Susan's completed Schedule SE is shown at the end of this section.

If Susan were the proprietor of more than one business, she would have combined the profits and losses from all of them and filled out only one Schedule SE. If, in addition to operating her dress shop, Susan had worked for wages totaling $97,500 or more, she would have already paid the maximum amount of social security tax owed on her wages, but she would still be subject to the Medicare portion (2.9 percent) of self-employment tax. In this case, she would use the long Schedule SE.

The line numbers shown below in bold type refer to the line numbers on the sample filled-in Schedule SE on the following page.

Line 1. Since Susan has no earnings from farm self-employment, she leaves line 1 blank.

Line 2. Susan enters the net profit from her Schedule C, $35,100.

Line 3. Since Susan has no farm income, she enters the same amount on line 3.

Line 4. Multiply the amount of line 3 by .9235 and enter the result.

Line 5. Susan determines her self-employment tax by using the first option on line 5. She multiplies $32,415 on line 4 by 15.3 percent. She enters $4,959 on line 5. This is her self-employment tax. She also enters this amount on Form 1040, line 58.

SCHEDULE SE (Form 1040)

Department of the Treasury
Internal Revenue Service (99)

Self-Employment Tax

▶ Attach to Form 1040. ▶ See Instructions for Schedule SE (Form 1040).

OMB No. 1545-0074
2007
Attachment Sequence No. 17

Name of person with **self-employment** income (as shown on Form 1040)	Social security number of person with **self-employment** income ▶
Susan J Brown	XXX XX XXXX

Who Must File Schedule SE

You must file Schedule SE if:

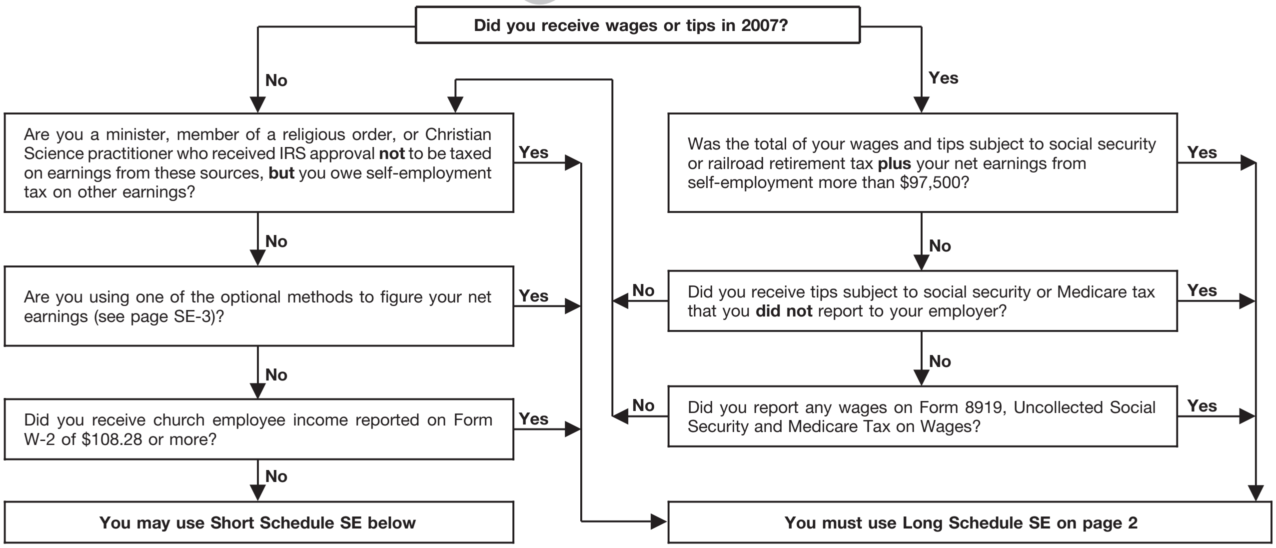
- You had net earnings from self-employment from **other than** church employee income (line 4 of Short Schedule SE or line 4c of Long Schedule SE) of $400 or more, **or**
- You had church employee income of $108.28 or more. Income from services you performed as a minister or a member of a religious order **is not** church employee income (see page SE-1).

Note. Even if you had a loss or a small amount of income from self-employment, it may be to your benefit to file Schedule SE and use either "optional method" in Part II of Long Schedule SE (see page SE-3).

Exception. If your only self-employment income was from earnings as a minister, member of a religious order, or Christian Science practitioner **and** you filed Form 4361 and received IRS approval not to be taxed on those earnings, **do not** file Schedule SE. Instead, write "Exempt–Form 4361" on Form 1040, line 58.

May I Use Short Schedule SE or Must I Use Long Schedule SE?

Note. Use this flowchart **only if** you must file Schedule SE. If unsure, see Who Must File Schedule SE, above.



Section A—Short Schedule SE. Caution. Read above to see if you can use Short Schedule SE.

1	Net farm profit or (loss) from Schedule F, line 36, and farm partnerships, Schedule K-1 (Form 1065), box 14, code A	1	
2	Net profit or (loss) from Schedule C, line 31; Schedule C-EZ, line 3; Schedule K-1 (Form 1065), box 14, code A (other than farming); and Schedule K-1 (Form 1065-B), box 9, code J1. Ministers and members of religious orders, see page SE-1 for amounts to report on this line. See page SE-3 for other income to report	2	35,100
3	Combine lines 1 and 2	3	35,100
4	**Net earnings from self-employment.** Multiply line 3 by 92.35% (.9235). If less than $400, **do not** file this schedule; you do not owe self-employment tax ▶	4	32,415
5	**Self-employment tax.** If the amount on line 4 is: • $97,500 or less, multiply line 4 by 15.3% (.153). Enter the result here and on **Form 1040, line 58.** • More than $97,500, multiply line 4 by 2.9% (.029). Then, add $12,090 to the result. Enter the total here and on **Form 1040, line 58.**	5	4959
6	**Deduction for one-half of self-employment tax.** Multiply line 5 by 50% (.5). Enter the result here and on **Form 1040, line 27** — 6: 2,480		

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 11358Z **Schedule SE (Form 1040) 2007**

The deduction for one-half of the SE tax will reduce Susan's income subject to income tax. However, if all of Susan's self-employment income qualifies for the foreign earned income exclusion, this deduction is allocable to the excluded income and must be included on Form 2555, line 44. This prevents the deduction from reducing other taxable income. See the earlier chapter on foreign earned income exclusion for additional information.

▶▶ Summing Up This Segment ◀◀

- ▶ As a volunteer assisting taxpayers abroad, you may be asked questions regarding self-employment tax. In this lesson you have learned how to determine if a taxpayer is considered a self-employed individual and how to compute the self-employment tax.

SUMMARY EXERCISES

Exercise 1

You must pay self-employment tax if you have net earnings from self-employment of $ ______________ or more a year.

Exercise 2

John has a business abroad in 2007, as a private contractor, and his self-employed income qualifies for the foreign earned income exclusion. His foreign earned income is $64,000, business expenses are $19,000, and net earnings are $45,000. Since his foreign earned income is completely excluded, is he liable for self-employment tax? If yes, what amount of income is subject to self-employment tax? ____________________________________

Exercise 3

The United States may reach agreements with foreign countries to eliminate dual coverage and dual contributions (taxes) to social security systems for the same work. These agreements may be applicable to self-employed persons.

True/False

Exercise 4

Janice Thompson is a self-employed babysitter overseas. She is a U.S. citizen living with her husband. He is a U.S. Army officer and also a U.S. citizen. She operates her sole proprietor babysitting service out of their apartment off base. She has no wage income. Her Schedule C shows a net profit of $9,500 in 2007. She qualifies for the foreign earned income exclusion. She receives no exemption from any agreement to exclude her self-employment tax.

Compute her self-employment tax for 2007 on the blank Schedule SE.

SCHEDULE SE (Form 1040)

Department of the Treasury Internal Revenue Service (99)

Self-Employment Tax

▶ Attach to Form 1040. ▶ See Instructions for Schedule SE (Form 1040).

OMB No. 1545-0074

2007

Attachment Sequence No. 17

Name of person with **self-employment** income (as shown on Form 1040)	Social security number of person with **self-employment** income ▶	

Who Must File Schedule SE

You must file Schedule SE if:

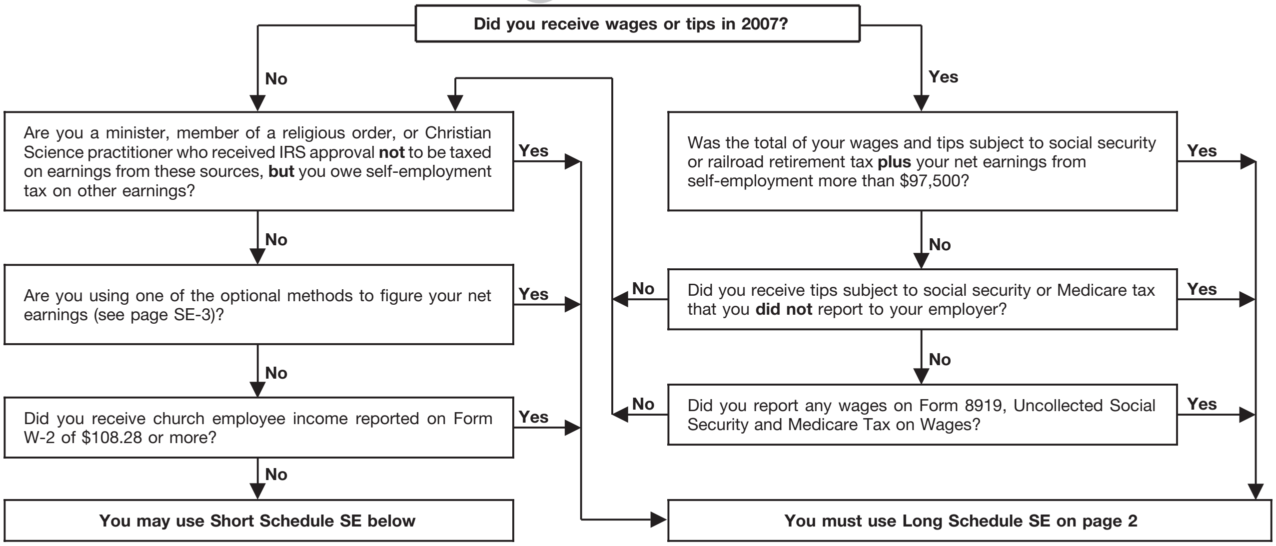
- You had net earnings from self-employment from **other than** church employee income (line 4 of Short Schedule SE or line 4c of Long Schedule SE) of $400 or more, **or**
- You had church employee income of $108.28 or more. Income from services you performed as a minister or a member of a religious order **is not** church employee income (see page SE-1).

Note. Even if you had a loss or a small amount of income from self-employment, it may be to your benefit to file Schedule SE and use either "optional method" in Part II of Long Schedule SE (see page SE-3).

Exception. If your only self-employment income was from earnings as a minister, member of a religious order, or Christian Science practitioner **and** you filed Form 4361 and received IRS approval not to be taxed on those earnings, **do not** file Schedule SE. Instead, write "Exempt–Form 4361" on Form 1040, line 58.

May I Use Short Schedule SE or Must I Use Long Schedule SE?

Note. Use this flowchart **only if** you must file Schedule SE. If unsure, see Who Must File Schedule SE, above.



Section A—Short Schedule SE. Caution. Read above to see if you can use Short Schedule SE.

1	Net farm profit or (loss) from Schedule F, line 36, and farm partnerships, Schedule K-1 (Form 1065), box 14, code A	1	
2	Net profit or (loss) from Schedule C, line 31; Schedule C-EZ, line 3; Schedule K-1 (Form 1065), box 14, code A (other than farming); and Schedule K-1 (Form 1065-B), box 9, code J1. Ministers and members of religious orders, see page SE-1 for amounts to report on this line. See page SE-3 for other income to report	2	
3	Combine lines 1 and 2	3	
4	**Net earnings from self-employment.** Multiply line 3 by 92.35% (.9235). If less than $400, **do not** file this schedule; you do not owe self-employment tax . . . . ▶	4	
5	**Self-employment tax.** If the amount on line 4 is: • $97,500 or less, multiply line 4 by 15.3% (.153). Enter the result here and on **Form 1040, line 58.** • More than $97,500, multiply line 4 by 2.9% (.029). Then, add $12,090 to the result. Enter the total here and on **Form 1040, line 58.** . . .	5	
6	**Deduction for one-half of self-employment tax.** Multiply line 5 by 50% (.5). Enter the result here and on **Form 1040, line 27** . . . 6		

Self-Employment Tax

Answers to Exercises

Exercise 1

$400

Exercise 2

Yes; John must take all of his earned income into account in figuring his self-employment tax, even though the income is exempt from income tax because of the foreign earned income exclusion. John's $45,000 net earnings are subject to self-employment tax in 2007.

Exercise 3

True; agreements may apply to self-employed persons.

Exercise 4

See completed form.

SCHEDULE SE (Form 1040) Department of the Treasury Internal Revenue Service (99)	**Self-Employment Tax** ▶ Attach to Form 1040. ▶ See Instructions for Schedule SE (Form 1040).	OMB No. 1545-0074 **2007** Attachment Sequence No. **17**

Name of person with **self-employment** income (as shown on Form 1040)	Social security number of person with **self-employment** income ▶
Janice Thompson	XXX XX XXXX

Who Must File Schedule SE

You must file Schedule SE if:

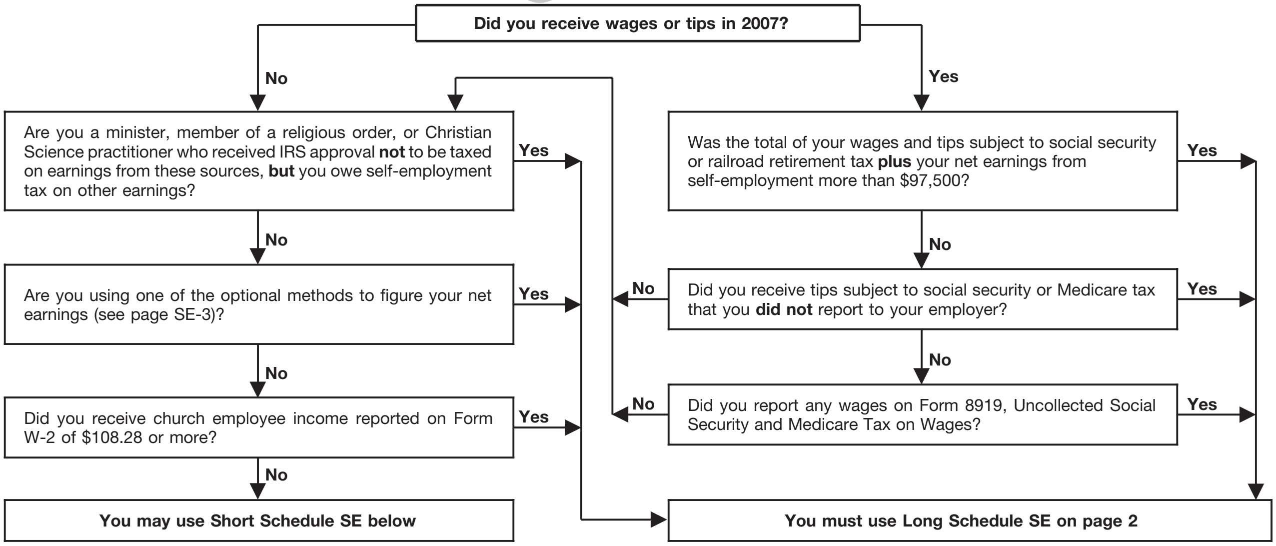
- You had net earnings from self-employment from **other than** church employee income (line 4 of Short Schedule SE or line 4c of Long Schedule SE) of $400 or more, **or**
- You had church employee income of $108.28 or more. Income from services you performed as a minister or a member of a religious order **is not** church employee income (see page SE-1).

Note. Even if you had a loss or a small amount of income from self-employment, it may be to your benefit to file Schedule SE and use either "optional method" in Part II of Long Schedule SE (see page SE-3).

Exception. If your only self-employment income was from earnings as a minister, member of a religious order, or Christian Science practitioner **and** you filed Form 4361 and received IRS approval not to be taxed on those earnings, **do not** file Schedule SE. Instead, write "Exempt–Form 4361" on Form 1040, line 58.

May I Use Short Schedule SE or Must I Use Long Schedule SE?

Note. Use this flowchart **only if** you must file Schedule SE. If unsure, see Who Must File Schedule SE, above.



Section A—Short Schedule SE. Caution. Read above to see if you can use Short Schedule SE.

1	Net farm profit or (loss) from Schedule F, line 36, and farm partnerships, Schedule K-1 (Form 1065), box 14, code A	1	
2	Net profit or (loss) from Schedule C, line 31; Schedule C-EZ, line 3; Schedule K-1 (Form 1065), box 14, code A (other than farming); and Schedule K-1 (Form 1065-B), box 9, code J1. Ministers and members of religious orders, see page SE-1 for amounts to report on this line. See page SE-3 for other income to report	2	9,500
3	Combine lines 1 and 2	3	9,500
4	**Net earnings from self-employment.** Multiply line 3 by 92.35% (.9235). If less than $400, **do not** file this schedule; you do not owe self-employment tax ▶	4	8,773
5	**Self-employment tax.** If the amount on line 4 is: • $97,500 or less, multiply line 4 by 15.3% (.153). Enter the result here and on **Form 1040, line 58.** • More than $97,500, multiply line 4 by 2.9% (.029). Then, add $12,090 to the result. Enter the total here and on **Form 1040, line 58.**	5	1,342
6	**Deduction for one-half of self-employment tax.** Multiply line 5 by 50% (.5). Enter the result here and on **Form 1040, line 27** — 6 — 671		

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 11358Z **Schedule SE (Form 1040) 2007**

STUDENT NOTES

Foreign Earned Income Exclusion

Introduction and Objectives

This lesson will discuss the **foreign earned income exclusion**. Certain taxpayers can exclude income earned in foreign countries. For 2007 the maximum exclusion amount is $85,700. However, the foreign earned income exclusion **does not apply** to wages and salaries of military and civilian employees of the United States government. Employees of the United States government include those who work at Armed Forces post exchanges, officer and enlisted personnel clubs, and embassy commissaries. Other foreign income earned by military personnel or their spouses may be eligible for the exclusion.

Potential Pitfalls

Foreign earned income is reported on Form 1040, line 7, and deducted on Form 1040, line 21.

To qualify for the foreign earned income exclusion, the taxpayer's tax home must be in a foreign country throughout his or her period of stay. This lesson will explain this requirement.

After completing this lesson you should be able to:

- Determine whether the taxpayer qualifies for the foreign earned income exclusion.
- Calculate the foreign earned income exclusion.
- Report income earned abroad.

Requirements to Qualify for the Foreign Earned Income Exclusion

There are two requirements to qualify for the foreign earned income exclusion. First, the taxpayer must show that his or her **tax home** is in a foreign country. ("Foreign country" does not include Puerto Rico, Guam, the Northern Mariana Islands, the Virgin Islands, or United States possessions such as American Samoa, Wake Island, the Midway Islands, and Johnston Island.) The second requirement is that the taxpayer must meet either the **bona fide residence test** or **the physical presence test.**

Exercise 1

Miranda has lived in Puerto Rico since 1998. Is she eligible for the foreign earned income exclusion?

Answer: ____

The requirements are applied separately to each individual. If a married couple are both working overseas, each must meet both requirements to apply the exclusion. If they do, each is entitled to an exclusion of up to $85,700 (on qualified income) for 2007. **(Remember military pay is not eligible for the exclusion.)**

Tax Home. To claim the foreign earned income exclusion, the taxpayer's home must be in a foreign country. Generally, one's tax home is the area of the taxpayer's main place of business, employment, or post of duty, regardless of where the taxpayer maintains his or her family home. If the taxpayer does not have a regular place of business because of the nature of the work, the taxpayer's tax home is the place where he or she regularly lives.

Military Note: The tax home for military personnel is the permanent duty station, either land-based or on a ship. This is true whether it is feasible or permissible for the taxpayer's family to live with him or her. **Generally, most military personnel and their dependents will not qualify for the foreign earned income exclusion.**

Example 1

John and Mary are both in the Armed Forces and have been permanently stationed in Germany since August 2003. Their tax home for 2007 would be Germany.

Exercise 2

Alan has lived and worked in China since August 16, 2000. For 2007, what country is his tax home?

Answer: ____________________

When the taxpayer has a tax home in the United States and goes overseas temporarily or on business, the tax home has not changed. If the taxpayer is assigned overseas on business for an indefinite period, his or her tax home is overseas, and the taxpayer may be eligible for the foreign earned income exclusion.

The law provides that the taxpayer will not be treated as temporarily away from home if the employment away from home exceeds one year. Therefore, the person will generally be considered to have a tax home in a foreign country if the employment in the foreign country will be for more than one year. However, for purposes of the foreign earned income exclusion, a person will not be considered to have a tax home in a foreign country for any time during which he or she is living in the United States.

Determining the Regular Place of Abode

Three questions are important in showing whether or not a United States home is the regular place of abode. The questions that you should ask the taxpayer are as follows:

1. Did you use your home in the United States as a residence while you worked at your job in the United States just before going abroad to your new job, and did you continue to maintain work contacts, job seeking, leave of absence, ongoing business, etc. in that area in the United States during the time you worked abroad?

2. Are your living expenses duplicated at the United States and foreign home because your work requires you to be away from your United States home?
3. Do you have a family member or members continuing to live at your United States home, or do you frequently use your United States home for lodging during the period you work abroad?

If the taxpayer **cannot** answer "yes" to at least two of these three questions, the taxpayer will be considered indefinitely assigned to the new location abroad. Thus, since the tax home is abroad, no expenses for travel, meals, or lodging while there are deductible. However, one may be able to exclude earnings from income under the foreign earned income exclusion rules.

If the taxpayer realistically expects the job to last (and it does last) less than one year, expects to return to the United States home, and can answer "yes" to all three questions, the taxpayer is considered temporarily away from home. The taxpayer does not qualify for the foreign earned income exclusion, but may qualify to deduct away-from-home expenses.

If the taxpayer can answer "yes" to two of the questions, with the same expectation of job duration and return to the United States home, the location of the tax home depends on all the facts and circumstances.

Example 2

Henry is in the Armed Forces. He was assigned to a post in Japan in 2007. This assignment was for an indefinite period. Margaret, his wife, accompanied him to Japan and has foreign earned income. Their tax home for 2007 would be Japan.

Period of Stay. Another qualification for the exclusion is the length of time the taxpayer stays overseas. This requirement can be satisfied in one of two ways.

The taxpayer must be:

1. A United States citizen or resident alien from a tax treaty country who is a **bona fide resident** of a foreign country (or countries) for an uninterrupted period that includes an entire tax year, or
2. A United States citizen or United States resident alien who is physically present in a foreign country or countries for at least 330 full days during any period of 12 consecutive months.

Exercise 3

Jennifer is a U.S. citizen who has lived in Israel since October 1, 2007. She expects to return to the United States in May, 2008. Does she meet either period-of-stay test?

Answer: ______________________________

Bona Fide Resident Test. To meet the test, the taxpayer must show that he or she has set up permanent quarters in a foreign country. The period must be uninterrupted for an entire tax year. Taking a brief trip to the United States will not prevent the taxpayer from being a bona fide resident as long as the intention is clear to return to the foreign country.

Example 3

Jane is a military spouse who has lived in England since 2000. Her mother still lives in the United States. Jane came to the United States for two weeks in 2007 to be with her mother after she had surgery. Jane's trip to the United States does not affect her status as a bona fide resident of a foreign country.

Physical Presence Test. The other test that may be met instead of the bona fide residence test is the physical presence test. To qualify, the taxpayer must be physically present in a foreign country 330 full days during a period of twelve consecutive months.

In order for a day to count for the test, it must be a full day in a foreign country. When arriving from the United States, or returning to the United States, any day in which part of the time is spent in the United States or over international waters does not count as a qualifying day in a foreign country.

The taxpayer may move about from one place to another in a foreign country, or to another foreign country, without losing full days. But if any part of the taxpayer's travel is not within a foreign country or countries and takes 24 hours or more, the taxpayer will lose full days.

Example 4

The taxpayer leaves Southampton, England, by ship at 10:00 p.m. on July 6 and arrives in Lisbon at 6:00 a.m. on July 8. Since the trip takes more than 24 hours, the taxpayer loses as full days, July 6, 7, and 8. If the taxpayer remains in Lisbon, the first full day is July 9.

Exercise 4

Shauntell is using the 12 months of 2007 to determine if she qualifies for the physical presence test. She arrived in Kenya on January 3, 2007 and worked there until August 12, 2007, when she returned to the United States for 6 weeks. On October 1, 2007, she returned to Kenya and worked there until she permanently returned to the United States on January 1, 2008. Does she meet the physical presence test for 2007?

Answer: ____

Figuring the 12-Month Period. Any 12-month period may be used if the 330 days in a foreign country fall within that period. If necessary, more than one period may be used, including periods that overlap. By using more than one period, it may be possible to meet the physical presence test for an entire stay, even though there may have been intervening visits to the United States.

Waiver of Time Requirements. The minimum time requirements for period of stay may be waived, if the taxpayer is forced to leave a foreign country because of war, civil unrest, or similar adverse conditions in that country. The taxpayer must show that he or she could have met the minimum time requirements if it had not been for the adverse conditions.

Qualifying Income

To qualify for the exclusion, income must be **earned income.** Examples of earned income are salaries, wages, commissions, and professional fees. Earned income does not include dividends, interest, capital gains, alimony, social security benefits, pensions, or annuities. To qualify for the exclusion, the earned income must be for services (other than military or United States government) performed in a foreign country.

Amounts paid by the United States or its agencies to its employees **do not qualify** for the exclusion. This includes military pay and payment for such activities as post exchanges, commissaries, and officers clubs.

Example 5

Maria, a U.S. resident, is in the Armed Forces and has lived in Lisbon since 2000. Her military pay is not eligible for the foreign earned income exclusion. In her spare time, she is a self-employed disk jockey in Lisbon and the surrounding area. The income from her self-employment may qualify for the exclusion.

Source of Earned Income. The source of earned income is the place where the services are performed. To qualify for the exclusion, services must be performed in a foreign country. Where the payments come from for the service or where they are deposited is not a factor in the determining source of the income. If a taxpayer works predominantly in a foreign country but does some work in the United States, an adjustment must be made to the total of foreign earned income.

Example 6

Charles Thompson works and lives in the Bahamas. After vacation he worked 50 weeks in 2007. For one of those weeks, he attended a business meeting in Florida. Because that week was spent working in Florida, $1/50$ or 2% of his wages are not foreign earned income.

Exercise 5

Maurice is stationed in Germany. His only income is from his U.S. military salary. Does he qualify for the foreign earned income exclusion?

Answer: ____

Exercise 6

Juanita lives in Scotland. She is retired and her income consists of U.S. social security, a pension, and several stock dividends. Does she qualify for the foreign earned income exclusion?

Answer: ____

Exercise 7

Jose and Kim live in a foreign country. Jose has wages from the U.S. military. Kim has wages from a bank where she works in the foreign country. Do they have qualifying income for the foreign earned income exclusion?

Answer: ____

Choosing the Exclusion

The foreign earned income exclusion is voluntary. (There are times when it may be to the taxpayer's advantage to not claim the exclusion. An example is that a taxpayer may not claim the earned income tax credit, if foreign income is excluded.) The initial choice of the exclusion on Form 2555 or Form 2555-EZ must be filed with a timely return (including extensions). Exceptions do apply that allow the initial choice to be made after a return is filed. Taxpayers who wish to take advantage of these exceptions should seek professional tax assistance.

The taxpayer may revoke the election for any tax year. When the exclusion is revoked, the taxpayer may not claim the exclusion again for the next five tax years without the approval of the IRS.

Completing and Filing Form 2555 or Form 2555-EZ

If the taxpayer is qualified and wishes to claim the foreign earned income exclusion, it is necessary to complete Form 2555 or Form 2555-EZ and attach it to Form 1040. The tax return should be filed with the Internal Revenue Service Center, Austin, TX, 73301-0215 USA.

To be able to use Form 2555-EZ, the taxpayer must be a United States citizen or resident alien who has wages and salaries but not self-employment income. The total foreign earned income must be $85,700 or less, and the person cannot be claiming any business or moving expenses. Taxpayers who do not meet these restrictions should file Form 2555 to claim the exclusion.

Example 7

Michael and his wife Melissa have been stationed in Hong Kong since 2004. Michael is employed by the Armed Forces. Melissa operates a home day care business. Their tax home is Hong Kong. They meet the physical presence test. Melissa wants to exclude her self-employment income from U.S. taxation.

She will need to complete Form 2555 instead of Form 2555-EZ because her income is from self-employment.

Exercise 8

Assuming that the following taxpayers meet the period-of-stay test, should they file a Form 2555 or Form 2555-EZ?

A. Mallory has $34,000 of foreign earned wages. She has no other income. Which form should she file?

Answer: ____

B. Jacob has U.S. military wages and self-employment income he earned in a foreign country. Which form should he file?

Answer: ____

C. Ramie has $86,000 of foreign earned income. Which form should he file?

Answer: ____

Taxpayers who are eligible to file Form 2555-EZ should complete all four sections of the form.

On the following two pages, you will find a sample copy of Form 2555-EZ for taxpayer Kenyon Napora, a United States citizen living and working in Germany for a German computer company.

Form **2555-EZ**

Department of the Treasury
Internal Revenue Service (99)

Foreign Earned Income Exclusion

▶ See separate instructions. ▶ Attach to Form 1040.

OMB No. 1545-0074

2007

Attachment Sequence No. **34A**

Name shown on Form 1040: Kenyon S Napora

Your social security number: XXX XX XXXX

You May Use This Form If You:

- Are a U.S. citizen or a resident alien.
- Earned wages/salaries in a foreign country.
- Had total foreign earned income of $85,700 or less.
- Are filing a calendar year return that covers a 12-month period.

And You:

- Do not have self-employment income.
- Do not have business/moving expenses.
- Do not claim the foreign housing exclusion or deduction.

Part I Tests To See If You Can Take the Foreign Earned Income Exclusion

1 Bona Fide Residence Test

a Were you a bona fide resident of a foreign country or countries for a period that includes an entire tax year (see page 2 of the instructions)? . . . ☐ Yes ☑ No

- If you answered "Yes," you meet this test. Fill in line 1b and then go to line 3.
- If you answered "No," you **do not** meet this test. Go to line 2 to see if you meet the Physical Presence Test.

b Enter the date your bona fide residence began ▶ ______, and ended (see instructions) ▶ ______.

2 Physical Presence Test

a Were you physically present in a foreign country or countries for at least 330 full days during—
2007 **or**
any other period of 12 months in a row starting or ending in 2007? . . . ☑ Yes ☐ No

- If you answered "Yes," you meet this test. Fill in line 2b and then go to line 3.
- If you answered "No," you **do not** meet this test. You **cannot** take the exclusion unless you meet the Bona Fide Residence Test above.

b The physical presence test is based on the 12-month period from ▶ 12/30/2006 through ▶ 12/29/2007.

3 Tax Home Test. Was your tax home in a foreign country or countries throughout your period of bona fide residence or physical presence, whichever applies? . . . ☑ Yes ☐ No

- If you answered "Yes," you can take the exclusion. Complete Part II below and then go to page 2.
- If you answered "No," you **cannot** take the exclusion. **Do not** file this form.

Part II General Information

4 Your foreign address (including country): 278345 Waldorf Lane, Munich, Germany

5 Your occupation: Computer sales

6 Employer's name: Wagner Computers

7 Employer's U.S. address (including ZIP code):

8 Employer's foreign address: 567524 Gannon Lane, Munich, Germany

9 Employer is (check any that apply):

a A U.S. business . . . ☐

b A foreign business . . . ☑

c Other (specify) ▶ ______ ☐

10a If you filed Form 2555 or 2555-EZ after 1981, enter the last year you filed the form. ▶ ______

b If you did not file Form 2555 or 2555-EZ after 1981, check here ▶ ☐ and go to line 11a now.

c Have you ever revoked the foreign earned income exclusion? . . . ☐ Yes ☑ No

d If you answered "Yes," enter the tax year for which the revocation was effective. ▶ ______

11a List your tax home(s) during 2007 and date(s) established. ▶ 1/2007, 278435 Waldorf Lane, Munich, Germany

b Of what country are you a citizen/national? ▶ United States of America

For Paperwork Reduction Act Notice, see page 3 of separate instructions. Cat. No. 13272W Form **2555-EZ** (2007)

Form 2555-EZ (2007) Page 2

Part III Days Present in the United States—Complete this part if you were in the United States or its possessions during 2007.

12 (a) Date arrived in U.S.	(b) Date left U.S.	(c) Number of days in U.S. on business	(d) Income earned in U.S. on business (attach computation)	
12/29/2007	01/05/2008			

Part IV Figure Your Foreign Earned Income Exclusion

13	Maximum foreign earned income exclusion	13	$85,700	00
14	Enter the number of days in your qualifying period that fall within 2007 . . . 14 362 days			
15	Did you enter 365 on line 14? ☐ **Yes.** Enter “1.000.” ☑ **No.** Divide line 14 by 365 and enter the result as a decimal (rounded to at least three places).	15	× .992	
16	Multiply line 13 by line 15	16	85,014	
17	Enter, in U.S. dollars, the total foreign earned income you earned and received in 2007 (see instructions). Be sure to include this amount on Form 1040, line 7	17	21,000	
18	**Foreign earned income exclusion.** Enter the **smaller** of line 16 or line 17 here and in parentheses on **Form 1040, line 21.** Next to the amount enter “2555-EZ.” On Form 1040, subtract this amount from your income to arrive at total income on Form 1040, line 22 ▶	18	21,000	

Form **2555-EZ** (2007)

For those who must file Form 2555, Part I of the form is for general information and must be completed by all taxpayers who claim the exclusion.

Taxpayers who claim the bona fide residence test must complete Part II of Form 2555. Taxpayers who qualify under the physical presence test must complete Part III.

Part IV, completed by all taxpayers, is where foreign earned income is listed. It must be completed in United States dollars. If the taxpayer has difficulty in converting income, IRS can provide exchange rates to be used. However, the taxpayer is not required to use only rates provided by the IRS or the federal government. Note that earned income includes not only wages and salaries but also non-cash income and allowances and reimbursements received by the taxpayer.

Military Note: Do not list military wages in this section; they are not considered foreign earned income.

Page 3 of the form is where the exclusion is computed. Taxpayers claiming only the basic exclusion fill out Parts V and VII. Most of the lines are self-explanatory. The concept of qualifying period is essential. For those qualifying under the bona fide residence test, this qualifying period is the period of actual residence. For the physical presence test, the qualifying period or periods is chosen by the taxpayer. Any period may be chosen as long as 330 days are spent in a foreign country during the period.

Military Note: Generally, Armed Forces personnel and their spouses will not qualify for the housing exclusion (the housing allowance is already considered nontaxable income).

On the following three pages, you will find a sample Form 2555 for taxpayer Howard Humboldt, a United States citizen living and working in Germany for a Dutch pharmaceutical company.

Form **2555**

Department of the Treasury
Internal Revenue Service (99)

Foreign Earned Income

▶ See separate instructions. ▶ Attach to Form 1040.

OMB No. 1545-0074

2007

Attachment Sequence No. 34

For Use by U.S. Citizens and Resident Aliens Only

Name shown on Form 1040: Howard Humboldt

Your social security number: XXX XX XXXX

Part I General Information

1 Your foreign address (including country): **156782 Albion Lane, Munich, Germany**

2 Your occupation: **Medical sales**

3 Employer's name ▶ **Feagler Pharmacy**

4a Employer's U.S. address ▶

b Employer's foreign address ▶ **367631 Felrum Lane, Munich, Germany**

5 Employer is (check any that apply): a ☑ A foreign entity b ☐ A U.S. company c ☐ Self d ☐ A foreign affiliate of a U.S. company e ☐ Other (specify) ▶

6a If, after 1981, you filed Form 2555 or Form 2555-EZ, enter the last year you filed the form. ▶

b If you did not file Form 2555 or 2555-EZ after 1981 to claim either of the exclusions, check here ▶ ☑ and go to line 7.

c Have you ever revoked either of the exclusions? ☐ Yes ☐ No

d If you answered "Yes," enter the type of exclusion and the tax year for which the revocation was effective. ▶

7 Of what country are you a citizen/national? ▶ **United States of America**

8a Did you maintain a separate foreign residence for your family because of adverse living conditions at your tax home? See **Second foreign household** on page 3 of the instructions ☐ Yes ☑ No

b If "Yes," enter city and country of the separate foreign residence. Also, enter the number of days during your tax year that you maintained a second household at that address. ▶

9 List your tax home(s) during your tax year and date(s) established. ▶ **1/2007, 156782 Albion Lane, Munich, Germany**

Next, complete either Part II or Part III. If an item does not apply, enter "NA." If you do not give the information asked for, any exclusion or deduction you claim may be disallowed.

Part II Taxpayers Qualifying Under Bona Fide Residence Test (see page 2 of the instructions)

10 Date bona fide residence began ▶ **01/01/2007**, and ended ▶ **Continues**

11 Kind of living quarters in foreign country ▶ a ☐ Purchased house b ☑ Rented house or apartment c ☐ Rented room d ☐ Quarters furnished by employer

12a Did any of your family live with you abroad during any part of the tax year? ☐ Yes ☑ No

b If "Yes," who and for what period? ▶

13a Have you submitted a statement to the authorities of the foreign country where you claim bona fide residence that you are not a resident of that country? See instructions ☐ Yes ☑ No

b Are you required to pay income tax to the country where you claim bona fide residence? See instructions ☑ Yes ☐ No

If you answered "Yes" to 13a and "No" to 13b, you do not qualify as a bona fide resident. Do not complete the rest of this part.

14 If you were present in the United States or its possessions during the tax year, complete columns **(a)–(d)** below. **Do not** include the income from column **(d)** in Part IV, but report it on Form 1040.

(a) Date arrived in U.S.	(b) Date left U.S.	(c) Number of days in U.S. on business	(d) Income earned in U.S. on business (attach computation)	(a) Date arrived in U.S.	(b) Date left U.S.	(c) Number of days in U.S. on business	(d) Income earned in U.S. on business (attach computation)

15a List any contractual terms or other conditions relating to the length of your employment abroad. ▶

b Enter the type of visa under which you entered the foreign country. ▶

c Did your visa limit the length of your stay or employment in a foreign country? If "Yes," attach explanation ☐ Yes ☐ No

d Did you maintain a home in the United States while living abroad? ☐ Yes ☑ No

e If "Yes," enter address of your home, whether it was rented, the names of the occupants, and their relationship to you. ▶

For Paperwork Reduction Act Notice, see page 4 of separate instructions. Cat. No. 11900P Form **2555** (2007)

Part III **Taxpayers Qualifying Under Physical Presence Test** (see page 2 of the instructions)

16 The physical presence test is based on the 12-month period from ▶ .... through ▶ ....

17 Enter your principal country of employment during your tax year. ▶ ....

18 If you traveled abroad during the 12-month period entered on line 16, complete columns **(a)–(f)** below. Exclude travel between foreign countries that did not involve travel on or over international waters, or in or over the United States, for 24 hours or more. If you have no travel to report during the period, enter "Physically present in a foreign country or countries for the entire 12-month period." **Do not** include the income from column **(f)** below in Part IV, but report it on Form 1040.

(a) Name of country (including U.S.)	**(b)** Date arrived	**(c)** Date left	**(d)** Full days present in country	**(e)** Number of days in U.S. on business	**(f)** Income earned in U.S. on business (attach computation)

Part IV **All Taxpayers**

Note: *Enter on lines 19 through 23 all income, including noncash income, you earned and actually or constructively received during your 2007 tax year for services you performed in a foreign country. If any of the foreign earned income received this tax year was earned in a prior tax year, or will be earned in a later tax year (such as a bonus), see the instructions.* ***Do not*** *include income from line 14, column* ***(d),*** *or line 18, column* ***(f).*** *Report amounts in U.S. dollars, using the exchange rates in effect when you actually or constructively received the income.*

If you are a cash basis taxpayer, report on Form 1040 all income you received in 2007, no matter when you performed the service.

2007 Foreign Earned Income				**Amount (in U.S. dollars)**
19 Total wages, salaries, bonuses, commissions, etc.			19	100,000
20 Allowable share of income for personal services performed (see instructions):				
a In a business (including farming) or profession			20a	
b In a partnership. List partnership's name and address and type of income. ▶			20b	
21 Noncash income (market value of property or facilities furnished by employer—attach statement showing how it was determined):				
a Home (lodging)			21a	
b Meals			21b	
c Car			21c	
d Other property or facilities. List type and amount. ▶			21d	
22 Allowances, reimbursements, or expenses paid on your behalf for services you performed:				
a Cost of living and overseas differential	22a			
b Family	22b			
c Education	22c			
d Home leave	22d			
e Quarters	22e			
f For any other purpose. List type and amount. ▶	22f			
g Add lines 22a through 22f			22g	
23 Other foreign earned income. List type and amount. ▶			23	
24 Add lines 19 through 21d, line 22g, and line 23			24	100,000
25 Total amount of meals and lodging included on line 24 that is excludable (see instructions)			25	
26 Subtract line 25 from line 24. Enter the result here and on line 27 on page 3. This is your **2007 foreign earned income** ▶			26	100,000

Form **2555** (2007)

Part V All Taxpayers

27	Enter the amount from line 26	27	100,000	

Are you claiming the housing exclusion or housing deduction?

☐ **Yes.** Complete Part VI.
☑ **No.** Go to Part VII.

Part VI Taxpayers Claiming the Housing Exclusion and/or Deduction

28	Qualified housing expenses for the tax year (see instructions)	28		
29a	Enter location where housing expenses incurred (see instructions) ▶			
b	Enter limit on housing expenses (see instructions)	29b		
30	Enter the **smaller** of line 28 or line 29b	30		
31	Number of days in your qualifying period that fall within your 2007 tax year (see instructions) — 31 ____ days			
32	Multiply $37.57 by the number of days on line 31. If 365 is entered on line 31, enter $13,712.00 here	32		
33	Subtract line 32 from line 30. If the result is zero or less, do not complete the rest of this part or any of Part IX	33		
34	Enter employer-provided amounts (see instructions) — 34 ____			
35	Divide line 34 by line 27. Enter the result as a decimal (rounded to at least three places), but do not enter more than "1.000"	35	× .	
36	**Housing exclusion.** Multiply line 33 by line 35. Enter the result but do not enter more than the amount on line 34. Also, complete Part VIII ▶	36		

Note: *The housing deduction is figured in Part IX. If you choose to claim the foreign earned income exclusion, complete Parts VII and VIII before Part IX.*

Part VII Taxpayers Claiming the Foreign Earned Income Exclusion

37	Maximum foreign earned income exclusion	37	$85,700	00
38	• If you completed Part VI, enter the number from line 31. • All others, enter the number of days in your qualifying period that fall within your 2007 tax year (see the instructions for line 31). — 38 365 days			
39	• If line 38 and the number of days in your 2007 tax year (usually 365) are the same, enter "1.000." • Otherwise, divide line 38 by the number of days in your 2007 tax year and enter the result as a decimal (rounded to at least three places).	39	× . 1.000	
40	Multiply line 37 by line 39	40	85,700	
41	Subtract line 36 from line 27	41	100,000	
42	**Foreign earned income exclusion.** Enter the **smaller** of line 40 or line 41. Also, complete Part VIII ▶	42	85,700	

Part VIII Taxpayers Claiming the Housing Exclusion, Foreign Earned Income Exclusion, or Both

43	Add lines 36 and 42	43		
44	Deductions allowed in figuring your adjusted gross income (Form 1040, line 37) that are allocable to the excluded income. See instructions and attach computation	44		
45	Subtract line 44 from line 43. Enter the result here and in parentheses on **Form 1040, line 21.** Next to the amount enter "Form 2555." On Form 1040, subtract this amount from your income to arrive at total income on Form 1040, line 22 ▶	45		

Part IX Taxpayers Claiming the Housing Deduction—Complete this part only if (a) line 33 is more than line 36 and (b) line 27 is more than line 43.

46	Subtract line 36 from line 33	46		
47	Subtract line 43 from line 27	47		
48	Enter the **smaller** of line 46 or line 47	48		

Note: *If line 47 is **more than** line 48 and you could not deduct all of your 2006 housing deduction because of the 2006 limit, use the worksheet on page 4 of the instructions to figure the amount to enter on line 49. Otherwise, go to line 50.*

49	Housing deduction carryover from 2006 (from worksheet on page 4 of the instructions)	49		
50	**Housing deduction.** Add lines 48 and 49. Enter the total here and on Form 1040 to the left of line 36. Next to the amount on Form 1040, enter "Form 2555." Add it to the total adjustments reported on that line ▶	50		

Although the exclusion may never be more than the foreign earned income, it may be less. The exclusion can be no more than $85,700. If the number of qualifying days in the tax year is less than 365, the $85,700 limit is lowered proportionally.

Example 8

Tina York is claiming the exclusion. Her qualifying period is March 15, 2006 to March 14, 2007. On Form 2555, line 38, Tina enters 73 days, because 73 days of her qualifying period fall in the 2007 tax year.

On line 39, she divides 73 by 365, and enters the result, .200.

On line 40, $85,700 is multiplied by .200, which results in $17,140.

Exhibit 6 **Form 2555, lines 37-42**

Part VII **Taxpayers Claiming the Foreign Earned Income Exclusion**

37	Maximum foreign earned income exclusion	37	$85,700	00
38	• If you completed Part VI, enter the number from line 31. • All others, enter the number of days in your qualifying period that fall within your 2007 tax year (see the instructions for line 31). — 38 73 days			
39	• If line 38 and the number of days in your 2007 tax year (usually 365) are the same, enter “1.000.” • Otherwise, divide line 38 by the number of days in your 2007 tax year and enter the result as a decimal (rounded to at least three places).	39	× . 200	
40	Multiply line 37 by line 39	40	17,140.	
41	Subtract line 36 from line 27	41		
42	**Foreign earned income exclusion.** Enter the **smaller** of line 40 or line 41. Also, complete Part VIII ▶	42		

Regardless of how much foreign earned income Tina had, her exclusion can be no more than $17,140.

Deductions Allocable to Excluded Income

In Part VIII of Form 2555, the taxpayer is required to list the deductions allowed in figuring adjusted gross income that are allocable to the excluded income. To the extent a deduction that is allocable to the excluded income is claimed, the exclusion must be reduced by the deduction.

The three most common deductions that may affect the exclusion are **self-employment tax**, **itemized deductions,** and **moving expenses.**

1. **Self-Employment Tax.** The taxpayer must take all earned income into account in figuring self-employment tax, even though the income is exempt from income tax because of the foreign earned income exclusion.

An individual is allowed a deduction for one-half of self-employment tax on the Form 1040. This deduction is related to the operation of the business. If foreign earned income is excluded, the deduction for self-employment tax must be allocated to the excluded income. The amount allocated to the excluded income reduces the foreign earned income exclusion allowed.

The following formula is used to determine the amount of the deduction allocable to excluded income:

$$\frac{\text{Excluded earned income}}{\text{Qualifying earned income}} \times \text{Self-employment tax deduction (from Form 1040, line 27)}$$

When the qualifying earned income is fully excluded, none of the self-employment tax deduction is allowed; therefore, the full amount of this deduction is entered on Form 2555, line 44. This will reduce the foreign earned income exclusion by the amount of the deduction. However, the self-employment tax deduction is still entered on the appropriate line in the adjustment section of Form 1040.

2. **Itemized Deductions.** The treatment for itemized deductions is somewhat different. In reporting itemized deductions on Form 1040, Schedule A that are wholly or partly allocable to excluded income, the taxpayer must reduce the gross deduction by the disallowed amount in arriving at the net deduction shown on Schedule A. Then the taxpayer attaches a statement showing how the deductible amount was figured and writes "Form 2555" in the upper right corner of Schedule A. The most common itemized deductions that are allocable to excluded foreign earned income are employee business expenses that were not reimbursed. The same formula, as presented above, is used to determine the amounts allocable to the excluded foreign income.
3. **Moving Expenses.** The rules for deducting moving expenses allocable to excluded income are still more complex. ln the year of the move, if the taxpayer has at least 120 days of his or her qualifying period during the tax year, the moving expense is allocated solely to the year of the move. If the taxpayer has less than 120 full days in the tax year, the moving expense is allocated to income in the year of the move and the year after. Taxpayers affected by this provision may want to seek assistance from the IRS or a tax professional.

After adjusting the exclusion for any deductions allocable to excluded income, the net exclusion needs to be carried to Form 1040. The amount from Form 2555-EZ, line 18 or Form 2555, line 45 is entered in parentheses on Form 1040, line 21. It is subtracted from other sources of income.

▶▶ Summing Up This Segment ◀◀

The foreign earned income exclusion does not apply to income from the United States government, regardless of the tax home. The exclusion can be up to $85,700 for income earned in a foreign country. It is necessary to complete either Form 2555 or 2555-EZ to claim the exclusion.

In this lesson, we have discussed the basic examples of the exclusion. When a taxpayer has a more complex situation, he or she will need to seek professional tax assistance.

Foreign Earned Income Exclusion

Answers to Exercises

Exercise 1

No; Puerto Rico is not considered a foreign country.

Exercise 2

His 2007 tax home is China.

Exercise 3

No.

Exercise 4

No; she was not present in the foreign country for a full 330 days.

Exercise 5

No; U.S. military pay is not eligible.

Exercise 6

No; only earned income is eligible.

Exercise 7

Yes; Kim's salary.

Exercise 8

A. Form 2555-EZ

B. Form 2555

C. Form 2555

SUMMARY EXERCISES

1. List the two forms where the foreign earned income exclusion can be claimed.
2. Is a taxpayer required to take the exclusion on foreign earned income?
3. Are military wages eligible for the foreign earned income exclusion?
4. Complete Form 2555-EZ on the next two pages, using the following information.

Robert (000-00-0001) and Sara (000-00-0002) Johnson (both U.S. citizens) have lived in Germany since August 2006. Robert is employed by the U.S. Armed Forces. In 2007, Sara worked at a local bakery (Gulden's, 349028 Gannon Lane, Munich, Germany) and earned the equivalent of $12,000. Robert and Sara do not consider themselves bona fide residents of Germany. During 2007, they resided in Germany for the full year, except for a three-day vacation period in U.S. Their address in Germany is 239084 Menlo Lane, Munich, Germany. They have never claimed the foreign earned income exclusion before.

Form **2555-EZ**

Department of the Treasury
Internal Revenue Service (99)

Foreign Earned Income Exclusion

▶ See separate instructions. ▶ Attach to Form 1040.

OMB No. 1545-0074

2007

Attachment Sequence No. 34A

Name shown on Form 1040

Your social security number

You May Use This Form If You:

- Are a U.S. citizen or a resident alien.
- Earned wages/salaries in a foreign country.
- Had total foreign earned income of $85,700 or less.
- Are filing a calendar year return that covers a 12-month period.

And You:

- Do not have self-employment income.
- Do not have business/moving expenses.
- Do not claim the foreign housing exclusion or deduction.

Part I Tests To See If You Can Take the Foreign Earned Income Exclusion

1 Bona Fide Residence Test

a Were you a bona fide resident of a foreign country or countries for a period that includes an entire tax year (see page 2 of the instructions)? . . . . ☐ **Yes** ☐ **No**

- If you answered "Yes," you meet this test. Fill in line 1b and then go to line 3.
- If you answered "No," you **do not** meet this test. Go to line 2 to see if you meet the Physical Presence Test.

b Enter the date your bona fide residence began ▶ ________, and ended (see instructions) ▶ ________.

2 Physical Presence Test

a Were you physically present in a foreign country or countries for at least 330 full days during—
{ 2007 **or**
any other period of 12 months in a row starting or ending in 2007? } . . . . ☐ **Yes** ☐ **No**

- If you answered "Yes," you meet this test. Fill in line 2b and then go to line 3.
- If you answered "No," you **do not** meet this test. You **cannot** take the exclusion unless you meet the Bona Fide Residence Test above.

b The physical presence test is based on the 12-month period from ▶ ________ through ▶ ________.

3 Tax Home Test. Was your tax home in a foreign country or countries throughout your period of bona fide residence or physical presence, whichever applies? . . . . ☐ **Yes** ☐ **No**

- If you answered "Yes," you can take the exclusion. Complete Part II below and then go to page 2.
- If you answered "No," you **cannot** take the exclusion. **Do not** file this form.

Part II General Information

4 Your foreign address (including country)

5 Your occupation

6 Employer's name

7 Employer's U.S. address (including ZIP code)

8 Employer's foreign address

9 Employer is (check any that apply):

a A U.S. business . . . . ☐

b A foreign business . . . . ☐

c Other (specify) ▶ ________ ☐

10a If you filed Form 2555 or 2555-EZ after 1981, enter the last year you filed the form. ▶ ________

b If you did not file Form 2555 or 2555-EZ after 1981, check here ▶ ☐ and go to line 11a now.

c Have you ever revoked the foreign earned income exclusion? . . . . ☐ **Yes** ☐ **No**

d If you answered "Yes," enter the tax year for which the revocation was effective. ▶ ________

11a List your tax home(s) during 2007 and date(s) established. ▶ ________

b Of what country are you a citizen/national? ▶

For Paperwork Reduction Act Notice, see page 3 of separate instructions. Cat. No. 13272W Form **2555-EZ** (2007)

Part III Days Present in the United States—Complete this part if you were in the United States or its possessions during 2007.

12 (a) Date arrived in U.S.	(b) Date left U.S.	(c) Number of days in U.S. on business	(d) Income earned in U.S. on business (attach computation)

Part IV Figure Your Foreign Earned Income Exclusion

13	Maximum foreign earned income exclusion	13	$85,700 00
14	Enter the number of days in your qualifying period that fall within 2007 . . . 14 ______ days		
15	Did you enter 365 on line 14? ☐ **Yes.** Enter “1.000.” ☐ **No.** Divide line 14 by 365 and enter the result as a decimal (rounded to at least three places).	15	× .
16	Multiply line 13 by line 15	16	
17	Enter, in U.S. dollars, the total foreign earned income you earned and received in 2007 (see instructions). Be sure to include this amount on Form 1040, line 7	17	
18	**Foreign earned income exclusion.** Enter the **smaller** of line 16 or line 17 here and in parentheses on **Form 1040, line 21.** Next to the amount enter “2555-EZ.” On Form 1040, subtract this amount from your income to arrive at total income on Form 1040, line 22 ▶	18	

Form **2555-EZ** (2007)

ANSWERS TO SUMMARY EXERCISE

1. Form 2555 and Form 2555-EZ.
2. No; it is voluntary.
3. No.
4. See the completed form on the next two pages.

Foreign Earned Income Exclusion
Answers to Exercises

Form 2555-EZ, page 1

Form **2555-EZ** Department of the Treasury Internal Revenue Service (99)

Foreign Earned Income Exclusion

▶ See separate instructions. ▶ Attach to Form 1040.

OMB No. 1545-0074 **2007** Attachment Sequence No. **34A**

Name shown on Form 1040: **Robert and Sara Johnson**
Your social security number: **XXX XX XXXX**

You May Use This Form If You:
- Are a U.S. citizen or a resident alien.
- Earned wages/salaries in a foreign country.
- Had total foreign earned income of $85,700 or less.
- Are filing a calendar year return that covers a 12-month period.

And You:
- Do not have self-employment income.
- Do not have business/moving expenses.
- Do not claim the foreign housing exclusion or deduction.

Part I Tests To See If You Can Take the Foreign Earned Income Exclusion

1 Bona Fide Residence Test

a Were you a bona fide resident of a foreign country or countries for a period that includes an entire tax year (see page 2 of the instructions)? . . . ☐ Yes ☑ No
- If you answered "Yes," you meet this test. Fill in line 1b and then go to line 3.
- If you answered "No," you **do not** meet this test. Go to line 2 to see if you meet the Physical Presence Test.

b Enter the date your bona fide residence began ▶ ________, and ended (see instructions) ▶ ________.

2 Physical Presence Test

a Were you physically present in a foreign country or countries for at least 330 full days during—
2007 **or**
any other period of 12 months in a row starting or ending in 2007? . . . ☑ Yes ☐ No
- If you answered "Yes," you meet this test. Fill in line 2b and then go to line 3.
- If you answered "No," you **do not** meet this test. You **cannot** take the exclusion unless you meet the Bona Fide Residence Test above.

b The physical presence test is based on the 12-month period from ▶ **01/01/2007** through ▶ **12/31/2007**.

3 Tax Home Test. Was your tax home in a foreign country or countries throughout your period of bona fide residence or physical presence, whichever applies? . . . ☑ Yes ☐ No
- If you answered "Yes," you can take the exclusion. Complete Part II below and then go to page 2.
- If you answered "No," you **cannot** take the exclusion. **Do not** file this form.

Part II General Information

4 Your foreign address (including country): **239084 Menlo Lane, Munich, Germany**

5 Your occupation: **Baker worker**

6 Employer's name: **Gulden's Bakery**

7 Employer's U.S. address (including ZIP code):

8 Employer's foreign address: **349028 Gannon Lane, Munich, Germany**

9 Employer is (check any that apply):
a A U.S. business . . . ☐
b A foreign business . . . ☑
c Other (specify) ▶ ________ ☐

10a If you filed Form 2555 or 2555-EZ after 1981, enter the last year you filed the form. ▶ ________
b If you did not file Form 2555 or 2555-EZ after 1981, check here ▶ ☑ and go to line 11a now.
c Have you ever revoked the foreign earned income exclusion? . . . ☐ Yes ☐ No
d If you answered "Yes," enter the tax year for which the revocation was effective. ▶ ________
11a List your tax home(s) during 2007 and date(s) established. ▶ **8/2006, 239084 Menlo Lane, Munich, Germany**
b Of what country are you a citizen/national? ▶ **United States of America**

For Paperwork Reduction Act Notice, see page 3 of separate instructions. Cat. No. 13272W Form **2555-EZ** (2007)

Form 2555-EZ, page 2

Form 2555-EZ (2007) Page 2

Part III **Days Present in the United States—**Complete this part if you were in the United States or its possessions during 2007.

12 (a) Date arrived in U.S.	(b) Date left U.S.	(c) Number of days in U.S. on business	(d) Income earned in U.S. on business (attach computation)
07/03/2007	07/05/2007		

Part IV **Figure Your Foreign Earned Income Exclusion**

13	Maximum foreign earned income exclusion	13	$85,700 00
14	Enter the number of days in your qualifying period that fall within 2007 . . . 14 — 362 days		
15	Did you enter 365 on line 14? ☐ **Yes.** Enter "1.000." ☐ **No.** Divide line 14 by 365 and enter the result as a decimal (rounded to at least three places).	15	× .992
16	Multiply line 13 by line 15	16	85,014
17	Enter, in U.S. dollars, the total foreign earned income you earned and received in 2007 (see instructions). Be sure to include this amount on Form 1040, line 7	17	12,000
18	**Foreign earned income exclusion.** Enter the **smaller** of line 16 or line 17 here and in parentheses on **Form 1040, line 21.** Next to the amount enter "2555-EZ." On Form 1040, subtract this amount from your income to arrive at total income on Form 1040, line 22 ▶	18	12,000

Form **2555-EZ** (2007)

STUDENT NOTES

DEDUCTIONS AND TAX COMPUTATIONS

Lesson 4

INTRODUCTION AND OBJECTIVES

In this lesson you will learn about the standard deduction, itemized deductions, and tax computations. You will learn which expenses can be included in itemized deductions. You will also learn when the taxpayer will use the Tax Tables and the Qualified Dividends and Capital Gain Tax Worksheet to compute his or her total tax.

After completing this lesson you should be able to:

- Identify the correct standard deduction.
- Calculate and accurately report itemized deductions on Schedule A.
- Identify the miscellaneous deductions reported on Schedule A, lines 21 through 23 that are subject to the 2 percent AGI limitation.
- Complete the Qualified Dividends and Capital Gain Tax Worksheet.
- Explain the process to calculate and report tax liability.

ALERT

This lesson contains tax law and information relating to all courses of training. Your course facilitator will teach only the information required to assist taxpayers you will serve.

INTAKE AND INTERVIEW PROCESS FORM 13614—STANDARD DEDUCTION

Use **Form 13614, Intake and Interview Sheet,** to engage the taxpayer in preparing an accurate return. Use the Intake and Interview Sheet as a starting point for a comprehensive interaction with the taxpayer, in combination with all the source documents provided by the taxpayer, to assure quality and accuracy on each return.

Confirm each item on Form 13614 (or similar tool used at your site) to make sure you and the taxpayer have considered all the necessary information. Ensure all questions and issues have been addressed. If items are incorrect or incomplete, revisit the issue and make corrections to the return, as needed.

To ensure accurate reporting of the standard deduction, use the appropriate chart to help determine the taxpayer's correct standard deduction.

STANDARD DEDUCTION

ALERT

Remind students that Publication 4012, Volunteer Resource Guide, has the standard deduction charts and amounts.

The standard deduction is a dollar amount that reduces the amount of income on which you are taxed. The **standard deduction** depends on:

- The taxpayer's filing status,
- Whether the taxpayer (or the taxpayer's spouse) is 65 or older and/or blind, and
- Whether the taxpayer can be claimed as a dependent on another taxpayer's return.

Based on the taxpayer's situation, you will figure the standard deduction by using one of the following:

- *Standard Deduction Chart for Most People,*
- *Standard Deduction Chart for People Age 65 or Older or Blind,* or
- *Standard Deduction Worksheet for Dependents.*

Example 1

Bob is 60 years old and is married to Janice, age 59. If they are filing a joint return and neither is blind, they can enter $10,700 on either Form 1040 or Form 1040A for their standard deduction amount.

Example 2

John is 83 years old, blind, and files a single tax return. To find his standard deduction, use the *Standard Deduction Chart for People Age 65 or Older or Blind.* His standard deduction is $7,950.

PERSONAL EXEMPTION IN CONNECTION WITH STANDARD DEDUCTION ON FORM 1040EZ

If the taxpayer (or spouse, if married filing a joint return) can be claimed as a dependent on another taxpayer's return, check the applicable box(es) on page 1, line 5 of Form 1040EZ. To fill in the amount on line 5 for this taxpayer, you must turn the form over to page 2 and complete the worksheet (Exhibit 1 shows a completed worksheet from Form 1040EZ, page 2).

If the taxpayer (or spouse, if married filing a joint return) cannot be claimed as a dependent on another taxpayer's return, enter $8,750 if single; $17,500 if married filing jointly.

A. Single, enter $8,750. This is the total of the taxpayer's standard deduction ($5,350) and personal exemption ($3,400).

B. Married, enter $17,500. This is the total of the taxpayer's and spouse's standard deduction ($10,700), exemption for the taxpayer ($3,400), and exemption for the taxpayer's spouse ($3,400).

Exhibit 1 **Form 1040EZ, page 2**

Worksheet for dependents who checked one or both boxes on line 5

(keep a copy for your records)

Use this worksheet to figure the amount to enter on line 5 if someone can claim you (or your spouse if married filing jointly) as a dependent, even if that person chooses not to do so. To find out if someone can claim you as a dependent, use TeleTax topic 354 (see page 6).

A. Amount, if any, from line 1 on front . . . 5,700 + 300.00 Enter total ►	**A.**	6,000
B. Minimum standard deduction	**B.**	850.00
C. Enter the **larger** of line A or line B here	**C.**	6,000
D. Maximum standard deduction. If **single,** enter $5,350; if **married filing jointly,** enter $10,700	**D.**	5,350
E. Enter the **smaller** of line C or line D here. This is your standard deduction	**E.**	5,350
F. Exemption amount. ● If single, enter -0-. ● If married filing jointly and— —both you and your spouse can be claimed as dependents, enter -0-. —only one of you can be claimed as a dependent, enter $3,400.	**F.**	0
G. Add lines E and F. Enter the total here and on line 5 on the front . . .	**G.**	5,350

If you did not check any boxes on line 5, enter on line 5 the amount shown below that applies to you.

- Single, enter $8,750. This is the total of your standard deduction ($5,350) and your exemption ($3,400).
- Married filing jointly, enter $17,500. This is the total of your standard deduction ($10,700), your exemption ($3,400), and your spouse's exemption ($3,400).

Example 3

Clarence is 22 years old and a full-time student. He is single and can be claimed as a dependent on his parents' tax return. Clarence works part-time and earned $5,700 during 2007. His savings account earned $80 in interest. Clarence's standard deduction is $5,350. See Exhibit 1 above.

POTENTIAL PITFALLS

Entering an incorrect standard deduction amount is a frequently made error on tax returns. Take care to report the correct standard deduction amount.

Exercise 1

Use the Standard Deduction for Most People, Standard Deduction for People 65 or Older or Blind, and Standard Deduction Worksheet for Dependents in Publication 4012, *Volunteer Resource Guide,* section G.—Credits, to determine the standard deduction amounts below.

A. Jennifer is 25 years old. She has one child who lives with her and she files as head of household. What is Jennifer's standard deduction? ______________________________

B. Janie is 50 years old. She was divorced in 2007. She is blind and has no dependent children. What is Janie's standard deduction? ______________________________

C. James is 63 years old and married to Betty, who is 67 years old. Neither is blind. If they file a joint return, what is their standard deduction? ______________________________

D. If they are filing separate returns, what is Betty's standard deduction? ______________________________

E. If they are filing separate returns, what is James's standard deduction? ______________________________

F. Randy is 18 years old and is claimed as a dependent on his parents' tax return. He earned $2,500 during the summer and deposited it all into his savings account, where he earned $40 in interest. What is his standard deduction? ______________
____

FINDING THE TAX

Taxpayers with taxable income of less than $100,000 use the Tax Table to find their tax. The Tax Table is in Publication 678W. The tax is based on the person's filing status and taxable income. To find the tax, use the **taxable income** from form 1040EZ, line 6. Form 1040A and Form 1040 are discussed later.

STOP

Stop here for the basic course.
Go to Lesson 5, page 5-1.

All others continue.

Taxpayers can either claim the standard deduction or itemize their deductions. Either the standard deduction or itemized deductions are subtracted from adjusted gross income in calculating taxable income. Most taxpayers choose the larger of their itemized deductions or the standard deduction. However, there are some exceptions:

- A married taxpayer filing a separate return cannot claim the standard deduction if the taxpayer's spouse itemizes deductions, and
- Nonresident aliens cannot claim the standard deduction.

When itemizing, you should complete the taxpayer's return through line 38 of Form 1040. Then figure itemized deductions on Schedule A.

POTENTIAL PITFALLS

Explain to taxpayers that they can only deduct expenses in the year they are paid. They cannot deduct expenses that are owed but not paid.

Medical and Dental Expenses

Claim medical and dental expenses paid in 2007 on lines 1 through 4 of Schedule A. Include expenses incurred for:

- The taxpayer and spouse, and
- Dependents claimed on the return.
- A child of divorced or separated parents is claimed as a dependent on either parent's return, each parent may deduct the medical expenses that he or she pays for the child.
- Any person the taxpayer could have claimed as a dependent on his or her return except that person received $3,400 or more of gross income or filed a joint return.
- Any person the taxpayer could have claimed as a dependent except that taxpayer, or spouse if filing a joint return, can be claimed as a dependent on someone else's 2007 return.

ALERT

The standard mileage rate for operating a vehicle for medical transportation is 20 cents a mile.

Deductible expenses include:

- Prescription medicines and drugs (including insulin).
- Medical, dental, and nursing care, including amounts paid for unreimbursed qualified long-term care services. (Some senior residences have an amount in the monthly cost which is a medical or nursing care expense.)
- Medical and hospital insurance premiums (if not paid with pretax dollars), including amounts paid for eligible long-term care (subject to certain limitations based on the insured person's age — see Exhibit 2, page 4-7).
- Prescription eyeglasses, hearing aids, crutches, wheelchairs, braces, and guide dogs.
- Transportation for medical care at 20 cents a mile, or actual out-of-pocket expenses, plus parking fees and tolls.

- Certain lodging expenses (see Publication 17, Your Federal Income Tax).
- Certain home improvements made for medical care purposes or to make the home suitable for a disabled person (see Publication 502, Medical and Dental Expenses).
- Medicare A premiums for persons not enrolled in Social Security.
- Medicare B, which is a supplemental medical insurance.
- Medicare D premiums paid for a voluntary prescription drug insurance program for persons with Medicare A or B.
- Certain weight-loss programs to treat disease diagnosed by a physician, including obesity.
- Unreimbursed costs of smoking-cessation programs, including the cost of prescription drugs designed to alleviate nicotine withdrawal.
- Expenses for admission and transportation to a medical conference relating to the chronic disease of a dependent (if the costs are primarily for and essential to the medical care of the dependent).
- Operations that are not for unnecessary cosmetic surgery.
- Cosmetic surgery if it is necessary to improve a deformity arising from, or directly related to, a congenital abnormality, a personal injury resulting from an accident or trauma, or a disfiguring disease. **Example:** An individual undergoes surgery that removes a breast as part of treatment for cancer. A surgeon is paid to reconstruct the breast. The surgery to reconstruct the breast corrects a deformity directly related to a disease. The cost of the surgery is includable in the individual's medical expenses.

Total medical and dental expenses must exceed 7.5 percent of a taxpayer's adjusted gross income (Form 1040, line 38) for the Schedule A deduction.

Nondeductible expenses include:

- Medical expenses paid from a medical savings account (MSA). (Refer taxpayers with MSAs to **Publication 969, Health Savings Accounts and Other Tax-Favored Health Plans, Publication 502, Medical and Dental Expenses** [including the Health Coverage Tax Credit], and a professional tax preparer.)
- Payroll tax paid for Medicare A.
- Life insurance policy premiums.
- Babysitting, child care, and nursing care for a normal healthy baby.
- Controlled substances.
- Nonprescription drugs or medicines.
- The cost of purchasing diet food items.

- Nonprescription nicotine gum and patches designed to stop smoking.
- Funeral, burial, or cremation costs.
- Unnecessary cosmetic surgery (surgery that does not correct a congenital abnormality or an abnormality caused by injury or disease).
- Income protection policies, including nursing home policy premiums, if the policy ensures a maximum out-of-pocket expense per day.
- Meals and lodging while attending a medical conference relating to the chronic disease of a dependent.

Eligible Long-Term Care Premiums

Exhibit 2

IF the person was, at the end of 2007, age . . .	THEN the most you may deduct for each person is . . .
40 or under	$290
41–50	$550
51–60	$1,110
61–70	$2,950
71 or older	$3,680

Exercise 2

Marcus and Tracey Clinton file a joint return. Marcus's social security number is xxx-xx-xxxx. Their adjusted gross income is $35,000. They paid the following medical bills:

Unreimbursed doctor's bills	$600
Unreimbursed orthodontist bill for braces	$800
Hospital insurance premiums	$200
Life insurance premiums	$400
Unreimbursed prescription medicines	$200
Vitamins	$100
Hospital bill (before deducting $500) reimbursed by insurance company)	$600
Smoking cessation program	$200

Complete the Medical and Dental Expenses section of Schedule A for the Clinton family.

Exhibit 3 — **Schedule A, lines 1 through 4**

Medical and Dental Expenses		**Caution.** Do not include expenses reimbursed or paid by others.				
	1	Medical and dental expenses (see page A-1) . . .	1			
	2	Enter amount from Form 1040, line 38 [2]				
	3	Multiply line 2 by 7.5% (.075).	3			
	4	Subtract line 3 from line 1. If line 3 is more than line 1, enter -0-			4	

Taxes

To be deductible, a tax must be imposed on and paid by the taxpayer. Taxpayers **cannot** deduct:

- A tax that they do not owe but pay for someone else,
- A tax that they owe but someone else pays, or
- A tax that was not paid in 2007.

Report deductible taxes on lines 5 through 9 of Schedule A.

State and Local Income or General Sales Taxes

The taxpayer can elect to deduct state and local general sales taxes instead of state and local income taxes. The taxpayer cannot deduct both.

State and Local Income Taxes — State and local income taxes that are deductible are either withheld taxes, estimated tax payments, or other tax payments made during the year.

Taxpayers who receive a refund of state and local income taxes in a year after the year in which they were paid, may have to report the refund as income on line 10 of Form 1040, as taxable refunds.

If the taxpayer did not itemize their deductions in the previous year, then they are not required to include the refund as income.

If the taxpayer deducted taxes on Schedule A in the previous year, then the refund should be included on line 10 as taxable refunds. If the taxpayer deducts State and Local Income taxes check box “a” on line 5 and enter the state and local income taxes.

State and Local General Sales Taxes — If the taxpayer elects to deduct state and local general sales taxes he or she must check box “b” on line 5 of Schedule A. To figure the state and local sales tax deduction, use either the actual expenses or the tables contained in the Optional State and Certain Local Sales Tax Tables of the Schedule A Instructions.

The taxpayer may also be able to add the following items to the table amount:

- Local general sales tax if his or her locality imposes a general sales tax.
- State and local general sales taxes paid on certain specified items such as motor vehicles, boats, aircrafts, and a home or a substantial addition or major renovation to a home may be added to the taxable amount.

To compute the state and local general sales tax deduction using the Optional State Sales Tax tables the taxpayer must know his or her available income. Total available income is the amount shown on Form 1040, line 38 (AGI), plus any nontaxable items such as tax-exempt interest, veterans benefits, nontaxable combat pay, workers' compensation, nontaxable part of social security and railroad retirement benefits, nontaxable part of IRA, pension, or annuity distributions (do not include rollovers), and public assistance payments.

Example 4

Tom and Mary Gordan are itemizing their deductions. Tom had wages of $31,000 in 2007. Mary had wages of $4,000 in 2007 before being injured at her job. She received $6,300 of worker's compensation benefits for 2007. Mary and Tom's total available income for purposes of computing the Optional Sales Tax is $41,300.

Real Estate Taxes. State, local, or foreign taxes on real property, such as the taxpayer's house or land, are deductible. Any rebate of property taxes received in the tax year must be subtracted from property taxes. Real estate taxes are deductible when paid. If the taxes are paid with a mortgage payment and held in escrow, do not deduct the taxes until they are paid by the bank or mortgage lender.

Members of the clergy and military personnel can deduct real estate taxes even if they receive a housing allowance that is excluded from income. Also, they can deduct allowable mortgage interest even if the interest was paid from a nontaxable housing allowance.

Assessments to pave a street or install lighting or a sewer generally are not deductible.

Personal Property Taxes. Taxes that state and local governments charge on the value of personal property are deductible (for example, ad valorem taxes paid on car tags). A portion of the cost of personal vehicle registration may fall in this category.

Nondeductible Taxes. Many federal, state, and local government taxes are not deductible. The following taxes are not deductible:

- Federal taxes—income tax, social security (FICA), Medicare, railroad retirement tax, gift tax, and excise taxes or customs duties
- Hunting licenses and dog licenses
- Water and sewer taxes
- Taxes on alcoholic beverages, cigarettes, and tobacco
- State, local, and federal taxes on gasoline, diesel, and other motor fuels used in a nonbusiness vehicle
- Utility taxes—telephone, gas, electricity, etc.

Interest

Interest is the amount that is paid in order to borrow money. Only taxpayers who are legally liable for the debt can deduct the interest in the year it is paid or accrued. Interest expenses are reported on lines 10 through 14 of Schedule A.

Home Mortgage Interest. The amount of mortgage interest that a taxpayer can deduct depends on the:

- Date of the loan,
- Amount of the loan, and
- Use of the proceeds of the loan.

If the mortgage debt was incurred on or before October 13, 1987, and was secured by a main or second home, the interest on that debt is fully deductible, regardless of the amount of the loan or the use of the loan proceeds.

If the mortgage debt was incurred after October 13, 1987, and was secured by a main or second home, the interest is fully deductible if:

- The loans plus any grandfathered debt do not exceed $1 million ($500,000 if married filing separate returns), and
- The proceeds were used to buy, build, or improve the home or homes.

In addition to loans used to buy, build, or improve a main or second home, taxpayers can deduct interest on other loans secured by a main or second home, regardless of the use of the proceeds, if:

- The total of these loans does not exceed $100,000 ($50,000 if married filing separate returns), and
- The total amount of the secured debt is not more than the home's fair market value minus any outstanding acquisition debt and any grandfathered debt on the home.

Points. Certain charges paid by a borrower and/or a seller to a lender to secure a loan are called points. They are also called loan origination fees (including VA and FHA loan origination fees), maximum loan charges, premium charges, loan discount, or discount points.

Points paid only for the use of money are considered prepaid interest. This interest, even if it qualifies as home mortgage interest, must be spread over the life of the mortgage and is considered paid and deductible over that period unless it meets the following exception.

Exception. A taxpayer may fully deduct points in the year he or she pays them only if all of the following conditions apply:

- The taxpayer itemizes deductions.
- The taxpayer's loan is secured by his or her main home. (The main home is the one the taxpayer lives in most of the time.)
- Paying points is an established business practice in the area where the loan was made.

POTENTIAL PITFALLS

Personal interest cannot be claimed as an itemized deduction. Personal interest includes interest on car loans, credit card balances, and installment plan loans that are incurred for personal use or for personal expenses.

- The points paid were not more than the points generally charged in that area.
- The taxpayer uses the cash method of accounting. (The cash method means that the taxpayer reports income in the year received and deducts expenses in the year paid.)
- 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.
- The taxpayer uses his or her loan to buy or build his or her main home.
- The points were computed as a percentage of the principal amount of the mortgage.
- The amount is clearly shown on the settlement statement (such as Form HUD-1) as points charged for the mortgage.
- The points may be shown as paid from either the taxpayer's or the seller's funds.
- The funds the taxpayer provided at or before closing, plus any points the seller paid, were at least as much as the points charged. The funds the taxpayer 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 the taxpayer paid at or before closing for any purpose. The taxpayer cannot have borrowed these funds from his or her lender or mortgage broker.

Charges by the lender for specific services, such as appraisal fees, preparation costs, VA funding fees, or notary fees, may be called points. However, these charges are not considered interest and are not deductible.

Points paid by the seller are deductible as interest by the buyer.

Points paid to refinance a mortgage are generally not deductible in full in the year the taxpayer paid them (unless they are paid in connection with the improvement of a main home and the first seven statements, discussed earlier under Exception, are true).

Points paid in excess of those generally charged in the area and points paid to refinance a mortgage can be deducted over the life of the mortgage. Deduct points reported to the taxpayer on Form 1098 on line 10 of Schedule A (Form 1040). Deduct points not reported to the taxpayer on Form 1098 on line 12 of Schedule A (Form 1040).

Mortgage Insurance Premium Deduction. Premiums that taxpayers pay or accrue for "qualified mortgage insurance" during 2007, in connection with home acquisition debt on the qualified home are deductible as an itemized deduction. The loan that is insured must qualify as home acquisition debt. The deduction is subject to limitations due to income. The expense will be claimed in the Interest You Paid section of Schedule A.

Refinanced debt qualifies as home acquisition debt only to the extent that the new loan does not exceed the balance being refinanced. Refinanced debt can still qualify within certain limits as it always had under the general home mortgage interest deduction rules.

Investment Interest. Interest that is paid on money borrowed to buy or carry property held for investment is called **investment interest.** Taxpayers with investment interest expense that exceeds investment income (interest and ordinary dividend income) should see a paid professional tax preparer.

Interest that cannot be deducted. Interest that cannot be deducted includes:

- Interest on car loans where the car is used for personal use and other personal loans,
- Credit investigation fees,
- Loan fees; aid for services necessary to get a loan,
- Interest on a debt the taxpayer is not legally liable to pay, and
- Finance charges on credit card purchases of personal items.

Exercise 3

Mike and Brenda file a joint return. During the year, they paid the bank $4,539 of interest on their home mortgage that was reported to them on Form 1098 (all qualified), $1,000 in credit card interest, $900 on an installment loan, and $4,300 on a car loan. Complete the Interest You Paid section of Schedule A for Mike and Brenda.

Exhibit 4 **Schedule A, lines 10 through 15**

Interest You Paid (See page A-5.)	10	Home mortgage interest and points reported to you on Form 1098	10		
	11	Home mortgage interest not reported to you on Form 1098. If paid to the person from whom you bought the home, see page A-6 and show that person's name, identifying no., and address ►	11		
Note. Personal interest is not deductible.	12	Points not reported to you on Form 1098. See page A-6 for special rules	12		
	13	Qualified mortgage insurance premiums (See page A-7)	13		
	14	Investment interest. Attach Form 4952 if required. (See page A-7.)	14		
	15	Add lines 10 through 14		15	

Contributions

Taxpayers can deduct contributions to organizations that:

- Are organized and operated exclusively for religious, charitable, educational, scientific, or literary purposes,
- Work to prevent cruelty to children or animals, and

- Foster national or international amateur sports competition if they do not provide athletic facilities or equipment.

To be deductible, contributions must be made to an organization, not an individual.

Qualifying organizations include:

- Churches, synagogues, temples, mosques, Salvation Army, Red Cross, CARE, United Way, Boy Scouts, Girl Scouts, World Wildlife Fund, etc.,
- Fraternal orders (if used for the purposes listed above),
- Nonprofit schools and hospitals,
- Nonprofit medical research organizations,
- Veterans' groups and certain cultural groups, and
- Federal, state, and local governments (if the gifts are exclusively for public purposes).

Nonqualifying organizations include:

- Business organizations, such as the Chamber of Commerce,
- Civic leagues and associations,
- Political organizations and candidates,
- Social clubs,
- Foreign organizations,
- Homeowners' associations, and
- Communist organizations.

Deductible items include:

- Money gifts,
- Dues, fees, and assessments paid to qualified organizations above the value of the benefits received (not country clubs or other social organizations),
- Fair market value (FMV is the price at which the 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 necessary facts) of used clothing or furniture or appliances (i.e., the price paid in used clothing stores, consignment shops, and thrift stores) that are in good used condition or better. Deductions are disallowed for the charitable contribution of items not in good used condition or better.
- Cost and upkeep of uniforms that have no general use but must be worn while performing donated services,
- Unreimbursed transportation expenses that relate directly to the services the taxpayer gave the qualified organization, including bus fare, parking fees, tolls, and either the actual cost of gas and oil or a standard mileage charge of 14 cents per mile, and

ALERT

Effective for contributions made after August 17, 2006, deductions are disallowed for the charitable contribution of clothing and household items if the items are not in good used condition or better.

- The part of a contribution above the fair market value for items such as merchandise and tickets to charity balls or sporting events.
- If the taxpayer makes a contribution to a qualifying organization that is more than $75 and is partly for goods or services, the qualifying organization must give the taxpayer a written statement. For more information, see **Publication 526, Charitable Contributions.**
- If the taxpayer donates a car to a qualified organization in 2007, the deduction is limited to the gross sales proceeds the organization received from the sale of the car. This rule applies if the value of the donated vehicle is more than $500. If the organization makes significant use of or materially improves the car, the taxpayer can generally deduct its market value. These rules also apply to donations of boats, aircraft, and vehicles manufactured mainly for use on public streets, roads, and highways.

  Form 1098-C, Contributions of Motor Vehicles, Boats, and Airplanes, is used by donee organizations to report the contribution of qualified vehicles to the Internal Revenue Service. The form may also be used to provide the donor with a written acknowledgment of the contribution.

Nondeductible items include:

- Cost of raffle, bingo, or lottery tickets,
- Tuition,
- Value of a person's time or service,
- Blood donated to a blood bank or the Red Cross,
- Car depreciation, insurance, general repairs, or maintenance,
- Direct contributions to an individual,
- Sickness or burial expenses for members of a fraternal society, and
- The part of a contribution that personally benefits the taxpayer (such as the fair market value of the meal eaten at a charity dinner).

Report cash and check contributions on Schedule A, line 16. Contributions other than cash or check are entered on line 17. Taxpayers with noncash contributions exceeding $500 should see a professional tax preparer.

The taxpayer must keep records to prove the amount of the cash and noncash contributions he or she makes during the year. The taxpayer cannot deduct a cash contribution, regardless of the amount, unless the taxpayer keeps as a record of the contribution a bank record (such as a canceled check, a bank copy of a canceled check, or a bank statement containing the name of the charity, the date, and the amount) or a written communication from the charity. The written communication must include the name of the charity, date of the contribution, and amount of the contribution.

Exercise 4

Tim contributed $500 to St. John's Church (church gave letter verifying amount), $20 to the Girl Scouts, and $50 to a family whose house burned. He purchased $75 worth of lottery tickets and spent $100 playing bingo at his church. He donated used furniture with a fair market value of $200 to Goodwill.

Complete the *Gifts to Charity* section of Schedule A for Tim.

Exhibit 5 **Schedule A, lines 16 through 19**

Gifts to Charity	16	Gifts by cash or check. If you made any gift of $250 or more, see page A-8	16			
If you made a gift and got a benefit for it, see page A-7.	17	Other than by cash or check. If any gift of $250 or more, see page A-8. You **must** attach Form 8283 if over $500	17			
	18	Carryover from prior year	18			
	19	Add lines 16 through 18			19	

Casualty and Theft Losses

A **casualty** occurs when property is damaged as a result of a sudden, unexpected, or unusual event such as fire, storm, shipwreck, flood, earthquake, or automobile accident. **Theft** is the unlawful taking and removing of money or property with the intent to deprive the owner of it. Theft does not include the mere disappearance of money or property.

A casualty or theft may result in a gain if the insurance proceeds or other reimbursements exceed the adjusted basis of destroyed or stolen property.

Usually, however, a casualty or theft results in a loss. Part of a casualty or theft loss may be deductible if the taxpayer can prove that the casualty or theft occurred to property that the taxpayer owned. The taxpayer must also prove the dollar amount of the loss. Taxpayers with a casualty and theft loss should seek assistance from a paid professional tax preparer.

Miscellaneous Itemized Deductions

Certain employee expenses, expenses of producing income, and other qualifying expenses are reported as miscellaneous itemized deductions on Schedule A. Miscellaneous itemized deductions that exceed 2 percent of adjusted gross income are deductible. There are some miscellaneous itemized deductions that are deductible, regardless of a taxpayer's adjusted gross income.

Examples of deductions that are subject to the 2 percent limit and that are reported on lines 21 through 23 of Schedule A are:

- Union dues and fees,
- Professional society dues,
- Uniforms not adaptable to general use,
- Small tools and supplies,

- Professional books, magazines, journals,
- Employment-related educational expenses,
- Expenses of looking for a new job,
- Investment counsel fees,
- Investment expenses,
- Tax counsel and assistance,
- Fees paid to an IRA custodian, and
- Safe deposit box rental for investment documents.

Examples of deductions that are not subject to the 2 percent limit and that are reported on line 28 of Schedule A are:

- Unrecovered after-tax pension contributions (see Lesson 11).
- Gambling losses to the extent of gambling winnings, and
- Work-related expenses for an individual with a disability, such as attendant-care services at the individual's place of work, that are necessary for the person to work.

Nondeductible expenses include:

- Burial or funeral expenses,
- Wedding expenses,
- Fees and licenses, such as car and marriage licenses and dog tags,
- Fines and penalties, such as parking tickets,
- Home repairs, insurance, and rent,
- Illegal bribes and kickbacks,
- Insurance premiums (except medical insurance premiums),
- Losses from sale of a taxpayer's home, furniture, or personal car,
- Lost or misplaced cash or property,
- Personal legal expenses, and
- Commuting expenses to and from work.

Exercise 5

Don is a city bus driver. His adjusted gross income is $29,500. He wants to deduct the following items on his tax return:

2006 income tax preparation fee	$80
Safe deposit box rental (used to keep bonds)	$50
Life insurance premiums	$200
Investment expenses	$50
Loss on sale of personal home	$500
Investment journals and newsletters	$200
Investment advisory fees	$100
Attorney fees for preparation of will	$150

Complete Don's Schedule A, line 21 through 27.

Job Expenses and Certain Miscellaneous Deductions	21	Unreimbursed employee expenses—job travel, union dues, job education, etc. Attach Form 2106 or 2106-EZ if required. (See page A-9.) ▶	21		
	22	Tax preparation fees	22		
(See page A-9.)	23	Other expenses—investment, safe deposit box, etc. List type and amount ▶	23		
	24	Add lines 21 through 23	24		
	25	Enter amount from Form 1040, line 38 | 25 |			
	26	Multiply line 25 by 2% (.02)	26		
	27	Subtract line 26 from line 24. If line 26 is more than line 24, enter -0-		27	

Total Itemized Deductions

Schedule A, line 29, is Total Itemized Deductions. It is the sum of lines 4, 9, 15, 19, 20, 27 and 28.

Compare the amount on line 29 to the standard deduction. If the taxpayer elects to itemize deductions even though they are less than the standard deductions, check the box on line 30 of Schedule A. Otherwise, enter the larger of the standard deduction or the taxpayer's itemized deductions on Form 1040, line 40.

Exercise 6

George and Debby Cooper live in the state of Georgia and their adjusted gross income is $37,000. George's social security number is xxx-xx-xxxx. They gave you a list of their itemized deductions. They received no insurance reimbursement for medical expenses. They purchased their home in 2000, and a commercial mortgage company holds the mortgage. They have not refinanced the mortgage or increased the principal balance since they bought their home. They are both under age 65 and not blind. Neither can be claimed as a dependent by another taxpayer.

Unreimbursed medical expenses:

Medical insurance premiums	$400
Hospital	$100
Doctors and dentists	$1,000
Vitamins	$50
Prescription drugs	$500
Insulin	$300

Taxes:

State income tax	$1,000
Federal income tax	$4,000
Real estate tax	$700
Ad valorem (personal property)	$500

Interest:

Interest on mortgage (reported on Form 1098)	$4,000
Car loan	$900
Credit cards	$500

Contributions:

Church (gave the Coopers a letter verifying this amount)	$900
Bingo costs	$60
American Cancer Society	$200
Canned goods donated to a food drive	$15
Fair market value of donated used clothing	$60

Miscellaneous:

Union dues	$50
IRA custodial fee	$10
Traffic fine	$300
Investment expenses	$50

Complete the Cooper's Schedule A. Should they take the standard deduction or itemized deduction?

Use the Interview Tips chart (in Publication 4012, section F.—Deductions) to help determine if they should take the standard or itemized deduction.

SCHEDULES A&B (Form 1040)

Department of the Treasury
Internal Revenue Service (99)

Schedule A—Itemized Deductions

(Schedule B is on back)

▶ Attach to Form 1040. ▶ See Instructions for Schedules A&B (Form 1040).

OMB No. 1545-0074

2007

Attachment Sequence No. 07

Name(s) shown on Form 1040: GEORGE & DEBBY COOPER

Your social security number: XXX XX XXXX

Medical and Dental Expenses		**Caution.** Do not include expenses reimbursed or paid by others.		
	1	Medical and dental expenses (see page A-1)	1	
	2	Enter amount from Form 1040, line 38 [2]		
	3	Multiply line 2 by 7.5% (.075)	3	
	4	Subtract line 3 from line 1. If line 3 is more than line 1, enter -0-		4
Taxes You Paid (See page A-2.)	5	State and local **(check only one box):** a ☑ Income taxes, **or** b ☐ General sales taxes	5	
	6	Real estate taxes (see page A-5)	6	
	7	Personal property taxes	7	
	8	Other taxes. List type and amount ▶	8	
	9	Add lines 5 through 8		9
Interest You Paid (See page A-5.)	10	Home mortgage interest and points reported to you on Form 1098	10	
	11	Home mortgage interest not reported to you on Form 1098. If paid to the person from whom you bought the home, see page A-6 and show that person's name, identifying no., and address ▶	11	
Note. Personal interest is not deductible.	12	Points not reported to you on Form 1098. See page A-6 for special rules	12	
	13	Qualified mortgage insurance premiums (See page A-7)	13	
	14	Investment interest. Attach Form 4952 if required. (See page A-7.)	14	
	15	Add lines 10 through 14		15
Gifts to Charity	16	Gifts by cash or check. If you made any gift of $250 or more, see page A-8	16	
If you made a gift and got a benefit for it, see page A-7.	17	Other than by cash or check. If any gift of $250 or more, see page A-8. You **must** attach Form 8283 if over $500	17	
	18	Carryover from prior year	18	
	19	Add lines 16 through 18		19
Casualty and Theft Losses	20	Casualty or theft loss(es). Attach Form 4684. (See page A-9.)		20
Job Expenses and Certain Miscellaneous Deductions (See page A-9.)	21	Unreimbursed employee expenses—job travel, union dues, job education, etc. Attach Form 2106 or 2106-EZ if required. (See page A-9.) ▶	21	
	22	Tax preparation fees	22	
	23	Other expenses—investment, safe deposit box, etc. List type and amount ▶	23	
	24	Add lines 21 through 23	24	
	25	Enter amount from Form 1040, line 38 [25]		
	26	Multiply line 25 by 2% (.02)	26	
	27	Subtract line 26 from line 24. If line 26 is more than line 24, enter -0-		27
Other Miscellaneous Deductions	28	Other—from list on page A-9. List type and amount ▶		28
Total Itemized Deductions	29	Is Form 1040, line 38, over $156,400 (over $78,200 if married filing separately)? ☑ **No.** Your deduction is not limited. Add the amounts in the far right column for lines 4 through 28. Also, enter this amount on Form 1040, line 40. ☐ **Yes.** Your deduction may be limited. See page A-10 for the amount to enter. ▶		29
	30	If you elect to itemize deductions even though they are less than your standard deduction, check here ▶ ☐		

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 11330X **Schedule A (Form 1040) 2007**

Electing to Itemize

Even if the taxpayer's itemized deductions are less than the amount of his or her standard deduction, he or she may want to itemize. For example, if the tax benefit of being able to itemize the deductions on his or her state tax return is greater than the tax benefit he or she loses on the federal return by not taking the standard deduction. To make this election, the taxpayer must check the box on line 30, Schedule A.

Finding the Tax

Taxpayers with taxable income of less than $100,000 use the Tax Table to find their tax unless their return contains Qualified Dividends, Capital Gain Distributions, or Long Term Capital Gains (see Taxable Income Computation, below). However, children under 18 years of age who have more than $1,700 of investment income (interest, dividends, etc.) might not be able to use the Tax Table. Their income might have to be taxed at the parents' tax rate. These taxpayers should be referred to a paid professional tax preparer.

The Tax Table is in Publication 678W. The tax is based on the person's filing status and taxable income. To find the tax, use the **taxable income** from Form 1040EZ, line 6; Form 1040A, line 27; or Form 1040, line 43 and:

- Locate the income bracket for the taxable income,
- Read across that line until you reach the column for the appropriate filing status, and
- Find the amount where the taxable income and filing status meet. This is the tax liability.

If the taxable income is the same as the ending amount in an income bracket, go to the next bracket to find the tax.

Qualifying widow(er) use the married filing jointly column.

Enter the tax on Form 1040EZ, line 11, Form 1040A, line 28, or Form 1040, line 44.

Double check the amount entered. **Common errors** include:

- Using the wrong standard deduction,
- Incorrectly figuring the exemption amount,
- Using an amount other than taxable income to find the tax,
- Picking up the wrong number from the Tax Table, and
- Transposing the numbers when entering the tax amount.

Once you have determined the standard deduction, compare it to the total itemized deductions. In most cases, you will enter the larger of the two amounts on Form 1040, line 40. Subtract line 40 from line 38 and enter the result on line 41. Then subtract the exemption deduction (line 42) to compute the taxable income.

If the taxpayer has capital gain distributions that are reported directly on Form 1040 or Form 1040A, or has Qualified Dividends reported on Form 1040, line 9b, or has Long Term Capital Gains reported on Schedule D, the taxpayer should use the Qualified Dividends and Capital Gain Tax Worksheet to determine if the tax is less.

The taxpayer should:

- Check the box next to line 13, Form 1040, and
- Use the Qualified Dividends and Capital Gain Tax Worksheet (Exhibit 8) from either Form 1040 or Form 1040A instruction booklet to compute the tax.

Example 5

Mary is a single taxpayer with taxable income of $30,200. She files Form 1040 and does not have to file a Schedule D. In 2007, she received capital gain distributions of $500 from ABC Investments. Mary pays less tax by using the Qualified Dividends and Capital Gain Tax Worksheet (Exhibit 8).

Qualified Dividends and Capital Gain Tax Worksheet—Line 44

Keep for Your Records

Before you begin:
- √ See the instructions for line 44 that begin on page 36 to see if you can use this worksheet to figure your tax.
- √ If you do not have to file Schedule D and you received capital gain distributions, be sure you checked the box on line 13 of Form 1040.

1. Enter the amount from Form 1040, line 43 . . . . **1.** ______

2. Enter the amount from Form 1040, line 9b . . . . **2.** ______

3. Are you filing Schedule D?

☐ **Yes.** Enter the **smaller** of line 15 or 16 of Schedule D. If either line 15 or line 16 is a loss, enter -0-

☐ **No.** Enter the amount from Form 1040, line 13 . . . **3.** ______

4. Add lines 2 and 3 . . . . **4.** ______

5. If you are claiming investment interest expense on Form 4952, enter the amount from line 4g of that form. Otherwise, enter -0- . . . . **5.** ______

6. Subtract line 5 from line 4. If zero or less, enter -0- . . . . **6.** ______

7. Subtract line 6 from line 1. If zero or less, enter -0- . . . . **7.** ______

8. Enter the **smaller** of:
- The amount on line 1, or
- $30,650 if single or married filing separately, $61,300 if married filing jointly or qualifying widow(er), $41,050 if head of household.

. . . . **8.** ______

9. Is the amount on line 7 equal to or more than the amount on line 8?

☐ **Yes.** Skip lines 9 through 11; go to line 12 and check the ''No'' box.

☐ **No.** Enter the amount from line 7 . . . . **9.** ______

10. Subtract line 9 from line 8 . . . . **10.** ______

11. Multiply line 10 by 5% (.05) . . . . **11.** ______

12. Are the amounts on lines 6 and 10 the same?

☐ **Yes.** Skip lines 12 through 15; go to line 16.

☐ **No.** Enter the **smaller** of line 1 or line 6 . . . . **12.** ______

13. Enter the amount from line 10 (if line 10 is blank, enter -0-) . . . . **13.** ______

14. Subtract line 13 from line 12 . . . . **14.** ______

15. Multiply line 14 by 15% (.15) . . . . **15.** ______

16. Figure the tax on the amount on line 7. Use the Tax Table or Tax Computation Worksheet, whichever applies . . . . **16.** ______

17. Add lines 11, 15, and 16 . . . . **17.** ______

18. Figure the tax on the amount on line 1. Use the Tax Table or Tax Computation Worksheet, whichever applies . . . . **18.** ______

19. **Tax on all taxable income.** Enter the **smaller** of line 17 or line 18. Also include this amount on Form 1040, line 44 . . . . **19.** ______

TAXWISE® HINTS

If a taxpayer wants to determine whether the standard or itemized deduction is best, input Schedule A information. TaxWise® will automatically select the deduction that is more beneficial.

QUALITY REVIEW (QR)—ITEMIZED DEDUCTIONS

Use **Form 8158, Quality Review Sheet,** or an approved alternative form to review all returns prepared. Apply the quality review tools in combination with the Intake and Interview Sheet and all the source documents to the returns you prepare to ensure quality and accuracy for every taxpayer.

Consider each item on the Quality Review Sheet which applies to the taxpayer's situation to confirm that all the necessary questions and issues have been addressed. If items are incorrect or incomplete, revisit the issue and make corrections to the return, as needed.

Excerpt from Form 8158

Yes	No	
☐	☐	All **adjustments, deductions and credits** indicated on the intake/interview sheet and supporting documents are included on the return.

To ensure accurate reporting of deductions, verify that the information on the Intake and Interview Sheet and on the taxpayer's supporting documents is included on the return.

Confirm that all potential deductions and credits have been discussed with the taxpayer and shown on the return, if applicable.

▶▶ Summing Up This Lesson ◀◀

Both the standard deduction (or total itemized deductions, if greater) and exemption amounts are subtracted from adjusted gross income to arrive at taxable income.

The standard deduction depends upon:

- Filing status,
- Age, eyesight, and
- Whether the taxpayer can be claimed as a dependent on another taxpayer's return.

Determine the standard deduction by using the:

- Standard deduction amount for the appropriate filing status from the appropriate tax form, or
- *Standard Deduction Chart for Most People,* or
- *Standard Deduction Chart for People Age 65 or Older, or Blind,* or
- *Standard Deduction Worksheet for Dependents.*

Itemized deductions are specifically allowed by law. Claim itemized deductions on Form 1040, Schedule A.

Itemized deductions include:

- Medical and dental expenses,
- Taxes paid,
- Home mortgage and certain investment interest paid,
- Charitable contributions,
- Casualty and theft losses,
- Miscellaneous itemized deductions.

Medical and dental expenses that exceed 7.5 percent of adjusted gross income are deductible.

▶▶ Summing Up This Lesson ◀◀
(continued)

To be deductible as a charitable contribution, the new requirement is that all cash contributions, regardless of the amount, must have a written receipt or communication.

Most miscellaneous itemized deductions that exceed 2 percent of adjusted gross income are deductible. However, there are certain miscellaneous itemized deductions that are fully deductible, regardless of gross income.

If deducted investment interest expense exceeds investment income, refer the taxpayer to a paid professional tax preparer.

If you are uncertain whether an expense qualifies as a deduction, do not guess. Use onsite reference material to make the determination.

Most taxpayers compare their total itemized deductions to their standard deduction and enter the larger amount on Form 1040, line 40.

Do not use the Tax Table for taxpayers with taxable income of $100,000 or more or who have Qualified Dividends, Capital Gain Distributions, or Long Term Capital Gains.

Common errors include:

- Using the wrong standard deduction,
- Incorrectly figuring the exemption amount,
- Using an amount other than taxable income to find the tax,
- Picking up the wrong number from the Tax Table, and
- Transposing the numbers when entering the tax amount, and
- Failing to use the Qualified Dividends Capital Gain Worksheet to figure the tax when it is appropriate.

Exercise 1

A. $7,850 (Standard Deduction for Most People)

B. $6,650 (Standard Deduction for People Age 65 or Older or Blind)

C. $11,750 (Standard Deduction for People Age 65 or Older or Blind)

D. $6,400 (Standard Deduction for People Age 65 or Older or Blind)

E. $5,350 (Standard Deduction for Most People)

F. $2,800 (Standard Deduction Worksheet for Dependents)

Exercise 2 — **Marcus and Tracey's Schedule A**

SCHEDULES A&B (Form 1040)
Department of the Treasury
Internal Revenue Service (99)

Schedule A—Itemized Deductions

(Schedule B is on back)

► **Attach to Form 1040.** ► **See Instructions for Schedules A&B (Form 1040).**

OMB No. 1545-0074
2007
Attachment Sequence No. **07**

Name(s) shown on Form 1040: **MARCUS & TRACEY CLINTON**
Your social security number: **XXX XX XXXX**

Medical and Dental Expenses		**Caution.** Do not include expenses reimbursed or paid by others.				
	1	Medical and dental expenses (see page A-1) . . .	1	2100		
	2	Enter amount from Form 1040, line 38 [2] 35000				
	3	Multiply line 2 by 7.5% (.075)	3	2625		
	4	Subtract line 3 from line 1. If line 3 is more than line 1, enter -0-			4	0

Exercise 3 — **Mike and Brenda's Schedule A**

Interest You Paid (See page A-5.)	10	Home mortgage interest and points reported to you on Form 1098	10	4539		
	11	Home mortgage interest not reported to you on Form 1098. If paid to the person from whom you bought the home, see page A-6 and show that person's name, identifying no., and address ►	11			
Note. Personal interest is not deductible.	12	Points not reported to you on Form 1098. See page A-6 for special rules	12			
	13	Qualified mortgage insurance premiums (See page A-7) .	13			
	14	Investment interest. Attach Form 4952 if required. (See page A-7.)	14			
	15	Add lines 10 through 14			15	4539

DEDUCTIONS AND TAX COMPUTATION

Lesson 4

ANSWERS TO EXERCISES

Exercise 4 **Tim's Schedule A**

Gifts to Charity If you made a gift and got a benefit for it, see page A-7.	16	Gifts by cash or check. If you made any gift of $250 or more, see page A-8	16	520		
	17	Other than by cash or check. If any gift of $250 or more, see page A-8. You **must** attach Form 8283 if over $500	17	200		
	18	Carryover from prior year	18			
	19	Add lines 16 through 18			19	720

Exercise 5 **Don's Schedule A**

Job Expenses and Certain Miscellaneous Deductions (See page A-9.)	21	Unreimbursed employee expenses—job travel, union dues, job education, etc. Attach Form 2106 or 2106-EZ if required. (See page A-9.) ▶	21			
	22	Tax preparation fees	22	80		
	23	Other expenses—investment, safe deposit box, etc. List type and amount ▶ SAFE DEPOSIT BOX 50, INVESTMENT EXP 50, INVST JOURNALS AND FEES 300	23	400		
	24	Add lines 21 through 23	24	480		
	25	Enter amount from Form 1040, line 38 | 25 | 29500				
	26	Multiply line 25 by 2% (.02)	26	590		
	27	Subtract line 26 from line 24. If line 26 is more than line 24, enter -0-			27	0

Exercise 6

The Coopers' Schedule A

SCHEDULES A&B (Form 1040)

Department of the Treasury
Internal Revenue Service (99)

Schedule A—Itemized Deductions

(Schedule B is on back)

► Attach to Form 1040. ► See Instructions for Schedules A&B (Form 1040).

OMB No. 1545-0074

2007

Attachment Sequence No. 07

Name(s) shown on Form 1040: GEORGE & DEBBY COOPER

Your social security number: XXX XX XXXX

Medical and Dental Expenses		**Caution.** Do not include expenses reimbursed or paid by others.				
	1	Medical and dental expenses (see page A-1)	1	2300		
	2	Enter amount from Form 1040, line 38 [2] 37000				
	3	Multiply line 2 by 7.5% (.075)	3	2775		
	4	Subtract line 3 from line 1. If line 3 is more than line 1, enter -0-			4	0
Taxes You Paid (See page A-2.)	5	State and local **(check only one box):** a ☑ Income taxes, **or** b ☐ General sales taxes	5	1000		
	6	Real estate taxes (see page A-5)	6	700		
	7	Personal property taxes	7	500		
	8	Other taxes. List type and amount ►	8			
	9	Add lines 5 through 8			9	2200
Interest You Paid (See page A-5.)	10	Home mortgage interest and points reported to you on Form 1098	10	4000		
	11	Home mortgage interest not reported to you on Form 1098. If paid to the person from whom you bought the home, see page A-6 and show that person's name, identifying no., and address ►	11			
Note. Personal interest is not deductible.	12	Points not reported to you on Form 1098. See page A-6 for special rules	12			
	13	Qualified mortgage insurance premiums (See page A-7)	13			
	14	Investment interest. Attach Form 4952 if required. (See page A-7.)	14			
	15	Add lines 10 through 14			15	4000
Gifts to Charity If you made a gift and got a benefit for it, see page A-7.	16	Gifts by cash or check. If you made any gift of $250 or more, see page A-8	16	1100		
	17	Other than by cash or check. If any gift of $250 or more, see page A-8. You **must** attach Form 8283 if over $500	17	75		
	18	Carryover from prior year	18			
	19	Add lines 16 through 18			19	1175
Casualty and Theft Losses	20	Casualty or theft loss(es). Attach Form 4684. (See page A-9.)			20	
Job Expenses and Certain Miscellaneous Deductions (See page A-9.)	21	Unreimbursed employee expenses—job travel, union dues, job education, etc. Attach Form 2106 or 2106-EZ if required. (See page A-9.) ►	21	50		
	22	Tax preparation fees	22			
	23	Other expenses—investment, safe deposit box, etc. List type and amount ► INVESTMENT EXPENSE 50 IRA CUSTODIAN FEE 10	23	60		
	24	Add lines 21 through 23	24	110		
	25	Enter amount from Form 1040, line 38 [25] 37000				
	26	Multiply line 25 by 2% (.02)	26	740		
	27	Subtract line 26 from line 24. If line 26 is more than line 24, enter -0-			27	0
Other Miscellaneous Deductions	28	Other—from list on page A-9. List type and amount ►			28	0
Total Itemized Deductions	29	Is Form 1040, line 38, over $156,400 (over $78,200 if married filing separately)? ☑ **No.** Your deduction is not limited. Add the amounts in the far right column for lines 4 through 28. Also, enter this amount on Form 1040, line 40. ☐ **Yes.** Your deduction may be limited. See page A-10 for the amount to enter. ►			29	7375
	30	If you elect to itemize deductions even though they are less than your standard deduction, check here ► ☐				

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 11330X **Schedule A (Form 1040) 2007**

Note: It would be more advantageous for the Coopers to take the standard deduction.

STOP

Military/International students continue.

All others go to Lesson 5, page 5-1.

TRAVEL EXPENSES

INTRODUCTION AND OBJECTIVES

This segment identifies and explains how to apply the rules concerning travel and transportation expenses for members of the Armed Forces.

When we have concluded this segment, you will be able to identify travel and transportation expenses (including meals) deductible by Armed Forces personnel.

GENERAL INFORMATION

Fully reimbursed employee business expenses, such as travel and transportation expenses, generally are not reported on the tax return if an adequate accounting is made to the employer, and any excess reimbursement is required to be returned to the employer.

Armed Forces employees must substantiate their expenses to the federal government and return any excess reimbursement.

FORM W-2

If the employee is reimbursed under a plan that requires the employee to adequately account for all business-connected expenses and return any funds that are more than the substantiated expenses, the reimbursement should not be included as income in box 1 of Form W-2. Therefore, the employee cannot deduct these expenses.

Temporary duty (TDY) and temporary additional duty (TAD) allowances for travel and transportation are not reported as income on Form W-2. If there are excess expenses on some trips and the employee wants to claim them as employee business expenses, the employee must report all TAD and TDY trip expenses incurred during the year on Form 2106 and include all TAD and TDY allowances received as reimbursements.

FORM 2106

To claim unreimbursed job-related expenses, such as travel or transportation expenses, Armed Forces personnel must complete **Form 2106, Employee Business Expense,** and attach it to their Form 1040. Form 2106 will not have to be used if the Armed Forces member is claiming only unreimbursed employee business expenses for professional dues, subscriptions to professional journals, educational expenses, and uniform expenses. These expenses are reported on line 21 on Schedule A as miscellaneous itemized deductions subject to the 2 percent AGI limit.

MEALS

The cost of meals can be an employee business expense. This includes meals while on business travel away from home and for business-related entertainment. The deduction for meals is generally limited to 50 percent of the actual expenses. For employees subject to Department of Transportation (DOT) hours of service limits, deductible meal expenses incurred while away from home on business is 70 percent

The deduction is taken on Form 2106 where the 50 percent limit is applied before the amount is carried to line 21 on Schedule A where it is subject to the 2 percent AGI limit.

If the employee is fully reimbursed for the meals under an accountable plan that excludes reimbursement from gross income, there is no amount to deduct and, therefore, no amount subject to the 50 percent limit.

TRAVEL EXPENSES

To be deductible, travel expenses must be ordinary and necessary expenses of traveling away from home temporarily for your job and must be greater than the total of any advances, allowances, and reimbursements you receive for such expenses. Ordinary expenses are customary or usual in the employee's field, trade, business, or profession. Necessary expenses are appropriate or helpful in the employee's job or business. Such expenses include airfares, the costs of operating and maintaining a car, and meals and lodging.

Deductible travel expenses are reported on Form 2106 (or Form 2106-EZ, if you qualify) and are deductible as a miscellaneous itemized deduction on Schedule A of Form 1040 where it is subject to the 2 percent AGI limit.

Away From Home

For costs other than local transportation to be deductible, the traveler must be away from home. The term "away from home" has a special meaning for tax purposes.

Home, for this purpose, generally is the taxpayer's main place of business or post of duty. This includes the entire city or general area where his or her business or work is located, regardless of where the taxpayer or his or her family lives. For the military, "home" is the permanent duty station. 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.

Away from home means away for a period substantially longer than an ordinary day's work, during which taxpayers need time off for sleep or rest to meet the demands of work.

Members of the Armed Forces are away from home if they are away from their permanent duty stations long enough to require significant rest or sleep in order to be able to conduct and complete their duties.

Note: Away from home assignments that last or are realistically expected to last more than one year are not temporary in nature. Therefore, taxpayers cannot deduct travel expenses incurred while on an assignment of more than one year.

No Deduction for Personal Expenses

For travel expenses to be deductible, there must be a work-related purpose for the travel. The taxpayer may not deduct expenses for personal travel, such as vacations, sightseeing, entertaining, or family visits.

Allowable Expenses

Common travel expenses for a member of the Armed Forces include:

- Expenses incurred while on TDY or TAD if away from home (ship, base, or station),
- Expenses of a reservist attending drills away from home overnight,
- Meals and lodging of a reservist temporarily called to active duty,
- Travel expenses, including meals and lodging, incurred in connection with deductible educational activities,
- Travel expenses incurred when carrying on official business while on "No Cost" (to the government) orders.

Mess bills afloat are not deductible by an officer assigned to permanent duty aboard a ship. Bills may be deductible as travel expenses by individuals and members of mobile units in a travel or TAD status while away from their permanent ships or stations.

Travel expense deductions are available to air squadron personnel when away from the squadron's home base on TAD and to army personnel when on field duty or maneuvers in a TDY status. Air squadron personnel and members of staffs permanently embarked on ships on extended deployments may not deduct expenses of living aboard ships as travel expenses.

Officers assigned permanent duty afloat may deduct the cost of meals and lodging incurred while on travel or TAD ashore if the ship is not berthed at the temporary duty station, or if the ship is berthed at the temporary duty station but quarters aboard are not available. No deduction is permitted for meals or lodging furnished or available in kind at the place of TAD, even if they are not used.

Example 1

Captain Glendale traveled from his duty station in California to Washington, DC, for a conference. He was away for 5 days. The army advanced Captain Glendale $700 for the trip. Captain Glendale's actual expenses were $625. When he filed his travel voucher with the army, he returned the excess of $75. He does not have to complete Form 2106.

Remember, if the Armed Forces member does not claim reimbursement for expenses that he or she is entitled to, no deduction for those expenses is allowed.

Exercise 1

A. Sergeant Martin's permanent duty station is in Korea. His wife and children could not accompany him and have remained at their home in the United States. Can he deduct the cost of his meals and lodging?

Answer: ______________________________

B. Can Sergeant Martin, in the circumstances described above, deduct the cost of meals and lodging for his wife and children?

Answer: ______________________________

C. Can Sergeant Martin take a deduction for the cost of returning home to visit his family?

Answer: ______________________________

Exercise 2

Which of the following can be taken as deductions?

A. Travel expenses in excess of allowances and reimbursements when the taxpayer is on TAD trips.

B. Mess bills of an officer permanently assigned to a ship.

C. Meals that are not lavish or extravagant but cost more than allowances or reimbursements while the taxpayer attends assigned schooling away from his or her permanent station.

D. Laundry expenses the taxpayer incurs while traveling on TAD and for which no allowance or reimbursement is received.

Answer: ______________________________

LOCAL TRANSPORTATION EXPENSES

Local transportation expenses are generally the expenses of getting from one workplace to another while not traveling away from home. Such expenses include the costs of operating and maintaining a car but not meals and lodging. If taxpayers are required during their time on duty to go from one place to another (for example, as a courier or to attend meetings) without being away from home, their unreimbursed transportation expenses are deductible. When they must use their own vehicle, they can deduct transportation expenses. The taxpayer may be able to use the standard mileage rate to figure the deductible costs of operating his or her car for business purposes. The standard mileage rate is **48.5 cents per mile.** This rate is adjusted periodically for inflation. Commuting expenses are usually not deductible. However, the taxpayer may be able to deduct certain daily transportation expenses, as explained next, under Temporary Work Location.

Temporary Work Location

A taxpayer can deduct local transportation expenses.

Local transportation expenses include the ordinary and necessary costs of all of the following:

- Getting from one workplace to another in the course of the taxpayer's business or profession when he or she is traveling within the city or general area that is his or her tax home,
- Visiting clients or customers,
- Going to a business meeting away from the taxpayer's regular workplace,
- Getting from the taxpayer's home to a temporary workplace when he or she has one or more regular places of work. These temporary workplaces can be either within the area of his or her tax home or outside that area.

Local business transportation does **not** include expenses the taxpayer has while traveling away from home overnight. Those expenses are deductible as travel expenses.

If the taxpayer's 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 the taxpayer's employment at a work location is realistically expected to last for more than one year or if there is no realistic expectation that the employment will last for one year or less, the employment is not temporary, regardless of whether it actually lasts for more than one year. If employment at a work location initially is realistically expected to last for one year or less, but at some later date the employment is expected to last for more than one year, that employment will be treated as temporary (unless there are facts and circumstances that would indicate otherwise) until the taxpayer's expectation changes. It will not be treated as temporary after the date the taxpayer determines it will last for more than one year.

Armed Forces Reservists

Unreimbursed travel expenses, including meals and lodging, are deductible for military reservists who, under competent orders and with or without compensation, must remain away from their main place of business to perform authorized drills and training duty.

Temporary Active Duty. Reservists temporarily called to active duty may deduct meals and lodging while on active duty if they kept their regular job while on active duty, returned to it after release, and were stationed away from the general area of that job or business. These expenses are deductible only if the reservists pay for meals and lodging at their official military post and only to the extent the expenses exceed Basic Allowance for Housing (BAH) and Basic Allowance for Subsistence (BAS).

Deduction for Overnight Travel Expenses of National Guard and Reserve Members. A member of a reserve component of the Armed Forces of the United States who travels more than 100 miles away from home and stays overnight to attend drill or reserve meetings can deduct travel expenses as an adjustment to gross income rather than as a miscellaneous itemized deduction. The amount of expenses that can be deducted as an adjustment to income is limited to the regular federal per diem rate (for lodging, meals, and incidental expenses) and the standard mileage rate (for car expenses) plus any parking fees, ferry fees, and tolls. The standard mileage rate for 2007 is **48.5 cents per mile.** Any expenses in excess of these amounts and expenses that do not qualify for the adjustment to gross income deduction can be claimed only as a miscellaneous itemized deduction subject to the 2 percent limit.

Member of a Reserve Component. A member of a reserve component (RC) of the Armed Forces of the United States is a member in the Army, Navy, Marine Corps, Air Force, or Coast Guard Reserve, the Army National Guard of the United States, the Air National Guard of the United States, or the Reserve Corps of the Public Health Service.

How to Report. The member should first complete Form 2106 or Form 2106-EZ. Include the qualified expenses for reserve travel from line 10 of Form 2106 or line 6 of Form 2106-EZ in the total on line 24 of Form 1040. Subtract this amount from the total on line 10 of Form 2106 or line 6 of Form 2106-EZ and deduct the balance as an itemized deduction on line 20 of Form 1040, Schedule A.

Example 2

Mary is an Armed Forces reservist. She lives in a town that is 120 miles from Base A where she normally reports for a drill or meeting. During 2007, she also occasionally traveled to Base B which was only 40 miles from her home. During 2007, Mary made 9 trips to Base A for a total of 2,160 miles (240 × 9). For each of the nine trips that she made to Base A, she incurred one night of lodging cost (her meals were furnished by the government). She was not reimbursed for the $72 per night she paid for the lodging. She does have a receipt for the lodging expenses and they are within the per diem allowance. Mary also made 4 trips to Base B.

Mary's expenses should be reported on Form 2106. She has total vehicle expenses of $1,048 (2,160 miles @ 48.5 cents per mile) on line 1. She has overnight lodging expense of $648 (9 nights @ $72) on line 3. Total expenses on line 6 are $1,696. Since her trips to Base A were over 100 miles and she was gone overnight, she can deduct these expenses ($1,048 mileage and $648 lodging) on line 24 of Form 1040. The remaining expenses can be claimed as an itemized deduction subject to the 2 percent of AGI limitation.

A member cannot deduct expenses of travel that does not take him or her more than 100 miles from home as an adjustment to gross income. Instead, he or she must complete Form 2106 or Form 2106-EZ and deduct those expenses as an itemized deduction on line 21 of Form 1040, Schedule A.

▶▶ Summing Up This Military Segment ◀◀

In this lesson, you have learned that:

- ▶ Travel and transportation expenses can be taken as miscellaneous itemized deductions on Schedule A, subject to the 2 percent AGI limit.
- ▶ Travel expenses for meals, lodging, and incidentals must be incurred while temporarily away from home on business to be deductible. Assignments that last or are realistically expected to last more than one year are not considered temporary.
- ▶ Commuting and other personal expenses are not deductible.
- ▶ Travel costs associated with deductible educational expenses are treated like other business travel costs.
- ▶ Form 2106 and Form 1040, Schedule A are used to figure and claim the itemized deduction for employee business expenses that exceed reimbursement.

TRAVEL EXPENSES

ANSWERS TO EXERCISES

Exercise 1

A. No. His home is in Korea.

B. No. Their home is in the U.S.

C. No. This is personal, not work related.

Exercise 2

A., C., and **D.**

OTHER MISCELLANEOUS DEDUCTIONS

Lesson 4
Military Segment

INTRODUCTION AND OBJECTIVE

As you learned earlier in this lesson, certain miscellaneous itemized deductions, which include unreimbursed employee business expenses and investment expenses, are deductible only if the total itemized deductions are more than 2 percent of the taxpayer's adjusted gross income (AGI). All deductible miscellaneous itemized deductions discussed in this Military Segment are subject to the 2 percent AGI limit. In this segment we will cover additional itemized deductions of special interest to members of the military. To claim these expenses, a taxpayer must itemize using Form 1040, Schedule A, Itemized Deductions.

At the end of this segment you will be able to identify other job-related expenses and miscellaneous deductions, other than travel, of particular interest to the military.

UNIFORMS

Taxpayers can deduct the cost of buying and maintaining uniforms if the uniforms are specifically required as a condition of employment and they are not adaptable to general use as regular clothing.

Generally, members of the Armed Forces are required to wear uniforms when they are on duty but may be allowed to wear them when they are off duty. Because their uniforms can be worn in place of regular civilian clothing, members of the military cannot claim a deduction for uniform cost and upkeep. However, if military regulations prohibit off-duty wear of certain uniforms, the member can deduct the cost and upkeep of these uniforms. But he or she must reduce any deductible uniform costs incurred by any nontaxable uniform allowances or reimbursements received to pay for these expenses.

Active Duty and Reservist Uniforms

Members of the Armed Forces on active duty can deduct amounts spent to buy and maintain required military battle dress uniforms and utility uniforms if local military regulations prohibit their off-duty wear. The member must reduce the expense by any nontaxable uniform allowance or reimbursement received.

Articles Not Replacing Regular Clothing

A member of the Armed Forces can deduct the cost of required items that do not replace regular clothing. Such items include insignia of rank, corps devices, epaulets, aiguillettes, and swords.

Exercise 1

Indicate if the following are deductible or nondeductible by a member of the Armed Forces.

A. The cost of an Army dress blue uniform (without shoulder boards or gold stripe on trousers), including cape. Off-duty wear is not prohibited.

Answer: ____

B. The cost of a full Army green uniform (without braid) that can be worn anytime.

Answer: ____

C. The cost of gold braid for decoration of a cap and uniform.

Answer: ____

D. The cost of battle dress uniforms and utility uniforms that can be worn only while on duty or while traveling to and from duty.

Answer: ____

Professional Dues

Taxpayers, including members of the Armed Forces, can deduct dues paid to professional societies that are directly related to their trade or business. For example, Lieutenant Margaret Allen, an electrical engineer at Maxwell Air Force Base, can deduct professional dues paid to the American Society of Electrical Engineers.

However, members of the Armed Forces cannot deduct amounts paid to an officers' club or a noncommissioned officers' club.

Educational Expenses

Travel and transportation expenses for educational purposes are discussed in Lesson 8. In this segment, you will learn what educational expenses can be claimed as miscellaneous deductions on Schedule A. Certain rules must be met, however, for the expenses to qualify as a deduction.

Qualifications

A member of the Armed Forces can deduct expenses for education, even though the education may lead to a degree, if the education:

- Is required by the taxpayer's employer or by law or regulations for the taxpayer to keep his or her salary, status, or job (if these requirements serve a business purpose of his or her employer); or
- Maintains or improves the skills required in the taxpayer's present work.

A taxpayer cannot deduct educational expenses, even though the above requirements are met, if the education:

- Is to meet the minimum educational requirements needed to qualify the taxpayer in his or her trade or business, or
- Is part of a program of study that will qualify the taxpayer for a new trade or business, even if he or she has no plans to enter that trade or business.

Some examples will help illustrate the various rules.

Example 1

Warrant Officer Newberry, an Army pilot, incurred educational expenses to obtain an accounting degree. He cannot deduct these expenses as a work-related educational expense, but he can take the lifetime learning credit if he takes the course to acquire new job skills.

Example 2

Lieutenant Commander Morris, who has a degree in financial management, is in charge of base finance. She incurred educational expenses when taking an advanced finance course. She can deduct educational expenses that were more than the educational allowance she received because she had already met the minimum qualifications of her job. By taking the course, she improved skills in her current position. The course did not qualify her for a new trade or business. Depending on her tax liablilty, it may be more beneficial to take the nonrefundable credit (lifetime learning credit).

POTENTIAL PITFALLS

Remind students that qualified educational expenses can qualify for an educational credit or as a miscellaneous itemized deduction.

The volunteer should calculate the various ways and claim these expenses where they are most beneficial.

Deductible Expenses

Educational expenses and certain travel and transportation expenses related to education may be claimed on Form 2106, Employee Business Expenses. Expenses in excess of reimbursement are deductible only as a miscellaneous itemized deduction on Schedule A, subject to the 2 percent AGI limit discussed earlier.

Deductible educational expenses include amounts spent for tuition, books, supplies, laboratory fees, correspondence courses, costs of research, and typing as part of an educational program, and travel. Educational expenses of a personal nature are not deductible. For example, a taxpayer cannot deduct the cost of dinner on campus while he or she attends evening classes. Also, deductible educational expenses do not include items of a capital nature, such as computers or desks.

Treatment of Allowances and Reimbursements

A member of the Armed Forces must reduce deductible educational expenses by any allowance or reimbursement he or she receives. Any educational services provided in kind are not deductible. For example, base-provided transportation to or from class cannot be claimed.

Exercise 2

Sergeant Stephen Butler is a mess sergeant. On his own, he takes courses at the local university in early childhood education. Does he have deductible educational expenses? Why?

Answer: ____

Exercise 3

Specialist Bates is a qualified X-ray technician. Would he have deductible educational expenses if he took a course required by the Army in new radiology techniques? Why? Assume his expenses exceed reimbursement or allowance received.

Answer: ____

Exercise 4

Which of the following can be claimed as miscellaneous itemized deductions by a member of the Armed Forces?

A. Payment to an officers' club.

B. Expenses incurred by a flight operations officer to obtain an accounting degree.

C. Cost of epaulets.

D. Cost and upkeep of a reservist's uniform when local military regulations prohibit off-duty wear (no uniform allowance received).

E. Expenses incurred by a Navy disbursing clerk to learn television repair.

Answer: ____

▶▶ SUMMING UP THIS MILITARY SEGMENT ◀◀

In this segment, you learned about some of the more common itemized deductions of special interest to military members. The total of these miscellaneous deductions must be more than 2 percent of adjusted gross income to be deductible.

Miscellaneous Itemized Deductions

Answers to Exercises

Exercise 1

A. Nondeductible

B. Nondeductible

C. Deductible

D. Deductible

Exercise 2

No. The courses were not required, do not improve Sergeant Baker's skills as a mess sergeant, and could lead to qualifying him for a new trade or business. However, he may be able to take the lifetime learning credit if the course is taken to acquire new job skills.

Exercise 3

Yes. The course is required by Specialist Bates's employer, improves his skills in his present job, is not needed to meet the minimum educational requirements for his job, and will not lead to qualifying him for a new trade or business.

Exercise 4

C. and **D.**

STUDENT NOTES

BUSINESS TRAVEL EXPENSES

INTRODUCTION AND OBJECTIVES

This lesson will explain how to compute business travel expenses for a United States citizen or resident alien living aboard.

At the end of this segment, you will be able to:

- Determine when employee business expenses are deductible.
- Determine what expenses are deductible.
- Determine who is eligible for home leave expenses.
- Determine how to report the expenses.
- Complete **Form 2106, Employee Business Expenses.**
- Determine how to compute the expenses when the taxpayer elects to take the foreign earned income exclusion.

TRAVEL EXPENSES

Travel expenses incurred must be ordinary and necessary. Ordinary expenses are those that are customary for the type of travel being done. Necessary expenses are those that are appropriate and helpful to achieving the purpose of the travel. Treatment of the various expenses, allowances, and reimbursements depends on whether the expenses were more than allowances and reimbursements, or whether the allowances and reimbursements were more than the expenses. It also depends on whether or not the employer included these allowances and reimbursements as income on Form W-2. These situations will be discussed in this lesson.

Away from Home Overnight. For costs other than transportation, the taxpayer must be away from his tax home overnight. "Tax home" is defined as the taxpayer's main place of business. "Overnight" is defined as a period substantially longer than an ordinary day's work during which the taxpayer would need time off for sleep or rest.

Example 1

John lives with his family in Manchester, England, but works in London, where he has lodging and meal expenses during the week. He travels back and forth from London to Manchester on weekends. He may not deduct any of his expenses for travel, meals, and lodging in London because that is his main place of business and the travel on weekends is not for business reasons.

Deductible Expenses

Travel expenses that are ordinary and necessary while traveling away from your home for business purposes include such things as:

- Air, rail, and bus transportation;
- Operating and maintaining your car;
- Taxi fares or other costs of transportation between the airport or station and hotel, from one customer to another, or from one place of business to another;
- Transportation from the meals and lodging to the temporary work assignment;
- Baggage and charges and transportation costs for sample and display material;
- Meals and lodging when away from home on business;
- Cleaning and laundry expenses;
- Telephone and telegraph expenses;
- Public stenographer's fees;
- Operating and maintaining house trailers;
- Tips that are incidental to any of these expenses; and
- Other ordinary and necessary expenses related to travel.

Car Expenses. When using a car for business purposes, the taxpayer is entitled to the actual expenses, which would include such things as gas, oil, repairs, insurance, and depreciation on the car, or the taxpayer can use the standard mileage rate. The standard mileage rate is **48.5 cents per mile.** If the taxpayer uses the car for both business and personal mileage, he or she should maintain a log book. He or she will have to allocate the expenses between business and personal use.

Meal Expenses. Expenses for meals claimed on a taxpayer's return are only 50 percent deductible. When an employee is reimbursed for substantiated meal expenses, the reimbursement will generally be nontaxable and the expenses will not be claimed. For employees subject to Department of Transportation (DOT) hours of service limits, deductible meal expenses incurred while away from home on business are 70 percent.

Home Leave. Section 903 of the Foreign Service Act of 1980 provides that the head of a foreign affairs agency may order a member of the Foreign Service who is a citizen of the United States to take home leave upon completion of 18 months of continuous service abroad, and shall so order as soon as possible after completion of 3 years of continuous service abroad. Because members of the Foreign Service are required by law to take a leave of absence, they are allowed to deduct amounts paid for travel, meals, and lodging while on home leave as employee business expenses. The taxpayers who are eligible for this leave will deduct these expenses on Form 2106, just like an employee who is conducting business away from home. As with all deductible employee business expenses, records and receipts must be maintained to support the deductions that are taken. The deductible expenses are those discussed in the previous lesson, and these expenses are subject to the same limitations. Any expenses paid for on behalf of a Foreign Service member's family are personal expenses and therefore are not deductible.

How to Report

The following discusses how the taxpayer should report his or her allowable expenses for travel, meals, and lodging. Self-employed individuals must report their expenses on the appropriate form used to report their business income and expenses by using Schedule C or Schedule C-EZ, Form 1040. Employees, including outside sales persons, must complete Form 2106, *Employee Business Expenses,* and attach it to their Form 1040 to claim these expenses.

Expenses paid by an employee under a reimbursement or other expense allowance arrangement with an employer generally do not need to be claimed, and the employer will not include the reimbursement as taxable income on the employee's Form W-2. To qualify as nontaxable reimbursements, the arrangement must require that the employee substantiate the expenses to the employer and return any excess reimbursements. Per diem or other fixed allowance reimbursements that are similar to allowances specified by the federal government will also be nontaxable to the extent that the amounts do not exceed government rates.

Form 2106 needs to be completed if:

1. The taxpayer received a reimbursement or an allowance and the employer included the amount on Form W-2 or 1099 MISC as taxable income;
2. The taxpayer seeks to deduct expenses in excess of the amounts paid under a reimbursement allowance arrangement;
3. The taxpayer received no reimbursement for his or her employee business expenses; or
4. The taxpayer received reimbursement or an allowance and did not account to his or her employer for the expenses.

If the expenses equal the reimbursements and the taxpayer accounted to his or her employer, the taxpayer does not have to complete Form 2106 unless item (1) above applies.

Example 2

George has incurred qualified employee business expenses. His company's policy is that all employees must turn in a travel voucher showing all expenses incurred, and the company reimburses the employee an amount equal to the expenses. George does not have to file Form 2106 because he reports directly to his employer and is reimbursed in full.

Example 3

Judy incurred employee business expenses of $1,500. Her Form W-2 shows that her employer reimbursed Judy $2,000. Judy will have to file Form 2106 and claim $1,500 as an employee business expense on Form 2106 subject to the 50% meals limitation and 2% limitation on Schedule A. The entire $2,000 reimbursement must be reported as income on line 7, Form 1040.

Claiming Employee Business Expenses on Form 1040
The taxpayer can claim employee business expenses on Form 1040 only as a miscellaneous itemized deduction subject to the overall 2 percent limitation on Schedule A. Exceptions are provided for certain government officials, qualified performing artists, and individuals with a disability.

Example 4

Frank has a total of $2,000 of unreimbursed employee business expenses (after reducing meals by 50 percent) and no other miscellaneous itemized deductions. His total adjusted gross income is $52,000. Frank is entitled to a total of $960 ($2,000 – ($52,000 × 0.02) = $960) as a miscellaneous itemized deduction.

COMPLETING FORM 2106

Form 2106 is divided into 2 parts. See Exhibit 1, Form 2106, pages 1 and 2. Part I deals with all the expenses, and Part II deals specifically with car expenses. Part II should be completed, if applicable, before entering an amount on line 1, Part I.

Part II, Section B, of Form 2106 will be used if the taxpayer owns the vehicle and chooses, or has previously chosen, to use the standard mileage rate for the same vehicle.

As mentioned previously, the taxpayer is entitled to **48.5 cents per mile.** The business standard mileage rate may not be used to compute the deductible expenses of vehicles used for hire, such as taxicabs, two or more automobiles used simultaneously (such as fleet operations), or any vehicle that is leased, rather than owned, by the taxpayer. The business standard mileage rate may not be used if the automobile has previously been depreciated using a method other than straight-line for its estimated useful life.

The front side of Form 2106 is divided into 3 steps. Let's look at each step and how it will apply to the taxpayer.

Step 1 of Form 2106 is used to summarize the employee business expenses of the taxpayer. Column A is used for all expenses except meals and entertainment. Column B is used only for meals and entertainment expenses. Step 1 must always be filled out. (**Note:** If the employer did not reimburse the employee for any of the expenses, skip Step 2 and go directly to Step 3 to figure the amount deductible.)

Step 2 is filled out only if the taxpayer is reimbursed by the employer and the reimbursement is not shown as income to the taxpayer on a Form W-2 or Form 1099 MISC. On line 7, include only amounts from box 13 of Form W-2 identified as code "L."

Many overseas employees will receive Form W-2 reflecting only a portion of their total compensation, while others will receive no Form W-2 at all.

Step 3 is used when the employer did not reimburse the employee in full. This section will show how much the taxpayer is allowed as a miscellaneous itemized deduction on the taxpayer's Schedule A, Form 1040.

Form **2106**
Department of the Treasury Internal Revenue Service (99)

Employee Business Expenses

► See separate instructions.
► Attach to Form 1040 or Form 1040NR.

OMB No. 1545-0074
2007
Attachment Sequence No. 54

Your name	Occupation in which you incurred expenses	Social security number
Jerome & Marilyn York	Sales Representative	xxx xx xxxx

Part I **Employee Business Expenses and Reimbursements**

Step 1 Enter Your Expenses		Column A Other Than Meals and Entertainment	Column B Meals and Entertainment
1 Vehicle expense from line 22 or line 29. (Rural mail carriers: See instructions.)	1	6,378	
2 Parking fees, tolls, and transportation, including train, bus, etc., that **did not** involve overnight travel or commuting to and from work	2	700	
3 Travel expense while away from home overnight, including lodging, airplane, car rental, etc. **Do not** include meals and entertainment	3	10,500	
4 Business expenses not included on lines 1 through 3. **Do not** include meals and entertainment	4		
5 Meals and entertainment expenses (see instructions)	5		6,500
6 **Total expenses.** In Column A, add lines 1 through 4 and enter the result. In Column B, enter the amount from line 5	6	17,578	6,500

Note: *If you were not reimbursed for any expenses in Step 1, skip line 7 and enter the amount from line 6 on line 8.*

Step 2 Enter Reimbursements Received From Your Employer for Expenses Listed in Step 1

7 Enter reimbursements received from your employer that were **not** reported to you in box 1 of Form W-2. Include any reimbursements reported under code "L" in box 12 of your Form W-2 (see instructions)	7	9,300	0

Step 3 Figure Expenses To Deduct on Schedule A (Form 1040 or Form 1040NR)

8 Subtract line 7 from line 6. If zero or less, enter -0-. However, if line 7 is greater than line 6 in Column A, report the excess as income on Form 1040, line 7 (or on Form 1040NR, line 8)	8	8,278	6,500
Note: *If **both columns** of line 8 are zero, you cannot deduct employee business expenses. Stop here and attach Form 2106 to your return.*			
9 In Column A, enter the amount from line 8. In Column B, multiply line 8 by 50% (.50). (Employees subject to Department of Transportation (DOT) hours of service limits: Multiply meal expenses incurred while away from home on business by 75% (.75) instead of 50%. For details, see instructions.)	9	8,278	3,250

10 Add the amounts on line 9 of both columns and enter the total here. **Also, enter the total on Schedule A (Form 1040), line 21** (or on **Schedule A (Form 1040NR), line 9**). (Reservists, qualified performing artists, fee-basis state or local government officials, and individuals with disabilities: See the instructions for special rules on where to enter the total.) ►	10	11,528

For Paperwork Reduction Act Notice, see instructions. Cat. No. 11700N Form **2106** (2007)

Form 2106 (2007) Page 2

Part II Vehicle Expenses

Section A—General Information (You must complete this section if you are claiming vehicle expenses.)

			(a) Vehicle 1	(b) Vehicle 2
11	Enter the date the vehicle was placed in service	11	02 / 01 / 07	/ /
12	Total miles the vehicle was driven during 2007	12	45,000 miles	miles
13	Business miles included on line 12	13	13,150 miles	miles
14	Percent of business use. Divide line 13 by line 12	14	29 %	%
15	Average daily roundtrip commuting distance	15	20 miles	miles
16	Commuting miles included on line 12	16	5,200 miles	miles
17	Other miles. Add lines 13 and 16 and subtract the total from line 12	17	26,650 miles	miles

18 Do you (or your spouse) have another vehicle available for personal use? ☐ Yes ☑ No

19 Was your vehicle available for personal use during off-duty hours? ☑ Yes ☐ No

20 Do you have evidence to support your deduction? ☑ Yes ☐ No

21 If "Yes," is the evidence written? ☑ Yes ☐ No

Section B—Standard Mileage Rate (See the instructions for Part II to find out whether to complete this section or Section C.)

22 Multiply line 13 by 48.5¢ (.485) . . . 22 6,378

Section C—Actual Expenses

			(a) Vehicle 1	(b) Vehicle 2
23	Gasoline, oil, repairs, vehicle insurance, etc.	23		
24a	Vehicle rentals	24a		
b	Inclusion amount (see instructions)	24b		
c	Subtract line 24b from line 24a	24c		
25	Value of employer-provided vehicle (applies only if 100% of annual lease value was included on Form W-2—see instructions)	25		
26	Add lines 23, 24c, and 25	26		
27	Multiply line 26 by the percentage on line 14	27		
28	Depreciation (see instructions)	28		
29	Add lines 27 and 28. Enter total here and on line 1	29		

Section D—Depreciation of Vehicles (Use this section only if you owned the vehicle and are completing Section C for the vehicle.)

			(a) Vehicle 1	(b) Vehicle 2
30	Enter cost or other basis (see instructions)	30		
31	Enter section 179 deduction (see instructions)	31		
32	Multiply line 30 by line 14 (see instructions if you claimed the section 179 deduction or special allowance)	32		
33	Enter depreciation method and percentage (see instructions)	33		
34	Multiply line 32 by the percentage on line 33 (see instructions)	34		
35	Add lines 31 and 34	35		
36	Enter the applicable limit explained in the line 36 instructions	36		
37	Multiply line 36 by the percentage on line 14	37		
38	Enter the **smaller** of line 35 or line 37. If you skipped lines 36 and 37, enter the amount from line 35. Also enter this amount on line 28 above	38		

Form 2106 (2007)

As you can see from Exhibit 1, the total expenses in Column A are reduced by the $9,300 reimbursement not included as taxable income on Jerome's Form W-2. He will be entitled to an itemized miscellaneous deduction of $11,528. If Jerome's adjusted gross income was $35,000, Jerome would have to reduce the $11,528 by $700 ($35,000 $\times$ 0.02), giving him a total of $10,828 as a net miscellaneous deduction if Jerome had no other miscellaneous deductions.

Exercise 1

Eric Kilgore, social security number xxx-xx-xxxx, works in Manila and is temporarily assigned to his company's Tokyo, Japan, office. His round-trip air fare was $500. He also incurred lodging expenses of $1,576 and meal expenses of $900. He used mass transportation while in Tokyo and spent $150. His employer, who is in the retail sales trade, did not reimburse him for any of the expenses. Complete Form 2106 for Eric Kilgore.

Form **2106**

Department of the Treasury
Internal Revenue Service (99)

Employee Business Expenses

▶ See separate instructions.

▶ Attach to Form 1040 or Form 1040NR.

OMB No. 1545-0074

2007

Attachment Sequence No. 54

Your name	Occupation in which you incurred expenses	Social security number

Part I Employee Business Expenses and Reimbursements

Step 1 Enter Your Expenses

		Column A Other Than Meals and Entertainment	Column B Meals and Entertainment
1 Vehicle expense from line 22 or line 29. (Rural mail carriers: See instructions.)	1		
2 Parking fees, tolls, and transportation, including train, bus, etc., that **did not** involve overnight travel or commuting to and from work	2		
3 Travel expense while away from home overnight, including lodging, airplane, car rental, etc. **Do not** include meals and entertainment	3		
4 Business expenses not included on lines 1 through 3. **Do not** include meals and entertainment	4		
5 Meals and entertainment expenses (see instructions)	5		
6 **Total expenses.** In Column A, add lines 1 through 4 and enter the result. In Column B, enter the amount from line 5	6		

Note: *If you were not reimbursed for any expenses in Step 1, skip line 7 and enter the amount from line 6 on line 8.*

Step 2 Enter Reimbursements Received From Your Employer for Expenses Listed in Step 1

		Column A	Column B
7 Enter reimbursements received from your employer that were **not** reported to you in box 1 of Form W-2. Include any reimbursements reported under code "L" in box 12 of your Form W-2 (see instructions)	7		

Step 3 Figure Expenses To Deduct on Schedule A (Form 1040 or Form 1040NR)

		Column A	Column B
8 Subtract line 7 from line 6. If zero or less, enter -0-. However, if line 7 is greater than line 6 in Column A, report the excess as income on Form 1040, line 7 (or on Form 1040NR, line 8)	8		
Note: *If **both columns** of line 8 are zero, you cannot deduct employee business expenses. Stop here and attach Form 2106 to your return.*			
9 In Column A, enter the amount from line 8. In Column B, multiply line 8 by 50% (.50). (Employees subject to Department of Transportation (DOT) hours of service limits: Multiply meal expenses incurred while away from home on business by 75% (.75) instead of 50%. For details, see instructions.)	9		

10 Add the amounts on line 9 of both columns and enter the total here. **Also, enter the total on Schedule A (Form 1040), line 21** (or on **Schedule A (Form 1040NR), line 9**). (Reservists, qualified performing artists, fee-basis state or local government officials, and individuals with disabilities: See the instructions for special rules on where to enter the total.) ▶ **10** ______

For Paperwork Reduction Act Notice, see instructions. Cat. No. 11700N Form **2106** (2007)

FOREIGN EARNED INCOME EXCLUSION

If the taxpayer is eligible and elects the foreign earned income exclusion, he or she must adjust the amount of the business deductions related to the income excluded. The disallowed portion of the expenses is calculated by dividing the excluded foreign earned income by total foreign earned income.

Example 5

Carolyn is a U.S. citizen, is employed as a salesperson in a foreign country, and is eligible and elects to exclude $25,000 of her $40,000 a year salary. Her AGI is $20,000. She had a total of $500 of unreimbursed employee business expenses, of which $200 was for meals; these expenses are deductible only as miscellaneous itemized deductions on Form 1040, Schedule A. First, it is necessary to complete Form 2106. On that form Carolyn reduces the meal expenses by 50 percent of the $200 amount spent, yielding a total of $400 ($100 + $300).

Carolyn must reduce the $400 by 63% (25,000/40,000) because she excluded 63% of her earned income. Thus, $252 of her expenses is not deductible. Carolyn carries the $148 ($400 – $252) deductible amount to Schedule A.

Carolyn also has $500 of other miscellaneous deductions subject to the 2% of AGI limit. She adds the $148 from Form 2106 plus the $500 for a total of $648 miscellaneous expenses. 2 percent of Carolyn's AGI is $400 (0.02 × $20,000). Carolyn's deductible miscellaneous itemized deductions are $248 ($648 – $400).

If Carolyn did not have the other miscellaneous expenses of $500, she would not have been able to claim any miscellaneous deductions. Her remaining expenses ($148) would have been less than 2% of her AGI ($400).

SUMMARY EXERCISES

1. Which of the following taxpayers would be entitled to employee business expenses, and if so, indicate the type of expense.

Vehicle
Lodging
Meals
Travel

A. Joseph Fulton works in London and drives from and to his house every day.

Answer: ____

B. Mary Banks works in Paris and has to go to Lyons for the day to conduct business. She returns home to Paris that evening. She uses her car.

Answer: ____

C. Alice Canton is a nurse working in Rome, Italy. Her employer gives her a temporary assignment for 2 months in Oslo, Norway.

Answer: ____

2. What form do you use to calculate a taxpayer's employee business expenses?

Answer: ____

3. When are employee business expense reimbursements not included in gross income?

Answer: ____

4. When are employee business expenses itemized miscellaneous deductions?

Answer: ____

5. How are reimbursements that are more than expenses incurred treated?

Answer: ____

6. Larry is a Foreign Service employee. He has been stationed in a foreign country for 3 years and comes back to the United States for 4 weeks of home leave. Is Larry eligible for the home leave deduction?

Answer: ____

▶▶ Summing Up This International Segment ◀◀

Reimbursements from an accountable plan for substantiated employee business expenses are not included as income on the employee's return if the employee is required to return, and does return, any excess reimbursements.

- If the reimbursements are included as income, deductible expenses are allowed as miscellaneous itemized deductions subject to the 2 percent limitation.
- Travel expenses for meals, lodging, and incidentals must be incurred while away from home overnight to be deductible.
- Form 2106 is used to calculate the amount of itemized deductions that are in excess of reimbursements.
- If reimbursements exceed expenses, the excess is income to the employee and must be reported on Form 1040. (If reimbursements exceed the expenses, it is probably a nonaccountable plan, and therefore the entire reimbursement is taxable.)
- If it is the company's policy for employees to account for business expenses to the employer by supplying the employer with documented evidence and the employer reimburses the employee for the amount in full, Form 2106 is not required.
- Taxpayers who are United States citizens and members of the Foreign Service can deduct travel, meals, and lodging expenses while on home leave.

Exercise 1 **Kilgore's Form 2106, page 1**

Form **2106** Department of the Treasury Internal Revenue Service (99)

Employee Business Expenses

▶ See separate instructions.

▶ Attach to Form 1040 or Form 1040NR.

OMB No. 1545-0074 **2007** Attachment Sequence No. 54

Your name	Occupation in which you incurred expenses	Social security number
ERIC KILGORE	SALES	xxx xx xxxx

Part I **Employee Business Expenses and Reimbursements**

Step 1 Enter Your Expenses		**Column A** Other Than Meals and Entertainment	**Column B** Meals and Entertainment
1 Vehicle expense from line 22 or line 29. (Rural mail carriers: See instructions.)	1		
2 Parking fees, tolls, and transportation, including train, bus, etc., that **did not** involve overnight travel or commuting to and from work	2	150	
3 Travel expense while away from home overnight, including lodging, airplane, car rental, etc. **Do not** include meals and entertainment	3	2076	
4 Business expenses not included on lines 1 through 3. **Do not** include meals and entertainment	4		
5 Meals and entertainment expenses (see instructions)	5		900
6 **Total expenses.** In Column A, add lines 1 through 4 and enter the result. In Column B, enter the amount from line 5	6	2226	900

Note: *If you were not reimbursed for any expenses in Step 1, skip line 7 and enter the amount from line 6 on line 8.*

Step 2 Enter Reimbursements Received From Your Employer for Expenses Listed in Step 1

7 Enter reimbursements received from your employer that were **not** reported to you in box 1 of Form W-2. Include any reimbursements reported under code "L" in box 12 of your Form W-2 (see instructions)	7		

Step 3 Figure Expenses To Deduct on Schedule A (Form 1040 or Form 1040NR)

8 Subtract line 7 from line 6. If zero or less, enter -0-. However, if line 7 is greater than line 6 in Column A, report the excess as income on Form 1040, line 7 (or on Form 1040NR, line 8)	8	2226	900
Note: *If **both columns** of line 8 are zero, you cannot deduct employee business expenses. Stop here and attach Form 2106 to your return.*			
9 In Column A, enter the amount from line 8. In Column B, multiply line 8 by 50% (.50). (Employees subject to Department of Transportation (DOT) hours of service limits: Multiply meal expenses incurred while away from home on business by 75% (.75) instead of 50%. For details, see instructions.)	9	2226	450

10 Add the amounts on line 9 of both columns and enter the total here. **Also, enter the total on Schedule A (Form 1040), line 21** (or on **Schedule A (Form 1040NR), line 9**). (Reservists, qualified performing artists, fee-basis state or local government officials, and individuals with disabilities: See the instructions for special rules on where to enter the total.) ▶	10	2676

For Paperwork Reduction Act Notice, see instructions. Cat. No. 11700N Form **2106** (2007)

Business Travel Expenses

Answers to Exercises

Exercise 1

A. No (commuting expenses)

B. Yes (vehicle expenses)

C. Yes (travel, lodging, meals expenses)

Exercise 2

Form 2106

Exercise 3

When the employee is required to substantiate his or her business expenses under a reimbursement arrangement and return any excess allowance to his or her employer. Also, per diem reimbursements that are similar to allowances specified by the federal government will be nontaxable to the extent that the amounts do not exceed government rates.

Exercise 4

When the expenses are more than the amount reimbursed. Itemized deductions are also created in the case of an employee reimbursed under a nonaccountable plan.

Exercise 5

They are treated as income and shown on line 7 of Form 1040.

Exercise 6

Yes

Earned Income Credit (EIC)

Lesson 5

Introduction and Objectives

In this lesson you will learn about the Earned Income Credit (EIC) or Earned Income Tax Credit (EITC).

This credit is for taxpayers who work and earn less than a certain amount, depending on their filing status. Those who qualify can reduce their federal tax liability and/or receive a refund. Qualifying individuals should file a tax return for this credit even though they may not otherwise be required to file.

After completing this lesson, you should be able to:

- Determine which taxpayers may be eligible for the Earned Income Credit by using Publication 4012, Volunteer Resource Guide, and Form 13614, Intake and Interview Sheet.
- Determine if a taxpayer has a qualifying child for the EIC.
- Calculate the credit using the EIC worksheet and apply it to the tax return.
- Request advance payment of the EIC in a paycheck.
- Report (AEIC) on the tax return.

Alert

This lesson contains basic tax law and is required training for all volunteers.

Intake and Interview Process
Form 13614—Earned Income Credit

Use **Form 13614, Intake and Interview Sheet,** or your site's approved equivalent to engage the taxpayer in preparing an accurate return. Use the Intake and Interview Sheet as a starting point for a comprehensive interaction with the taxpayer, in combination with all the source documents provided by the taxpayer, to ensure quality and accuracy on each return.

Confirm each item on Form 13614 (or a similar tool used at your site) to make sure you and the client have considered all the necessary information. Ensure that all questions and issues have been addressed. If items are incorrect or incomplete, revisit the issue and make corrections to the return as well as to the intake sheet, as needed.

Alert

Verbal interaction between the volunteer and the taxpayer cannot be stressed enough here. You must discuss each aspect of the law regarding Earned Income Credit.

GENERAL EIC REQUIREMENTS

> **ALERT**
>
> Use and share with the taxpayer the decision tree and/or Interview Tips in Publication 4012 to determine if the taxpayer qualifies for EIC.

Eligible taxpayers can receive an Earned Income Credit even if they owe no tax and had no income tax withheld. In order to receive this credit, taxpayers must meet certain eligibility rules and must file a tax return even if the taxpayer would otherwise not be required to file a tax return. For tax year 2007, the maximum credit is:

Two or more qualifying children	$4,716
One qualifying child	$2,853
No children	$428

To be eligible for a full or partial credit, the taxpayer cannot have investment income of more than $2,900. The taxpayer must have earned income of at least $1. Earned income and adjusted gross income must each be less than the limitation amounts discussed below.

WHO CAN CLAIM THE EIC—GENERAL ELIGIBILITY RULES

All taxpayers claiming the EIC:

1. **Must have earned income and adjusted gross income (AGI) that are both less than:**
   - $37,783 ($39,783 if married filing jointly) with two or more qualifying children;
   - $33,241 ($35,241 married filing jointly) with one qualifying child;
   - $12,590 ($14,590 married filing jointly) with no qualifying children.

   AGI is the amount on line 4, Form 1040EZ; line 21, Form 1040A; or line 38, Form 1040.

> **ALERT**
>
> Confirm, by inspecting social security cards, that the taxpayer (and spouse, if filing jointly) and any qualifying children have valid social security numbers.

2. **Must have a valid social security number (SSN):**

   SSNs are required for the taxpayer (and spouse, if filing jointly) and any qualifying children (discussed later) listed on Schedule EIC. The Social Security Administration issues SSNs to United States citizens and to certain aliens.

   If a social security card has the **Not Valid for Employment** imprint and the cardholder obtained the SSN solely to get federally funded benefits, such as Medicaid, **the SSN is not valid for EIC purposes.** Similarly, if the taxpayer(s) has an individual taxpayer identification number (ITIN), rather than an SSN, the taxpayer cannot claim the EIC. If a qualifying child has an ITIN or an adoption taxpayer identification number (ATIN), the taxpayer cannot use that child to claim the EIC.

Example 1

John and Mary and their youngest child have valid SSNs. Their older son has an ITIN. When they file a tax return and claim both children, they receive EITC if otherwise eligible, based on the "one child" rate only. They receive the exemption amount and child tax credit, discussed in another lesson, if eligible, for both children, but EIC is based on the child with the SSN.

3. **Must not use married filing separately filing status:**

   To qualify for the credit, the taxpayer's filing status must be single, married filing jointly, head of household, or qualifying widow(er) with a dependent child.

4. **Must be a United States citizen or resident alien for the entire year:**

   There are three types of aliens for tax purposes: nonresident, dual-status, and resident. Dual-status and resident aliens are taxed as United States citizens. A taxpayer claiming the EIC must be a United States citizen or resident alien all year, or a nonresident alien married to a United States citizen or resident alien and filing a joint return.

5. **Must not file Form 2555 or Form 2555-EZ:**

   To qualify for the EIC, taxpayers must not exclude from gross income any income earned in foreign countries or deduct or exclude a foreign housing amount.

6. **Must meet the investment income limitation:**

   Investment income (such as interest from savings or tax-exempt bonds, dividends, etc.) must be $2,900 or less for the tax year.

7. **Must have earned income:**

   Taxpayers must have **earned** income during the tax year. The income may be from employment or self-employment. If married and filing jointly, at least one spouse must have earned income. Earned income is discussed in detail later.

   Combat pay election. If a taxpayer is a member of the United States Armed Forces, he or she may elect to have his or her nontaxable combat pay included in earned income for the Earned Income Credit. See "Note" later discussing the combat pay election.

8. **Must not be the qualifying child of another person.**

   In the case of a joint return, neither the taxpayer nor the spouse can be a qualifying child of another person. The taxpayer is a qualifying child of another person (the taxpayer's parent, guardian, foster parent, etc.) if all the following statements are true:

   - **Relationship:** The taxpayer is the other person's son, daughter, adopted child (or child lawfully placed with the other person for legal adoption), stepson, stepdaughter, or eligible foster child (placed with the other person by an authorized placement agency or by judgment, decree, or other order of any court of competent jurisdiction), brother, sister, stepbrother, stepsister, or a descendant of any of them.

POTENTIAL PITFALLS

A major reason for rejected returns is that SSNs and names on returns do not match social security cards.

ALERT

If the taxpayer chooses to be treated as a resident alien for the entire year, the taxpayer and spouse are taxed on their worldwide income.

- **Age:** On December 31, the taxpayer was under age 19, or under age 24 and a full-time student, or any age and permanently and totally disabled at any time during the year.
- **Residency:** The taxpayer lived with that person in the United States for more than half of the year.

  If the taxpayer (or spouse, if filing a joint return) is a qualifying child of another person, the taxpayer cannot claim the EIC.

Example 2

Mary is 18, and she lived with her parents from 1/1/2007 until she married Joe, who is 25, on 12/20/2007. Mary and Joe have no children, and she is a qualifying child to her parents. She and Joe may not claim EIC if the only reason they file a tax return is for refund. Mary is a qualifying child of her parents.

Investment and Earned Income

Investment Income

Taxpayers whose investment income is more than $2,900 cannot claim the EIC. Investment income includes but may not be limited to:

1. Taxable interest
2. Tax-exempt interest
3. Ordinary dividends
4. Capital gain net income
5. Certain net income from rents and royalties (beyond the scope of VITA/TCE)
6. Net income from passive activities (beyond the scope of VITA/TCE)

Earned Income

To be eligible for an Earned Income Credit, the taxpayer must have earned income of at least $1 but less than:

- $37,783 ($39,783 if married filing jointly) with two or more qualifying children,
- $33,241 ($35,241 if married filing jointly) with one qualifying child, or
- $12,590 ($14,590 if married filing jointly) with no qualifying children.

Earned income includes wages, salaries, tips, and other employee compensation, but only if the amounts are includible in gross income; plus net earnings from self-employment. The earned income table behind Tab H in Publication 4012, *Volunteer Resource Guide,* provides examples of what to include and what not to include as earned income in computing the Earned Income Credit.

Notes:

Nontaxable Combat Pay Election. The taxpayer can elect to have his or her nontaxable combat pay included in earned income for the Earned Income Credit. Electing to include nontaxable combat pay in earned income may increase or decrease his or her EIC. The credit should be figured with and without the nontaxable combat pay before making the election. If the taxpayer makes the election, he or she must include in earned income all nontaxable combat pay that he or she received. The amount of his or her nontaxable combat pay should be shown on Form W-2, in box 12, with Code Q. If the taxpayer is filing a joint return, and if both taxpayer and spouse received nontaxable combat pay, each taxpayer can make his or her own election. TaxWise® makes the comparison automatically and allows the best benefit to the taxpayer.

Example 3

Margaret Monteiro was in a combat zone designated area from January 5, 2007 to June 30, 2007. Margaret received a W-2, which reads as follows: box 1 = -0-, box 12 shows code Q and $20,000 income. The remaining boxes are filled in correctly.

Margaret has a second W-2 showing income in box 1 of $15,000.

Margaret's filing status is HH with a qualified child under the age of 19 that qualifies her for the EIC.

If Margaret elects to include the combat zone income, she will not be entitled to the EIC due to the maximum EIC threshold.

However:
Using the same scenario on Margaret; if she chooses to exclude the combat zone income from the EIC calculation, she will qualify for the Earned Income Credit.

Earnings While an Inmate. Amounts received for work performed while an inmate in a penal institution **are not considered** earned income for purposes of the Earned Income Credit. Enter PRI and the amount of the income earned while an inmate next to line 7, Form 1040 or Form 1040A, or line 1, Form 1040EZ. This income is still considered taxable for purposes of determining the taxpayer's federal income tax.

Earnings While a Household Employee. If the taxpayer was a household employee who did not receive a Form W-2 because he or she was paid less than $1,500, the income must be included on line 7, Form 1040A or Form 1040, or line 1, Form 1040EZ. The income **is included in earned income for EIC.** Enter HSH and the amount not reported on Form W-2 next to line 7, Form 1040A or Form 1040, or line 1, Form 1040EZ.

Disability Benefits. If a taxpayer retires on disability, benefits received under his or her employer's disability retirement plan **are considered earned income for EIC purposes until** the taxpayer reaches minimum retirement age. Minimum retirement age generally is the earliest age at which the taxpayer can receive a pension or annuity if not disabled. Taxpayers must report their

ALERT

Age is the determining factor in including disability payments in the EIC calculation.

taxable disability payments on line 7 of either Form 1040 or Form 1040A until they reach minimum retirement age (see Pensions and Other Retirement Income, Lesson 11).

Beginning on the day after a taxpayer reaches minimum retirement age, payments the taxpayer receives are taxable as a pension and **are not considered earned income** for EIC purposes. Report taxable pension payments on lines 16a and 16b, Form 1040, or lines 12a and 12b, Form 1040A.

Disability Insurance Payments. Payments that taxpayers receive from a disability insurance policy for which they paid the premiums **are not earned income.** It does not matter whether the taxpayers have reached minimum retirement age. If this policy is provided by their employer, the amount may be shown in box 12 of Form W-2 with code J.

Examples of Earned Income for the EIC

ALERT

Net earnings from self-employment—Schedule C-EZ is within the scope of VITA. Volunteers should remember to *include all allowable expenses* when completing the form.

To qualify for the EIC, taxpayers must have earned income during the tax year. If married and filing jointly, at least one spouse must work and have earned income. Earned income includes all taxable income gained from working as an employee and net earnings from self-employment. Nontaxable income generally does not count as earned income. (See Publication 4012, *Volunteer Resource Guide,* Earned Income Credit Tab H for earned income table listing both earned and unearned income.)

The interview tips you should use when determining EIC General Eligibility Rules are shown in Publication 4012, *Volunteer Resource Guide,* behind Tab H.

WHO CAN CLAIM THE CREDIT—WITH A QUALIFYING CHILD

If the taxpayer meets the EIC general eligibility rules (previously discussed), you must now determine if the taxpayer can claim the credit with a qualifying child or without a qualifying child.

To be a qualifying child for the EIC, a child must meet the qualifying child general tests (relationship, age, and residency tests.)

Note: A child is not a qualifying child until the child meets all three tests.

The following table outlines the three tests for a qualifying child:

Table 5-1

Relationship	Age	Residency
■ Son, daughter, stepson, stepdaughter, or a descendant of any of them* or ■ Brother, sister, stepbrother, stepsister, or a descendant of any of them or ■ Eligible foster child or that child's descendant and...	■ Under age 19 at the end of the tax year or ■ Under age 24 and a full-time student at the end of the tax year or ■ Any age and permanently and totally disabled at any time during the year and...	■ Lived with the taxpayer in the United States for more than half the tax year (at least 183 days for 2007). This includes the time that the taxpayer and the child are temporarily apart due to special circumstances, such as military service, school attendance, hospitalization, or juvenile detention. **Note:** Military personnel stationed outside the U.S. are considered to reside in the U.S. for this purpose. **Note:** Child birth/death: If the child was born or died during the year and fails the above test, the child must live with the taxpayer for the entire time the child was alive during the tax year (except for temporary absences).

*If the child was married at the end of the year, he or she does not meet the relationship test unless:

1. The taxpayer can claim the child's exemption; or
2. The taxpayer cannot claim the child's exemption because the taxpayer gave that right to the child's other parent.

Note: An **adopted child** is treated as a biological child and includes a child placed with the taxpayer for adoption by an authorized placement agency, even if the adoption is not final.

Definitions

An **eligible foster child** is a child placed with the taxpayer by an authorized placement agency or by judgment, decree, or order of any court of competent jurisdiction. An authorized placement agency includes a state or local government agency or court. It also includes a tax-exempt organization licensed by a state. In addition, it includes an Indian tribal government, or an organization authorized by an Indian tribal government to place Indian children.

A child is **permanently and totally disabled** if:

1. He or she cannot engage in any substantial gainful activity because of a physical or mental condition; and

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.

A **kidnapped child** is a child that has been declared such by authorities. The child nor the taxpayer's family can be suspected as the kidnapper. The child must have lived with the taxpayer more than half of the year before the kidnapping. (See **Publication 596, Earned Income Credit.**)

A taxpayer does not need a home to claim the EIC. For example, if the taxpayer and his or her child(ren) lived together for more than half the year in one or more homeless shelter(s), the child meets the residency test.

After you have determined that a child meets the three tests for qualifying child, make sure that the child has a valid SSN. (See General Eligibility Rule 2 earlier in this chapter.)

Qualifying Child of More Than One Taxpayer

If the child is the qualifying child of more than one person, only one person can claim the child as a qualifying child for all of the following:

- Dependency exemption
- Child tax credit
- Head of household filing status
- Credit for child and dependent care expenses
- Earned income credit

If the taxpayer and the other person(s) cannot agree on who will claim the child and more than one person files a return claiming the same child, the IRS will disallow all but one of the claims using the tie-breaker rules. See Publication 4012, Tab H, Tie Breaker Rules

Example 4

Jane (age 25) is unmarried. In 2007, Jane lived with her four children (Al, Ben, Cam, and Dan) and her mother, Linda. Provided they each meet the eligibility and income requirements, Jane may claim the EIC based on two of the children (for example, Al and Ben), and Linda may claim the EIC based on the other two children (for example, Cam and Dan). They must be consistent, though, which means that only Jane can claim any of the other child-related benefits she may be eligible for with respect to Al and Ben, and only Linda can claim any of the other child-related benefits she may be eligible for with respect to Cam and Dan. (For instance, Dependent Care Credit, medical expenses, etc. should follow the child.)

Example 5

In 2007, John is 35 and unmarried. He and his daughter Lynn lived with his father Paul all year; Paul is unmarried. John's sole income was wages of $19,000 and Paul's sole income was wages of $12,000. Lynn is a qualifying child of both John and Paul. John and Paul examine their tax situations and agree that Paul will claim the EIC and the other available child-related benefits on the basis of Lynn. If John later decides to claim the credit (and any other child-related benefits available to him), under the tie-breaker rule, Paul will lose the credit (and other child-related benefits) he claimed. John would win the tie-breaker rule because he is the parent.

Children of Divorced, Separated or Never Married Parents

The residency requirements, that are necessary for a taxpayer to qualify for the EIC based on a qualifying child, prevent a non-custodial parent from EIC eligibility. The same concept applies if never married parents live apart.

A child can be the qualifying child of a non-custodial parent (whether ever married or not) for dependency and child tax credit purposes only if a pre 1985 divorce decree or a written separation agreement allows it or a Form 8332 (or a substantially similar statement) is provided to the non-custodial parent.

If a child qualifies more than one taxpayer for the potential benefit of EIC, those taxpayers have the option to choose which one will claim the EIC and all other benefits they may be entitled to relative to that child. For instance: the child would still have to be under 13 years of age or disabled for the dependent care credit and under 19 or under 24 and a full time student for the EIC, etc.

The most important factor is the residency test for the earned income credit.

Tie Breaker Rule

As previously stated, if more than one taxpayer claims the same qualifying child, the IRS will apply the tie breaker rule. This process will require that taxpayers submit additional information, if it is not clear from the original returns, and any refunds will be delayed.

If the taxpayer and any other person claims the child as a qualifying child, the IRS will apply the rules shown under Qualifying Child of More Than One Person (see page 5-8). If the taxpayer will not be taking the EIC with a qualifying child because of these rules, put "No" on the dotted line next to line 66a on Form 1040 or line 40a on Form 1040A.

Example 6

Tina is 14 and lives with her aunt and uncle. They are brother and sister and both want to claim Tina. Mary earns $15,000 and Joe earns $41,000. Joe has the highest AGI but it is too high to qualify for any credit. If they don't agree to let Mary claim the child as a dependent, get the child tax credit and the Earned Income Credit (providing she qualifies for each), then the credit will be lost, as neither are Tina's parent. EIC will be lost because Joe would win the tie-breaker rule with the highest AGI since no parent is involved.

Use the interview tips in Publication 4012, behind Tab H.

Who Can Claim the EIC—Without a Qualifying Child

In addition to meeting the basic eligibility requirements discussed earlier, taxpayers without a qualifying child must meet the following requirements:

1. Must have lived in the United States for more than half of the tax year. If filing a joint return, both spouses must have lived in the United States (including the 50 states and the District of Columbia) for more than half of the tax year.

   Note: Stationed out of the country on extended military duty is considered to be living in the United States for EIC purposes.

2. Must be at least age 25 but under age 65 by December 31 of the tax year. If filing a joint return, only one spouse must meet this requirement.

3. Cannot qualify as the dependent of another person. If filing a joint return, both spouses must meet this requirement.

The interview tips you should use when determining EIC without a qualifying child are shown in Publication 4012, behind Tab H.

For a summary of the eligibility requirements, see the *Summary of EIC Eligibility Requirements,* and the *interview tips—EIC without a Qualifying Child* in Publication 4012, behind Tab H.

Exercise 1—EIC Eligibility Requirements

A. Sharon has an eligible foster child, Eric. Eric is 12 years old and began living with Sharon in August 2007. Sharon's earned income and her adjusted gross income are $15,525. Can Sharon claim the Earned Income Credit? ______________

____

B. Doug and Donna are married and live together. Their combined earned income is $25,400. Doug reports adjusted gross income of $11,432 on his separate tax return, and Donna reports adjusted gross income of $13,968 on her separate return. Sam, their 4-year-old son, lives with Doug and Donna. Can Doug and/or Donna claim the Earned Income Credit? ______________

C. Joe and Tina were married and lived together until May, when they divorced. Joe and Tina have two children: Jimmy, age 7, and Anna, age 5. The children lived with both of their parents until May, and then they lived with their mother. Joe's earned income and adjusted gross income are $25,000. Tina's earned income is $17,000, and her adjusted gross income is $17,500. Can Joe and/or Tina claim the Earned Income Credit? _______

____

D. Benjamin, age 25, lives alone, is single, and earns $9,100. His adjusted gross income is $9,050. Can Benjamin claim the Earned Income Credit? ______________________________

E. Carlos is 21 years old and married. Carlos's wife is overseas, and he lives with his mother, Maria. Maria's earned income is $22,000 and her adjusted gross income is $22,300. Maria cannot claim Carlos as a dependent. Can Maria claim the Earned Income Credit? ______________________________

F. Circle the items that are considered earned income for Earned Income Credit purposes.

1. Child support

2. Dividend income

3. Interest income

4. Nontaxable combat pay election

5. Tip income

6. Unemployment compensation

7. Wages

8. Welfare benefits

Exercise 2

Doris and George got a divorce in 2003. They have one child together, Olivia, who lives with Doris. All are U.S. citizens and have SSNs. Doris and George provide more than half of Olivia's support. Doris's AGI is $28,000 and George's AGI is $36,000. Olivia is 8 years old. The divorce decree does not state who can claim the child.

Who may claim Olivia as a qualifying child for EIC?

A. George says he can claim Olivia as a dependent and the EIC.

B. George and Doris need to choose who can claim Olivia as a dependent and the EIC.

C. Doris signed a Form 8332 to give the dependency exemption to George. He can claim Olivia as a dependent and the child tax credit. Doris can use Olivia to claim the Earned Income Credit, head of household, and child and dependent care credit on the condition she meets the requirements for those specific benefits.

D. Neither George nor Doris can claim Olivia as a qualifying child for EIC purposes.

Exercise 3

Henry and Jane are married and lived together with their 7 year old daughter, Jenny, until they separated on August 1, 2007. They were not legally separated and there is no written legal separation agreement. Jenny lived with Jane during August and September, and then lived with Henry for the rest of 2007. Neither Henry nor Jane may be claimed as a dependent by any other taxpayer. All three are U.S. citizens and have SSNs. Jenny did not provide any of her own support.

Who may claim the Earned Income Credit using Jenny as a qualifying child?

A. Jenny meets the requirements as a qualifying child for only Jane. Henry and Jane need to decide who will claim any related benefits since the rules for divorced or separated parents do not apply.

B. Jane is the only one who can claim Jenny as a dependent since Jenny lived with Jane for the most time after Henry and Jane separated.

C. Henry can claim Jenny as a dependent and the other benefits.

D. Henry and Jane must file a joint tax return with Jenny as the qualifying child in order to be eligible for EIC.

Determining Eligibility and Figuring the Credit

The EIC is not for everyone. You can **minimize delays** in processing the taxpayer's current and future returns by using the EIC worksheets to **determine eligibility** and figure the credit.

Taxpayers determine their eligibility for EIC by working through the steps in the EIC instructions for 1040, 1040A, or 1040EZ. Taxpayers complete the EIC Worksheet with the instructions to figure the credit. Taxpayers should keep the worksheets with their records.

Before entering an amount on the Earned Income Credit line of Form 1040, Form 1040A, or Form 1040EZ, you must complete the applicable EIC worksheet. If the taxpayer is not eligible to claim the credit but appears to be eligible based on income limitations, write "No" on the appropriate line on 1040 and 1040A.

The **Earned Income Credit Table** is used to determine the amount of the credit. The tables are found in the instructions for Forms 1040EZ, 1040A, and 1040, Publication 596, *Earned Income Credit,* and also in Appendix A of Publication 678W.

Using the EIC Worksheets

The EIC talking points and tables in Publication 4012, *Volunteer Resource Guide,* are used to determine eligibility. The EIC worksheet is used to determine the credit. Example 7 will focus on using Form 1040 instruction EIC steps and worksheet, which consist of 5 pages.

Forms 1040, 1040A, and 1040EZ have separate worksheets. The differences are described below:

- **Form 1040 EIC Worksheet.** If the taxpayer files Form 1040, you will use the steps in the Form 1040 package and either Worksheet A (Exhibit 5) or Worksheet B. Worksheet A is for taxpayers whose earned income was received as an employee. Worksheet B is for taxpayers who have self-employment income, are members of the clergy, or church employees who file Schedule SE, or are statutory employees filing Schedule C or C-EZ.
- **Form 1040A Worksheet.** If the taxpayer files Form 1040A, you will use the steps and EIC Worksheet in the Form 1040A package. Self-employed taxpayers cannot use 1040A.
- **Form 1040EZ Worksheet.** If the taxpayer files Form 1040EZ, you will use the steps and EIC Worksheet in the Form 1040EZ package.

Potential Pitfalls

Remember that the amount of the Earned Income Credit depends on the taxpayer's income, number of qualifying children, and filing status. Be sure to use the correct column from the EIC table.

Using the EIC Table (See Publication 678W, Appendix A)

POTENTIAL PITFALLS

Errors are easily made when using the Earned Income Credit table. To ensure you have entered the correct amount on the tax form, look up the credit twice—once before you enter the credit on the form and once after you enter it on the form.

When using the Earned Income Credit table to determine the credit, read down the columns labeled *"At least…. But less than"* and find the line that includes the amount you are instructed to look up from the EIC worksheet. Read across to the column that includes the number of qualifying children of the taxpayer and filing status. Enter the Earned Income Credit from that column on the EIC worksheet.

Example 7

Betty's filing status is head of household, and she has one qualifying child. The amount shown on lines 1 and 3 of her Form 1040 EIC Worksheet is $15,750.

Betty's Earned Income Credit from the EIC table is $2,791. Exhibits 1–5 show how Betty's EIC is computed.

Form 1040—Lines 66a and 66b

Lines 66a and 66b—Earned Income Credit (EIC)

What Is the EIC?

The EIC is a credit for certain people who work. The credit may give you a refund even if you do not owe any tax.

To Take the EIC:

- Follow the steps below.
- Complete the worksheet that applies to you or let the IRS figure the credit for you.
- If you have a qualifying child, complete and attach Schedule EIC.

For help in determining if you are eligible for the EIC, go to *www.irs.gov/eitc* and click on "EITC Assistant." This service is available in English and Spanish.

CAUTION *If you take the EIC even though you are not eligible and it is determined that your error is due to reckless or intentional disregard of the EIC rules, you will not be allowed to take the credit for 2 years even if you are otherwise eligible to do so. If you fraudulently take the EIC, you will not be allowed to take the credit for 10 years. See* Form 8862, who must file, *on page 47. You may also have to pay penalties.*

Step 1 All Filers

1. If, in 2007:
   - 2 children lived with you, is the amount on Form 1040, line 38, less than $37,783 ($39,783 if married filing jointly)?
   - 1 child lived with you, is the amount on Form 1040, line 38, less than $33,241 ($35,241 if married filing jointly)?
   - No children lived with you, is the amount on Form 1040, line 38, less than $12,590 ($14,590 if married filing jointly)?

   ☑ **Yes.** Continue ☐ **No.** STOP You cannot take the credit.

2. Do you, and your spouse if filing a joint return, have a social security number that allows you to work or is valid for EIC purposes (see page 47)?

   ☑ **Yes.** Continue ☐ **No.** STOP You cannot take the credit. Enter "No" on the dotted line next to line 66a.

3. Is your filing status married filing separately?

   ☐ **Yes.** STOP You cannot take the credit. ☑ **No.** Go to question 4.

4. Are you filing Form 2555 or 2555-EZ (relating to foreign earned income)?

   ☐ **Yes.** STOP You cannot take the credit. ☑ **No.** Continue

5. Were you or your spouse a nonresident alien for any part of 2007?

   ☐ **Yes.** See *Nonresident aliens* on page 47. ☑ **No.** Go to Step 2.

Step 2 Investment Income

1. Add the amounts from Form 1040:

Line 8a		
Line 8b	+	
Line 9a	+	
Line 13*	+	
Investment Income	=	-0-

*If line 13 is a loss, enter -0-.

2. Is your investment income more than $2,900?

   ☐ **Yes.** Continue ☑ **No.** Skip question 3; go to question 4.

3. Are you filing Form 4797 (relating to sales of business property)?

   ☐ **Yes.** See *Form 4797 filers* on page 47. ☐ **No.** STOP You cannot take the credit.

4. Do any of the following apply for 2007?
   - You are filing Schedule E.
   - You are reporting income or a loss from the rental of personal property not used in a trade or business.
   - You are reporting income on Form 1040, line 21, from Form 8814 (relating to election to report child's interest and dividends).

   ☐ **Yes.** You must use Worksheet 1 in Pub. 596 to see if you can take the credit. ☑ **No.** Go to Step 3.

Need more information or forms? See page 80.

Continued from page 44

Step 3 Qualifying Child

A qualifying child for the EIC is a child who is your...

Son, daughter, stepchild, foster child, brother, sister, stepbrother, stepsister, or a descendant of any of them (for example, your grandchild, niece, or nephew)

AND

was ...

Under age 19 at the end of 2007

or

Under age 24 at the end of 2007 and a student (see page 47)

or

Any age and permanently and totally disabled (see page 47)

AND

who...

Lived with you in the United States for more than half of 2007.
If the child did not live with you for the required time, see *Exception to time lived with you* on page 47.

CAUTION *If the child meets the conditions to be a qualifying child of any other person (other than your spouse if filing a joint return) for 2007, or the child was married, see page 47.*

1. Do you have at least one child who meets the conditions to be your qualifying child?

   ☑ **Yes.** The child must have a valid social security number as defined on page 47 unless the child was born and died in 2007. Go to question 2.

   ☐ **No.** Skip question 2; go to Step 4.

2. Could you, or your spouse if filing a joint return, be a qualifying child of another person in 2007?

   ☐ **Yes.** STOP You cannot take the credit. Enter "No" on the dotted line next to line 66a.

   ☑ **No.** Skip Step 4; go to Step 5 on page 46.

Step 4 Filers Without a Qualifying Child

1. Is the amount on Form 1040, line 38, less than $12,590 ($14,590 if married filing jointly)?

   ☐ **Yes.** Continue

   ☐ **No.** STOP You cannot take the credit.

2. Could you, or your spouse if filing a joint return, be a qualifying child of another person in 2007?

   ☐ **Yes.** STOP You cannot take the credit. Enter "No" on the dotted line next to line 66a.

   ☐ **No.** Continue

3. Can you, or your spouse if filing a joint return, be claimed as a dependent on someone else's 2007 tax return?

   ☐ **Yes.** STOP You cannot take the credit.

   ☐ **No.** Continue

4. Were you, or your spouse if filing a joint return, at least age 25 but under age 65 at the end of 2007?

   ☐ **Yes.** Continue

   ☐ **No.** STOP You cannot take the credit.

5. Was your home, and your spouse's if filing a joint return, in the United States for more than half of 2007? Members of the military stationed outside the United States, see page 47 before you answer.

   ☐ **Yes.** Go to Step 5 on page 46.

   ☐ **No.** STOP You cannot take the credit. Enter "No" on the dotted line next to line 66a.

Form 1040—Lines 66a and 66b

Continued from page 45

Step 5 Earned Income

1. Are you filing Schedule SE because you were a member of the clergy or you had church employee income of $108.28 or more?

   ☐ **Yes.** See *Clergy* or *Church employees,* whichever applies, on this page.

   ☑ **No.** Continue

2. Figure earned income:

Form 1040, line 7	15,750
Subtract, if included on line 7, any: • Taxable scholarship or fellowship grant not reported on a Form W-2. • Amount received for work performed while an inmate in a penal institution (enter "PRI" and the amount subtracted on the dotted line next to Form 1040, line 7). • Amount received as a pension or annuity from a nonqualified deferred compensation plan or a nongovernmental section 457 plan (enter "DFC" and the amount subtracted on the dotted line next to Form 1040, line 7). This amount may be shown in box 11 of Form W-2. If you received such an amount but box 11 is blank, contact your employer for the amount received as a pension or annuity.	–
Add all of your nontaxable combat pay if you elect to include it in earned income. Also enter this amount on Form 1040, line 66b. See *Combat pay, nontaxable* on this page.	+ 0

CAUTION *Electing to include nontaxable combat pay may increase or decrease your EIC. Figure the credit with and without your nontaxable combat pay before making the election.*

Earned Income = 15,750

3. Were you self-employed at any time in 2007, or are you filing Schedule SE because you were a member of the clergy or you had church employee income, or are you filing Schedule C or C-EZ as a statutory employee?

   ☐ **Yes.** Skip question 4 and Step 6; go to Worksheet B on page 49.

   ☑ **No.** Continue

4. If you have:
   - 2 or more qualifying children, is your earned income less than $37,783 ($39,783 if married filing jointly)?
   - 1 qualifying child, is your earned income less than $33,241 ($35,241 if married filing jointly)?
   - No qualifying children, is your earned income less than $12,590 ($14,590 if married filing jointly)?

   ☑ **Yes.** Go to Step 6.

   ☐ **No.** STOP You cannot take the credit.

Step 6 How To Figure the Credit

1. Do you want the IRS to figure the credit for you?

   ☐ **Yes.** See *Credit figured by the IRS* below.

   ☑ **No.** Go to Worksheet A on page 48.

Definitions and Special Rules

(listed in alphabetical order)

Adopted child. An adopted child is always treated as your own child. An adopted child includes a child lawfully placed with you for legal adoption.

Church employees. Determine how much of the amount on Form 1040, line 7, was also reported on Schedule SE, line 5a. Subtract that amount from the amount on Form 1040, line 7, and enter the result in the first space of Step 5, line 2. Be sure to answer "Yes" to question 3 in Step 5.

Clergy. The following instructions apply to ministers, members of religious orders who have not taken a vow of poverty, and Christian Science practitioners. If you are filing Schedule SE and the amount on line 2 of that schedule includes an amount that was also reported on Form 1040, line 7:

1. Enter "Clergy" on the dotted line next to Form 1040, line 66a.
2. Determine how much of the amount on Form 1040, line 7, was also reported on Schedule SE, line 2.
3. Subtract that amount from the amount on Form 1040, line 7. Enter the result in the first space of Step 5, line 2.
4. Be sure to answer "Yes" to question 3 in Step 5.

Combat pay, nontaxable. If you were a member of the U.S. Armed Forces who served in a combat zone, certain pay is excluded from your income. See *Combat Zone Exclusion* in Pub. 3. You can elect to include this pay in your earned income when figuring the EIC. The amount of your nontaxable combat pay should be shown in box 12 of Form(s) W-2 with code Q. If you are filing a joint return and both you and your spouse received nontaxable combat pay, you can each make your own election.

Credit figured by the IRS. To have the IRS figure your EIC:

1. Enter "EIC" on the dotted line next to Form 1040, line 66a.
2. Be sure you enter the nontaxable combat pay you elect to include in earned income on Form 1040, line 66b. See *Combat pay, nontaxable* above.
3. If you have a qualifying child, complete and attach Schedule EIC. If your EIC for a year after 1996 was reduced or disallowed, see *Form 8862, who must file* on page 47.

Exception to time lived with you. A child is considered to have lived with you for all of 2007 if the child was born or died in 2007 and your home was this child's home for the entire time he or she was alive in 2007. Temporary absences for special circumstances, such as for school, vacation, medical care, military service, or detention in a juvenile facility, count as time lived at home. Also see *Kidnapped child* on page 17 or *Members of the military* below.

Form 4797 filers. If the amount on Form 1040, line 13, includes an amount from Form 4797, you must use Worksheet 1 in Pub. 596 to see if you can take the EIC. Otherwise, stop; you cannot take the EIC.

Form 8862, who must file. You must file Form 8862 if your EIC for a year after 1996 was reduced or disallowed for any reason other than a math or clerical error. But do not file Form 8862 if either of the following applies.

- You filed Form 8862 for another year, the EIC was allowed for that year, and your EIC has not been reduced or disallowed again for any reason other than a math or clerical error.
- You are taking the EIC without a qualifying child and the only reason your EIC was reduced or disallowed in the other year was because it was determined that a child listed on Schedule EIC was not your qualifying child.

Also, do not file Form 8862 or take the credit for the:

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

Foster child. A foster child is any child placed with you by an authorized placement agency or by judgment, decree, or other order of any court of competent jurisdiction. For more details on authorized placement agencies, see Pub. 596.

Married child. A child who was married at the end of 2007 is a qualifying child only if (a) you can claim him or her as your dependent on Form 1040, line 6c, or (b) you could have claimed him or her as your dependent except for the special rule for *Children of divorced or separated parents* that begins on page 16.

Members of the military. If you were on extended active duty outside the United States, your home is considered to be in the United States during that duty period. Extended active duty is military duty ordered for an indefinite period or for a period of more than 90 days. Once you begin serving extended active duty, you are considered to be on extended active duty even if you do not serve more than 90 days.

Nonresident aliens. If your filing status is married filing jointly, go to Step 2 on page 44. Otherwise, stop; you cannot take the EIC.

Permanently and totally disabled. A person is permanently and totally disabled if, at any time in 2007, the person cannot engage in any substantial gainful activity because of a physical or mental condition and a doctor has determined that this condition (a) has lasted or can be expected to last continuously for at least a year, or (b) can be expected to lead to death.

Qualifying child of more than one person. If the child is the qualifying child of more than one person, only one person can claim the child as a qualifying child for all of the following tax benefits, unless the special rule for *Children of divorced or separated parents* beginning on page 16 applies.

1. Dependency exemption (line 6c).
2. Child tax credits (lines 52 and 68).
3. Head of household filing status (line 4).
4. Credit for child and dependent care expenses (line 47).
5. Exclusion for dependent care benefits (Form 2441, Part III).
6. Earned income credit (lines 66a and 66b).

No other person can take any of the six tax benefits listed above unless he or she has a different qualifying child. If you and any other person claim the child as a qualifying child, the IRS will apply the following rules.

- If only one of the persons is the child's parent, the child will be treated as the qualifying child of the parent.
- If two of the persons are the child's parents, the child will be treated as the qualifying child of the parent with whom the child lived for the longer period of time in 2007. If the child lived with each parent for the same amount of time, the child will be treated as the qualifying child of the parent who had the higher adjusted gross income (AGI) for 2007.
- If none of the persons is the child's parent, the child will be treated as the qualifying child of the person who had the highest AGI for 2007.

Example. Your daughter meets the conditions to be a qualifying child for both you and your mother. If you and your mother both claim tax benefits based on the child, the rules above apply. Under these rules, you are entitled to treat your daughter as a qualifying child for any of the six tax benefits listed above for which you otherwise qualify. Your mother would not be entitled to take any of the six tax benefits listed above unless she has a different qualifying child.

If you will not be taking the EIC with a qualifying child, enter "No" on the dotted line next to line 66a. Otherwise, go to Step 3, question 1, on page 45.

Social security number (SSN). For the EIC, a valid SSN is a number issued by the Social Security Administration unless "Not Valid for Employment" is printed on the social security card and the number was issued solely to apply for or receive a federally funded benefit.

To find out how to get an SSN, see page 12. If you will not have an SSN by the date your return is due, see *What if You Cannot File on Time?* on page 6.

Student. A student is a child who during any part of 5 calendar months of 2007 was enrolled as a full-time student at a school, or took a full-time, on-farm training course given by a school or a state, county, or local government agency. A school includes a technical, trade, or mechanical school. It does not include an on-the-job training course, correspondence school, or school offering courses only through the Internet.

Welfare benefits, effect of credit on. Any refund you receive as a result of taking the EIC will not be used to determine if you are eligible for the following programs or how much you can receive from them. But if the refund you receive because of the EIC is not spent within a certain period of time, it can count as an asset (or resource) and affect your eligibility.

- Temporary Assistance for Needy Families (TANF).
- Medicaid and supplemental security income (SSI).
- Food stamps and low-income housing.

 Need more information or forms? See page 80.

Worksheet A—Earned Income Credit (EIC)—Lines 66a and 66b

Keep for Your Records

Before you begin: √ Be sure you are using the correct worksheet. Use this worksheet only if you answered "No" to Step 5, question 3, on page 48. Otherwise, use Worksheet B that begins on page 51.

Part 1

All Filers Using Worksheet A

1. Enter your earned income from Step 5 on page 48. **1** 15,750

2. Look up the amount on line 1 above in the EIC Table on pages 53–59 to find the credit. Be sure you use the correct column for your filing status and the number of children you have. Enter the credit here. **2** 2,791

If line 2 is zero, STOP You cannot take the credit. Enter "No" on the dotted line next to line 66a.

3. Enter the amount from Form 1040, line 38. **3** 15,750

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. If you have:

- No qualifying children, is the amount on line 3 less than $7,000 ($9,000 if married filing jointly)?
- 1 or more qualifying children, is the amount on line 3 less than $15,400 ($17,400 if married filing jointly)?

☐ **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 53–59 to find the credit. Be sure you use the correct column for your filing status and the number of children you have. Enter the credit here. **5**

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.** **6** 2,791

Enter this amount on Form 1040, line 66a.

Reminder—

√ If you have a qualifying child, complete and attach Schedule EIC.

CAUTION

If your EIC for a year after 1996 was reduced or disallowed, see page 49 to find out if you must file Form 8862 to take the credit for 2007.

Exercise 4—Determining Eligibility and Figuring the Credit

A. Alex and Cheryl have three qualifying children. Their filing status is married filing jointly. The amount shown on lines 1 and 3 of their EIC Worksheet is $25,875.

What is the Earned Income Credit from the EIC table? ______

____

B. Roxanne divorced two years ago. She lives with her infant daughter. The amount shown on lines 1 and 3 of her EIC Worksheet is $12,500.

What is the Earned Income Credit from the EIC table? ______

____

C. Sam U. Bell is a member of the Army and served 6 months in Iraq in 2007. Sam is married to Robin O. Bell, and they are filing a joint return. Sam's social security number is xxx-xx-xxxx, and Robin's is xxx-xx-xxxx. Sam received $8,000 of combat pay and is electing not to include it in his earned income when figuring the EIC. Form 1040, line 7 shows $14,950, line 8a shows $50 of taxable interest income, and line 38 shows the Bells' adjusted gross income of $15,000.

They have a child, Robert S. Bell (SSN xxx-xx-xxxx), who was born in 1999. Robert lived with his parents for the entire year.

Complete Form 1040 EIC eligibility questions and worksheet, Exhibits 6–10.

Form 1040—Lines 66a and 66b

Lines 66a and 66b—Earned Income Credit (EIC)

What Is the EIC?

The EIC is a credit for certain people who work. The credit may give you a refund even if you do not owe any tax.

To Take the EIC:

- Follow the steps below.
- Complete the worksheet that applies to you or let the IRS figure the credit for you.
- If you have a qualifying child, complete and attach Schedule EIC.

For help in determining if you are eligible for the EIC, go to *www.irs.gov/eitc* and click on "EITC Assistant." This service is available in English and Spanish.

CAUTION *If you take the EIC even though you are not eligible and it is determined that your error is due to reckless or intentional disregard of the EIC rules, you will not be allowed to take the credit for 2 years even if you are otherwise eligible to do so. If you fraudulently take the EIC, you will not be allowed to take the credit for 10 years. See* Form 8862, who must file, *on page 47. You may also have to pay penalties.*

Step 1 All Filers

1. If, in 2007:
   - 2 children lived with you, is the amount on Form 1040, line 38, less than $37,783 ($39,783 if married filing jointly)?
   - 1 child lived with you, is the amount on Form 1040, line 38, less than $33,241 ($35,241 if married filing jointly)?
   - No children lived with you, is the amount on Form 1040, line 38, less than $12,590 ($14,590 if married filing jointly)?

   ☐ **Yes.** Continue ☐ **No.** STOP You cannot take the credit.

2. Do you, and your spouse if filing a joint return, have a social security number that allows you to work or is valid for EIC purposes (see page 47)?

   ☐ **Yes.** Continue ☐ **No.** STOP You cannot take the credit. Enter "No" on the dotted line next to line 66a.

3. Is your filing status married filing separately?

   ☐ **Yes.** STOP You cannot take the credit. ☐ **No.** Go to question 4.

4. Are you filing Form 2555 or 2555-EZ (relating to foreign earned income)?

   ☐ **Yes.** STOP You cannot take the credit. ☐ **No.** Continue

5. Were you or your spouse a nonresident alien for any part of 2007?

   ☐ **Yes.** See *Nonresident aliens* on page 47. ☐ **No.** Go to Step 2.

Step 2 Investment Income

1. Add the amounts from Form 1040:

Line 8a		________
Line 8b	+	________
Line 9a	+	________
Line 13*	+	________
Investment Income	=	

*If line 13 is a loss, enter -0-.

2. Is your investment income more than $2,900?

   ☐ **Yes.** Continue ☐ **No.** Skip question 3; go to question 4.

3. Are you filing Form 4797 (relating to sales of business property)?

   ☐ **Yes.** See *Form 4797 filers* on page 47. ☐ **No.** STOP You cannot take the credit.

4. Do any of the following apply for 2007?
   - You are filing Schedule E.
   - You are reporting income or a loss from the rental of personal property not used in a trade or business.
   - You are reporting income on Form 1040, line 21, from Form 8814 (relating to election to report child's interest and dividends).

   ☐ **Yes.** You must use Worksheet 1 in Pub. 596 to see if you can take the credit. ☐ **No.** Go to Step 3.

Continued from page 44

Step 3 Qualifying Child

A qualifying child for the EIC is a child who is your...

Son, daughter, stepchild, foster child, brother, sister, stepbrother, stepsister, or a descendant of any of them (for example, your grandchild, niece, or nephew)

AND

was ...

Under age 19 at the end of 2007

or

Under age 24 at the end of 2007 and a student (see page 47)

or

Any age and permanently and totally disabled (see page 47)

AND

who...

Lived with you in the United States for more than half of 2007.
If the child did not live with you for the required time, see *Exception to time lived with you* on page 47.

CAUTION *If the child meets the conditions to be a qualifying child of any other person (other than your spouse if filing a joint return) for 2007, or the child was married, see page 47.*

1. Do you have at least one child who meets the conditions to be your qualifying child?
   - ☐ **Yes.** The child must have a valid social security number as defined on page 47 unless the child was born and died in 2007. Go to question 2.
   - ☐ **No.** Skip question 2; go to Step 4.

2. Could you, or your spouse if filing a joint return, be a qualifying child of another person in 2007?
   - ☐ **Yes.** STOP You cannot take the credit. Enter "No" on the dotted line next to line 66a.
   - ☐ **No.** Skip Step 4; go to Step 5 on page 46.

Step 4 Filers Without a Qualifying Child

1. Is the amount on Form 1040, line 38, less than $12,590 ($14,590 if married filing jointly)?
   - ☐ **Yes.** Continue
   - ☐ **No.** STOP You cannot take the credit.

2. Could you, or your spouse if filing a joint return, be a qualifying child of another person in 2007?
   - ☐ **Yes.** STOP You cannot take the credit. Enter "No" on the dotted line next to line 66a.
   - ☐ **No.** Continue

3. Can you, or your spouse if filing a joint return, be claimed as a dependent on someone else's 2007 tax return?
   - ☐ **Yes.** STOP You cannot take the credit.
   - ☐ **No.** Continue

4. Were you, or your spouse if filing a joint return, at least age 25 but under age 65 at the end of 2007?
   - ☐ **Yes.** Continue
   - ☐ **No.** STOP You cannot take the credit.

5. Was your home, and your spouse's if filing a joint return, in the United States for more than half of 2007? Members of the military stationed outside the United States, see page 47 before you answer.
   - ☐ **Yes.** Go to Step 5 on page 46.
   - ☐ **No.** STOP You cannot take the credit. Enter "No" on the dotted line next to line 66a.

Need more information or forms? See page 80.

Form 1040—Lines 66a and 66b

Continued from page 45

Step 5 Earned Income

1. Are you filing Schedule SE because you were a member of the clergy or you had church employee income of $108.28 or more?

   ☐ **Yes.** See *Clergy* or *Church employees*, whichever applies, on this page.
   ☐ **No.** Continue

2. Figure earned income:

   Form 1040, line 7 ____________

   Subtract, if included on line 7, any:
   - Taxable scholarship or fellowship grant not reported on a Form W-2.
   - Amount received for work performed while an inmate in a penal institution (enter "PRI" and the amount subtracted on the dotted line next to Form 1040, line 7).
   - Amount received as a pension or annuity from a nonqualified deferred compensation plan or a nongovernmental section 457 plan (enter "DFC" and the amount subtracted on the dotted line next to Form 1040, line 7). This amount may be shown in box 11 of Form W-2. If you received such an amount but box 11 is blank, contact your employer for the amount received as a pension or annuity.

   −____________

   Add all of your nontaxable combat pay if you elect to include it in earned income. Also enter this amount on Form 1040, line 66b. See *Combat pay, nontaxable* on this page. +____________

   CAUTION *Electing to include nontaxable combat pay may increase or decrease your EIC. Figure the credit with and without your nontaxable combat pay before making the election.*

   Earned Income = ☐

3. Were you self-employed at any time in 2007, or are you filing Schedule SE because you were a member of the clergy or you had church employee income, or are you filing Schedule C or C-EZ as a statutory employee?

   ☐ **Yes.** Skip question 4 and Step 6; go to Worksheet B on page 49.
   ☐ **No.** Continue

4. If you have:
   - 2 or more qualifying children, is your earned income less than $37,783 ($39,783 if married filing jointly)?
   - 1 qualifying child, is your earned income less than $33,241 ($35,241 if married filing jointly)?
   - No qualifying children, is your earned income less than $12,590 ($14,590 if married filing jointly)?

   ☐ **Yes.** Go to Step 6.
   ☐ **No.** STOP You cannot take the credit.

Step 6 How To Figure the Credit

1. Do you want the IRS to figure the credit for you?

   ☐ **Yes.** See *Credit figured by the IRS* below.
   ☐ **No.** Go to Worksheet A on page 48.

Definitions and Special Rules

(listed in alphabetical order)

Adopted child. An adopted child is always treated as your own child. An adopted child includes a child lawfully placed with you for legal adoption.

Church employees. Determine how much of the amount on Form 1040, line 7, was also reported on Schedule SE, line 5a. Subtract that amount from the amount on Form 1040, line 7, and enter the result in the first space of Step 5, line 2. Be sure to answer "Yes" to question 3 in Step 5.

Clergy. The following instructions apply to ministers, members of religious orders who have not taken a vow of poverty, and Christian Science practitioners. If you are filing Schedule SE and the amount on line 2 of that schedule includes an amount that was also reported on Form 1040, line 7:

1. Enter "Clergy" on the dotted line next to Form 1040, line 66a.
2. Determine how much of the amount on Form 1040, line 7, was also reported on Schedule SE, line 2.
3. Subtract that amount from the amount on Form 1040, line 7. Enter the result in the first space of Step 5, line 2.
4. Be sure to answer "Yes" to question 3 in Step 5.

Combat pay, nontaxable. If you were a member of the U.S. Armed Forces who served in a combat zone, certain pay is excluded from your income. See *Combat Zone Exclusion* in Pub. 3. You can elect to include this pay in your earned income when figuring the EIC. The amount of your nontaxable combat pay should be shown in box 12 of Form(s) W-2 with code Q. If you are filing a joint return and both you and your spouse received nontaxable combat pay, you can each make your own election.

Credit figured by the IRS. To have the IRS figure your EIC:

1. Enter "EIC" on the dotted line next to Form 1040, line 66a.
2. Be sure you enter the nontaxable combat pay you elect to include in earned income on Form 1040, line 66b. See *Combat pay, nontaxable* above.
3. If you have a qualifying child, complete and attach Schedule EIC. If your EIC for a year after 1996 was reduced or disallowed, see *Form 8862, who must file* on page 47.

Exception to time lived with you. A child is considered to have lived with you for all of 2007 if the child was born or died in 2007 and your home was this child's home for the entire time he or she was alive in 2007. Temporary absences for special circumstances, such as for school, vacation, medical care, military service, or detention in a juvenile facility, count as time lived at home. Also see *Kidnapped child* on page 17 or *Members of the military* below.

Form 4797 filers. If the amount on Form 1040, line 13, includes an amount from Form 4797, you must use Worksheet 1 in Pub. 596 to see if you can take the EIC. Otherwise, stop; you cannot take the EIC.

Form 8862, who must file. You must file Form 8862 if your EIC for a year after 1996 was reduced or disallowed for any reason other than a math or clerical error. But do not file Form 8862 if either of the following applies.

- You filed Form 8862 for another year, the EIC was allowed for that year, and your EIC has not been reduced or disallowed again for any reason other than a math or clerical error.
- You are taking the EIC without a qualifying child and the only reason your EIC was reduced or disallowed in the other year was because it was determined that a child listed on Schedule EIC was not your qualifying child.

Also, do not file Form 8862 or take the credit for the:

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

Foster child. A foster child is any child placed with you by an authorized placement agency or by judgment, decree, or other order of any court of competent jurisdiction. For more details on authorized placement agencies, see Pub. 596.

Married child. A child who was married at the end of 2007 is a qualifying child only if (a) you can claim him or her as your dependent on Form 1040, line 6c, or (b) you could have claimed him or her as your dependent except for the special rule for *Children of divorced or separated parents* that begins on page 16.

Members of the military. If you were on extended active duty outside the United States, your home is considered to be in the United States during that duty period. Extended active duty is military duty ordered for an indefinite period or for a period of more than 90 days. Once you begin serving extended active duty, you are considered to be on extended active duty even if you do not serve more than 90 days.

Nonresident aliens. If your filing status is married filing jointly, go to Step 2 on page 44. Otherwise, stop; you cannot take the EIC.

Permanently and totally disabled. A person is permanently and totally disabled if, at any time in 2007, the person cannot engage in any substantial gainful activity because of a physical or mental condition and a doctor has determined that this condition (a) has lasted or can be expected to last continuously for at least a year, or (b) can be expected to lead to death.

Qualifying child of more than one person. If the child is the qualifying child of more than one person, only one person can claim the child as a qualifying child for all of the following tax benefits, unless the special rule for *Children of divorced or separated parents* beginning on page 16 applies.

1. Dependency exemption (line 6c).
2. Child tax credits (lines 52 and 68).
3. Head of household filing status (line 4).
4. Credit for child and dependent care expenses (line 47).
5. Exclusion for dependent care benefits (Form 2441, Part III).
6. Earned income credit (lines 66a and 66b).

No other person can take any of the six tax benefits listed above unless he or she has a different qualifying child. If you and any other person claim the child as a qualifying child, the IRS will apply the following rules.

- If only one of the persons is the child's parent, the child will be treated as the qualifying child of the parent.
- If two of the persons are the child's parents, the child will be treated as the qualifying child of the parent with whom the child lived for the longer period of time in 2007. If the child lived with each parent for the same amount of time, the child will be treated as the qualifying child of the parent who had the higher adjusted gross income (AGI) for 2007.
- If none of the persons is the child's parent, the child will be treated as the qualifying child of the person who had the highest AGI for 2007.

Example. Your daughter meets the conditions to be a qualifying child for both you and your mother. If you and your mother both claim tax benefits based on the child, the rules above apply. Under these rules, you are entitled to treat your daughter as a qualifying child for any of the six tax benefits listed above for which you otherwise qualify. Your mother would not be entitled to take any of the six tax benefits listed above unless she has a different qualifying child.

If you will not be taking the EIC with a qualifying child, enter "No" on the dotted line next to line 66a. Otherwise, go to Step 3, question 1, on page 45.

Social security number (SSN). For the EIC, a valid SSN is a number issued by the Social Security Administration unless "Not Valid for Employment" is printed on the social security card and the number was issued solely to apply for or receive a federally funded benefit.

To find out how to get an SSN, see page 12. If you will not have an SSN by the date your return is due, see *What if You Cannot File on Time?* on page 6.

Student. A student is a child who during any part of 5 calendar months of 2007 was enrolled as a full-time student at a school, or took a full-time, on-farm training course given by a school or a state, county, or local government agency. A school includes a technical, trade, or mechanical school. It does not include an on-the-job training course, correspondence school, or school offering courses only through the Internet.

Welfare benefits, effect of credit on. Any refund you receive as a result of taking the EIC will not be used to determine if you are eligible for the following programs or how much you can receive from them. But if the refund you receive because of the EIC is not spent within a certain period of time, it can count as an asset (or resource) and affect your eligibility.

- Temporary Assistance for Needy Families (TANF).
- Medicaid and supplemental security income (SSI).
- Food stamps and low-income housing.

Worksheet A—Earned Income Credit (EIC)—Lines 66a and 66b

Keep for Your Records

Before you begin: √ Be sure you are using the correct worksheet. Use this worksheet only if you answered "No" to Step 5, question 3, on page 48. Otherwise, use Worksheet B that begins on page 51.

Part 1

All Filers Using Worksheet A

1. Enter your earned income from Step 5 on page 48. **1** ______

2. Look up the amount on line 1 above in the EIC Table on pages 53–59 to find the credit. Be sure you use the correct column for your filing status and the number of children you have. Enter the credit here. **2** ______

If line 2 is zero, STOP You cannot take the credit. Enter "No" on the dotted line next to line 66a.

3. Enter the amount from Form 1040, line 38. **3** ______

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. If you have:

- No qualifying children, is the amount on line 3 less than $7,000 ($9,000 if married filing jointly)?
- 1 or more qualifying children, is the amount on line 3 less than $15,400 ($17,400 if married filing jointly)?

☐ **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 53–59 to find the credit. Be sure you use the correct column for your filing status and the number of children you have. Enter the credit here. **5** ______

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. **6** ______

Enter this amount on Form 1040, line 66a.

Reminder—

√ If you have a qualifying child, complete and attach Schedule EIC.

1040 EIC 1040

CAUTION

If your EIC for a year after 1996 was reduced or disallowed, see page 49 to find out if you must file Form 8862 to take the credit for 2007.

Schedule EIC for Qualifying Children

Schedule EIC contains only information about qualifying children. Only taxpayers who have a qualifying child must fill out the schedule and attach it to Form 1040A or Form 1040.

Note: The taxpayer cannot use Form 1040EZ to claim the EIC with a qualifying child.

Example 8

Pam Fink (SSN xxx-xx-xxxx) is single. Her son, Steve (SSN xxx-xx-xxxx), was born in 2000. Steve lived with Pam during all of 2007. Steve is a qualifying child of only his mother.

Exhibit 11 shows a completed Schedule EIC.

SCHEDULE EIC
(Form 1040A or 1040)

Department of the Treasury
Internal Revenue Service (99)

Earned Income Credit

Qualifying Child Information

1040A
1040
EIC

Complete and attach to Form 1040A or 1040 only if you have a qualifying child.

OMB No. 1545-0074

2007

Attachment Sequence No. **43**

Name(s) shown on return	Your social security number
Pam Fink	XXX XX XXXX

Before you begin: See the instructions for Form 1040A, lines 40a and 40b, or Form 1040, lines 66a and 66b, to make sure that **(a)** you can take the EIC, and **(b)** you have a qualifying child.

CAUTION

- 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.
- Be sure the child's name on line 1 and social security number (SSN) on line 2 agree with the child's social security card. Otherwise, at the time we process your return, we may reduce or disallow your EIC. If the name or SSN on the child's social security card is not correct, call the Social Security Administration at 1-800-772-1213.

Qualifying Child Information	**Child 1**	**Child 2**
1 Child's name If you have more than two qualifying children, you only have to list two to get the maximum credit.	First name Last name STEVE FINK	First name Last name
2 Child's SSN The child must have an SSN as defined on page 43 of the Form 1040A instructions or page 49 of the Form 1040 instructions unless the child was born and died in 2007. If your child was born and died in 2007 and did not have an SSN, enter "Died" on this line and attach a copy of the child's birth certificate.	XXX XX XXXX	
3 Child's year of birth	Year 2 0 0 0 *If born after 1988, skip lines 4a and 4b; go to line 5.*	Year ___ ___ ___ ___ *If born after 1988, skip lines 4a and 4b; go to line 5.*
4 If the child was born before 1989— **a** Was the child under age 24 at the end of 2007 and a student?	☐ **Yes.** *Go to line 5.* ☐ **No.** *Continue.*	☐ **Yes.** *Go to line 5.* ☐ **No.** *Continue.*
b Was the child permanently and totally disabled during any part of 2007?	☐ **Yes.** *Continue.* ☐ **No.** The child is not a qualifying child.	☐ **Yes.** *Continue.* ☐ **No.** The child is not a qualifying child.
5 Child's relationship to you (for example, son, daughter, grandchild, niece, nephew, foster child, etc.)	SON	
6 Number of months child lived with you in the United States during 2007 • If the child lived with you for more than half of 2007 but less than 7 months, enter "7." • If the child was born or died in 2007 and your home was the child's home for the entire time he or she was alive during 2007, enter "12."	12 months *Do not enter more than 12 months.*	______ months *Do not enter more than 12 months.*

TIP You may also be able to take the additional child tax credit if your child **(a)** was under age 17 at the end of 2007, **and (b)** is a U.S. citizen or resident alien. For more details, see the instructions for line 41 of Form 1040A or line 68 of Form 1040.

For Paperwork Reduction Act Notice, see Form 1040A or 1040 instructions. Cat. No. 13339M **Schedule EIC (Form 1040A or 1040) 2007**

Exercise 5—Schedule EIC

Complete Schedule EIC, Exhibit 12, for Sam U. and Robin O. Bell in Exercise 4C, using the information provided.

Exhibit 12

SCHEDULE EIC
(Form 1040A or 1040)

Department of the Treasury
Internal Revenue Service (99)

Earned Income Credit

Qualifying Child Information

1040A
1040
EIC

Complete and attach to Form 1040A or 1040 only if you have a qualifying child.

OMB No. 1545-0074

2007

Attachment Sequence No. **43**

Name(s) shown on return	**Your social security number**

Before you begin: See the instructions for Form 1040A, lines 40a and 40b, or Form 1040, lines 66a and 66b, to make sure that **(a)** you can take the EIC, and **(b)** you have a qualifying child.

CAUTION

- 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.
- Be sure the child's name on line 1 and social security number (SSN) on line 2 agree with the child's social security card. Otherwise, at the time we process your return, we may reduce or disallow your EIC. If the name or SSN on the child's social security card is not correct, call the Social Security Administration at 1-800-772-1213.

Qualifying Child Information	**Child 1**	**Child 2**
1 Child's name If you have more than two qualifying children, you only have to list two to get the maximum credit.	First name Last name	First name Last name
2 Child's SSN The child must have an SSN as defined on page 43 of the Form 1040A instructions or page 49 of the Form 1040 instructions unless the child was born and died in 2007. If your child was born and died in 2007 and did not have an SSN, enter "Died" on this line and attach a copy of the child's birth certificate.		
3 Child's year of birth	Year ___ ___ ___ ___ *If born after 1988, skip lines 4a and 4b; go to line 5.*	Year ___ ___ ___ ___ *If born after 1988, skip lines 4a and 4b; go to line 5.*
4 If the child was born before 1989— **a** Was the child under age 24 at the end of 2007 and a student?	☐ **Yes.** ***Go to line 5.*** ☐ **No.** ***Continue.***	☐ **Yes.** ***Go to line 5.*** ☐ **No.** ***Continue.***
b Was the child permanently and totally disabled during any part of 2007?	☐ **Yes.** ***Continue.*** ☐ **No.** The child is not a qualifying child.	☐ **Yes.** ***Continue.*** ☐ **No.** The child is not a qualifying child.
5 Child's relationship to you (for example, son, daughter, grandchild, niece, nephew, foster child, etc.)		
6 Number of months child lived with you in the United States during 2007 • If the child lived with you for more than half of 2007 but less than 7 months, enter "7." • If the child was born or died in 2007 and your home was the child's home for the entire time he or she was alive during 2007, enter "12."	_______ months *Do not enter more than 12 months.*	_______ months *Do not enter more than 12 months.*

TIP

You may also be able to take the additional child tax credit if your child **(a)** was under age 17 at the end of 2007, **and** **(b)** is a U.S. citizen or resident alien. For more details, see the instructions for line 41 of Form 1040A or line 68 of Form 1040.

For Paperwork Reduction Act Notice, see Form 1040A or 1040 instructions. Cat. No. 13339M **Schedule EIC (Form 1040A or 1040) 2007**

EIC—ELIGIBILITY TOOLS

Not all taxpayers are eligible for EIC. Only those taxpayers who are eligible should claim the credit. It is important to understand the eligibility requirements and claim the EIC on the returns of only those taxpayers who qualify for it. The following resources are available to navigate the complexity of the EIC.

- Publication 4012, *Volunteer Resource Guide,* Tab H
- EIC eligibility questions and worksheet (Form 1040, Form 1040A, and Form 1040EZ instructions)
- Publication 596, *Earned Income Credit*
- EITC Assistant—An interactive tool that shows whether the taxpayer qualifies for EIC and why. Available on www.irs.gov/eitc.

COMMON EIC RETURN ERRORS

1. **Claiming children who are not the taxpayer's EIC-qualifying child.** Make sure the taxpayer's (children) pass the EIC qualifying child tests—relationship, age, and residency. Always verify that the child in question is not the qualifying child of another taxpayer.
2. **Selecting the incorrect filing status.** Married taxpayers filing separately are not eligible for the EIC. Married taxpayers cannot use the single filing status. Married taxpayers who lived apart during the last 6 months of the year may qualify as head of household and take advantage of the credit. Use Publication 4012 Tab B, Decision Tree, to make that determination.
3. **Submitting returns with income errors.** Earned income for EIC purposes includes wages, salaries, and tips (box 1, Form W-2), net earnings from self-employment, and statutory employee gross income (line 1 on Schedule C or Schedule C-EZ). **Statutory employee issues are beyond the scope of VITA/TCE.**
4. **Submitting returns with incorrect social security numbers.** Confirm the accuracy of all names and SSNs shown on the return. The name(s) and number(s) **must match** official government records. Always ask to see the social security cards of the taxpayers and their children.

DISALLOWED EARNED INCOME CREDIT

If a taxpayer's Earned Income Credit was disallowed for any year after 1996 as a result of the deficiency procedures, he or she cannot claim the credit again unless **Form 8862 Information To Claim Earned Income Credit After Disallowance,** is attached to the return, and the taxpayer meets all the EIC requirements. If the credit is claimed without attaching Form 8862, it will be automatically denied, under the math error procedures.

> **ALERT** ⚠
> Remember to ask the taxpayer if the IRS disallowed the EIC in past years.

Excerpt from Form 13614

Part VIII. Earned Income Tax Credit Determination – EITC Eligibility

- ☐ Yes ☐ No 1. Was EITC previously disallowed? (if yes, taxpayer may not be eligible for EITC)
- ☐ Yes ☐ No 2. Based on the interview, is the taxpayer qualified for EITC?

To ensure accurate reporting of the Earned Income Credit, ask the taxpayer the pertinent questions to verify that the EITC was not previously disallowed and the taxpayer is eligible for the credit.

Exception: Form 8862 is not required if the taxpayer's EIC was disallowed or reduced for any year after 2001 as a result of the deficiency procedures solely because a child listed on **Schedule EIC** was determined not to be the taxpayer's qualifying child, and the taxpayer is claiming the credit for the current year without a qualifying child.

A deficiency procedure occurs when the IRS questions the taxpayer's eligibility for the Earned Income Credit for reasons other than a mathematical or clerical error. If the credit was disallowed in the earlier year because of a mathematical or clerical error, Form 8862 should not be completed.

A taxpayer who is determined to have claimed the EIC due to reckless or intentional disregard of rules or regulations is ineligible to claim the EIC for the next two tax years. A taxpayer who is determined to have **fraudulently claimed** the EIC is ineligible to claim the EIC for the next 10 tax years.

Advance Earned Income Credit Payments (AEIC)

> **ALERT**
> Remember to check box 9 of Form W-2 for advance Earned Income Credit.

Some taxpayers may choose to receive advance payments of the EIC. To receive advance payments, the taxpayer must be employed, must expect to have at least one qualifying child for the tax year, must expect to be eligible for the EIC, and must expect his or her earned income and adjusted gross income to be less than the year's maximum earnings eligible for the credit based on the taxpayers' filing status.

To receive advance payments, the taxpayer must give the employer **Form W-5, Earned Income Credit Advance Payment Certificate.** The employer will regularly include part of the credit in the employee's pay. Farm workers are excluded.

Taxpayers can receive only a portion of the credit through advance payments, so the eligibility questions and the EIC Worksheet must be completed when the tax return is prepared to determine the full amount of the credit the taxpayer is entitled to receive.

Employees who receive advance Earned Income Credit payments must file a tax return even if they are not otherwise required to file. If the taxpayer received advance EIC payments in 2007, he or she **must file** a tax return to report the payments. Report the amount on line 61 (Form 1040) or line 36 (Form 1040A). Form 1040EZ cannot be used to report advance payments. The taxpayer's Form W-2 will show the advance EIC amount in box 9.

Exercise 6—Advance EIC Payment

Kyle B. Evans is a single parent. His son Thomas lives with him, and Kyle claims him as a dependent on his tax return. Kyle's social security number is xxx-xx-xxxx. Thomas was born in April 2003. His social security number is xxx-xx-xxxx. Kyle's earned income was $15,500, and his total income and adjusted gross income were $17,200. His filing status is head of household, and he does not itemize deductions. Kyle's child tax credit is $256, and his Earned Income Credit is $2,559. He received $800 in advance Earned Income Credit payments.

A. Compute Kyle's total tax, lines 38 through 63, using the attached page 2 of Form 1040, Exhibit 13.

Form 1040 (2007) Page **2**

Tax and Credits

38	Amount from line 37 (adjusted gross income)	38
39a	Check if: ☐ **You** were born before January 2, 1943, ☐ Blind. ☐ **Spouse** was born before January 2, 1943, ☐ Blind. **Total boxes checked** ▶ **39a**	
b	If your spouse itemizes on a separate return or you were a dual-status alien, see page 34 and check here ▶**39b** ☐	
40	**Itemized deductions** (from Schedule A) **or** your **standard deduction** (see left margin)	40
41	Subtract line 40 from line 38	41
42	If line 38 is $117,300 or less, multiply $3,400 by the total number of exemptions claimed on line 6d. If line 38 is over $117,300, see the worksheet on page XX	42
43	**Taxable income.** Subtract line 42 from line 41. If line 42 is more than line 41, enter -0-	43
44	**Tax** (see page 36). Check if any tax is from: **a** ☐ Form(s) 8814 **b** ☐ Form 4972 **c** ☐ Form(s) 8889	44
45	**Alternative minimum tax** (see page 39). Attach Form 6251	45
46	Add lines 44 and 45 ▶	46
47	Credit for child and dependent care expenses. Attach Form 2441	47
48	Credit for the elderly or the disabled. Attach Schedule R	48
49	Education credits. Attach Form 8863	49
50	Residential energy credits. Attach Form 5695	50
51	Foreign tax credit. Attach Form 1116 if required	51
52	Child tax credit (see page XX). Attach Form 8901 if required	52
53	Retirement savings contributions credit. Attach Form 8880	53
54	Credits from: **a** ☐ Form 8396 **b** ☐ Form 8859 **c** ☐ Form 8839	54
55	Other credits: **a** ☐ Form 3800 **b** ☐ Form 8801 **c** ☐ Form ____	55
56	Add lines 47 through 55. These are your **total credits**	56
57	Subtract line 56 from line 46. If line 56 is more than line 46, enter -0- ▶	57

Standard Deduction for—

- People who checked any box on line 39a or 39b **or** who can be claimed as a dependent, see page 34.
- All others:

Single or Married filing separately, $5,350

Married filing jointly or Qualifying widow(er), $10,700

Head of household, $7,850

Other Taxes

58	Self-employment tax. Attach Schedule SE	58
59	Unreported social security and Medicare tax from: **a** ☐ Form 4137 **b** ☐ Form 8919	59
60	Additional tax on IRAs, other qualified retirement plans, etc. Attach Form 5329 if required	60
61	Advance earned income credit payments from Form(s) W-2, box 9	61
62	Household employment taxes. Attach Schedule H	62
63	Add lines 57 through 62. This is your **total tax** ▶	63

Payments

64	Federal income tax withheld from Forms W-2 and 1099	64
65	2007 estimated tax payments and amount applied from 2006 return	65
66a	**Earned income credit (EIC)**	66a
b	Nontaxable combat pay election ▶ 66b	
67	Excess social security and tier 1 RRTA tax withheld (see page 60)	67
68	Additional child tax credit. Attach Form 8812	68
69	Amount paid with request for extension to file (see page 60)	69
70	Payments from: **a** ☐ Form 2439 **b** ☐ Form 4136 **c** ☐ Form 8885	70
71	Refundable credit for prior year minimum tax from Form 8801, line 27	71
72	Add lines 64, 65, 66a, and 67 through 71. These are your **total payments** ▶	72

If you have a qualifying child, attach Schedule EIC.

Refund

Direct deposit? See page 61 and fill in 74b, 74c, and 74d, or Form 8888.

73	If line 72 is more than line 63, subtract line 63 from line 72. This is the amount you **overpaid**	73
74a	Amount of line 73 you want **refunded to you.** If Form 8888 is attached, check here ▶ ☐	74a
▶ b	Routing number ▶ **c** Type: ☐ Checking ☐ Savings	
▶ d	Account number	
75	Amount of line 73 you want **applied to your 2008 estimated tax** ▶	75

Amount You Owe

76	**Amount you owe.** Subtract line 72 from line 63. For details on how to pay, see page 62 ▶	76
77	Estimated tax penalty (see page 62)	77

Third Party Designee

Do you want to allow another person to discuss this return with the IRS (see page 63)? ☐ **Yes.** Complete the following. ☐ **No**

Designee's name ▶ Phone no. ▶ ( ) Personal identification number (PIN) ▶

Sign Here

Joint return? See page 17. Keep a copy for your records.

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.

Your signature	Date	Your occupation	Daytime phone number ( )
Spouse's signature. If a joint return, **both** must sign.	Date	Spouse's occupation	

Paid Preparer's Use Only

Preparer's signature	Date	Check if self-employed ☐	Preparer's SSN or PTIN
Firm's name (or yours if self-employed), address, and ZIP code		EIN	
		Phone no. ( )	

Form **1040** (2007)

Printed on recycled paper

TaxWise® Hints

1. When completing the dependent section on the main information sheet, always check the EIC boxes for the taxpayer's youngest two dependents. The boxes need to be checked in all cases so that the software can make the correct calculation based on the answers provided on the EIC Worksheet.
2. List dependents from youngest to oldest on the main information screen. This may save keystrokes in a situation where a child is 19 or older as the data for the first two children flows through to the worksheet.

Quality Review (QR)—Earned Income Credit

Use **Form 8158, Quality Review Sheet,** or your site's approved equivalent form to review all returns prepared. Apply the quality review tools in combination with the Intake/Interview Sheet and all the source documents to the returns you prepare to ensure quality and accuracy for every taxpayer.

Consider each item on the Quality Review Sheet that applies to the taxpayer's situation to confirm that all the necessary questions and issues have been addressed. If items are incorrect or incomplete, revisit the issues and make corrections to the return, as needed.

Excerpt from Form 8158

Yes	No	
☐	☐	All **adjustments, deductions and credits** indicated on the intake/interview sheet and supporting documents are included on the return.

To ensure accurate reporting of adjustments, deductions, and credits, a conversation with the taxpayer is necessary to verify that the information on the Intake/Interview Sheet and on the taxpayer's supporting documents is included on the return.

Confirm that all potential adjustments, deductions, and credits have been discussed with the taxpayer and are shown on the return, if applicable.

▶▶ Summing Up This Lesson ◀◀

- EIC is a tax credit for qualified taxpayers. Eligible taxpayers must file a tax return to claim the credit.
- When the credit exceeds the amount of tax owed, it can result in a tax refund.
- The taxpayer may be entitled to the credit even if he or she does not have a filing requirement. The taxpayer must have earned income of at least $1.
- There are specific eligibility rules for all taxpayers: taxpayers with a qualifying child, and taxpayers without a qualifying child. Review the eligibility requirements table in Publication 4012, Tab H.
- EIC is not for everyone; the taxpayer must qualify for the credit.
- Some of the most common reasons for disallowance are:
  - Claiming the credit with a child who is not the taxpayer's qualifying child.
  - Married taxpayers filing as single or head of household.
  - Reporting income incorrectly.
  - Mismatched or incorrect names and/or incorrect social security numbers.
- Use Publication 4012, the EIC worksheets, Publication 596, and other tools when assisting taxpayers in claiming the EIC.

Exercise 1

A. No; to be a qualifying child, the child must live with the taxpayer more than half of the year.

B. Neither Donna nor Doug can claim the credit; in order to claim the Earned Income Credit, married taxpayers living together must file a joint return.

C. Tina is the custodial parent; she can give Joe one or both of the children for the dependency exemption and the child tax credit only. Tina would be entitled to claim the Earned Income Credit and any other pertinent issues relative to the children, provided she and the children live alone.

D. Yes. He is between 25 and 65; his earned income is less than $12,590; he cannot be claimed as a dependent, and he is not a qualifying child of another person.

E. No; to be a qualifying child, a married child must generally be eligible to be claimed as a dependent by the taxpayer.

F. Numbers 4, 5, and 7 should be circled.

Exercise 2

C. Doris gave the exemption and child tax credit to the noncustodial parent but Olivia only qualifies Doris for the EIC.

Exercise 3

D. Henry and Jane were not separated in any capacity (legally or under an agreement) for the last six months of the year. Therefore, neither can qualify for head of household filing status nor the Earned Income Credit for Jenny. If they do not file a joint return, they both must use the married filing separately filing status.

Exercise 4

A. $2,929

B. $2,853

C. See following pages for completed forms.

Exercise 5

See following pages for completed forms.

Exercise 6

See following pages for completed forms.

Exercise 4(C) **Sam U. and Robin O.'s Eligibility Questions, page 1**

Form 1040—Lines 66a and 66b

Lines 66a and 66b—Earned Income Credit (EIC)

What Is the EIC?

The EIC is a credit for certain people who work. The credit may give you a refund even if you do not owe any tax.

To Take the EIC:

- Follow the steps below.
- Complete the worksheet that applies to you or let the IRS figure the credit for you.
- If you have a qualifying child, complete and attach Schedule EIC.

For help in determining if you are eligible for the EIC, go to *www.irs.gov/eitc* and click on "EITC Assistant." This service is available in English and Spanish.

CAUTION *If you take the EIC even though you are not eligible and it is determined that your error is due to reckless or intentional disregard of the EIC rules, you will not be allowed to take the credit for 2 years even if you are otherwise eligible to do so. If you fraudulently take the EIC, you will not be allowed to take the credit for 10 years. See* Form 8862, who must file, *on page 47. You may also have to pay penalties.*

Step 1 All Filers

1. If, in 2007:
   - 2 children lived with you, is the amount on Form 1040, line 38, less than $37,783 ($39,783 if married filing jointly)?
   - 1 child lived with you, is the amount on Form 1040, line 38, less than $33,241 ($35,241 if married filing jointly)?
   - No children lived with you, is the amount on Form 1040, line 38, less than $12,590 ($14,590 if married filing jointly)?

   ☑ **Yes.** Continue ☐ **No.** STOP You cannot take the credit.

2. Do you, and your spouse if filing a joint return, have a social security number that allows you to work or is valid for EIC purposes (see page 47)?

   ☑ **Yes.** Continue ☐ **No.** STOP You cannot take the credit. Enter "No" on the dotted line next to line 66a.

3. Is your filing status married filing separately?

   ☐ **Yes.** STOP You cannot take the credit. ☑ **No.** Go to question 4.

4. Are you filing Form 2555 or 2555-EZ (relating to foreign earned income)?

   ☐ **Yes.** STOP You cannot take the credit. ☑ **No.** Continue

5. Were you or your spouse a nonresident alien for any part of 2007?

   ☐ **Yes.** See *Nonresident aliens* on page 47. ☐ **No.** Go to Step 2.

Step 2 Investment Income

1. Add the amounts from Form 1040:

Line 8a		$50
Line 8b	+	
Line 9a	+	
Line 13*	+	
Investment Income	=	$50

*If line 13 is a loss, enter -0-.

2. Is your investment income more than $2,900?

   ☐ **Yes.** Continue ☑ **No.** Skip question 3; go to question 4.

3. Are you filing Form 4797 (relating to sales of business property)?

   ☐ **Yes.** See *Form 4797 filers* on page 47. ☐ **No.** STOP You cannot take the credit.

4. Do any of the following apply for 2007?
   - You are filing Schedule E.
   - You are reporting income or a loss from the rental of personal property not used in a trade or business.
   - You are reporting income on Form 1040, line 21, from Form 8814 (relating to election to report child's interest and dividends).

   ☐ **Yes.** You must use Worksheet 1 in Pub. 596 to see if you can take the credit. ☑ **No.** Go to Step 3.

Exercise 4(C) **Sam U. and Robin O.'s Eligibility Questions, page 2**

Form 1040—Lines 66a and 66b

Continued from page 44

Step 3 Qualifying Child

A qualifying child for the EIC is a child who is your...

Son, daughter, stepchild, foster child, brother, sister, stepbrother, stepsister, or a descendant of any of them (for example, your grandchild, niece, or nephew)

AND

was ...

Under age 19 at the end of 2007

or

Under age 24 at the end of 2007 and a student (see page 47)

or

Any age and permanently and totally disabled (see page 47)

AND

who...

Lived with you in the United States for more than half of 2007.
If the child did not live with you for the required time, see *Exception to time lived with you* on page 47.

CAUTION *If the child meets the conditions to be a qualifying child of any other person (other than your spouse if filing a joint return) for 2007, or the child was married, see page 47.*

1. Do you have at least one child who meets the conditions to be your qualifying child?
   - ☑ **Yes.** The child must have a valid social security number as defined on page 47 unless the child was born and died in 2007. Go to question 2.
   - ☐ **No.** Skip question 2; go to Step 4.

2. Could you, or your spouse if filing a joint return, be a qualifying child of another person in 2007?
   - ☐ **Yes.** STOP You cannot take the credit. Enter "No" on the dotted line next to line 66a.
   - ☑ **No.** Skip Step 4; go to Step 5 on page 46.

Step 4 Filers Without a Qualifying Child

1. Is the amount on Form 1040, line 38, less than $12,590 ($14,590 if married filing jointly)?
   - ☐ **Yes.** Continue
   - ☐ **No.** STOP You cannot take the credit.

2. Could you, or your spouse if filing a joint return, be a qualifying child of another person in 2007?
   - ☐ **Yes.** STOP You cannot take the credit. Enter "No" on the dotted line next to line 66a.
   - ☐ **No.** Continue

3. Can you, or your spouse if filing a joint return, be claimed as a dependent on someone else's 2007 tax return?
   - ☐ **Yes.** STOP You cannot take the credit.
   - ☐ **No.** Continue

4. Were you, or your spouse if filing a joint return, at least age 25 but under age 65 at the end of 2007?
   - ☐ **Yes.** Continue
   - ☐ **No.** STOP You cannot take the credit.

5. Was your home, and your spouse's if filing a joint return, in the United States for more than half of 2007? Members of the military stationed outside the United States, see page 47 before you answer.
   - ☐ **Yes.** Go to Step 5 on page 46.
   - ☐ **No.** STOP You cannot take the credit. Enter "No" on the dotted line next to line 66a.

Exercise 4(C) **Sam U. and Robin O.'s Eligibility Questions, page 3**

Form 1040—Lines 66a and 66b

Continued from page 45

Step 5 **Earned Income**

1. Are you filing Schedule SE because you were a member of the clergy or you had church employee income of $108.28 or more?

   ☐ **Yes.** See *Clergy* or *Church employees*, whichever applies, on this page.
   ☑ **No.** Continue

2. Figure earned income:

   Form 1040, line 7 $14,950

   Subtract, if included on line 7, any:
   - Taxable scholarship or fellowship grant not reported on a Form W-2.
   - Amount received for work performed while an inmate in a penal institution (enter "PRI" and the amount subtracted on the dotted line next to Form 1040, line 7).
   - Amount received as a pension or annuity from a nonqualified deferred compensation plan or a nongovernmental section 457 plan (enter "DFC" and the amount subtracted on the dotted line next to Form 1040, line 7). This amount may be shown in box 11 of Form W-2. If you received such an amount but box 11 is blank, contact your employer for the amount received as a pension or annuity. − ______

   Add all of your nontaxable combat pay if you elect to include it in earned income. Also enter this amount on Form 1040, line 66b. See *Combat pay, nontaxable* on this page. + 0

   CAUTION *Electing to include nontaxable combat pay may increase or decrease your EIC. Figure the credit with and without your nontaxable combat pay before making the election.*

   Earned Income = $14,950

3. Were you self-employed at any time in 2007, or are you filing Schedule SE because you were a member of the clergy or you had church employee income, or are you filing Schedule C or C-EZ as a statutory employee?

   ☐ **Yes.** Skip question 4 and Step 6; go to Worksheet B on page 49.
   ☑ **No.** Continue

4. If you have:
   - 2 or more qualifying children, is your earned income less than $37,783 ($39,783 if married filing jointly)?
   - 1 qualifying child, is your earned income less than $33,241 ($35,241 if married filing jointly)?
   - No qualifying children, is your earned income less than $12,590 ($14,590 if married filing jointly)?

   ☑ **Yes.** Go to Step 6.
   ☐ **No.** STOP You cannot take the credit.

Step 6 **How To Figure the Credit**

1. Do you want the IRS to figure the credit for you?

   ☐ **Yes.** See *Credit figured by the IRS* below.
   ☑ **No.** Go to Worksheet A on page 48.

Definitions and Special Rules

(listed in alphabetical order)

Adopted child. An adopted child is always treated as your own child. An adopted child includes a child lawfully placed with you for legal adoption.

Church employees. Determine how much of the amount on Form 1040, line 7, was also reported on Schedule SE, line 5a. Subtract that amount from the amount on Form 1040, line 7, and enter the result in the first space of Step 5, line 2. Be sure to answer "Yes" to question 3 in Step 5.

Clergy. The following instructions apply to ministers, members of religious orders who have not taken a vow of poverty, and Christian Science practitioners. If you are filing Schedule SE and the amount on line 2 of that schedule includes an amount that was also reported on Form 1040, line 7:

1. Enter "Clergy" on the dotted line next to Form 1040, line 66a.
2. Determine how much of the amount on Form 1040, line 7, was also reported on Schedule SE, line 2.
3. Subtract that amount from the amount on Form 1040, line 7. Enter the result in the first space of Step 5, line 2.
4. Be sure to answer "Yes" to question 3 in Step 5.

Combat pay, nontaxable. If you were a member of the U.S. Armed Forces who served in a combat zone, certain pay is excluded from your income. See *Combat Zone Exclusion* in Pub. 3. You can elect to include this pay in your earned income when figuring the EIC. The amount of your nontaxable combat pay should be shown in box 12 of Form(s) W-2 with code Q. If you are filing a joint return and both you and your spouse received nontaxable combat pay, you can each make your own election.

Credit figured by the IRS. To have the IRS figure your EIC:

1. Enter "EIC" on the dotted line next to Form 1040, line 66a.
2. Be sure you enter the nontaxable combat pay you elect to include in earned income on Form 1040, line 66b. See *Combat pay, nontaxable* above.
3. If you have a qualifying child, complete and attach Schedule EIC. If your EIC for a year after 1996 was reduced or disallowed, see *Form 8862, who must file* on page 47.

Need more information or forms? See page 80.

Worksheet A—Earned Income Credit (EIC)—Lines 66a and 66b *Keep for Your Records*

Before you begin: √ Be sure you are using the correct worksheet. Use this worksheet only if you answered "No" to Step 5, question 3, on page 48. Otherwise, use Worksheet B that begins on page 51.

Part 1

All Filers Using Worksheet A

1. Enter your earned income from Step 5 on page 48. | **1** | 14,950 |

2. Look up the amount on line 1 above in the EIC Table on pages 53–59 to find the credit. Be sure you use the correct column for your filing status and the number of children you have. Enter the credit here. | **2** | 2,853 |

If line 2 is zero, STOP You cannot take the credit. Enter "No" on the dotted line next to line 66a.

3. Enter the amount from Form 1040, line 38. | **3** | 15,000 |

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. If you have:

- No qualifying children, is the amount on line 3 less than $7,000 ($9,000 if married filing jointly)?
- 1 or more qualifying children, is the amount on line 3 less than $15,400 ($17,400 if married filing jointly)?

☑ **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 53–59 to find the credit. Be sure you use the correct column for your filing status and the number of children you have. Enter the credit here. | **5** | |

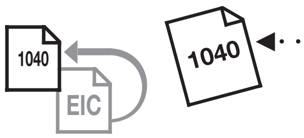
Look at the amounts on lines 5 and 2. Then, enter the **smaller** amount on line 6.

Part 3

Your Earned Income Credit

6. This is your earned income credit. | **6** | 2,853 |

Enter this amount on Form 1040, line 66a.



Reminder—

√ If you have a qualifying child, complete and attach Schedule EIC.

CAUTION

If your EIC for a year after 1996 was reduced or disallowed, see page 49 to find out if you must file Form 8862 to take the credit for 2007.

Earned Income Credit

Answers to Exercises

Exercise 5 — **Sam U. and Robin O.'s Schedule EIC**

SCHEDULE EIC (Form 1040A or 1040)

Department of the Treasury
Internal Revenue Service (99)

Earned Income Credit

Qualifying Child Information

Complete and attach to Form 1040A or 1040 only if you have a qualifying child.

1040A
1040
EIC

OMB No. 1545-0074

2007

Attachment Sequence No. 43

Name(s) shown on return	Your social security number
Sam U. & Robin O. Bell	XXX XX XXX

Before you begin: See the instructions for Form 1040A, lines 40a and 40b, or Form 1040, lines 66a and 66b, to make sure that **(a)** you can take the EIC, and **(b)** you have a qualifying child.

CAUTION

- 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.
- Be sure the child's name on line 1 and social security number (SSN) on line 2 agree with the child's social security card. Otherwise, at the time we process your return, we may reduce or disallow your EIC. If the name or SSN on the child's social security card is not correct, call the Social Security Administration at 1-800-772-1213.

Qualifying Child Information	**Child 1**	**Child 2**
1 Child's name If you have more than two qualifying children, you only have to list two to get the maximum credit.	First name Last name Robert S. Bell	First name Last name
2 Child's SSN The child must have an SSN as defined on page 43 of the Form 1040A instructions or page 49 of the Form 1040 instructions unless the child was born and died in 2007. If your child was born and died in 2007 and did not have an SSN, enter "Died" on this line and attach a copy of the child's birth certificate.	xxx xx xxxx	
3 Child's year of birth	Year 1 9 9 9 *If born after 1988, skip lines 4a and 4b; go to line 5.*	Year ____ ____ ____ ____ *If born after 1988, skip lines 4a and 4b; go to line 5.*
4 If the child was born before 1989—		
a Was the child under age 24 at the end of 2007 and a student?	☐ **Yes.** ***Go to line 5.*** ☐ **No.** ***Continue.***	☐ **Yes.** ***Go to line 5.*** ☐ **No.** ***Continue.***
b Was the child permanently and totally disabled during any part of 2007?	☐ **Yes.** ***Continue.*** ☐ **No.** The child is not a qualifying child.	☐ **Yes.** ***Continue.*** ☐ **No.** The child is not a qualifying child.
5 Child's relationship to you (for example, son, daughter, grandchild, niece, nephew, foster child, etc.)	Son	
6 Number of months child lived with you in the United States during 2007 • If the child lived with you for more than half of 2007 but less than 7 months, enter "7." • If the child was born or died in 2007 and your home was the child's home for the entire time he or she was alive during 2007, enter "12."	12 months *Do not enter more than 12 months.*	______ months *Do not enter more than 12 months.*

TIP

You may also be able to take the additional child tax credit if your child **(a)** was under age 17 at the end of 2007, **and (b)** is a U.S. citizen or resident alien. For more details, see the instructions for line 41 of Form 1040A or line 68 of Form 1040.

For Paperwork Reduction Act Notice, see Form 1040A or 1040 instructions. Cat. No. 13339M **Schedule EIC (Form 1040A or 1040) 2007**

Exercise 6 — **Kyle B. Evans' 1040, page 2**

Form 1040 (2007) — Page **2**

Tax and Credits

Standard Deduction for—
- People who checked any box on line 39a or 39b **or** who can be claimed as a dependent, see page 34.
- All others:

Single or Married filing separately, $5,350

Married filing jointly or Qualifying widow(er), $10,700

Head of household, $7,850

38	Amount from line 37 (adjusted gross income)		17,200
39a	Check if: ☐ **You** were born before January 2, 1943, ☐ Blind. ☐ **Spouse** was born before January 2, 1943, ☐ Blind. **Total boxes checked** ▶ 39a		
b	If your spouse itemizes on a separate return or you were a dual-status alien, see page 34 and check here ▶39b ☐		
40	**Itemized deductions** (from Schedule A) **or** your **standard deduction** (see left margin)		7,850
41	Subtract line 40 from line 38		9,350
42	If line 38 is $117,300 or less, multiply $3,400 by the total number of exemptions claimed on line 6d. If line 38 is over $117,300, see the worksheet on page XX		6,800
43	**Taxable income.** Subtract line 42 from line 41. If line 42 is more than line 41, enter -0-		2,550
44	**Tax** (see page 36). Check if any tax is from: **a** ☐ Form(s) 8814 **b** ☐ Form 4972 **c** ☐ Form(s) 8889		256
45	**Alternative minimum tax** (see page 39). Attach Form 6251		
46	Add lines 44 and 45 ▶		
47	Credit for child and dependent care expenses. Attach Form 2441		
48	Credit for the elderly or the disabled. Attach Schedule R		
49	Education credits. Attach Form 8863		
50	Residential energy credits. Attach Form 5695		
51	Foreign tax credit. Attach Form 1116 if required		
52	Child tax credit (see page XX). Attach Form 8901 if required	256	
53	Retirement savings contributions credit. Attach Form 8880		
54	Credits from: **a** ☐ Form 8396 **b** ☐ Form 8859 **c** ☐ Form 8839		
55	Other credits: **a** ☐ Form 3800 **b** ☐ Form 8801 **c** ☐ Form____		
56	Add lines 47 through 55. These are your **total credits**		256
57	Subtract line 56 from line 46. If line 56 is more than line 46, enter -0- ▶		0

Other Taxes

58	Self-employment tax. Attach Schedule SE		
59	Unreported social security and Medicare tax from: **a** ☐ Form 4137 **b** ☐ Form 8919		
60	Additional tax on IRAs, other qualified retirement plans, etc. Attach Form 5329 if required		
61	Advance earned income credit payments from Form(s) W-2, box 9		800
62	Household employment taxes. Attach Schedule H		
63	Add lines 57 through 62. This is your **total tax** ▶		800

Payments

If you have a qualifying child, attach Schedule EIC.

64	Federal income tax withheld from Forms W-2 and 1099		
65	2007 estimated tax payments and amount applied from 2006 return		
66a	**Earned income credit (EIC)**		
b	Nontaxable combat pay election ▶ 66b		
67	Excess social security and tier 1 RRTA tax withheld (see page 60)		
68	Additional child tax credit. Attach Form 8812		
69	Amount paid with request for extension to file (see page 60)		
70	Payments from: **a** ☐ Form 2439 **b** ☐ Form 4136 **c** ☐ Form 8885		
71	Refundable credit for prior year minimum tax from Form 8801, line 27		
72	Add lines 64, 65, 66a, and 67 through 71. These are your **total payments** ▶		

Refund

Direct deposit? See page 61 and fill in 74b, 74c, and 74d, or Form 8888.

73	If line 72 is more than line 63, subtract line 63 from line 72. This is the amount you **overpaid**		
74a	Amount of line 73 you want **refunded to you.** If Form 8888 is attached, check here ▶ ☐		
▶ b	Routing number ▶ **c** Type: ☐ Checking ☐ Savings		
▶ d	Account number		
75	Amount of line 73 you want **applied to your 2008 estimated tax** ▶		

Amount You Owe

76	**Amount you owe.** Subtract line 72 from line 63. For details on how to pay, see page 62 ▶		
77	Estimated tax penalty (see page 62)		

Third Party Designee

Do you want to allow another person to discuss this return with the IRS (see page 63)? ☐ **Yes.** Complete the following. ☐ **No**

Designee's name ▶ Phone no. ▶ ( ) Personal identification number (PIN) ▶

Sign Here

Joint return? See page 17. Keep a copy for your records.

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.

Your signature | Date | Your occupation | Daytime phone number ( )

Spouse's signature. If a joint return, **both** must sign. | Date | Spouse's occupation

Paid Preparer's Use Only

Preparer's signature | Date | Check if self-employed ☐ | Preparer's SSN or PTIN

Firm's name (or yours if self-employed), address, and ZIP code | EIN | Phone no. ( )

Form **1040** (2007)

Printed on recycled paper

STUDENT NOTES

Child Tax Credit

Lesson 6

Introduction and Objectives

In this lesson you will learn about the child tax credit. This credit is unique because it can be both nonrefundable and refundable. The Child Tax Credit is a credit that may reduce tax by as much as $1000 for each qualifying child. The Additional Child Tax Credit is a credit a taxpayer may be able to claim if the taxpayer is not able to claim the full amount of the Child Tax Credit. This lesson will discuss who qualifies for the credit and how to calculate the credit.

After completing this lesson you should be able to:

- Determine who is eligible to claim the Child Tax Credit and the Additional Child Tax Credit.
- Determine the amount of the Child Tax Credit and the Additional Child Tax Credit.

Note: Additional information about the child tax credit is available in Publication 972, *Child Tax Credit*.

Alert

This lesson contains basic tax law and is *required training* for all volunteers.

Intake and Interview Process Form 13614—Child Tax Credit

Use **Form 13614, Intake and Interview Sheet,** to engage the taxpayer in preparing an accurate return. Use the Intake and Interview Sheet as a starting point for a comprehensive interaction with the taxpayer, in combination with all the source documents provided by the taxpayer, to assure quality and accuracy on each return.

Confirm each item on Form 13614 (or similar tool used at your site) to make sure you and the taxpayer have considered all the necessary information. Ensure that all questions and issues have been addressed. If items are incorrect or incomplete, revisit the issue and make corrections to the return, as needed.

To ensure accurate reporting of the child tax credit, verify that the child is a qualifying child of the taxpayer and that the birth date of the child is correct.

Alert

The requirements for a "qualifying child" for purposes of the child tax credit differ from those for a "qualifying child" for purposes of the earned income credit.

ALERT

A taxpayer may be able to claim the child tax credit for a qualifying child who is not his or her dependent. When this occurs Form 8901, *Information on Qualifying Children Who Are Not Dependents (For Child Tax Credit Only),* must be completed and attached to Form 1040 or Form 1040A.

CHILD TAX CREDIT

A taxpayer can claim a child tax credit for each of the taxpayer's qualifying children. The maximum child tax credit is $1,000 per child for 2007. The credit can be claimed on either Form 1040 or Form1040A.

Qualifying Child

A qualifying child (is):

- The taxpayer's child, including son or daughter, adopted child, stepson or stepdaughter, eligible foster child (any child placed with the taxpayer by an authorized placement agency or by order of the court), brother or sister, stepbrother or stepsister, descendent of one of the above-listed relatives (including a grandchild, a niece, or nephew);
- Under age 17 at the end of 2007,
- A United States citizen, United States national, or resident of the United States,

Note: A United States national is an individual who, although not a United States citizen, owes his or her allegiance to the United States. United States nationals include American Samoans and Northern Mariana Islanders who chose to become United States nationals instead of United States citizens.

- Did not provide over half of his or her own support during 2007, and
- Lived with the taxpayer for more than half of 2007.

There are some exceptions to the **"time lived with"** requirement. A child is considered to have lived with the taxpayer for all of 2007 if:

- The child was born or died in 2007 and whose only residence was with the taxpayer, or
- The child was kidnapped under the following circumstances:
  - In the year the kidnapping occurred, the kidnapped child is presumed by law enforcement to have been taken by someone who is not a family member, and
  - The kidnapped child lived with the taxpayer for more than half of the portion of the year prior to the kidnapping.
- The child who meets the rules to be treated as a child of divorced, separated or never married parents.

Note: Temporary absences for special circumstances, such as school, vacation, medical care, military service, or detention in a juvenile facility, count as time lived at home.

Children of Divorced or Separated or Never Married Parents

A child will be treated as being the qualifying child or qualifying relative of his or her **noncustodial parent** (the parent with whom the child lived with for the lesser part of 2007) if all of the following apply:

1. The parents are divorced, legally separated, separated under a written separation agreement, or lived apart at all times during the last 6 months of 2007.
2. The child received over half of his or her support for 2007 from the parents (without regard to the rules on Multiple Support Agreements). Support of a child received from a parent's spouse is treated as provided by the parent.
3. The child is in custody of one or both of the parents for more than half of 2007.
4. Either of the following applies:
    a. The custodial parent signs Form 8332 or a substantially similar statement that he or she will not claim the child as a dependent for 2007, and the noncustodial parent attaches the form or statement to his or her return.
    b. A decree of divorce or separate maintenance or written separation agreement between the parents that applies to 2007 provides that the noncustodial parent can claim the child as a dependent.

If the rules above apply and this child would otherwise be the qualifying child of more than one person, then

- Only the noncustodial parent can claim the child for purposes of the Dependency Exemption and the Child Tax Credits.
- For Head of Household Filing Status, the Credit for Child and Dependent Care Expenses, and the Earned Income Credit (EIC), only one person can claim these three benefits. No other person can claim any of these three benefits unless he or she has a different qualifying child. If the taxpayer and any other person claim the child as a qualifying child, the IRS will apply the rules shown under **Qualifying Child of More Than One Person** (see below). If the taxpayer will not be taking the EIC with a qualifying child because of these rules, write "No" on the dotted line next to line 66a.

Example 1

Mary and Ralph got a divorce in 2002. They have one child together, Amy, who lives with Mary. All are U.S. citizens and have SSNs. Mary and Ralph provide more than half of Amy's support. Mary's AGI is $31,000 and Ralph's AGI is $39,000. Amy is 12 and single. The divorce decree does not state who can claim the child.

If Mary signs Form 8332, the Dependency Exemption and the Child Tax Credit is given up to Ralph, the non-custodial parent. However, Mary can still claim the Earned Income Credit, Head of Household, and Child and Dependent Care Credit based on Amy, assuming she otherwise qualifies for them.

Qualifying Child of More Than One Person

If the child is the qualifying child of more than one person, only one person can claim the child as a qualifying child for all of the following tax benefits, unless the rules for Children of Divorced, Separated, or Never Married Parents apply:

1. Dependency Exemption
2. Child Tax Credits
3. Head of Household Filing Status
4. Credit for Child and Dependent Care Expenses
5. Earned Income Credit

No other person can claim any of the five tax benefits listed above unless he or she has a different qualifying child. If the taxpayer and any other person claim the child as a qualifying child, the IRS will apply the following rules:

- If only one of the persons is the child's parent, the child will be treated as the qualifying child of the parent.
- If two of the persons are the child's parents, the child will be treated as the qualifying child of the parent with whom the child lived for the longer period of time in 2007. If the child lived with each parent for the same amount of time, the child will be treated as the qualifying child of the parent who had the higher adjusted gross income (AGI) for 2007.
- If none of the persons are the child's parent, the child will be treated as the qualifying child of the person who had the highest AGI for 2007.

The taxpayer must provide the name and identification number (usually a social security number) of each qualifying child on his or her tax return.

Example 2

Larry and Denise were separated in October 2007. They have 2 children, Mike 7, and Meredith 4. Both of the children are U.S. citizens and have SSNs. Mike and Denise together paid more than half of the support of the children. The children lived with Denise all year. There is no legal separation or written agreement that states who is entitled to the children's exemptions. Larry thinks that instead of fighting, they should each claim one of the children on their returns so they will each get the $1,000 Child Tax Credit. Larry's AGI is $29,000 and Denise has an AGI of $37,000. At the end of the year since they were still not divorced, not legally separated, nor under a separation agreement, the rules for children of divorced or separated parents do not apply. Therefore the parents need to decide who should claim the children.

Limits on Credit

The amount of a taxpayer's child tax credit depends on the taxpayer's modified adjusted gross income (AGI) and the taxpayer's filing status.

Modified AGI

The credit begins to phase out if the taxpayer's modified AGI is above a certain amount (Table 1). For most taxpayers, modified AGI is generally the same as AGI. For 2007, AGI is shown on line 21 of Form 1040A and on line 37 of Form 1040.

Table 1: Child Tax Credit Threshold Modified AGI Amounts for Claiming Child Tax Credit

Filing Status	Amount
Married filing jointly	$110,000
Qualifying widow(er)	$75,000
Head of household	$75,000
Single	$75,000
Married filing separately	$55,000

Note: If you are using TaxWise® to prepare the tax return, the calculation of the Child Tax Credit is done for you.

Before you can figure a taxpayer's credit amount for the year, you must have the taxpayer answer certain questions (Exhibit 1) to see if you must use the worksheet in Publication 972, *Child Tax Credit*. If you do not need to use Publication 972, you can use the shorter Child Tax Credit Worksheet (Exhibit 2) in the Form 1040 or Form 1040A instructions.

Example 3

Curtis and Twylette Drake are married filing a joint return and have two dependent children under age 17. The children are qualifying children for purposes of claiming the child tax credit. Curtis and Twylette have a modified AGI of $38,000. Their tax on Form 1040, line 46 for 2007 is $1,453. Curtis and Twylette need to answer questions to determine if they must use Publication 972 (Exhibit 1). The completed Child Tax Credit Worksheet (Exhibit 2) shows that their credit is $1,453. Their modified AGI is less than the phaseout amount for their filing status ($110,000). They do not need to use Publication 972 to compute their child tax credit.

Line 52—Child Tax Credit

Three Steps To Take the Child Tax Credit!

Step 1. Make sure you have a qualifying child for the child tax credit (see the instructions for line 6c).

Step 2. Make sure that for each qualifying child you either checked the box on Form 1040, line 6c, column (4), or completed Form 8901 (if the child is not your dependent).

Step 3. Answer the questions on this page to see if you can use the worksheet on page 40 to figure your credit or if you must use Pub. 972.

Questions **Who Must Use Pub. 972**

1. Is the amount on Form 1040, line 38, 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

   ☐ **Yes.** STOP You must use Pub. 972 to figure your credit.

   ☑ **No.** Go to question 2.

2. Are you claiming either of the following credits?
   - Retirement savings contributions credit, Form 8880.
   - Adoption credit, Form 8839.

   ☐ **Yes.** STOP You must use Pub. 972 to figure your child tax credit. You will also need the form(s) listed above for any credit(s) you are claiming.

   ☑ **No.** Continue

3. 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).

   ☐ **Yes.** STOP You must use Pub. 972 to figure your credit.

   ☑ **No.** Use the worksheet on page 40 to figure your credit.

 Need more information or forms? See page 80.

Child Tax Credit Worksheet—Line 52

Keep for Your Records

CAUTION

- To be a qualifying child for the child tax credit, the child must be **under age 17** at the end of 2007 and meet the other requirements listed on page 19.
- **Do not** use this worksheet if you answered "Yes" to question 1, 2, or 3 on page 42. Instead, use Pub. 972.
- If you are claiming the mortgage interest credit or District of Columbia first-time homebuyer credit, complete the applicable credit form (Form 8396 or Form 8859, respectively) before you start this worksheet.

1. Number of qualifying children: 2 × $1,000. Enter the result. — **1** 2,000

2. Enter the amount from Form 1040, line 46. — **2** 1,453

3. Add the amounts from Form 1040:

Line 47 ______

Line 48 + ______

Line 49 + ______

Line 50 + ______

Line 51 + ______

Line 54* + ______ Enter the total. — **3** 0

*Include only the amounts, if any, from Form 8396, line 13, and Form 8859, line 13.

4. Are the amounts on lines 2 and 3 the same?

☐ **Yes.** STOP You cannot take this credit because there is no tax to reduce. However, you may be able to take the **additional child tax credit.** See the **TIP** below.

☑ **No.** Subtract line 3 from line 2. — **4** 1,453

5. Is the amount on line 1 more than the amount on line 4?

☑ **Yes.** Enter the amount from line 4. Also, you may be able to take the **additional child tax credit.** See the **TIP** below.

☐ **No.** Enter the amount from line 1.

This is your child tax credit. — **5** 1,453

Enter this amount on Form 1040, line 52.

1040

TIP You may be able to take the **additional child tax credit** on Form 1040, line 68, if you answered "Yes" on line 4 **or** line 5 above.

- First, complete your Form 1040 through line 67.
- Then, use Form 8812 to figure any additional child tax credit.

Checking Your Withholding

The child tax credit decreases the tax liability dollar for dollar, but not below zero. If the taxpayer is having too much tax withheld and he or she prefers to have the money during the year, the taxpayer may be able to reduce his or her withholding. A new Form W-4, *Employee's Withholding Allowance Certificate,* should be completed and given to his or her employer.

ADDITIONAL CHILD TAX CREDIT

Taxpayers must use Form 8812, *Additional Child Tax Credit,* to claim the additional child tax credit. This credit is based on 15 percent of the taxpayer's earned income in excess of $11,750.

If you are preparing the return using TaxWise®, the software will figure the additional child tax credit. If not, then, before figuring the additional child tax credit, figure the taxpayer's:

- Unused nonrefundable child tax credit amount,
- Total social security and Medicare taxes withheld (Form W-2, *Wage and Tax Statement,* boxes 4 and 6), if the taxpayer has three or more qualifying children,
- Earned income credit amount,
- Total earned income (back of Form 8812), and
- For 1040 filers, one-half of self-employment tax paid (Form 1040, line 27).

The taxpayer will need to seek the assistance of a tax professional if he or she has:

- Excess social security and Railroad Retirement Tax Act (RRTA) tax withheld (more than one employer and gross income in excess of $97,500), or
- Social security and Medicare tax on unreported tip income.

If the taxpayer (or spouse, if married filing a joint return) received nontaxable combat pay and the taxpayer did not elect to include this pay in computing the EIC (or the taxpayer is not claiming the EIC), the taxpayer **must** include this amount in the total on lines 4a and 4b of Form 8812, *Additional Child Tax Credit.*

POTENTIAL PITFALLS

When figuring the additional child tax credit, you must use the back of Form 8812 to determine earned income (line 4a).

Example 4

Dan Glendale (SSN xxx-xx-xxxx) is filing Form 1040. His filing status is head of household for 2007. He has three dependent children, all of whom are qualifying children for purposes of the child tax credit. Dan's earned income (and adjusted gross income) is $35,375, his tax is $1,656, Social Security/Medicare taxes are $2,706, and his earned income credit is $416. Based on this information, Dan's child tax credit is $1,656 (Exhibit 4) and his additional child tax credit is $1,344. Exhibits 5 and 6 illustrate how Dan's additional child tax credit was figured.

Line 52—Child Tax Credit

Three Steps To Take the Child Tax Credit!

Step 1. Make sure you have a qualifying child for the child tax credit (see the instructions for line 6c).

Step 2. Make sure that for each qualifying child you either checked the box on Form 1040, line 6c, column (4), or completed Form 8901 (if the child is not your dependent).

Step 3. Answer the questions on this page to see if you can use the worksheet on page 40 to figure your credit or if you must use Pub. 972.

Questions **Who Must Use Pub. 972**

1. Is the amount on Form 1040, line 38, 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

   ☐ **Yes.** STOP You must use Pub. 972 to figure your credit.

   ☑ **No.** Go to question 2.

2. Are you claiming either of the following credits?
   - Retirement savings contributions credit, Form 8880.
   - Adoption credit, Form 8839.

   ☐ **Yes.** STOP You must use Pub. 972 to figure your child tax credit. You will also need the form(s) listed above for any credit(s) you are claiming.

   ☑ **No.** Continue

3. 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).

   ☐ **Yes.** STOP You must use Pub. 972 to figure your credit.

   ☑ **No.** Use the worksheet on page 40 to figure your credit.

Need more information or forms? See page 80.

Child Tax Credit Worksheet—Line 52

Keep for Your Records

CAUTION

- To be a qualifying child for the child tax credit, the child must be **under age 17** at the end of 2007 and meet the other requirements listed on page 19.
- **Do not** use this worksheet if you answered "Yes" to question 1, 2, or 3 on page 42. Instead, use Pub. 972.
- If you are claiming the mortgage interest credit or District of Columbia first-time homebuyer credit, complete the applicable credit form (Form 8396 or Form 8859, respectively) before you start this worksheet.

1. Number of qualifying children: 3 × $1,000. Enter the result. — **1** 3,000

2. Enter the amount from Form 1040, line 46. — **2** 1,656

3. Add the amounts from Form 1040:

Line 47 ________

Line 48 + ________

Line 49 + ________

Line 50 + ________

Line 51 + ________

Line 54* + ________ Enter the total. — **3** 0

*Include only the amounts, if any, from Form 8396, line 13, and Form 8859, line 13.

4. Are the amounts on lines 2 and 3 the same?

☐ **Yes.** STOP
You cannot take this credit because there is no tax to reduce. However, you may be able to take the **additional child tax credit.** See the **TIP** below.

☑ **No.** Subtract line 3 from line 2. — **4** 1,656

5. Is the amount on line 1 more than the amount on line 4?

☑ **Yes.** Enter the amount from line 4. Also, you may be able to take the **additional child tax credit.** See the **TIP** below.

☐ **No.** Enter the amount from line 1.

This is your child tax credit. — **5** 1,656

Enter this amount on Form 1040, line 52.

1040

TIP

You may be able to take the **additional child tax credit** on Form 1040, line 68, if you answered "Yes" on line 4 **or** line 5 above.

- First, complete your Form 1040 through line 67.
- Then, use Form 8812 to figure any additional child tax credit.

Form **8812**

Department of the Treasury
Internal Revenue Service (99)

Additional Child Tax Credit

1040
1040A
1040NR
8812

Complete and attach to Form 1040, Form 1040A, or Form 1040NR.

OMB No. 1545-0074

2007

Attachment Sequence No. **47**

Name(s) shown on return	Your social security number
Dan Glendale	xxx xx xxxx

Part I All Filers

1	Enter the amount from line 1 of your Child Tax Credit Worksheet on page 43 of the Form 1040 instructions, page 38 of the Form 1040A instructions, or page 20 of the Form 1040NR instructions. If you used Pub. 972, enter the amount from line 8 of the worksheet on page 4 of the publication			**1**	3,000
2	Enter the amount from Form 1040, line 52, Form 1040A, line 32, or Form 1040NR, line 47			**2**	1,656
3	Subtract line 2 from line 1. If zero, **stop**; you cannot take this credit			**3**	1,344
4a	Enter your total earned income (see instructions on back)	**4a**	35,375		
b	Nontaxable combat pay (see instructions on back) **4b** 0				
5	Is the amount on line 4a more than $11,750? ☐ **No.** Leave line 5 blank and enter -0- on line 6. ☐ **Yes.** Subtract $11,750 from the amount on line 4a. Enter the result	**5**	23,625		
6	Multiply the amount on line 5 by 15% (.15) and enter the result			**6**	3,544

Next. Do you have three or more qualifying children?

☐ **No.** If line 6 is zero, stop; you cannot take this credit. Otherwise, skip Part II and enter the **smaller** of line 3 or line 6 on line 13.

☐ **Yes.** If line 6 is equal to or more than line 3, skip Part II and enter the amount from line 3 on line 13. Otherwise, go to line 7.

Part II Certain Filers Who Have Three or More Qualifying Children

7	Withheld 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 instructions on back	**7**			
8	**1040 filers:** Enter the total of the amounts from Form 1040, lines 27 and 59, plus any taxes that you identified using code "UT" and entered on the dotted line next to line 63. **1040A filers:** Enter -0-. **1040NR filers:** Enter the total of the amounts from Form 1040NR, line 54, plus any taxes that you identified using code "UT" and entered on the dotted line next to line 58.	**8**			
9	Add lines 7 and 8	**9**			
10	**1040 filers:** Enter the total of the amounts from Form 1040, lines 66a and 67. **1040A filers:** Enter the total of the amount from Form 1040A, line 40a, plus any excess social security and tier 1 RRTA taxes withheld that you entered to the left of line 42 (see instructions on back). **1040NR filers:** Enter the amount from Form 1040NR, line 61.	**10**			
11	Subtract line 10 from line 9. If zero or less, enter -0-			**11**	
12	Enter the **larger** of line 6 or line 11			**12**	

Next, enter the **smaller** of line 3 or line 12 on line 13.

Part III Additional Child Tax Credit

13	**This is your additional child tax credit**	**13**	1,344

Enter this amount on Form 1040, line 68, Form 1040A, line 41, or Form 1040NR, line 62.

1040
1040A
1040NR

Form 8812 (2007) Page **2**

Instructions

Purpose of Form

Use Form 8812 to figure your additional child tax credit. The additional child tax credit may give you a refund even if you do not owe any tax.

Who Should Use Form 8812

First, complete the Child Tax Credit Worksheet that applies to you. See the instructions for Form 1040, line 52, Form 1040A, line 32, or Form 1040NR, line 47. If you meet the condition given in the *TIP* at the end of your Child Tax Credit Worksheet, use Form 8812 to see if you can take the additional child tax credit.

Effect of Credit on Welfare Benefits

Any refund you receive as a result of taking the additional child tax credit will not be used to determine if you are eligible for the following programs, or how much you can receive from them. But if the refund you receive because of the additional child tax credit is not spent within a certain period of time, it may count as an asset (or resource) and affect your eligibility.

- Temporary Assistance for Needy Families (TANF).
- Medicaid and supplemental security income (SSI).
- Food stamps and low-income housing.

Nontaxable Combat Pay

Enter on line 4b the total amount of nontaxable combat pay that you, and your spouse if filing jointly, received in 2007. This amount should be shown in Form W-2, box 12, with code Q.

Railroad Employees

If you worked for a railroad, include the following taxes in the total on Form 8812, line 7.

- Tier 1 tax withheld from your pay. This tax should be shown in box 14 of your Form(s) W-2 and identified as "Tier 1 tax."
- If you were an employee representative, 50% of the total tier 1 tax and tier 1 Medicare tax you paid for 2007.

1040A Filers

If you, or your spouse if filing jointly, had more than one employer for 2007 and total wages of over $97,500, figure any excess social security and tier 1 railroad retirement (RRTA) taxes withheld. See Pub. 505. Include any excess on Form 8812, line 10.

Paperwork Reduction Act Notice. We ask for the information on this form to carry out the Internal Revenue laws of the United States. You are required to give us the information. We need it to ensure that you are complying with these laws and to allow us to figure and collect the right amount of tax.

You are not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number. Books or records relating to a form or its instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and return information are confidential, as required by Internal Revenue Code section 6103.

The average time and expenses required to complete and file this form will vary depending on individual circumstances. For the estimated averages, see the instructions for your income tax return.

If you have suggestions for making this form simpler, we would be happy to hear from you. See the instructions for your income tax return.

Earned Income Chart—Line 4a

IF you...	AND you...	THEN enter on line 4a...
have net earnings from self-employment	use either optional method to figure those net earnings	the amount figured using Pub. 972.
are taking the EIC on Form 1040, line 66a, or Form 1040A, line 40a	completed Worksheet B on page 51 of your Form 1040 instructions	your earned income from Worksheet B, line 4b, plus all of your nontaxable combat pay if you did not elect to include it in earned income for the EIC. If you were a member of the clergy, subtract (a) the rental value of a home or the nontaxable portion of an allowance for a home furnished to you (including payments for utilities), and (b) the value of meals and lodging provided to you, your spouse, and your dependents for your employer's convenience.
	did not complete Worksheet B or filed Form 1040A	your earned income from Step 5 on page 48 of your 1040 instructions or page 42 of your 1040A instructions, plus all of your nontaxable combat pay if you did not elect to include it in earned income for the EIC.
are not taking the EIC	were self-employed, or you are filing Schedule SE because you were a member of the clergy or you had church employee income, or you are filing Schedule C or C-EZ as a statutory employee	the amount figured using Pub. 972.
	are not self-employed or filing Schedule SE, C, or C-EZ for the above reasons	your earned income figured as follows: Line 7 of Form 1040 or Form 1040A, or line 8 of Form 1040NR ______ Subtract, if included on line 7 (line 8 for Form 1040NR), any: • Taxable scholarship or fellowship grant not reported on a Form W-2. • Amount received for work performed while an inmate in a penal institution (put "PRI" and the amount subtracted in the space next to line 7 of Form 1040 or 1040A (line 8 for Form 1040NR)). • Amount received as a pension or annuity from a nonqualified deferred compensation plan or a nongovernmental section 457 plan (put "DFC" and the amount subtracted in the space next to line 7 of Form 1040 or Form 1040A (line 8 for Form 1040NR)). This amount may be shown in box 11 of your Form W-2. If you received such an amount but box 11 is blank, contact your employer for the amount received as a pension or annuity. • Amount from Form 2555, line 43, or Form 2555-EZ, line 18. − ______ Add all your nontaxable combat pay from Form(s) W-2, box 12, with code Q + ______ **Earned income =**

The interview tips you should use when determining the child tax credit are shown in Publication 4012, *Volunteer Resource Guide,* Tab G, Credits.

Exercise 1

Assuming all other requirements are met, would a taxpayer be able to claim the CTC in the following situations:

A. The taxpayer's child turned 17 on 12/1/2007.

Answer: ____________________

B. The taxpayer's filing status is MFS.

Answer: ____________________

C. The child is the taxpayer's grandchild.

Answer: ____________________

D. The child paid over half of his own support.

Answer: ____________________

Form 8901—Information on Qualifying Children Who Are Not Dependents

Use **Form 8901, Information on Qualifying Children Who Are Not Dependents**, to report to the IRS information on any qualifying child for the child tax credit if the child is not your dependent. Complete and file Form 8901 if the qualifying child is not your dependent because of any of the following reasons:

- You, or your spouse if filing jointly, can be claimed as a dependent on someone else's return.
- You are a nonresident alien who is not allowed to claim exemptions for your dependents. However, your qualifying child must be a United States citizen, United States national, or United States resident alien.
- The qualifying child is married and files a joint return (and that joint return was not filed only as a claim for refund, or at least one spouse would have a tax liability if they had filed separate returns).

See Exhibit 7 for a copy of Linda's Form 8901, *Information on Qualifying Children Who Are Not Dependents*.

Example 5

Linda (17 years old) and her son Randy (2 years old) lived with her mother and father all year. Linda has a valid filing requirement and qualifies for the child tax credit for her son even though she can't claim him as a dependent. A dependent can't claim a dependent.

Form **8901**

Department of the Treasury
Internal Revenue Service (99)

Information on Qualifying Children Who Are Not Dependents
(For Child Tax Credit)

Complete and attach to Form 1040, Form 1040A, or Form 1040NR.

1040
1040A
1040NR
8901

OMB No. 1545-0074

2007

Attachment Sequence No. **59**

Name(s) shown on return	Your social security number
Linda	xxx xx xxxx

CAUTION

- Do not use this form for any child who is claimed as your dependent on Form 1040A or Form 1040, line 6c, or Form 1040NR, line 7c.
- It will take us longer to process your return and issue your refund if you do not complete all columns for each qualifying child.
- Be sure the child's name and social security number (SSN) agree with the child's social security card. Otherwise, at the time we process your return, we may reduce or disallow your child tax credit. If the name or SSN on the child's social security card is not correct, call the Social Security Administration at 1-800-772-1213.

Qualifying Child Information

	(a) First name	Last name	(b) Child's social security number	(c) Child's relationship to you (son, daughter, etc.)
Child 1	Randy		xxx xx xxxx	
Child 2				
Child 3				
Child 4				

General Instructions

Purpose of Form

Use Form 8901 to give the IRS information on any qualifying child (defined on back) who is not your dependent. To figure the amount of your child tax credit, see the instructions for Form 1040, line 52; Form 1040A, line 32; or Form 1040NR, line 47.

Who Must File

Use Form 8901 if your qualifying child is not your dependent because any of the following statements apply.

- You, or your spouse if filing jointly, can be claimed as a dependent on someone else's 2007 return.
- You are a nonresident alien who is not allowed to claim exemptions for your dependents. However, your qualifying child must be a U.S. citizen, U.S. national, or U.S. resident alien.
- Your qualifying child is married and files a joint return for 2007 (and that joint return was not filed only as a claim for refund, or at least one spouse would have a tax liability if they had filed separate returns).

Specific Instructions

Column (b)

If your child was born and died in 2007 and you do not have an SSN for the child, you can attach a copy of the child's birth certificate instead and enter "Died" in column (b).

If you do not have an SSN for your adopted child, enter "See page 2" in column (b). Then, on the bottom of page 2, enter the name and address of any agency or agent (such as an attorney) that assisted in the adoption.

Paperwork Reduction Act Notice. We ask for the information on this form to carry out the Internal Revenue laws of the United States. You are required to give us the information. We need it to ensure that you are complying with these laws and to allow us to figure and collect the right amount of tax.

You are not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number. Books or records relating to a form or its instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and return information are confidential, as required by Internal Revenue Code section 6103.

The average time and expenses required to complete and file this form will vary depending on individual circumstances. For the estimated averages, see the instructions for your income tax return.

If you have suggestions for making this form simpler, we would be happy to hear from you. See the instructions for your income tax return.

For Paperwork Reduction Act Notice, see above. Cat. No. 37710J Form **8901** (2007)

QUALITY REVIEW (QR)—CHILD TAX CREDIT

Use **Form 8158, Quality Review Sheet,** or an approved alternative form to review all returns prepared. Apply the quality review tools in combination with the Intake and Interview Sheet and all the source documents to the returns you prepare to ensure quality and accuracy for every taxpayer.

Consider each item on the quality review sheet which applies to your taxpayer's situation to confirm that all the necessary questions and issues have been addressed. If items are incorrect or incomplete, revisit the issue and make corrections to the return, as needed.

Excerpt from Form 8158

Yes	No	
☐	☐	All **adjustments, deductions and credits** indicated on the intake/interview sheet and supporting documents are included on the return.

To ensure accurate reporting of adjustments, deductions, and credits, verify that the information on the Intake and Interview Sheet and on the taxpayer's supporting documents is included on the return.

Confirm that all potential adjustments, deductions, and credits have been discussed with the taxpayer and are shown on the return, if applicable. Also verify that each qualifying child's date of birth is correct.

▶▶ SUMMING UP THIS LESSON ◀◀

- ▶ The child tax credit allows taxpayers to claim a credit of up to $1,000 per qualifying child.
- ▶ Taxpayers who are not eligible to take the full child tax credit may be eligible to take the additional child tax credit, which also allows taxpayers to claim a credit of up to $1,000 per qualifying child. This credit is refundable and is taken in addition to the child tax credit.

Threshold Modified AGI Amounts for Claiming Child Tax Credit	
Filing Status	**Amount**
Married filing jointly	$110,000
Qualifying widow(er)	$75,000
Head of household	$75,000
Single	$75,000
Married filing separately	$55,000

Exercise 1

A. No.

B. Yes.

C. Yes.

D. No.

CREDIT FOR CHILD AND DEPENDENT CARE EXPENSES

Lesson 7

INTRODUCTION AND OBJECTIVES

In this lesson you will learn about the credit for child and dependent care expenses. This nonrefundable credit is one of the most commonly used credits. The requirements for claiming the credit are the same, regardless of the form used. In fact, Form 2441 (used with Form 1040) and Schedule 2 (used with Form 1040A) are virtually identical; for the purposes of this lesson, we will work with Form 2441. In order to qualify for this credit, the taxpayer must satisfy all five tests of eligibility.

Some taxpayers receive employer-provided dependent care benefits which are covered later in this lesson. Dependent care benefits include amounts the employer paid directly to the taxpayer or to the care provider. These benefits can also include the fair market value of care in a day care facility provided or sponsored by the employer. The taxpayer's salary may have been reduced to pay for these benefits. The employer-provided benefits will be reported on Form W-2, box 10.

After completing this lesson you should be able to:

- Determine who is eligible for the Credit for Child and Dependent Care Expenses.
- Calculate the credit and the exclusion, and report the expenses on the correct form.

> **ALERT**
> This lesson contains basic tax law and is required training for all volunteers.

> **ALERT**
> If dependent care benefits were received from the employer during the year, some part of the benefits may be excludable. You must complete Part III of Form 2441 before you can figure the amount of credit.

INTAKE AND INTERVIEW PROCESS
FORM 13614—CHILD AND DEPENDENT CARE CREDITS

Use **Form 13614, Intake and Interview Sheet,** to engage the taxpayer in preparing an accurate return. Use the Intake and Interview Sheet as a starting point for a comprehensive interaction with the taxpayer, in combination with all the source documents provided by the taxpayer, to ensure quality and accuracy on each return.

Confirm each item on Form 13614 (or other form used at your site) to make sure you and the taxpayer have considered all the necessary information. Ensure all questions and issues have been addressed. If items are incorrect or incomplete, revisit the issue and make corrections to the return, as needed.

Excerpt from Form 13614

Part VII. Credits – **In 2007 did you (or your spouse) have:**

☐ Yes	☐ No	1. Child/dependent care expenses that allow you (and your spouse-if MFJ) to work
☐ Yes	☐ No	2. Educational expenses for you (or your spouse) and/or your dependents
☐ Yes	☐ No	3. Retirement Contribution to a traditional IRA, Roth IRA or 401k as shown on Form W-2

To ensure accurate reporting of credits, verify that the taxpayer's expenses are accurate and have been included. Confirm that all expenses paid by the taxpayer and/or employer have been discussed and shown on the return, if required.

QUALIFYING PERSON TEST

A qualifying **person** must:

- Be the taxpayer's dependent child, including:
  son or daughter,
  adopted child,
  stepson or stepdaughter,
  eligible foster child (who must have been placed with the taxpayer by an authorized placement agency or an order of a court),
  brother or sister,
  stepbrother or stepsister, or
  descendant of one of these listed relatives (including grandchild, niece, or nephew);
- Be a child under the age of 13 when the care was provided, or any age if permanently and totally disabled;
- Be a United States citizen, national, or resident;
- Have lived with the taxpayer for more than half of 2007. A child who was born or died in 2007 and whose only residence was with the taxpayer meets this requirement.

Note: Temporary absences for special circumstances, such as school, vacation, medical care, military service, or detention in a juvenile facility, count as time lived at home.

A qualifying **dependent**, other than a child, is:

- A dependent who was physically or mentally not able to care for himself or herself and for whom a dependency exemption can be claimed, unless the person had $3,400 or more in gross income or filed a joint return.
- A spouse who was physically or mentally not able to care for himself or herself.
- Any dependent who was physically or mentally not able to care for himself or herself and for whom a dependency exemption can be claimed except that the taxpayer (or taxpayer's spouse if filing a joint return), could be claimed as a dependent on someone else's 2007 return.

ALERT

Publication 4012, *Volunteer Resource Guide*, contains a decision tree to assist in determining whether a taxpayer can claim the credit. It also contains the definition of qualifying person and qualified expenses.

POTENTIAL PITFALLS

Normally, a qualifying person's age is defined as the age on the last day of the year. However, this credit allows a taxpayer to claim the child and dependent care expenses up to the day the child turns 13.

Example 1

Jim paid someone to care for his wife, Janet. Janet is physically unable to care for herself. Jim also paid to have someone prepare meals for his 12-year-old daughter, Jill. Both Janet and Jill are qualifying persons for the credit.

Example 2

Bob and Rhonda paid childcare expenses for their son, Ronnie. Ronnie turned 13 on July 15. Ronnie is a qualifying person until he reaches the age of 13.

Exercise 1

Emily has a son, Ray, who is 25. Ray was in an accident in May 2007 and moved in with Emily on May 26th. Ray is unable to care for himself since the accident. He would have been Emily's dependent except he made $8,200 the first part of the year. Ray is able to pay some of the bills and paid all of his expenses the first 5 months of the year. Emily did not pay over half the cost of keeping up a home for him. Emily works full time and has earned income of $38,000. Emily pays Francis, a 65-year-old church member, $150 per week to sit with him while she works. Frances is not a dependent of Emily. She has the name, address and SSN to use on the return. Emily is single, and Ray's father passed away in 1990.

Question: Can Emily claim the Child and Dependent Care Credit?

POTENTIAL PITFALLS

If taxpayers pay someone to come to their home and care for their dependent or spouse, the taxpayer may be a household employer. If the individuals who work in the home are self-employed, the taxpayer is not liable for employment taxes for those individuals. See section on Employment Taxes for Household Employers in Publication 17.

Children of Divorced or Separated Parents

Special rules apply to children of divorced or separated parents. Taxpayers who are the custodial parents for the greater part of the year can treat the child as a qualifying person even if they cannot claim the child's exemption.

Taxpayers who **are not** the custodial parents cannot treat the child as a qualifying person, even if they can claim the child's exemption.

The exception for divorced or separated parents can be applied only if all of the following are true:

- One or both parents had custody of the child for more than half the year,
- One or both parents provided more than half of the child's support for the year, and
- 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.

ALERT

This special rule for divorced or separated parents also applies to taxpayers who were never married.

POTENTIAL PITFALLS

Please see Publication 503, *Child and Dependent Care Expenses,* for information about expenses prepaid in an earlier year or not paid until the following year, as well as other detailed information about this credit.

Example 3

Amanda is divorced and has custody of her 8-year-old daughter, Carrie. Amanda signed Form 8332 to allow her ex-spouse to claim the dependency exemption for Carrie. In order to work, Amanda paid childcare expenses for Carrie. Under the special rules for children of divorced or separated parents, Amanda can claim the credit for child and dependent care expenses.

Exercise 2

Barb and Adam have been divorced for 5 years. They have two children, Carol 6 and Patty 11. The children live with Barb except for one weekend a month plus one full month during summer vacation that they spend with their father. Adam can claim the girls as dependents because Barb signed Form 8332. Barb works full-time and the girls go to the church day care in the mornings and evenings. She pays St. John's Day Care $260 a week. She has the name and address of the day care, but they are tax exempt and she does not have a taxpayer ID.

Question: Who can take the Child and Dependent Care Credit?

EARNED INCOME TEST

The taxpayer (and spouse, if married) must have earned income during the year. Earned income includes wages, salaries, tips, other taxable employee compensation, net earnings from self-employment, strike benefits, and disability pay reported as wages.

A spouse is treated as having earned income for any month he or she is a full-time student or physically or mentally unable to care for himself or herself. His or her earned income for each month is considered to be at least $250 if there is one qualifying person in the home, or at least $500 if there are two or more qualifying persons in the home. This applies to only one spouse for any one month. If, in the same month, both taxpayers do not work and are either full-time students or physically or mentally unable to care for themselves, only one of them can be treated as having earned income in that month.

A full-time student is defined as enrolled and attending a school for the number of hours or classes the school considers full-time. The taxpayer (or spouse) must be a student for some part of any five calendar months during the year. (The months need not be consecutive).

Example 4

Janice worked full-time. Her husband, Ken, was a full-time student from January through May. Their son, Jason, was in day care while Ken attended school. Ken's earned income for the time he attended school is considered to be $1,250 (5 months × $250).

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:

- The expenses allow the taxpayer (and spouse if married) to work or look for work. If the taxpayer or his or her spouse does not find a job and has no income for the year, they cannot take the credit.
- The expenses are for a qualifying person's care.

A spouse is treated as working during any month he or she is a full-time student or is physically or mentally unable to care for himself or herself.

To be work-related, the expenses must be to provide care for a qualifying person. Expenses are for the care of a qualifying person only if their main purpose is the person's well-being and protection.

Expenses for care do not include amounts paid for food, clothing, education, and entertainment. However, small amounts paid for these items can be included if they are incident to, and cannot be separated from, the cost of care.

Expenses to attend kindergarten or a higher grade are not expenses for care.

Example 5

A taxpayer takes his 3-year-old child to a nursery school that provides lunch and educational activities as a part of its preschool childcare service. The total cost can be counted to figure the credit.

Example 6

A taxpayer places her 10-year-old child in a boarding school so she can work full-time. Only the part of the boarding school expense that is for the care of the child is a work-related expense and only if it can be separated from the cost of education. The taxpayer cannot count any part of the amount paid for the child's education.

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

Payments to Relatives. Do not count amounts paid to:

- A dependent for whom the taxpayer (or spouse, if married) can claim an exemption, or
- The taxpayer's child who is under age 19 at the end of the year, even if he or she is not the taxpayer's dependent.

> **ALERT**
>
> **Note:** If a social services agency pays someone (e.g., a grandparent) to care for a child, while a parent works or goes to school, and issues a Form 1099-MISC, the parent cannot claim a credit for child and dependent care expense for that money.

JOINT RETURN TEST

Generally, a married couple must file a joint return to take the credit. However, a married taxpayer can claim the credit if the child qualifies him or her to file as head of household.

PROVIDER IDENTIFICATION TEST

ALERT

During the taxpayer's screening interview, Form 13614, *Intake and Interview Sheet,* will remind you to ask the taxpayer if he or she paid child-care expenses so they could work.

The taxpayer must provide the care provider's name, address, and taxpayer identification number. If the taxpayer is unable to provide this information, or if the information is incorrect, he or she must show they used due diligence to obtain the information.

Due Diligence. The taxpayer can show due diligence by getting and keeping any of the following documents:

- Form W-10, *Dependent Care Provider's Identification and Certification*
- Copy of the provider's social security card
- Copy of the provider's driver's license if it includes the social security number
- Copy of the provider's Form W-4 if the provider is the taxpayer's household employee
- Copy of the statement furnished by the taxpayer's employer if the provider has a dependent care plan
- Letter or invoice from the provider if it shows the name, address, and taxpayer identification number (EIN or SSN)

Provider Refusal. If the care provider refuses to give the taxpayer the identifying information, report whatever information is available, enter "see page 2" for the missing information, and provide a statement at the bottom of page 2 of Form 2441 or Schedule 2. **The taxpayer will be unable to e-file his or her return.**

Limit on Expenses

The amount of expenses eligible for the credit is limited to the lowest of the following amounts for the year:

- The lower-paid spouse's earned income (in the case of taxpayers married at the end of the year)
- The single taxpayer's earned income
- The actual expenses paid
- The overall limit of $3,000 for one qualifying person or $6,000 for two or more qualifying persons

Example 7

Mark earned $14,000. His wife, Evelyn, earned $5,600. Day care expenses for their 3-year-old daughter were $2,200. The maximum amount of qualifying child care expenses is $2,200.
This is the lowest of:

- The lower-paid spouse's earnings ($5,600),
- The amount actually paid ($2,200), and
- The overall limit for one qualifying person ($3,000).

Some taxpayers receive dependent care benefits from their employers. If so, the overall limit of $3,000/$6,000 is reduced, dollar for dollar, by any reimbursement excluded from the taxpayer's income. The amount of dependent care benefits received is shown in box 10 of Form W-2.

Example 8

Geraldine has one dependent child, Donald, who is 6 years old. She paid $2,900 in qualified expenses. Box 10 of Geraldine's Form W-2 shows she received $1,400 during the year from her employer's dependent care assistance program. Because she received dependent care benefits, Part III of Form 2441 must be completed before completing Part II.

Exercise 3

A. Karen earned $18,000. She paid $3,200 for childcare expenses for her 4-year-old daughter, Crystal. What is the maximum amount of childcare expenses Karen can claim? ____________

____

B. Andrea is married to Bill. They have a 7-year-old son, Charles. Charles lived with Andrea for the entire year. Andrea paid all the expenses of keeping up the home for herself and Charles. Andrea also paid for before-school and after-school child care. Her total child care expenses were $1,800. Bill left the home 18 months ago. He did not live with Andrea at all during 2007, but he did send $1,200 in child support. Andrea and Bill will file separate returns. Andrea signed Form 8332 to allow Bill to claim the dependency exemption for Charles. Who can claim the credit for child and dependent care expenses?

____

C. Ellen is divorced. She has custody of her 12-year-old daughter, Terri. Terri takes care of herself after school. In the summer, Ellen spends $2,000 to send Terri to a two-week-long overnight camp. Are the camp expenses qualified expenses for the credit for child and dependent care expenses? ____________________

____

Figuring the Credit

Potential Pitfalls

The Alternative Minimum Tax worksheet may be required to figure the credit.

The credit is a percentage of qualifying expenses. For taxpayers with adjusted gross incomes of $15,000 or less, the credit is 35 percent of qualifying expenses. As adjusted gross income increases, the percentage decreases. The lowest percentage is 20 percent for an AGI equal to or greater than $43,000. There is no upper limitation on income for this credit. The tables on Form 1040A, Schedule 2 and on Form 1040, Form 2441 show the percentage for each adjusted gross income bracket. After the credit is figured using Form 2441 or Schedule 2, it is reported on Form 1040, line 47, or Form 1040A, line 29.

Example 9

David A. and Edith B. Fullerton are married and file a joint return. Last year, they paid $3,500 for the care of their son, Jonathan. The payment was made to Karen's Kiddie Care, 456 Chapman Avenue, Your City, State, and Zip Code (EIN xx-xxxxxxx). The $3,500 payment includes a $1,000 dependent care benefit Edith received from her employer. This benefit was reported on Edith's Form W-2, box 10. Edith earned $18,979, and David earned $20,450 last year. Their adjusted gross income is $39,429, and their tax liability is $2,244.

Exhibits 1 and 2 show the completed Form 1040, Form 2441 for David and Edith.

Form **2441**

Department of the Treasury
Internal Revenue Service (99)

Child and Dependent Care Expenses

► Attach to Form 1040 or Form 1040NR.

► See separate instructions.

OMB No. 1545-0074

2007

Attachment Sequence No. 21

Name(s) shown on return	Your social security number
David A. & Edith B. Fullerton	XXX XX XXXX

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**

Part I **Persons or Organizations Who Provided the Care**—You **must** complete this part.
(If you have more than two care providers, see the instructions.)

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)
Karen's Kiddie Care	456 Chapman Avenue Your City, State Zip Code	XX-XXXXXXX	3,500

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 62, or Form 1040NR, line 57.

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 — First	Last	(b) Qualifying person's social security number	(c) **Qualified expenses** you incurred and paid in 2007 for the person listed in column (a)
Jonathan	Fullerton	XXX XX XXXX	2,500

3	Add the amounts in column (c) of line 2. **Do not** enter more than $3,000 for one qualifying person or $6,000 for two or more persons. If you completed Part III, enter the amount from line 35	3	2,000
4	Enter your **earned income.** See instructions	4	20,450
5	If married filing jointly, enter your spouse's earned income (if your spouse was a student or was disabled, see the instructions); **all others,** enter the amount from line 4	5	18,979
6	Enter the **smallest** of line 3, 4, or 5	6	2,000
7	Enter the amount from Form 1040, line 38, or Form 1040NR, line 36 — **7** 39,429		
8	Enter on line 8 the decimal amount shown below that applies to the amount on line 7	8	X . 22

If line 7 is:

Over — But not over	Decimal amount is	Over — But not over	Decimal amount is
$0—15,000	.35	$29,000—31,000	.27
15,000—17,000	.34	31,000—33,000	.26
17,000—19,000	.33	33,000—35,000	.25
19,000—21,000	.32	35,000—37,000	.24
21,000—23,000	.31	37,000—39,000	.23
23,000—25,000	.30	39,000—41,000	.22
25,000—27,000	.29	41,000—43,000	.21
27,000—29,000	.28	43,000—No limit	.20

9	Multiply line 6 by the decimal amount on line 8. If you paid 2006 expenses in 2007, see the instructions	9	440
10	Enter the amount from Form 1040, line 44, or Form 1040NR, line 41 — **10** 2,244		
11	Enter the amount from Form 6251, line 31 (see instructions) — **11** 0		
12	Subtract line 11 from line 10. If zero or less, **stop.** You cannot take the credit	12	2,244
13	**Credit for child and dependent care expenses.** Enter the **smaller** of line 9 or line 12 here and on Form 1040, line 47, or Form 1040NR, line 44	13	440

For Paperwork Reduction Act Notice, see page 4 of the instructions. Cat. No. 11862M Form **2441** (2007)

Part III Dependent Care Benefits

14	Enter the total amount of **dependent care benefits** you received in 2007. Amounts you received as an employee should be shown in box 10 of your Form(s) W-2. **Do not** include amounts reported as wages in box 1 of Form(s) W-2. If you were self-employed or a partner, include amounts you received under a dependent care assistance program from your sole proprietorship or partnership			14	1,000
15	Enter the amount, if any, you carried over from 2006 and used in 2007 during the grace period. See instructions			15	0
16	Enter the amount, if any, you forfeited or carried forward to 2008. See instructions			16	(0)
17	Combine lines 14 through 16. See instructions			17	1,000
18	Enter the total amount of **qualified expenses** incurred in 2007 for the care of the **qualifying person(s)**	18	3,500		
19	Enter the **smaller** of line 17 or 18	19	1,000		
20	Enter your **earned income.** See instructions	20	20,450		
21	Enter the amount shown below that applies to you. • If married filing jointly, enter your spouse's earned income (if your spouse was a student or was disabled, see the instructions for line 5). • If married filing separately, see the instructions for the amount to enter. • All others, enter the amount from line 20.	21	18,979		
22	Enter the **smallest** of line 19, 20, or 21	22	1,000		
23	Enter the amount from line 14 that you received from your sole proprietorship or partnership. If you did not receive any such amounts, enter -0-			23	0
24	Subtract line 23 from line 17	24	1,000		
25	Enter $5,000 ($2,500 if married filing separately **and** you were required to enter your spouse's earned income on line 21)			25	5,000
26	**Deductible benefits.** Enter the **smallest** of line 22, 23, or 25. Also, include this amount on the appropriate line(s) of your return. See instructions			26	0
27	Enter the **smaller** of line 22 or 25	27	1,000		
28	Enter the amount from line 26	28	0		
29	**Excluded benefits.** Subtract line 28 from line 27. If zero or less, enter -0-			29	1,000
30	**Taxable benefits.** Subtract line 29 from line 24. If zero or less, enter -0-. Also, include this amount on Form 1040, line 7, or Form 1040NR, line 8. On the dotted line next to Form 1040, line 7, or Form 1040NR, line 8, enter "DCB"			30	0

To claim the child and dependent care credit, complete lines 31–35 below.

31	Enter $3,000 ($6,000 if two or more qualifying persons)	31	3,000
32	Add lines 26 and 29	32	1,000
33	Subtract line 32 from line 31. If zero or less, **stop.** You cannot take the credit. **Exception.** If you paid 2006 expenses in 2007, see the instructions for line 9	33	2,000
34	Complete line 2 on the front of this form. **Do not** include in column (c) any benefits shown on line 32 above. Then, add the amounts in column (c) and enter the total here	34	2,500
35	Enter the **smaller** of line 33 or 34. Also, enter this amount on line 3 on the front of this form and complete lines 4–13	35	2,000

Form **2441** (2007)

Exercise 4

Sam L. (xxx-xx-xxxx) and Sue D. Windham are married and will file a joint return. They have two dependent children whom they send to day care to allow both parents to work. Sam's earned income is $18,500, and Sue's earned income is $19,350. Their AGI (Form 1040, line 38) is $37,850, and their tax liability (Form 1040, line 46) is $1,531.

During 2007 they paid The Learning Center (496 Irvine Road, Your City, State, and Zip Code, EIN xx-xxxxxxx) $5,450 to care for their children. The Windhams paid $2,950 of the total, and Sue's employer paid $2,500, under a dependent care benefits program. The $2,500 is in box 10 of Sue's Form W-2.

The children and the amounts paid for child care are as follows:

Doug	SSN xxx-xx-xxxx	$3,000	$1,250 dependent care benefit
Sally	SSN xxx-xx-xxxx	$2,450	$1,250 dependent care benefit

Complete their Form 1040, Form 2441 (Exhibits 3 and 4).

TAXWISE® HINTS

Use the decision tree in Publication 4012, *Volunteer Resource Guide,* to determine credit eligibility. For each qualifying child, check the "DC" box on the Main Information Sheet, Dependents/Non-dependents box. TaxWise® will add a Form 2441 or Schedule 2 to the forms tree. Complete all entries annotated in red. TaxWise® will then calculate any exclusion amounts, calculate the credit, complete the form, and insert the credit amount on Form 1040 or Form 1040A.

QUALITY REVIEW (QR)—CHILD AND DEPENDENT CARE CREDITS

Use **Form 8158, Quality Review Sheet,** or an approved alternative form to review all returns prepared. Apply the quality review tools, in combination with the Intake and Interview Sheet and all the source documents, to the returns you prepare to ensure quality and accuracy for every taxpayer.

Consider each item on the Quality Review Sheet that applies to the taxpayer's situation. Confirm that all the necessary questions and issues have been addressed. If items are incorrect or incomplete, revisit the issue and make corrections to the return and Intake and Interview Sheet, as needed.

Excerpt from Form 8158

Yes	No	
☐	☐	All **adjustments, deductions and credits** indicated on the intake/interview sheet and supporting documents are included on the return.

To ensure accurate reporting of adjustments, deductions, and credits, verify that the information on Form 13614, Intake and Interview Sheet and on the taxpayer's supporting documents is included on the return.

Confirm that all potential adjustments, deductions, and credits have been discussed with the taxpayer and shown on the return if applicable.

▶▶ SUMMING UP THIS LESSON ◀◀

The credit for child and dependent care expenses is a nonrefundable credit that allows taxpayers to reduce their tax liability for a portion of the expenses.

A taxpayer must satisfy all of the five tests to qualify for the credit. The tests are the qualifying person test, the earned income test, the work-related expense test, the joint return test, and the provider identification test.

The credit is calculated and reported on Form 1040, Form 2441 or Form 1040A, Schedule 2.

Form **2441**
Department of the Treasury
Internal Revenue Service (99)

Child and Dependent Care Expenses

► Attach to Form 1040 or Form 1040NR.
► See separate instructions.

OMB No. 1545-0074
2007
Attachment Sequence No. 21

Name(s) shown on return | Your social security number

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**

Part I **Persons or Organizations Who Provided the Care—**You **must** complete this part.
(If you have more than two care providers, see the instructions.)

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)

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 62, or Form 1040NR, line 57.

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 — First	Last	(b) Qualifying person's social security number	(c) **Qualified expenses** you incurred and paid in 2007 for the person listed in column (a)

3 Add the amounts in column (c) of line 2. **Do not** enter more than $3,000 for one qualifying person or $6,000 for two or more persons. If you completed Part III, enter the amount from line 35 . . . . . **3**

4 Enter your **earned income.** See instructions **4**

5 If married filing jointly, enter your spouse's earned income (if your spouse was a student or was disabled, see the instructions); **all others,** enter the amount from line 4 . . . **5**

6 Enter the **smallest** of line 3, 4, or 5 . . . . . **6**

7 Enter the amount from Form 1040, line 38, or Form 1040NR, line 36 . . . . . **7**

8 Enter on line 8 the decimal amount shown below that applies to the amount on line 7

If line 7 is: Over	But not over	Decimal amount is	If line 7 is: Over	But not over	Decimal amount is
$0	15,000	.35	$29,000	31,000	.27
15,000	17,000	.34	31,000	33,000	.26
17,000	19,000	.33	33,000	35,000	.25
19,000	21,000	.32	35,000	37,000	.24
21,000	23,000	.31	37,000	39,000	.23
23,000	25,000	.30	39,000	41,000	.22
25,000	27,000	.29	41,000	43,000	.21
27,000	29,000	.28	43,000	No limit	.20

8 X .

9 Multiply line 6 by the decimal amount on line 8. If you paid 2006 expenses in 2007, see the instructions **9**

10 Enter the amount from Form 1040, line 44, or Form 1040NR, line 41 **10**

11 Enter the amount from Form 6251, line 31 (see instructions) **11**

12 Subtract line 11 from line 10. If zero or less, **stop.** You cannot take the credit **12**

13 **Credit for child and dependent care expenses.** Enter the **smaller** of line 9 or line 12 here and on Form 1040, line 47, or Form 1040NR, line 44 . . . . . **13**

For Paperwork Reduction Act Notice, see page 4 of the instructions. Cat. No. 11862M Form **2441** (2007)

Form 2441 (2007) Page **2**

Part III **Dependent Care Benefits**

14	Enter the total amount of **dependent care benefits** you received in 2007. Amounts you received as an employee should be shown in box 10 of your Form(s) W-2. **Do not** include amounts reported as wages in box 1 of Form(s) W-2. If you were self-employed or a partner, include amounts you received under a dependent care assistance program from your sole proprietorship or partnership		14	
15	Enter the amount, if any, you carried over from 2006 and used in 2007 during the grace period. See instructions		15	
16	Enter the amount, if any, you forfeited or carried forward to 2008. See instructions		16	( )
17	Combine lines 14 through 16. See instructions		17	
18	Enter the total amount of **qualified expenses** incurred in 2007 for the care of the **qualifying person(s)**	18		
19	Enter the **smaller** of line 17 or 18	19		
20	Enter your **earned income.** See instructions	20		
21	Enter the amount shown below that applies to you. • If married filing jointly, enter your spouse's earned income (if your spouse was a student or was disabled, see the instructions for line 5). • If married filing separately, see the instructions for the amount to enter. • All others, enter the amount from line 20.	21		
22	Enter the **smallest** of line 19, 20, or 21	22		
23	Enter the amount from line 14 that you received from your sole proprietorship or partnership. If you did not receive any such amounts, enter -0-		23	
24	Subtract line 23 from line 17	24		
25	Enter $5,000 ($2,500 if married filing separately **and** you were required to enter your spouse's earned income on line 21)		25	
26	**Deductible benefits.** Enter the **smallest** of line 22, 23, or 25. Also, include this amount on the appropriate line(s) of your return. See instructions		26	
27	Enter the **smaller** of line 22 or 25	27		
28	Enter the amount from line 26	28		
29	**Excluded benefits.** Subtract line 28 from line 27. If zero or less, enter -0-		29	
30	**Taxable benefits.** Subtract line 29 from line 24. If zero or less, enter -0-. Also, include this amount on Form 1040, line 7, or Form 1040NR, line 8. On the dotted line next to Form 1040, line 7, or Form 1040NR, line 8, enter "DCB".		30	

To claim the child and dependent care credit, complete lines 31–35 below.

31	Enter $3,000 ($6,000 if two or more qualifying persons)	31	
32	Add lines 26 and 29	32	
33	Subtract line 32 from line 31. If zero or less, **stop.** You cannot take the credit. **Exception.** If you paid 2006 expenses in 2007, see the instructions for line 9	33	
34	Complete line 2 on the front of this form. **Do not** include in column (c) any benefits shown on line 32 above. Then, add the amounts in column (c) and enter the total here	34	
35	Enter the **smaller** of line 33 or 34. Also, enter this amount on line 3 on the front of this form and complete lines 4–13	35	

Form **2441** (2007)

Exercise 1

Yes. Even though Ray is not a dependent on Emily's return, he meets the qualifying person test for the credit. Emily does not have to provide over half the cost of keeping up a home for a qualifying person as in the past.

Exercise 2

Barb is eligible to take the credit. The children are under 13, and the rules for children of divorced or separated parents apply. She paid the expenses to a tax-exempt care provider, so she does not need the taxpayer ID. She can write "Tax-Exempt" in the space where the tax forms calls for the number.

Exercise 3

A. Karen can claim $3,000, which is the lowest of: earned income ($18,000); the amount actually paid ($3,200); and the limit of one qualifying person ($3,000).

B. Andrea. Although Andrea does not claim Charles as a dependent, under the special rules for divorced or separated parents, Andrea can claim the Child and Dependent Care Credit because she is the custodial parent. Bill cannot claim the credit because he is not the custodial parent.

C. No.

Exhibit 5 Exercise 4 **The Windhams' Form 2441, page 1**

Form **2441**

Department of the Treasury
Internal Revenue Service (99)

Child and Dependent Care Expenses

▶ Attach to Form 1040 or Form 1040NR.

▶ See separate instructions.

OMB No. 1545-0074

2007

Attachment Sequence No. 21

Name(s) shown on return: Sam L. & Sue D. Windham

Your social security number: XXX XX XXXX

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**

Part I Persons or Organizations Who Provided the Care—You **must** complete this part.
(If you have more than two care providers, see the instructions.)

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)
The Learning Center	496 Irvine Road Your City, State Zip Code	XX-XXXXXXX	5,450

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 62, or Form 1040NR, line 57.

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 — First	Last	(b) Qualifying person's social security number	(c) **Qualified expenses** you incurred and paid in 2007 for the person listed in column (a)
Doug	Windham	XXX XX XXXX	1,750
Sally	Windham	XXX XX XXXX	1,200

3	Add the amounts in column (c) of line 2. **Do not** enter more than $3,000 for one qualifying person or $6,000 for two or more persons. If you completed Part III, enter the amount from line 35	3	2,950
4	Enter your **earned income.** See instructions	4	18,500
5	If married filing jointly, enter your spouse's earned income (if your spouse was a student or was disabled, see the instructions); **all others,** enter the amount from line 4	5	19,350
6	Enter the **smallest** of line 3, 4, or 5	6	2,950
7	Enter the amount from Form 1040, line 38, or Form 1040NR, line 36 — 7: 37,850		
8	Enter on line 8 the decimal amount shown below that applies to the amount on line 7	8	X . 23

If line 7 is:

Over — But not over	Decimal amount is	Over — But not over	Decimal amount is
$0—15,000	.35	$29,000—31,000	.27
15,000—17,000	.34	31,000—33,000	.26
17,000—19,000	.33	33,000—35,000	.25
19,000—21,000	.32	35,000—37,000	.24
21,000—23,000	.31	37,000—39,000	.23
23,000—25,000	.30	39,000—41,000	.22
25,000—27,000	.29	41,000—43,000	.21
27,000—29,000	.28	43,000—No limit	.20

9	Multiply line 6 by the decimal amount on line 8. If you paid 2006 expenses in 2007, see the instructions	9	679
10	Enter the amount from Form 1040, line 44, or Form 1040NR, line 41 — 10: 1,531		
11	Enter the amount from Form 6251, line 31 (see instructions) — 11: 0		
12	Subtract line 11 from line 10. If zero or less, **stop.** You cannot take the credit	12	1,531
13	**Credit for child and dependent care expenses.** Enter the **smaller** of line 9 or line 12 here and on Form 1040, line 47, or Form 1040NR, line 44	13	679

For Paperwork Reduction Act Notice, see page 4 of the instructions. Cat. No. 11862M Form **2441** (2007)

Exhibit 6 Exercise 4 — **The Windhams' Form 2441, page 2**

Form 2441 (2007) Page 2

Part III Dependent Care Benefits

14	Enter the total amount of **dependent care benefits** you received in 2007. Amounts you received as an employee should be shown in box 10 of your Form(s) W-2. **Do not** include amounts reported as wages in box 1 of Form(s) W-2. If you were self-employed or a partner, include amounts you received under a dependent care assistance program from your sole proprietorship or partnership			14	2,500
15	Enter the amount, if any, you carried over from 2006 and used in 2007 during the grace period. See instructions			15	0
16	Enter the amount, if any, you forfeited or carried forward to 2008. See instructions			16	(0)
17	Combine lines 14 through 16. See instructions			17	2,500
18	Enter the total amount of **qualified expenses** incurred in 2007 for the care of the **qualifying person(s)**	18	5,450		
19	Enter the **smaller** of line 17 or 18	19	2,500		
20	Enter your **earned income.** See instructions	20	18,500		
21	Enter the amount shown below that applies to you. • If married filing jointly, enter your spouse's earned income (if your spouse was a student or was disabled, see the instructions for line 5). • If married filing separately, see the instructions for the amount to enter. • All others, enter the amount from line 20.	21	19,350		
22	Enter the **smallest** of line 19, 20, or 21	22	2,500		
23	Enter the amount from line 14 that you received from your sole proprietorship or partnership. If you did not receive any such amounts, enter -0-			23	0
24	Subtract line 23 from line 17	24	2,500		
25	Enter $5,000 ($2,500 if married filing separately **and** you were required to enter your spouse's earned income on line 21)			25	5,000
26	**Deductible benefits.** Enter the **smallest** of line 22, 23, or 25. Also, include this amount on the appropriate line(s) of your return. See instructions			26	0
27	Enter the **smaller** of line 22 or 25	27	2,500		
28	Enter the amount from line 26	28	0		
29	**Excluded benefits.** Subtract line 28 from line 27. If zero or less, enter -0-			29	2,500
30	**Taxable benefits.** Subtract line 29 from line 24. If zero or less, enter -0-. Also, include this amount on Form 1040, line 7, or Form 1040NR, line 8. On the dotted line next to Form 1040, line 7, or Form 1040NR, line 8, enter "DCB".			30	0

To claim the child and dependent care credit, complete lines 31–35 below.

31	Enter $3,000 ($6,000 if two or more qualifying persons)	31	6,000
32	Add lines 26 and 29	32	2,500
33	Subtract line 32 from line 31. If zero or less, **stop.** You cannot take the credit. **Exception.** If you paid 2006 expenses in 2007, see the instructions for line 9	33	3,500
34	Complete line 2 on the front of this form. **Do not** include in column (c) any benefits shown on line 32 above. Then, add the amounts in column (c) and enter the total here	34	2,950
35	Enter the **smaller** of line 33 or 34. Also, enter this amount on line 3 on the front of this form and complete lines 4–13	35	2,950

Form **2441** (2007)

STUDENT NOTES

EDUCATION CREDITS

Lesson 8

INTRODUCTION AND OBJECTIVES

For tax year 2007, there are several tax benefits for higher education. Some of these benefits may not be taxed (i.e., Coverdell education savings account, qualified tuition program, early IRA withdrawals, employer-provided educational assistance, and education savings bond programs). The student loan interest deduction and tuition and fees deductions are covered in Lesson 10, Adjustments to Income. These two deductions reduce the income subject to tax. In this lesson you will learn about the two education credits: Hope credit and the lifetime learning credit. The education credits directly reduce the amount of tax owed on the tax return.

After completing this lesson, you should be able to:

- Determine who is eligible to claim an education credit.
- Determine which credit(s) should be claimed.

ALERT

This lesson contains basic tax law and is required training for all volunteers.

INTAKE AND INTERVIEW PROCESS FORM 13614—EDUCATION CREDIT

Use **Form 13614, Intake and Interview Sheet,** to engage the taxpayer in preparing an accurate return. Use the Intake and Interview Sheet as a starting point for a comprehensive interaction with the taxpayer in combination with all the source documents provided by the taxpayer to ensure quality and accuracy on each return.

Confirm each item on Form 13614 (or similar tool used at your site) to make sure you and the taxpayer have considered all the necessary information. Ensure that all questions and issues have been addressed. If items are incorrect or incomplete, revisit the issue and make corrections to the return, as needed.

Excerpt from Form 13614

Part VII. Credits – In 2007 did you (or your spouse) have:		
☐ Yes	☐ No	1. Child/dependent care expenses that allow you (and your spouse-if MFJ) to work
☐ Yes	☐ No	2. Educational expenses for you (or your spouse) and/or your dependents
☐ Yes	☐ No	3. Retirement Contribution to a traditional IRA, Roth IRA or 401k as shown on Form W-2

To ensure accurate reporting of credits, verify that the taxpayer's expenses are accurate and have been included. Confirm that all expenses paid by the taxpayer and/or institution have been discussed and are shown on the return, if required.

GENERAL REQUIREMENTS

Taxpayers can claim the **Hope credit** and the **lifetime learning credit** for higher education expenses paid in 2007 for an eligible student. Both credits are **nonrefundable** and can be claimed on either Form 1040 or Form 1040A. These two credits are also called **education credits.**

To claim either of the education credits the taxpayer must

- File using any filing status other than married filing separately,
- Meet all of the general requirements,
- Meet all of the specific requirements for the individual credit, and
- Meet the income limits.

The general requirements provide that the taxpayer must have incurred **qualified expenses** for an **eligible student** to attend **an eligible educational institution** during the tax year.

Eligible Educational Institution

An eligible educational institution is generally any accredited public, nonprofit, or proprietary (private) postsecondary institution eligible to participate in the student aid programs administered by the Department of Education. Most universities and colleges, including community colleges, meet these requirements. The educational institution should be able to tell you if it is an eligible educational institution.

Qualified Education Expenses

The Hope credit and the lifetime learning credit are based on qualified tuition and certain related expenses required for enrollment or attendance at an eligible educational institution.

Qualified tuition and related expenses are tuition and fees required for enrollment or attendance at an eligible educational institution and generally **include fees for:**

- Course-related books, supplies, and equipment, and
- Student activities.

Note: It is rare for books to meet this test because all such fees must be paid **to the institution** as a condition of enrollment or attendance.

Qualified tuition and related expenses **do not include** the cost of:

- Insurance,
- Medical expenses (including student health fees),
- Room and board, or
- Transportation or similar personal, living, or family expenses, **even if** the fees must be paid to the institution as a condition of enrollment or attendance.

When considering qualified tuition and related expenses for the Hope credit, the cost of courses for athletics, sports, games, hobbies, or noncredit courses are not used unless the course is part of the student's degree program. However, when computing the qualified tuition and related expenses for the lifetime learning credit, these types of expenses are includable if the course was taken to acquire or improve the job skills of the student.

If a taxpayer **prepaid** qualified tuition and related expenses for an academic period that begins in the first three months of the following year, he or she can use the prepaid amount in figuring the credit.

Form 1098-T, Tuition Statement

Form 1098-T is used to report qualified tuition and related expenses. These expenses are tuition and fees a student must pay to be enrolled at or attend an eligible educational institution.

To help figure the taxpayer's education credit, the taxpayer should receive Form 1098-T. Generally, an eligible educational institution (such as a college or university) must send Form 1098-T (or acceptable substitute) to each enrolled student by January 31, 2008.

Note: Please ask the taxpayer how payments were made. Institutions may report either payments received in box 1 or amount billed in box 2. The amount shown in box 1 or 2 may represent an amount other than the amount actually paid in 2007.

Example 1

Thomas Gordon pays $1,500 in December 2007 for qualified tuition for the winter semester that begins in January 2008. He can use the $1,500 paid in December of 2007 to compute his credit for 2007.

Thomas' Form 1098-T is shown in Exhibit 1.

Exhibit 1 **Form 1098-T**

☐ CORRECTED

FILER'S name, street address, city, state, ZIP code, and telephone number State University 555 Elon Drive Your City, State, Zip Code	1 Payments received for qualified tuition and related expenses $ 1,500 2 Amounts billed for qualified tuition and related expenses $	OMB No. 1545-1574 2007 Form 1098-T	**Tuition Statement**
FILER'S federal identification no. XX-XXXXXXX STUDENT'S social security number XXX-XX-XXXX	3 If this box is checked, your educational institution has changed its reporting method for 2007 ☐		**Copy B For Student**
STUDENT'S name Thomas Gordon	4 Adjustments made for a prior year $	5 Scholarships or grants $	This is important tax information and is being furnished to the Internal Revenue Service.
Street address (including apt. no.) 25 Caldwell Lane City, state, and ZIP code Your City, State, Zip Code	6 Adjustments to scholarships or grants for a prior year $	7 Checked if the amount in box 1 or 2 includes amounts for an academic period beginning January - March 2008 ► ☐	
Service Provider/Acct. No. (see instr.) 8 Checked if at least half-time student ☑	9 Checked if a graduate student ☐	10 Ins. contract reimb./refund $	

Form **1098-T** (keep for your records) Department of the Treasury - Internal Revenue Service

Adjustments to Qualified Expenses

> **ALERT**
>
> A scholarship or fellowship is tax free only if the eligible student is a candidate for a degree at an eligible educational institution and the student can use the scholarship or fellowship to pay qualified education expenses. Please see the Income section to determine if the assistance is taxable.

Tax-free educational assistance can include:

- Scholarships and fellowships,
- Pell grants,
- Employer-provided educational assistance,
- Veteran's educational assistance, and
- Any other nontaxable payments (other than gifts, bequests, or inheritances) received for education expenses.

If the taxpayer paid qualified tuition expenses with these tax-free funds, a credit cannot be claimed for these amounts. Qualified expenses must be reduced by the amount of any tax-free educational assistance received.

Example 2

In 2007, Jackie paid $3,000 for tuition and $5,000 for room and board at her local university. To help pay these costs, she was awarded a $2,000 scholarship and a $4,000 student loan.

The scholarship is a qualified scholarship that is excludable from Jackie's income. For purposes of the education credit, she must first use the scholarship to reduce her tuition (her only qualified expense). The student loan is not considered tax-free educational assistance, so she does not use it to reduce the qualified expenses. Therefore, Jackie is treated as having paid only $1,000 in qualified expenses ($3,000 tuition – $2,000 scholarship).

Refunds

Qualified tuition and related expenses do not include expenses for which the taxpayer received a refund. If the refund or tax-free assistance is received in the same year in which the expenses were paid or in the following year before the tax return is filed, reduce the qualified expenses by the amount received and figure the education credits using the reduced amount of qualified expenses.

If the refund or tax-free assistance is received after the tax return is filed for the year in which the expenses were paid, the taxpayer may have to repay all or part of the credit. This is beyond the scope of the VITA/TCE program. Advise the taxpayer they need to consult a tax professional.

Payments with Borrowed Funds

Taxpayers can claim the Hope credit and the lifetime learning credit for qualified tuition and related expenses paid with the proceeds of a loan. Use the expenses to figure the credit for the year in which the expenses are paid, not the year in which the loan is repaid.

Eligible Student

The taxpayer, the taxpayer's spouse, or the taxpayer's dependent(s) (for whom the taxpayer claims a dependency exemption) can be an eligible student.

In addition, for the Hope credit, the student must be:

- Enrolled in a program that leads to a degree, certificate, or other recognized educational credential.
- Taking at least one-half of the normal full-time workload for his or her course of study for at least one academic period beginning during the calendar year.
- Enrolled for one of the first two years of his or her postsecondary education.
- Free of any felony conviction for possessing or distributing a controlled substance.

WHO CAN CLAIM EXPENSES?

The taxpayer must claim a dependent exemption for the eligible student in order to claim an education credit. Either the taxpayer or the dependent, but not both, can claim an education credit for that dependent's higher education expenses.

If the taxpayer...	**then only...**
claims an exemption on the tax return for a dependent who is an eligible student	the taxpayer can claim the Hope credit or lifetime learning credit based on that student's expenses. The student cannot claim the credit.
does not claim an exemption for a dependent who is an eligible student (even if entitled to the exemption)	the student can claim the Hope credit or lifetime learning credit. The taxpayer cannot claim the student's expenses.

If someone other than the taxpayer, the taxpayer's spouse, or the dependent (such as a relative or former spouse) makes a payment directly to the eligible educational institution to pay for an eligible student's tuition and related expenses, the student is treated as receiving the payment from the other person. In this case, the student is considered to have paid the qualified tuition and related expenses to the eligible institution. If the taxpayer claims an exemption for the student, the taxpayer is considered to have paid the expenses.

Example 3

Mary Birch paid her grandson Todd's tuition for 2007 directly to the university. For purposes of claiming the Hope credit, Todd is treated as receiving the money as a gift and in turn paying his qualified expenses himself. If Todd's parents claim his exemption, they may be able to use the expenses to claim the Hope credit. If anyone else claims an exemption for Todd, Todd cannot claim a Hope credit.

Income Requirements

The Hope credit and the lifetime learning credit are phased out (gradually reduced) if the taxpayer's modified adjusted gross income (MAGI) is between $47,000 and $57,000 ($94,000 and $114,000 if married filing jointly). The taxpayer cannot claim an education credit if his or her MAGI exceeds $57,000 (or $114,000 if married filing jointly). In addition, education credits are not allowed to taxpayers who file as married filing separately.

Modified Adjusted Gross Income (MAGI)

For most taxpayers, MAGI is adjusted gross income (AGI) as figured on their federal income tax return. MAGI when using Form 1040A is the AGI on line 22 of that form. MAGI when using Form 1040 is the AGI on line 38 of that form, modified by adding back any

- Foreign earned income exclusion,
- Foreign housing exclusion,
- Exclusion of income for bona fide residents of American Samoa, and,
- Exclusion of income from Puerto Rico.

HOPE CREDIT

A Hope credit can be claimed for **each** eligible student who is claimed on the taxpayer's return.

Credit Amounts

The Hope credit is figured on **Form 8863, Education Credits (Hope and Lifetime Learning Credits).** The maximum Hope credit is $1,650 **per student** for each of the first two taxable years of his or her postsecondary education. For each eligible student who qualifies for the Hope credit:

- If the expenses are $1,100 or less, the credit is the amount of the expenses.
- If the expenses are between $1,100 and $2,200, the credit is $1,100 plus one-half of the expenses over $1,100. For example, if the expenses are $1,500, the credit is $1,300 ($1,100 plus one-half of $400).
- If the expenses are $2,200 or more, the credit is $1,650.

Example 4

Sue and Ted Marshall paid $7,000 in qualified tuition and fees for their daughter, Mary, to attend the local university. They determine it would be more beneficial for them to take the Hope credit rather than the tuition and fees deduction. Their AGI and MAGI is $40,000 and their tax liability on Form 1040, line 46, is $2,634. Their Form 8863 is shown in Exhibit 2.

Form **8863**

Department of the Treasury
Internal Revenue Service (99)

Education Credits (Hope and Lifetime Learning Credits)

▶ See instructions.
▶ Attach to Form 1040 or Form 1040A.

OMB No. 1545-0074
2007
Attachment Sequence No. **50**

Name(s) shown on return	Your social security number
Ted & Sue Marshall	xxx xx xxxx

Caution:
- *You* ***cannot*** *take the Hope credit and the lifetime learning credit for the* ***same student*** *in the same year.*
- *You* ***cannot*** *take both an education credit and the tuition and fees deduction (see Form 8917) for the* ***same student*** *in the same year.*

Part I Hope Credit. Caution: *You* ***cannot*** *take the Hope credit for more than* ***2*** *tax years for the* ***same student.***

1	**(a)** Student's name (as shown on page 1 of your tax return) First name / Last name	**(b)** Student's social security number (as shown on page 1 of your tax return)	**(c)** Qualified expenses (see instructions). **Do not** enter more than $2,200 for each student.	**(d)** Enter the **smaller** of the amount in column (c) or $1,100	**(e)** Add column (c) and column (d)	**(f)** Enter one-half of the amount in column (e)
	Mary Marshall	xxx xx xxxx	2,200	1,100	3,300	1,650

2	**Tentative Hope credit.** Add the amounts on line 1, column (f). If you are taking the lifetime learning credit for another student, go to Part II; otherwise, go to Part III . . . . ▶	2	1,650

Part II Lifetime Learning Credit

3	**(a)** Student's name (as shown on page 1 of your tax return) First name / Last name	**(b)** Student's social security number (as shown on page 1 of your tax return)	**(c)** Qualified expenses (see instructions)

4	Add the amounts on line 3, column (c), and enter the total	4	
5	Enter the **smaller** of line 4 or $10,000	5	
6	**Tentative lifetime learning credit.** Multiply line 5 by 20% (.20) and go to Part III	6	

Part III Allowable Education Credits

7	Tentative education credits. Add lines 2 and 6			7	1,650
8	Enter: $114,000 if married filing jointly; $57,000 if single, head of household, or qualifying widow(er)	8	114,000		
9	Enter the amount from Form 1040, line 38*, or Form 1040A, line 22 .	9	40,000		
10	Subtract line 9 from line 8. If zero or less, **stop;** you cannot take any education credits	10	74,000		
11	Enter: $20,000 if married filing jointly; $10,000 if single, head of household, or qualifying widow(er)	11	20,000		
12	If line 10 is equal to or more than line 11, enter the amount from line 7 on line 13 and go to line 14. If line 10 is less than line 11, divide line 10 by line 11. Enter the result as a decimal (rounded to at least three places)			12	× .
13	Multiply line 7 by line 12 . . . . ▶			13	1,650
14	Enter the amount from Form 1040, line 44, or Form 1040A, line 28 (minus any alternative minimum tax included on Form 1040A, line 28)			14	2,634
15	Enter the total, if any, of your credits from Form 1040, lines 47 and 48, or Form 1040A, lines 29 and 30	15	0		
16	1040 filers: Enter the amount from Form 6251, line 31 (see instructions) 1040A filers: Enter the amount, if any, from the Alternative Minimum Tax Worksheet, line 23 (see instructions)	16	0		
17	Add lines 15 and 16			17	0
18	Subtract line 17 from line 14. If zero or less, **stop.** You cannot take any education credits . ▶			18	2,634
19	**Education credits.** Enter the smaller of line 13 or line 18 here and on Form 1040, line 49, or Form 1040A, line 31 . . . . ▶			19	1,650

* If you are filing Form 2555, 2555-EZ, or 4563, or you are excluding income from Puerto Rico, see Pub. 970 for the amount to enter.

For Paperwork Reduction Act Notice, see page 4. Cat. No. 25379M Form **8863** (2007)

LIFETIME LEARNING CREDIT

The lifetime learning credit is based on the total qualified education expenses paid by the taxpayer and not on the number of eligible students. Education expenses are qualified for the lifetime learning credit if they are

- for courses taken as part of a postsecondary degree program, or
- for courses that are not part of a postsecondary degree program but that are taken to improve or acquire job skills.

Example 5

Samantha, a professional photographer, enrolls in an advanced photography course at a local community college. Although the course is not part of a degree program, she enrolls in it to improve her job skills. The course fee paid by Samantha is considered qualified tuition for the purpose of claiming the lifetime learning credit.

Example 6

Cleve, an engineer, plans to vacation in Europe next year. In preparation for the trip, he enrolls in a noncredit photography class at a local community college. Because Cleve is not taking the course as part of a degree program or to acquire or improve his job skills, the cost of the course is not a qualifying expense for claiming the lifetime learning credit.

Credit Amounts

The lifetime learning credit is also figured on Form 8863. The maximum amount of the credit is $2,000 for taxpayers regardless of the number of students. The credit amount is figured by multiplying total qualified educational expenses, up to $10,000, by 20 percent. This number may be further reduced based on your MAGI.

Example 7

Judy Hood is single and took a course at the local college to recertify herself to teach in public schools. Her qualified tuition expenses were $800. She chooses to take the lifetime learning credit. Her AGI and MAGI is $30,000 and her tax liability on Form 1040, line 46, is $2,909. Her completed Form 8863 is shown in Exhibit 3.

Form **8863**

Department of the Treasury
Internal Revenue Service (99)

Education Credits
(Hope and Lifetime Learning Credits)

▶ See instructions.
▶ Attach to Form 1040 or Form 1040A.

OMB No. 1545-0074
2007
Attachment Sequence No. **50**

Name(s) shown on return	Your social security number
Judy Hood	xxx xx xxxx

Caution:
- *You **cannot** take the Hope credit and the lifetime learning credit for the **same student** in the same year.*
- *You **cannot** take both an education credit and the tuition and fees deduction (see Form 8917) for the **same student** in the same year.*

Part I **Hope Credit. Caution:** *You **cannot** take the Hope credit for more than **2** tax years for the **same student.***

1	**(a)** Student's name (as shown on page 1 of your tax return) First name / Last name	**(b)** Student's social security number (as shown on page 1 of your tax return)	**(c)** Qualified expenses (see instructions). **Do not** enter more than $2,200 for each student.	**(d)** Enter the **smaller** of the amount in column (c) or $1,100	**(e)** Add column (c) and column (d)	**(f)** Enter one-half of the amount in column (e)

2	**Tentative Hope credit.** Add the amounts on line 1, column (f). If you are taking the lifetime learning credit for another student, go to Part II; otherwise, go to Part III . . . . ▶	2	

Part II **Lifetime Learning Credit**

3	**(a)** Student's name (as shown on page 1 of your tax return) First name	Last name	**(b)** Student's social security number (as shown on page 1 of your tax return)	**(c)** Qualified expenses (see instructions)
	Judy	Hood	xxx xx xxxx	800

4	Add the amounts on line 3, column (c), and enter the total	4	800
5	Enter the **smaller** of line 4 or $10,000	5	800
6	**Tentative lifetime learning credit.** Multiply line 5 by 20% (.20) and go to Part III	6	160

Part III **Allowable Education Credits**

7	Tentative education credits. Add lines 2 and 6			7	160
8	Enter: $114,000 if married filing jointly; $57,000 if single, head of household, or qualifying widow(er)	8	57,000		
9	Enter the amount from Form 1040, line 38*, or Form 1040A, line 22 .	9	30,000		
10	Subtract line 9 from line 8. If zero or less, **stop;** you cannot take any education credits	10	27,000		
11	Enter: $20,000 if married filing jointly; $10,000 if single, head of household, or qualifying widow(er)	11	10,000		
12	If line 10 is equal to or more than line 11, enter the amount from line 7 on line 13 and go to line 14. If line 10 is less than line 11, divide line 10 by line 11. Enter the result as a decimal (rounded to at least three places)			12	× .
13	Multiply line 7 by line 12 . . . . ▶			13	160
14	Enter the amount from Form 1040, line 44, or Form 1040A, line 28 (minus any alternative minimum tax included on Form 1040A, line 28)			14	2,909
15	Enter the total, if any, of your credits from Form 1040, lines 47 and 48, or Form 1040A, lines 29 and 30	15	0		
16	1040 filers: Enter the amount from Form 6251, line 31 (see instructions) 1040A filers: Enter the amount, if any, from the Alternative Minimum Tax Worksheet, line 23 (see instructions)	16	0		
17	Add lines 15 and 16			17	0
18	Subtract line 17 from line 14. If zero or less, **stop.** You cannot take any education credits . ▶			18	2,909
19	**Education credits.** Enter the smaller of line 13 or line 18 here and on Form 1040, line 49, or Form 1040A, line 31 . . . . ▶			19	160

* If you are filing Form 2555, 2555-EZ, or 4563, or you are excluding income from Puerto Rico, see Pub. 970 for the amount to enter.

For Paperwork Reduction Act Notice, see page 4. Cat. No. 25379M Form **8863** (2007)

NO DOUBLE BENEFITS

A taxpayer cannot

- Deduct higher education expenses and claim a credit based on those same expenses (as, for example, a business expense).
- Claim a Hope credit and a lifetime learning credit based on the same qualified education expenses.
- Claim an education credit based on the expenses used to figure the tax-free portion of a distribution from a Coverdell Education Savings Account (ESA) or qualified tuition program (QTP).
- Claim a credit based on qualified education expenses paid with a tax-free scholarship, grant, or employer-provided educational assistance.

However, a taxpayer can claim a credit based on expenses paid with the eligible student's earnings, loans, gifts, inheritances, or personal savings.

An eligible student cannot claim an education credit if he or she is claimed as a dependent on another taxpayer's tax return. Any amounts paid by the student are considered paid by the taxpayer who claims the student as a dependent.

ALERT

If there is only one eligible student on the tax return and that student has more than $8,250 in qualified expenses, the lifetime learning credit may result in a higher credit for the taxpayer, even if the student would be eligible for the Hope credit.

The following table summarizes the differences between the credits.

Comparison of Education Credits

Hope Credit	Lifetime Learning Credit
Up to $1,650 credit per eligible student	Up to $2,000 per tax return
Available only until the first 2 years of postsecondary education are completed	Available for all years of postsecondary education and for courses to acquire or improve job skills
Available only for 2 tax years per eligible student	Available for an unlimited number of years
Student must be pursuing an undergraduate degree or other recognized education credential	Student does not need to be pursuing a degree or other recognized education credential
Student must be enrolled at least half time for at least one academic period during the year	Available for one or more courses
No felony drug conviction on student's record	Felony drug conviction not applicable

Exercise 1

Frank (SSN xxx-xx-xxxx) and Janet (SSN xxx-xx-xxxx) Averett are married and file a joint return. For 2007, their MAGI ($51,500) is the same as their AGI. They completed Form 1040 through line 46. Their tax amount on line 44 is $4,059. Janet is attending the local community college part-time to earn credits toward an associate degree in nursing. She paid $3,000 in tuition and fees. Their daughter, Nicole (SSN xxx-xx-xxxx), is a full-time freshman at the state university. Frank and Janet paid $8,800 in tuition and fees for Nicole in 2007. They choose to take the lifetime learning credit for Janet and the Hope credit for Nicole. They will claim no other credits. Complete their Form 8863 at Exhibit 4.

TaxWise® Hints

To input qualified tuition expenses and prepare Form 8863 using TaxWise®, link from Form 1040, line 49, to select Form 8863, enter the student's name in either the Hope credit section or the lifetime learning credit section, and complete all the entries annotated in red. TaxWise® will automatically complete the form and carry the mathematical calculations to Form 1040.

Quality Review (QR)—Education Credits

Use **Form 8158, Quality Review Sheet,** or an approved alternative form to review all returns prepared. Apply the quality review tools in combination with Form 13614, *Intake and Interview Sheet* and all the source documents to the returns you prepare to ensure quality and accuracy for every taxpayer.

Consider each item on the Quality Review Sheet which applies to the taxpayer's situation to confirm that all the necessary questions and issues have been addressed. If items are incorrect or incomplete, revisit the issue and make corrections to the return and the Intake and Interview Sheet, as needed.

Excerpt from Form 8158

Yes	No	
☐	☐	All **adjustments, deductions and credits** indicated on the intake/interview sheet and supporting documents are included on the return.

To ensure accurate reporting of adjustments, deductions, and credits, verify that the information on the Intake and Interview Sheet and on the taxpayer's supporting documents is included on the return.

Confirm that all potential adjustments, deductions, and credits have been discussed with the taxpayer and are shown on the return, if applicable.

▶ ▶ Summing Up This Lesson ◀ ◀

The Hope credit and lifetime learning credit are nonrefundable credits that allow a taxpayer to claim all or a portion of qualified tuition and related expenses paid for postsecondary education.

Generally, taxpayers can claim the Hope credit or lifetime learning credit if they pay qualified tuition and related expenses to an eligible higher education institution for an eligible student who is either the taxpayer, the taxpayer's spouse, or a dependent for whom the taxpayer can claim an exemption on his or her tax return.

A taxpayer cannot

- deduct higher education expenses on his or her tax return and also claim a Hope credit or lifetime learning credit based on those same expenses.
- claim a Hope credit and a lifetime learning credit based on the same qualified education expenses.
- claim a credit based on expenses paid with tax-free scholarship, grant, or employer-provided educational assistance.

The Hope credit and lifetime learning credit are claimed on Form 8863 which can be filed with either Form 1040 or Form 1040A.

Form **8863**

Department of the Treasury
Internal Revenue Service (99)

Education Credits
(Hope and Lifetime Learning Credits)

▶ See instructions.
▶ Attach to Form 1040 or Form 1040A.

OMB No. 1545-0074

2007

Attachment
Sequence No. 50

Name(s) shown on return	Your social security number

Caution: • *You* ***cannot*** *take the Hope credit and the lifetime learning credit for the* ***same student*** *in the same year.*
• *You* ***cannot*** *take both an education credit and the tuition and fees deduction (see Form 8917) for the* ***same student*** *in the same year.*

Part I Hope Credit. Caution: *You* ***cannot*** *take the Hope credit for more than* ***2*** *tax years for the* ***same student.***

1	(a) Student's name (as shown on page 1 of your tax return) First name / Last name	(b) Student's social security number (as shown on page 1 of your tax return)	(c) Qualified expenses (see instructions). **Do not** enter more than $2,200 for each student.	(d) Enter the **smaller** of the amount in column (c) or $1,100	(e) Add column (c) and column (d)	(f) Enter one-half of the amount in column (e)

2	**Tentative Hope credit.** Add the amounts on line 1, column (f). If you are taking the lifetime learning credit for another student, go to Part II; otherwise, go to Part III . . . . ▶	2	

Part II Lifetime Learning Credit

3	(a) Student's name (as shown on page 1 of your tax return) First name / Last name	(b) Student's social security number (as shown on page 1 of your tax return)	(c) Qualified expenses (see instructions)

4	Add the amounts on line 3, column (c), and enter the total	4	
5	Enter the **smaller** of line 4 or $10,000	5	
6	**Tentative lifetime learning credit.** Multiply line 5 by 20% (.20) and go to Part III	6	

Part III Allowable Education Credits

7	Tentative education credits. Add lines 2 and 6			7	
8	Enter: $114,000 if married filing jointly; $57,000 if single, head of household, or qualifying widow(er)	8			
9	Enter the amount from Form 1040, line 38*, or Form 1040A, line 22 .	9			
10	Subtract line 9 from line 8. If zero or less, **stop;** you cannot take any education credits	10			
11	Enter: $20,000 if married filing jointly; $10,000 if single, head of household, or qualifying widow(er)	11			
12	If line 10 is equal to or more than line 11, enter the amount from line 7 on line 13 and go to line 14. If line 10 is less than line 11, divide line 10 by line 11. Enter the result as a decimal (rounded to at least three places)			12	× .
13	Multiply line 7 by line 12 . . . . ▶			13	
14	Enter the amount from Form 1040, line 44, or Form 1040A, line 28 (minus any alternative minimum tax included on Form 1040A, line 28)			14	
15	Enter the total, if any, of your credits from Form 1040, lines 47 and 48, or Form 1040A, lines 29 and 30	15			
16	1040 filers: Enter the amount from Form 6251, line 31 (see instructions) 1040A filers: Enter the amount, if any, from the Alternative Minimum Tax Worksheet, line 23 (see instructions)	16			
17	Add lines 15 and 16			17	
18	Subtract line 17 from line 14. If zero or less, **stop.** You cannot take any education credits . ▶			18	
19	**Education credits.** Enter the smaller of line 13 or line 18 here and on Form 1040, line 49, or Form 1040A, line 31 . . . . ▶			19	

* If you are filing Form 2555, 2555-EZ, or 4563, or you are excluding income from Puerto Rico, see Pub. 970 for the amount to enter.

For Paperwork Reduction Act Notice, see page 4. Cat. No. 25379M Form **8863** (2007)

Form **8863**

Department of the Treasury
Internal Revenue Service (99)

Education Credits
(Hope and Lifetime Learning Credits)
► See instructions.
► Attach to Form 1040 or Form 1040A.

OMB No. 1545-0074
2007
Attachment Sequence No. 50

Name(s) shown on return: Frank & Janet Averett
Your social security number: xxx xx xxxx

Caution:
- *You **cannot** take the Hope credit and the lifetime learning credit for the **same student** in the same year.*
- *You **cannot** take both an education credit and the tuition and fees deduction (see Form 8917) for the **same student** in the same year.*

Part I Hope Credit. Caution: *You **cannot** take the Hope credit for more than **2** tax years for the **same student.***

1

(a) Student's name (as shown on page 1 of your tax return) First name / Last name	(b) Student's social security number (as shown on page 1 of your tax return)	(c) Qualified expenses (see instructions). Do not enter more than $2,200 for each student.	(d) Enter the smaller of the amount in column (c) or $1,100	(e) Add column (c) and column (d)	(f) Enter one-half of the amount in column (e)
Nicole Averett	xxx xx xxxx	2,200	1,100	3,300	1,650

2 **Tentative Hope credit.** Add the amounts on line 1, column (f). If you are taking the lifetime learning credit for another student, go to Part II; otherwise, go to Part III ►	2	1,650

Part II Lifetime Learning Credit

3

(a) Student's name (as shown on page 1 of your tax return) First name	Last name	(b) Student's social security number (as shown on page 1 of your tax return)	(c) Qualified expenses (see instructions)
Janet	Averett	xxx xx xxxx	3,000

4 Add the amounts on line 3, column (c), and enter the total	4	3,000
5 Enter the **smaller** of line 4 or $10,000	5	3,000
6 **Tentative lifetime learning credit.** Multiply line 5 by 20% (.20) and go to Part III	6	600

Part III Allowable Education Credits

7 Tentative education credits. Add lines 2 and 6			7	2,250
8 Enter: $114,000 if married filing jointly; $57,000 if single, head of household, or qualifying widow(er)	8	114,000		
9 Enter the amount from Form 1040, line 38*, or Form 1040A, line 22	9	51,500		
10 Subtract line 9 from line 8. If zero or less, **stop;** you cannot take any education credits	10	62,500		
11 Enter: $20,000 if married filing jointly; $10,000 if single, head of household, or qualifying widow(er)	11	20,000		
12 If line 10 is equal to or more than line 11, enter the amount from line 7 on line 13 and go to line 14. If line 10 is less than line 11, divide line 10 by line 11. Enter the result as a decimal (rounded to at least three places)			12	× .
13 Multiply line 7 by line 12 ►			13	2,250
14 Enter the amount from Form 1040, line 44, or Form 1040A, line 28 (minus any alternative minimum tax included on Form 1040A, line 28)			14	4,059
15 Enter the total, if any, of your credits from Form 1040, lines 47 and 48, or Form 1040A, lines 29 and 30	15	0		
16 1040 filers: Enter the amount from Form 6251, line 31 (see instructions) 1040A filers: Enter the amount, if any, from the Alternative Minimum Tax Worksheet, line 23 (see instructions)	16	0		
17 Add lines 15 and 16			17	0
18 Subtract line 17 from line 14. If zero or less, **stop.** You cannot take any education credits ►			18	4,059
19 **Education credits.** Enter the smaller of line 13 or line 18 here and on Form 1040, line 49, or Form 1040A, line 31 ►			19	2,250

* If you are filing Form 2555, 2555-EZ, or 4563, or you are excluding income from Puerto Rico, see Pub. 970 for the amount to enter.

For Paperwork Reduction Act Notice, see page 4. Cat. No. 25379M Form **8863** (2007)

STUDENT NOTES

MISCELLANEOUS TAX CREDITS

Lesson 9

INTRODUCTION AND OBJECTIVES

In this lesson you will learn about several "miscellaneous credits."

After completing this lesson you should be able to:

- Determine who is a qualified individual for the credit for the elderly or the disabled and apply the income limits.
- Calculate the credit for the elderly or the disabled.
- Calculate the credit for qualified retirement savings contributions by using Form 8880.
- Calculate the residential energy credit for nonbusiness energy property and residential energy efficient property using Form 5695.
- Calculate the alternative motor vehicle credit using Form 8910.
- Accurately report the foreign tax credit if Form 1116 is not required.
- Be aware of the mortgage interest credit.

This lesson contains basic and intermediate tax law course topics. The credits for the elderly or the disabled and the qualified retirement savings contributions are included in the Basic Course.

The residential energy credit, the alternative motor vehicle credit, the mortgage interest credit, and the foreign tax credit (if Form 1116 is not required) are covered in the Intermediate Course.

Form 1116, Foreign Tax Credit, is covered in the International portion of this lesson. Form 1116 should not be completed without this training.

ALERT

This lesson contains basic and intermediate tax law. Your course facilitator will teach only the information required to assist taxpayers you will serve.

ALERT

Pending legislation:

Based on the law at the time this material went to print, the credits covered in this lesson may be subject to limitations. Visit www.irs.gov for current information on tax law changes.

INTAKE AND INTERVIEW PROCESS
FORM 13614—MISCELLANEOUS CREDITS

Use **Form 13614, Intake and Interview Sheet,** or approved alternative form to engage the taxpayer in preparing an accurate return. Use the Intake and Interview Sheet as a starting point for a comprehensive interaction with the taxpayer. In addition, use all the source documents provided by the taxpayer to ensure each return is prepared correctly.

Confirm each item on Form 13614 (or approved alternative form used at your site) to make sure you and the taxpayer have considered all the necessary information. Ensure that all questions and issues have been addressed. If items are incorrect or incomplete, revisit each issue and make corrections to the return, as needed.

Excerpt from Form 13614

Part VII. Credits – In 2007 did you (or your spouse) have:

☐ Yes	☐ No	1. Child/dependent care expenses that allow you (and your spouse-if MFJ) to work
☐ Yes	☐ No	2. Educational expenses for you (or your spouse) and/or your dependents
☐ Yes	☐ No	3. Retirement Contribution to a traditional IRA, Roth IRA or 401k as shown on Form W-2

The retirement savings contribution credit is covered in this lesson. To ensure accurate reporting of the saver's credit, ask the taxpayer about contributions to a retirement plan or IRA. The amount of the credit is determined by the taxpayer's filing status, adjusted gross income, and qualified contributions. There are also age and other requirements. You will learn more about how a taxpayer may be eligible for this credit later on in this lesson.

Other credits are also covered in this lesson. Although they are not specifically listed on Form 13614, you should ask probing questions to ensure the accurate reporting of all credits.

CREDITS

A credit is a dollar-for-dollar reduction of the taxpayer's tax liability. A **refundable** credit can be greater than the tax. If a taxpayer's credits exceed the tax, then the excess credit can be refunded to the taxpayer. A **nonrefundable credit** can also be greater than the tax, but the nonrefundable credit can only reduce the tax to zero. Therefore, taxpayers will not receive a refund for any excess nonrefundable credit. All of the credits discussed in this lesson are nonrefundable credits.

Credit for the Elderly or the Disabled

Elderly individuals and individuals who are permanently and totally disabled may be able to claim a special credit on their tax returns if they are a United States citizen or resident.

To be eligible for the credit, an individual must be:

- At least 65 years old by the end of the year, or
- Under age 65, retired on permanent and total disability by the end of the year, and must not have reached mandatory retirement age before this year. He or she must also have received taxable disability income for this year.

Although physician statements related to permanent and total disability are no longer required to be attached to the return, they must be completed and kept with the taxpayer's records.

Certain work offered at qualified locations to persons with disabilities or with mental retardation is considered sheltered employment. Even if a person accepts sheltered employment, it is not proof of the person's ability to engage in substantial gainful activity.

Note: Since the credit for the elderly or the disabled is a nonrefundable credit, if the taxpayer has no tax liability, the taxpayer is not eligible for the credit.

Exhibit 1 helps to determine if the taxpayer is a qualified individual for this credit.

Income Limits

Taxpayers cannot exceed the income limits for their filing status. Refer to the page titled Credit for the Elderly or Disabled in the Credits tab of **Publication 4012, Volunteer Resource Guide.**

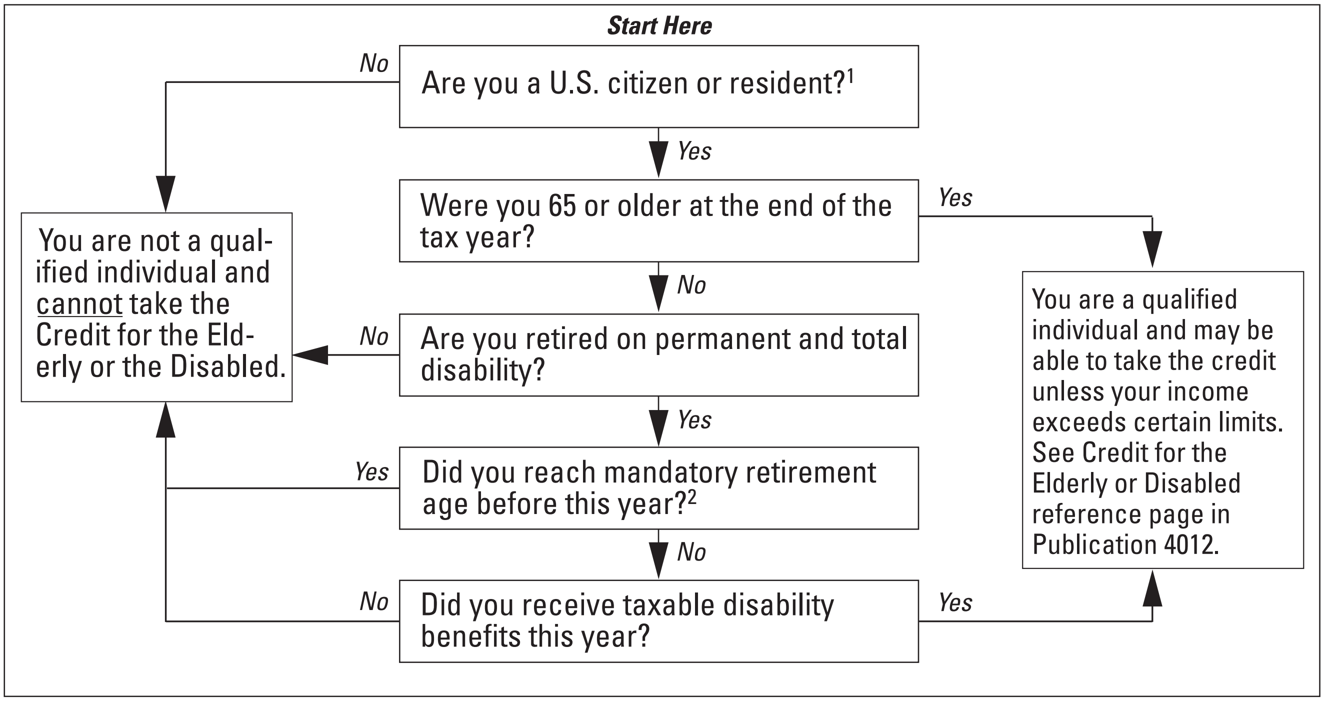
Calculate the Credit

If the taxpayer is a qualified individual and meets the income limits, complete Schedule R for Form 1040 filers or Schedule 3 for Form 1040A filers. Schedule R (Form 1040), and Schedule 3 (Form 1040A) are nearly identical. (See Schedule R—Exhibits 2 and 3 and Schedule 3—Exhibits 4 and 5.)

Example 1

Jerry Ash (123-00-1234) is 68 years old and single. He files Form 1040A. He received nontaxable social security benefits of $2,000. His adjusted gross income was $10,300. Jerry completes Form 1040A Schedule 3 to figure the amount of the credit. See completed Form 1040A Schedule 3—Exhibits 4 and 5.

Exhibit 1 **Are you a Qualified Individual?**



[1] 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 both choose to be treated as U.S. residents, answer yes to this question.

[2] Mandatory retirement age is the age set by your employer at which you would have been required to retire, had you not become disabled.

ALERT

Be sure to include social security benefit income (link from Form 1040, line 20a or Form 1040A, line 14a to the social security benefits worksheet) even if you know the benefits are not taxable. Without this information the tax preparation software may incorrectly calculate the credit.

TaxWise® Hints

The credit for the elderly or the disabled will be calculated automatically by the tax software. The software will check age, income, and filing status to determine eligibility. However, it is extremely important to input social security benefit income (link from Form 1040, line 20, to SSA worksheet) even if you know it is not taxable. Without this information the software may incorrectly calculate the credit.

Schedule R (Form 1040)
Department of the Treasury Internal Revenue Service (99)

Credit for the Elderly or the Disabled

▶ Attach to Form 1040. ▶ See Instructions for Schedule R (Form 1040).

OMB No. 1545-0074
2007
Attachment Sequence No. **16**

Name(s) shown on Form 1040 | **Your social security number**

You may be able to take this credit and reduce your tax if by the end of 2007:

- 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 page R-1.

TIP In most cases, the IRS can figure the credit for you. See page R-1.

Part I Check the Box for Your Filing Status and Age

If your filing status is:	And by the end of 2007:		Check only one box:
Single, Head of household, or Qualifying widow(er)	**1** You were 65 or older	**1**	☐
	2 You were under 65 and you retired on permanent and total disability	**2**	☐
Married filing jointly	**3** Both spouses were 65 or older	**3**	☐
	4 Both spouses were under 65, but only one spouse retired on permanent and total disability	**4**	☐
	5 Both spouses were under 65, and both retired on permanent and total disability	**5**	☐
	6 One spouse was 65 or older, and the other spouse was under 65 and retired on permanent and total disability	**6**	☐
	7 One spouse was 65 or older, and the other spouse was under 65 and **not** retired on permanent and total disability	**7**	☐
Married filing separately	**8** You were 65 or older and you lived apart from your spouse for all of 2007	**8**	☐
	9 You were under 65, you retired on permanent and total disability, and you lived apart from your spouse for all of 2007	**9**	☐

Did you check box 1, 3, 7, or 8?
- **Yes** ▶ Skip Part II and complete Part III on the 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**

2 Due to your continued disabled condition, you were unable to engage in any substantial gainful activity in 2007, check this box . . . ▶ ☐

- If you checked this box, you do not have to get another statement for 2007.
- If you **did not** check this box, have your physician complete the statement on page R-4. You **must** keep the statement for your records.

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 11359K **Schedule R (Form 1040) 2007**

Part III Figure Your Credit

10	**If you checked (in Part I):** **Enter:** Box 1, 2, 4, or 7 . . . $5,000 Box 3, 5, or 6 . . . $7,500 Box 8 or 9 . . . $3,750	10
	Did you check box 2, 4, 5, 6, or 9 in Part I? **Yes** → You **must** complete line 11. **No** → Enter the amount from line 10 on line 12 and go to line 13.	
11	**If you checked (in Part I):** • Box 6, add $5,000 to the taxable disability income of the spouse who was under age 65. Enter the total. • Box 2, 4, or 9, enter your taxable disability income. • Box 5, add your taxable disability income to your spouse's taxable disability income. Enter the total. TIP For more details on what to include on line 11, see page R-3.	11
12	If you completed line 11, enter the **smaller** of line 10 or line 11; **all others,** enter the amount from line 10 . . .	12
13	Enter the following pensions, annuities, or disability income that you (and your spouse if filing a joint return) received in 2007.	
a	Nontaxable part of social security benefits and nontaxable part of railroad retirement benefits treated as social security (see page R-3) . . . **13a**	
b	Nontaxable veterans' pensions and any other pension, annuity, or disability benefit that is excluded from income under any other provision of law (see page R-3) . . . **13b**	
c	Add lines 13a and 13b. (Even though these income items are not taxable, they **must** 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 . . . **13c**	
14	Enter the amount from Form 1040, line 38 . . . **14**	
15	**If you checked (in Part I):** **Enter:** Box 1 or 2 . . . $7,500 Box 3, 4, 5, 6, or 7 . . . $10,000 Box 8 or 9 . . . $5,000 **15**	
16	Subtract line 15 from line 14. If zero or less, enter -0- . . . **16**	
17	Enter one-half of line 16 . . . **17**	
18	Add lines 13c and 17 . . .	18
19	Subtract line 18 from line 12. If zero or less, **stop;** you **cannot** take the credit. Otherwise, go to line 20 . . .	19
20	Multiply line 19 by 15% (.15) . . .	20
21	Enter the amount from Form 1040, line 44, minus the amount, if any, on Form 1040, line 47 . . . **21**	
22	Enter the amount from Form 6251, line 31 (see page R-3) . **22**	
23	Subtract line 22 from line 21. If zero or less, **stop;** you **cannot** take the credit . . .	23
24	**Credit for the elderly or the disabled.** Enter the **smaller** of line 20 or line 23 here and on Form 1040, line 48 . . .	24

Printed on recycled paper **Schedule R (Form 1040) 2007**

Schedule 3 (Form 1040A)

Department of the Treasury—Internal Revenue Service

Credit for the Elderly or the Disabled for Form 1040A Filers

(99) **2007**

OMB No. 1545-0074

Name(s) shown on Form 1040A	Your social security number
Jerry Ash	123 00 1234

You may be able to take this credit and reduce your tax if by the end of 2007:

- 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 3.

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 2007:	Check only one box:
Single, Head of household, or Qualifying widow(er)	**1** You were 65 or older 1	☑
	2 You were under 65 and you retired on permanent and total disability 2	☐
Married filing jointly	**3** Both spouses were 65 or older 3	☐
	4 Both spouses were under 65, but only one spouse retired on permanent and total disability 4	☐
	5 Both spouses were under 65, and both retired on permanent and total disability 5	☐
	6 One spouse was 65 or older, and the other spouse was under 65 and retired on permanent and total disability 6	☐
	7 One spouse was 65 or older, and the other spouse was under 65 and **not** retired on permanent and total disability 7	☐
Married filing separately	**8** You were 65 or older and you lived apart from your spouse for all of 2007 8	☐
	9 You were under 65, you retired on permanent and total disability, and you lived apart from your spouse for all of 2007 9	☐

Did you check box 1, 3, 7, or 8?

- **Yes** ▶ Skip Part II and complete Part III on the back.
- **No** ▶ Complete Parts II and III.

Part II

Statement of permanent and total disability

Complete this part **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**

2 Due to your continued disabled condition, you were unable to engage in any substantial gainful activity in 2007, check this box . . . . ▶ ☐

- If you checked this box, you do not have to get another statement for 2007.
- 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.

For Paperwork Reduction Act Notice, see Form 1040A instructions. Cat. No. 12064K **Schedule 3 (Form 1040A) 2007**

Part III

Figure your credit

10	**If you checked (in Part I):** **Enter:** Box 1, 2, 4, or 7 . . . . $5,000 Box 3, 5, or 6 . . . . $7,500 Box 8 or 9 . . . . $3,750	10	5,000
	Did you check box 2, 4, 5, 6, or 9 in Part I? **Yes** → You **must** complete line 11. **No** → Enter the amount from line 10 on line 12 and go to line 13.		
11	**If you checked (in Part I):** • Box 6, add $5,000 to the taxable disability income of the spouse who was under age 65. Enter the total. • Box 2, 4, or 9, enter your taxable disability income. • Box 5, add your taxable disability income to your spouse's taxable disability income. Enter the total. TIP For more details on what to include on line 11, see the instructions.	11	
12	If you completed line 11, enter the **smaller** of line 10 or line 11; **all others,** enter the amount from line 10.	12	5,000

13	Enter the following pensions, annuities, or disability income that you (and your spouse if filing a joint return) received in 2007.		
a	Nontaxable part of social security benefits and Nontaxable part of railroad retirement benefits treated as social security (see the instructions).	13a	2,000
b	Nontaxable veterans' pensions and Any other pension, annuity, or disability benefit that is excluded from income under any other provision of law (see the instructions).	13b	0
c	Add lines 13a and 13b. (Even though these income items are not taxable, they **must** 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.	13c	2,000
14	Enter the amount from Form 1040A, line 22.	14	10,300
15	**If you checked (in Part I):** **Enter:** Box 1 or 2 . . . . $7,500 Box 3, 4, 5, 6, or 7 . . . . $10,000 Box 8 or 9 . . . . $5,000	15	7,500
16	Subtract line 15 from line 14. If zero or less, enter -0-.	16	2,800
17	Enter one-half of line 16.	17	1,400

18	Add lines 13c and 17.	18	3,400
19	Subtract line 18 from line 12. If zero or less, **stop;** you **cannot** take the credit. Otherwise, go to line 20.	19	1,600
20	Multiply line 19 by 15% (.15).	20	240
21	Enter the amount from Form 1040A, line 28, minus any amount on Form 1040A, line 29.	21	61
22	**Credit for the elderly or the disabled.** Enter the **smaller** of line 20 or line 21 here and on Form 1040A, line 30.	22	61

Credit for Qualified Retirement Savings Contributions

If the taxpayer contributed to a retirement plan or an IRA, he or she may be eligible for the qualified retirement savings contributions credit. The amount of the saver's credit is determined by the taxpayer's filing status, adjusted gross income, and his or her qualified contributions.

The credit is reported on Form 1040, line 53, or Form 1040A, line 33.

To be eligible for the saver's credit, the taxpayer:

- Must be born before January 2, 1990,
- Cannot be claimed as a dependent on another person's tax return, and
- Cannot be a full-time student.

A **full-time student** is anyone who attends school full time for some part of each of five calendar months of the year. The five months need not be consecutive. An individual is a full-time student if he or she is enrolled for the number of hours or courses the school considers as full-time attendance.

Figuring the Credit

The credit for qualified retirement savings contributions is figured by multiplying the **credit rate** by the lesser of the:

- Maximum allowable contribution ($2,000), or
- Eligible contributions.

The amount of the credit the taxpayer gets is based on the contributions made and the credit rate. The credit rate can be as low as 10 percent or as high as 50 percent. The credit rate depends on the taxpayer's adjusted gross income and filing status. Form 8880 is used to compute the credit.

Adjusted gross income is determined without regard to:

- The foreign income exclusion,
- The foreign housing exclusion or deduction,
- Income from sources within Guam, American Samoa, and the Northern Mariana Islands, or
- Income from Puerto Rico.

These exclusions or deductions must be added to the adjusted gross income on Form 1040, line 38, or Form 1040A, line 22, for purposes of determining the credit rate.

Eligible contributions are determined by reducing the taxpayer's **qualified retirement savings contributions** by the following distributions that were received during the **testing period. Testing period** is explained later.

- Any distribution that is included in the taxpayer's gross income from a qualified retirement plan or from an eligible deferred compensation plan. This includes distributions from any IRA, plan, or annuity described below under qualified retirement savings contributions.
- Any distribution from a Roth IRA that is not rolled over, even if the distribution is not taxable.

If the distributions received by the taxpayer are for loans or for excess IRA contributions returned before the due date of the return, they are not used to reduce the taxpayer's qualified retirement savings contributions.

Distributions from a military retirement plan are not used to reduce the taxpayer's qualified retirement savings contribution. The military retirement plan is a noncontributory plan that does not allow any contributions by the military employee.

Qualified retirement savings contributions are contributions made to a traditional or Roth IRA and salary reduction contributions to a 401(k) plan (including a SIMPLE 401(k)), a tax-sheltered annuity (403(b)) plan, an eligible deferred compensation plan of a state or local government (457(b)) plan), a SIMPLE IRA plan, or a salary reduction simplified employee plan (SEP). Also eligible are contributions to a section 501(c)(18) plan.

Qualified retirement savings contributions also include voluntary after-tax employee contributions to a tax-qualified retirement plan or a tax-sheltered annuity (403(b)) plan. For purposes of the credit, an employee contribution will be voluntary as long as it is not required as a condition of employment.

The **testing period** includes:

- The tax year,
- The two preceding tax years, and
- The period between the end of the tax year and the due date of the return (including extensions).

Example 2

Terry contributes $3,000 to a 401(k) plan during 2007. In 2006, Terry withdrew $500 from his IRA. In 2007, he withdrew $900 from his IRA. Neither of these withdrawals were rolled over. In 2007, Terry's adjusted gross income was $24,000 and his filing status was head of household. Based on these facts, Terry would figure his saver's credit as follows:

(Qualified retirement contributions – withdrawals) × credit rate (per table)

($3,000 − $1,400) × .20

$1,600 × .20 = $320 saver's credit

The credit is figured on **Form 8880, Credit for Qualified Retirement Savings Contributions.**

Married filing jointly. If the taxpayer is married filing a joint return, he or she and his or her spouse may both use the credit. Both the taxpayer and spouse are eligible for a credit of the maximum annual contribution amount of $2,000.

If the taxpayers file a joint return, the qualified contribution is reduced by the taxable distributions received by the taxpayer or the taxpayer's spouse if the taxpayers filed jointly for both:

- The year a distribution was made, and
- The year the credit is claimed.

In other words, any distributions received by a taxpayer's spouse is treated as received by the taxpayer if they file a joint return in the year of the distribution and in the year the credit is claimed.

Example 3

Billy and Margaret filed joint returns in 2005 and 2006, and intend to do so in 2007 and 2008. Billy received a taxable distribution from a qualified plan in 2005 and a taxable distribution from an eligible deferred compensation plan in 2006. Margaret received taxable distributions from a Roth IRA in 2007 and a tax-free distribution from a Roth IRA in 2008 before April 15. Billy made eligible contributions to his IRA in 2007 and otherwise qualifies for the retirement savings contributions credit. Billy must reduce the amount of his qualifying contributions in 2007 by the total distributions received in 2005, 2006, 2007, and 2008.

Exercise 1

Jason is 22 and earned $30,000. He is single and contributed $3,000 to his 401(k) plan at work. Is Jason eligible for the credit for qualified retirement savings contributions?

Exercise 2

Martha Barnard (000-00-0088) is 32 and files as head of household. Her only income is wages of $26,819. This year, she was able to contribute $1,000 to her employer's 401(k) plan. She did not put any money in an IRA. Use Exhibit 6 to complete Martha's Form 8880 through line 10.

TaxWise® Hints

If you are using TaxWise® software, the credit for qualified retirement savings contributions will be calculated automatically for contributions reported on Form W-2. The software picks up the information from the codes and dollar amounts entered on Form W-2. If manually preparing a return, be sure to carefully review Form W-2 for these contributions.

Form **8880**

Department of the Treasury
Internal Revenue Service

Credit for Qualified Retirement Savings Contributions

► Attach to Form 1040, Form 1040A, or Form 1040NR.
► See instructions on back.

OMB No. 1545-0074

2007

Attachment Sequence No. **129**

Name(s) shown on return | **Your social security number**

CAUTION

You **cannot** take this credit if **either** of the following applies.

- The amount on Form 1040, line 38; Form 1040A, line 22; or Form 1040NR, line 36 is more than $26,000 ($39,000 if head of household; $52,000 if married filing jointly).
- The person(s) who made the qualified contribution or elective deferral **(a)** was born after January 1, 1990, **(b)** is claimed as a dependent on someone else's 2007 tax return, or **(c)** was a **student** (see instructions).

			(a) You	(b) Your spouse
1	Traditional and Roth IRA contributions for 2007. **Do not** include rollover contributions	1		
2	Elective deferrals to a 401(k) or other qualified employer plan, voluntary employee contributions, and 501(c)(18)(D) plan contributions for 2007 (see instructions)	2		
3	Add lines 1 and 2	3		
4	Certain distributions received **after** 2004 and **before** the due date (including extensions) of your 2007 tax return (see instructions). If married filing jointly, include **both** spouses' amounts in **both** columns. See instructions for an exception	4		
5	Subtract line 4 from line 3. If zero or less, enter -0-	5		
6	In each column, enter the **smaller** of line 5 or $2,000	6		
7	Add the amounts on line 6. If zero, **stop**; you cannot take this credit	7		
8	Enter the amount from Form 1040, line 38*; Form 1040A, line 22; or Form 1040NR, line 36	8		
9	Enter the applicable decimal amount shown below:	9	X .	

If line 8 is—		And your filing status is—		
Over—	But not over—	Married filing jointly	Head of household	Single, Married filing separately, or Qualifying widow(er)
		Enter on line 9—		
---	$15,500	.5	.5	.5
$15,500	$17,000	.5	.5	.2
$17,000	$23,250	.5	.5	.1
$23,250	$25,500	.5	.2	.1
$25,500	$26,000	.5	.1	.1
$26,000	$31,000	.5	.1	.0
$31,000	$34,000	.2	.1	.0
$34,000	$39,000	.1	.1	.0
$39,000	$52,000	.1	.0	.0
$52,000	---	.0	.0	.0

Note: *If line 9 is zero, **stop**; you cannot take this credit.*

10	Multiply line 7 by line 9	10	
11	Enter the amount from Form 1040, line 46; Form 1040A, line 28; or Form 1040NR, line 43	11	
12	**1040 filers:** Enter the total of your credits from lines 47 through 52 plus the amounts, if any, from line 13 of Form 8396 and line 13 of Form 8859 **1040A filers:** Enter the total of your credits from lines 29 through 32. **1040NR filers:** Enter the total of your credits from lines 44 through 47 plus the amounts, if any, line 13 of Form 8396 and line 13 of Form 8859.	12	
13	Subtract line 12 from line 11. If zero, **stop**; you cannot take this credit	13	
14	**Credit for qualified retirement savings contributions.** Enter the **smaller** of line 10 or line 13 here and on Form 1040, line 53; Form 1040A, line 33; or Form 1040NR, line 48	14	

*See Pub. 590 for the amount to enter if you are filing Form 2555, 2555-EZ, or 4563 or you are excluding income from Puerto Rico.

STOP

Stop here for the Basic Course. Go to the end of this lesson for
>>SUMMING UP THIS LESSON<<

All others continue

Taxpayers may be eligible for two energy credits. The nonbusiness energy property credit and the residential energy efficient property credit are available to taxpayers for making energy-saving improvements to their home. The nonbusiness energy property credit applies to tax years 2006 and 2007. The residential energy efficient property credit applies to tax years 2006 through 2008. For credit purposes, costs are treated as being paid when the original installation of the item is completed or, in the case of costs connected with the construction or reconstruction of a building, when the original use of the constructed or reconstructed building begins.

A home includes a house, houseboat, mobile home, cooperative apartment, condominium, and certain manufactured homes. The taxpayer must reduce the basis of his or her home by the amount of any credit allowed.

Manufacturers offering energy efficient items can assure their customers that their energy efficient items will qualify for the tax credit by providing their customer with a certification statement. The certification statement may be provided by including a written copy of the statement with the packaging of the item, in printable form on the manufacturer's web site, or in any other manner that will permit the taxpayer to retain the certification statement for tax recordkeeping purposes.

Form 5695, Residential Energy Credits, is used to claim the credit (Exhibit 7).

Nonbusiness Energy Property Credit. The credit is equal to the sum of:

- 10 percent of the amount paid for qualified energy efficiency improvements installed, and
- Any residential energy property costs paid.

To qualify, a component must meet or exceed the criteria established by the 2000 International Energy Conservation Code (including supplements) and must be installed in the taxpayer's main home in the United States.

> **Potential Pitfalls**
>
> Installation costs are not included in the total costs eligible for the credit for qualified energy efficiency improvements such as insulation, storm doors, and storm windows. Refer to Form 5695 and instructions.

The following items are eligible:

- Insulation systems that reduce heat loss/gain
- Exterior windows (including skylights)
- Exterior doors and metal roofs (meeting applicable Energy Star requirements)

In addition, a credit is allowed for costs related to residential energy property. These costs are for new qualified energy property that is installed on or in a taxpayer's main home located in the United States. This includes labor costs properly allocable to the onsite preparation, assembly, or original installation of the property. Qualified energy property is any of the following:

- Certain electric heat pump water heaters, electric heat pumps, geothermal heat pumps, central air conditioners, and natural gas, propane, or oil water heaters

- Qualified natural gas, propane, or oil furnaces or hot water boilers
- Certain advanced main air circulating fans used in natural gas, propane, or oil furnaces

The credit is limited as follows:

- $50 for each advanced main air circulating fan,
- $150 for each qualified natural gas, propane, or oil furnace or water heater, and
- $300 for each item of qualified energy efficient property.

The maximum credit for all taxable years is $500. No more than $200 of the credit can be attributable to expenses for windows. In the interview process you will need to ask the taxpayer if they took the energy credit in 2006 since there are overall limits for this credit.

Residential Energy Efficient Property Credit. The credit is 30 percent of the cost of qualified photovoltaic property (solar panels), solar water heating equipment, or a fuel cell power plant added to the taxpayer's home in the United States. This includes labor costs properly allocable to the onsite preparation, assembly, or original installation of the property and piping or wiring to interconnect such property to the home.

In general, a qualified fuel cell power plant converts a fuel into electricity using electrochemical means. It has an electricity-only generation efficiency of more than 30 percent and generates at least 0.5 kilowatts of electricity.

The credit is limited as follows:

- $2,000 for qualified photovoltaic property (solar panels) costs,
- $2,000 for qualified solar water heating property costs, and
- $500 for each half kilowatt ($1,000 for each kilowatt) of capacity of qualified fuel cell property for which qualified fuel cell property costs are paid.

Costs allocable to a swimming pool or hot tub do not qualify for the residential energy efficiency credit.

If the taxpayer cannot use part of the credit because of the tax liability limit, the unused credit may be carried forward to the next year.

ALERT

If the taxpayer was entitled to Residential Energy Credits for tax year 2006, you will need information from the 2006 Form 5695 to properly complete the credit for 2007.

Example 4

Sam Clark incurred the following expenses in making some energy savings improvements to his main home in the United States:

- Insulation materials $1,000 (does not include installation costs)
- Exterior windows $1,500 (does not include installation costs)
- Solar panels $3,500
- Solar water heating property $1,000

Sam has a certification statement from the manufacturer stating that all of the energy efficient items qualify for the residential energy tax credit.

See Exhibit 7 for Sam's completed Form 5695.

Form **5695**

Department of the Treasury
Internal Revenue Service

Residential Energy Credits

► See instructions.
► Attach to Form 1040 or Form 1040NR.

OMB No. 1545-0074
2007
Attachment Sequence No. 158

Name(s) shown on return: Sam Clark
Your social security number: xxx xx xxxx

Part I **Nonbusiness Energy Property Credit** (See instructions before completing this part.)

1	Were the qualified energy efficiency improvements or residential energy property costs for your main home located in the United States? (see instructions) ►			1	☑ Yes ☐ No
	Caution: *If you checked the "No" box, you cannot claim the nonbusiness energy property credit. Do not complete Part I.*				
2	Qualified energy efficiency improvements (see instructions).				
a	Insulation material or system specifically and primarily designed to reduce heat loss or gain in your home			2a	1,000
b	Exterior doors			2b	
c	Metal roof with appropriate pigmented coatings that meet the Energy Star program requirements and is specifically and primarily designed to reduce heat gain in your home			2c	
d	Exterior windows (including skylights)	2d	1,500		
e	Maximum amount of cost on which the credit can be figured	2e	2,000		
f	Enter the amount, if any, from your 2006 Form 5695, line 2b. Otherwise, enter -0-	2f	0		
g	Subtract line 2f from line 2e	2g	2,000		
h	Enter the smaller of line 2d or line 2g			2h	1,500
3	Add lines 2a, 2b, 2c, and 2h			3	2,500
4	Multiply line 3 by 10% (.10)			4	250
5	Residential energy property costs (see instructions).				
a	Energy-efficient building property. Do not enter more than $300			5a	
b	Qualified natural gas, propane, or oil furnace or hot water boiler. Do not enter more than $150			5b	
c	Advanced main air circulating fan used in a natural gas, propane, or oil furnace. Do not enter more than $50			5c	
6	Add lines 5a through 5c			6	0
7	Add lines 4 and 6			7	250
8	Maximum credit amount. (If you jointly occupied the home, see instructions)			8	500
9	Enter the amount, if any, from your 2006 Form 5695, line 8. Otherwise, enter -0-			9	0
10	Subtract line 9 from line 8			10	500
11	Enter the smaller of line 7 or line 10			11	250
12	Enter the amount from Form 1040, line 44, or Form 1040NR, line 41	12	4,501		
13	Enter the total, if any, of your credits from Form 1040, lines 47 through 49, or Form 1040NR, line 44	13	0		
14	Enter the amount from Form 6251, line 31 (see instructions)	14	0		
15	Add lines 13 and 14	15	0		
16	Subtract line 15 from line 12. If zero or less, **stop.** You cannot take the nonbusiness energy property credit			16	4,501
17	**Nonbusiness energy property credit.** Enter the smaller of line 11 or line 16			17	250

For Paperwork Reduction Act Notice, see instructions. Form **5695** (2007)

Before you begin: Figure the amount of any mortgage interest credit or District of Columbia first-time homebuyer credit you are claiming.

Part II **Residential Energy Efficient Property Credit** (See instructions before completing this part.)

18	Qualified solar electric property costs	18	3,500		
19	Multiply line 13 by 30% (.30)	19	1,050		
20	Maximum credit amount	20	2,000		
21	Enter the smaller of line 19 or line 20			21	1,050
22	Qualified solar water heating property costs	22	1,000		
23	Multiply line 22 by 30% (.30)	23	300		
24	Maximum credit amount	24	2,000		
25	Enter the smaller of line 23 or line 24			25	300
26	Qualified fuel cell property costs	26			
27	Multiply line 26 by 30% (.30)	27			
28	Kilowatt capacity of property on line 26 above ► ______ X $1,000	28			
29	Enter the smaller of line 27 or line 28			29	
30	Credit carryforward from 2006. Enter the amount, if any, from your 2006 Form 5695, line 30			30	
31	Add lines 21, 25, 29, and 30			31	1,350
32	Enter the amount from Form 1040, line 44, or Form 1040NR, line 41	32	4,501		
33	**1040 filers:** Enter the total, if any, of your credits from Form 1040, lines 47 through 49, plus the amounts, if any, from line 17 of this form, line 13 of Form 8396, and line 13 of Form 8859. **1040NR filers:** Enter the amount, if any, from Form 1040NR, line 44, plus the amount, if any, from line 17 of this form, line 13 of Form 8396, and line 13 of Form 8859.	33	250		
34	Enter the amount from Form 6251, line 31 (see instructions)	34	0		
35	Add lines 33 and 34	35	250		
36	Subtract line 35 from line 32. If zero or less, enter -0- here and on line 37			36	4,251
37	**Residential energy efficient property credit.** Enter the smaller of line 31 or line 36			37	1,350
38	Credit carryforward to 2008. If line 37 is less than line 31, subtract line 37 from line 31	38			

Part III **Current Year Residential Energy Credits**

39	Add lines 17 and 37. Enter here and on Form 1040, line 50, or Form 1040NR, line 45	39	1,600

For tax year 2007, taxpayers may be able to claim a credit for an alternative motor vehicle placed in service for business or personal use. An alternative motor vehicle must meet certain requirements and be a new:

- Advanced lean-burn technology vehicle,
- Qualified alternative fuel vehicle,
- Qualified fuel cell vehicle, or
- Qualified hybrid vehicle.

Form 8910, Alternative Motor Vehicle Credit, is used to claim the credit.

Generally, for a qualified alternative fuel motor vehicle, an advanced lean burn technology vehicle, or a passenger car or truck (light- or heavy-duty) that is a qualified hybrid vehicle, taxpayers can rely on the manufacturer's (or, in the case of a foreign manufacturer, its domestic distributor's) certification that a specific make, model, and model year vehicle qualifies for the credit and the maximum amount of the credit for which it qualifies.

If the taxpayer purchased a qualified vehicle from a manufacturer who previously sold at least 60,000 qualified vehicles, the phaseout percentage may be reduced below 100 percent. The manufacturer should give the taxpayer the information needed to figure the phaseout percentage.

In addition to the certification, the following requirements must be met to qualify for the credit:

- Vehicle was placed in service after 2005;
- Original use of the vehicle began with the taxpayer;
- Vehicle was acquired for the taxpayer's use or lease to others, and not for resale; and
- Vehicle is used primarily in the United States.

There are some exceptions for sellers of a new vehicle to a tax exempt organization, governmental unit, or a foreign person or entity.

If the taxpayer cannot use part of the personal portion of the credit because of the tax liability limit, the unused personal portion of the credit is lost. The unused personal portion of the credit cannot be carried back or forward to other tax years.

Recapture of Credit. If the vehicle no longer qualifies for the credit, the taxpayer may need to recapture all or part of the credit.

Example 5

Johnny Wade purchased a 2007 Honda Civic Hybrid CVT model on July 1, 2007. He has the manufacturer's certification that the vehicle qualifies for a $2,100 alternative motor vehicle credit.

See Exhibit 8 for Johnny Wade's completed Form 8910.

Form **8910**

Department of the Treasury
Internal Revenue Service

Alternative Motor Vehicle Credit

▶ Attach to your tax return.

OMB No. 1545-1998

2007

Attachment Sequence No. 152

Name(s) shown on return	Identifying number
Johnny Wade	xxx-xx-xxxx

Part I Tentative Credit

Use a separate column for each vehicle. If you need more columns, use additional Forms 8910 and include the totals on lines 8 and 12.		(a)	(b)	(c)
1 Year, make, and model of vehicle	1	2007HondaCivic		
2 Enter date vehicle was placed in service (MM/DD/YYYY)	2	07 / 01 / 2007	/ /	/ /
3 Maximum credit allowable (see instructions)	3	2,100		
4 Phaseout percentage (see instructions)	4	100 %	%	%
5 **Tentative credit.** Multiply line 3 by line 4	5	2,100		

Part II Credit for Business/Investment Use Part of Vehicle

		(a)	(b)	(c)
6 Business/investment use percentage (see instructions)	6	%	%	%
7 Multiply line 5 by line 6	7			

8 Add columns (a) through (c) on line 7	8	
9 Alternative motor vehicle credit from partnerships and S corporations	9	
10 **Business/investment use part of credit.** Add lines 8 and 9. Partnerships and S corporations, report this amount on Schedule K; all others, report this amount on Form 3800, line 1s	10	

Part III Credit for Personal Use Part of Vehicle

		(a)	(b)	(c)
11 Subtract line 7 from line 5	11	2,100		

12 Add columns (a) through (c) on line 11			12	2,100
13 Regular tax before credits: • Individuals. Enter the amount from Form 1040, line 44 (or Form 1040NR, line 41) • Other filers. Enter the regular tax before credits from your return			13	5,001
14 Credits that reduce regular tax before the alternative motor vehicle credit:				
a Credits from Form 1040, lines 47 through 50 and 52 through 54 (or Form 1040NR, lines 44, 45, and 47 through 49)	14a			
b Foreign tax credit	14b			
c Qualified electric vehicle credit (Form 8834, line 20)	14c			
d Add lines 14a through 14c			14d	0
15 Net regular tax. Subtract line 14d from line 13. If zero or less, stop here; **do not** file this form unless you are claiming a credit on line 10			15	5,001
16 Tentative minimum tax (see instructions): • Individuals. Enter the amount from Form 6251, line 33 • Other filers. Enter the tentative minimum tax from your alternative minimum tax form or schedule			16	0
17 Subtract line 16 from line 15. If zero or less, stop here; **do not** file this form unless you are claiming a credit on line 10			17	5,001
18 **Personal use part of credit.** Enter the **smaller** of line 12 or 17 here and on Form 1040, line 55; Form 1040NR, line 50; or the appropriate line of your return. If line 17 is smaller than line 12, see instructions			18	2,100

For Paperwork Reduction Act Notice, see instructions. Cat. No. 37720F Form **8910** (2007)

Mortgage Interest Credit

Taxpayers who hold qualified mortgage credit certificates under a qualified state or local government program may claim a credit for mortgage interest paid. The certificate must be for the taxpayer's main home. If the interest is paid to certain related parties (such as relatives), the credit cannot be claimed.

The credit is figured on **Form 8396, Mortgage Interest Credit.** Include the amount of the credit on Form 1040, line 54 and check box a for Form 8396.

Any mortgage interest credit that the taxpayer cannot use in 2007 can be carried forward for up to three tax years. Figure the carryforward credit in Part II of Form 8396.

Reduce the mortgage interest deduction claimed on Form 1040, Schedule A, by the amount shown on Form 8396, line 3.

Note: If the taxpayer was issued (and used) a qualified mortgage credit certificate after 1990 for a home, the taxpayer may have to recapture (repay) all or part of the benefit if the taxpayer sells that home within 9 years. The recapture is figured on **Form 8828, Recapture of Federal Mortgage Subsidy.**

This credit is outside the scope of the volunteer program. It is introduced here only as an awareness topic. Taxpayers wanting to claim this credit may need to seek the assistance of a tax professional.

Foreign Tax Credit

The taxpayer may be able to take a **foreign tax credit** (FTC) for taxes paid if the taxpayer paid income, war profits, or excess profits taxes to any:

- Foreign country,
- United States possession, or
- Political subdivision or agency or instrumentality of the country or possession.

To determine if the tax paid is eligible for the foreign tax credit, the taxpayer **may** need to consult a paid tax preparer.

Generally, to claim the FTC, a taxpayer is required to file **Form 1116, Foreign Tax Credit (Individual, Estate, Trust, or Nonresident Alien Individual);** however, the taxpayer does not have to file Form 1116 to take the credit if he or she meets all of the following requirements:

- All of the taxpayer's gross foreign source income is from interest and dividends that are reported on Form 1099-INT or Form 1099-DIV (or substitute statement).
- The taxpayer has dividend income from shares of stock that he or she held for at least 16 days.

- The taxpayer is not filing **Form 4563, Exclusion of Income for Bona Fide Residents of American Samoa,** or excluding income from sources within Puerto Rico.
- The total of the taxpayer's foreign taxes is less than or equal to $300 ($600 if married filing jointly).
- All of the taxpayer's foreign taxes were:
  - Legally owed and not eligible for a refund, and
  - Paid to countries that are recognized by the United States and do not support terrorism.

For additional information, see the Instructions for Form 1116.

If the taxpayer meets all of the requirements listed above, Form 1116 is not required. The foreign tax credit can be entered directly on Form 1040, line 51. See potential pitfall box for TaxWise® users.

Example 6

Tabitha received a Form 1099-DIV that shows $219 of foreign taxes (box 6). According to Tabitha she paid no other foreign taxes. She meets all the requirements for not having to file Form 1116. She can claim the $219 on Form 1040, line 51.

> **Potential Pitfalls**
>
> For TaxWise® users: Be sure to link to the Form 1116 for the foreign tax credit. If you enter the foreign tax credit directly on Form 1040, Line 51, it may drop off the completed return. By linking to the Form 1116, TaxWise® will include the information to line 51 and will not include the Form 1116 unless it is required.

Exercise 3

Clyde comes to your site seeking help with his foreign tax credit. He is single and his Form(s) 1099-DIV show a total of $423 of foreign tax. Does Clyde need Form 1116 to claim his credit?

Health Coverage Tax Credit

The health coverage tax credit (HCTC) is a federal tax credit established by the Trade Act of 2002 to assist

1. Workers who lose their jobs due to the effects of international trade, and/or
2. People who receive benefits from the Pension Benefit Guaranty Corporation (PBGC) and who are at least 55 years old.

The HCTC is beyond the scope of the VITA/TCE programs. Taxpayers who are potentially eligible should be referred to a paid preparer or to www.**irs.gov** for more information.

Quality Review (QR)—Miscellaneous Tax Credits

Use **Form 8158, Quality Review Sheet** or an approved alternative form to review all returns prepared. Apply the quality review tools in combination with the Intake and Interview Sheet and all the source documents to the returns you prepare to ensure quality and accuracy for every taxpayer.

Consider each item on the Quality Review Sheet that applies to the taxpayer's situation to confirm that all the necessary questions and issues have been addressed. If items are incorrect or incomplete, revisit each issue and make corrections to the return and Form 13614, as needed.

Excerpt from Form 8158

Yes	No	
☐	☐	All **adjustments, deductions and credits** indicated on the intake/interview sheet and supporting documents are included on the return.

To ensure accurate reporting of adjustments, deductions, and credits, verify that the information on the Intake and Interview Sheet and the taxpayer's supporting documents are included on the return. Confirm that all potential adjustments, deductions, and credits have been discussed with the taxpayer and shown on the return, if applicable.

▶▶ Summing Up This Lesson ◀◀

- ▶ Due to the income limitations, very few taxpayers are eligible to receive the credit for the elderly or disabled.
- ▶ The credit for the elderly or the disabled is based on filing status, age, and income.
- ▶ The credit is calculated and reported on Form 1040, Schedule R, or Form 1040A, Schedule 3.
- ▶ If the taxpayer contributed to a retirement plan or an IRA, he or she may be eligible for the qualified retirement savings contribution credit. Example: A 401(k) plan contribution on Form W-2 shown in box 12.
- ▶ The nonbusiness energy property credit and the residential energy efficient property credit are available to taxpayers for making certain energy-savings improvements to their home.
- ▶ Taxpayers may be able to claim a tax credit for an alternative motor vehicle placed in service for business or personal use.
- ▶ Generally, to claim the foreign tax credit, a taxpayer is required to file Form 1116, Foreign Tax Credit. However, some taxpayers may claim the FTC without the form if they meet certain requirements.
- ▶ Taxpayers who hold qualified mortgage credit certificates may be able to claim a credit for mortgage interest paid.

Exercise 1

No; Jason is not eligible for the credit because his income exceeds the threshold limit for his filing status.

Exercise 2

See the completed Form 8880 on the next page.

Exercise 3

Yes, Clyde needs to complete Form 1116 since his foreign taxes exceed $300. Clyde will need to seek the assistance of a tax professional.

Answer to Exercise 2

Form **8880** — Department of the Treasury, Internal Revenue Service

Credit for Qualified Retirement Savings Contributions

► Attach to Form 1040, Form 1040A, or Form 1040NR.
► See instructions on back.

OMB No. 1545-0074 — **2007** — Attachment Sequence No. **129**

Name(s) shown on return	Your social security number
Martha Barnard	000 00 0088

CAUTION

You **cannot** take this credit if **either** of the following applies.

- The amount on Form 1040, line 38; Form 1040A, line 22; or Form 1040NR, line 36 is more than $26,000 ($39,000 if head of household; $52,000 if married filing jointly).
- The person(s) who made the qualified contribution or elective deferral **(a)** was born after January 1, 1990, **(b)** is claimed as a dependent on someone else's 2007 tax return, or **(c)** was a **student** (see instructions).

			(a) You	(b) Your spouse
1	Traditional and Roth IRA contributions for 2007. **Do not** include rollover contributions	1		
2	Elective deferrals to a 401(k) or other qualified employer plan, voluntary employee contributions, and 501(c)(18)(D) plan contributions for 2007 (see instructions)	2	1,000	
3	Add lines 1 and 2	3	1,000	
4	Certain distributions received **after** 2004 and **before** the due date (including extensions) of your 2007 tax return (see instructions). If married filing jointly, include **both** spouses' amounts in **both** columns. See instructions for an exception	4		
5	Subtract line 4 from line 3. If zero or less, enter -0-	5	1,000	
6	In each column, enter the **smaller** of line 5 or $2,000	6	1,000	

7 Add the amounts on line 6. If zero, **stop**; you cannot take this credit . . . **7** 1,000

8 Enter the amount from Form 1040, line 38*; Form 1040A, line 22; or Form 1040NR, line 36 . . . **8**

9 Enter the applicable decimal amount shown below:

If line 8 is—		And your filing status is—		
Over—	But not over—	Married filing jointly	Head of household	Single, Married filing separately, or Qualifying widow(er)
		Enter on line 9—		
---	$15,500	.5	.5	.5
$15,500	$17,000	.5	.5	.2
$17,000	$23,250	.5	.5	.1
$23,250	$25,500	.5	.2	.1
$25,500	$26,000	.5	.1	.1
$26,000	$31,000	.5	.1	.0
$31,000	$34,000	.2	.1	.0
$34,000	$39,000	.1	.1	.0
$39,000	$52,000	.1	.0	.0
$52,000	---	.0	.0	.0

9 X . 1

Note: *If line 9 is zero, **stop**; you cannot take this credit.*

10 Multiply line 7 by line 9 . . . **10** 100

11 Enter the amount from Form 1040, line 46; Form 1040A, line 28; or Form 1040NR, line 43 . . . **11**

12 **1040 filers:** Enter the total of your credits from lines 47 through 52 plus the amounts, if any, from line 13 of Form 8396 and line 13 of Form 8859
1040A filers: Enter the total of your credits from lines 29 through 32.
1040NR filers: Enter the total of your credits from lines 44 through 47 plus the amounts, if any, line 13 of Form 8396 and line 13 of Form 8859. . . . **12**

13 Subtract line 12 from line 11. If zero, **stop**; you cannot take this credit . . . **13**

14 **Credit for qualified retirement savings contributions.** Enter the **smaller** of line 10 or line 13 here and on Form 1040, line 53; Form 1040A, line 33; or Form 1040NR, line 48 . . . **14**

*See Pub. 590 for the amount to enter if you are filing Form 2555, 2555-EZ, or 4563 or you are excluding income from Puerto Rico.

For Paperwork Reduction Act Notice, see back of form. Cat. No. 33394D Form **8880** (2007)

Military/International students continue.

Basic Course students go to Lesson 14, others go to Lesson 10.

FOREIGN TAX CREDIT

INTRODUCTION AND OBJECTIVES

This lesson will discuss how to compute the foreign tax credit in situations where a United States citizen could pay taxes twice on the same income—once to the government of the foreign country where the income was earned and once to the United States government. This segment will address the foreign tax credit only as it applies to United States citizens and residents.

In the International segment of the income lesson, the topic of worldwide income was discussed. United States citizens and residents compute their United States taxes based on their worldwide income. This sometimes leads to a situation where a United States citizen may be paying tax twice on the same income. In order to avoid double taxation, a foreign tax credit was created. This allows an individual to take a tax credit for those taxes paid to a foreign government on income from sources in a foreign country.

Like other tax credits, the foreign tax credit is a dollar-for-dollar reduction in the amount of tax. However, in some cases, not all taxes paid to a foreign government can be used in the computation of the foreign tax credit.

After completing this lesson, you should be able to supplement the information you learned in the basic text and:

- Determine which taxes are eligible for the foreign tax credit,
- Apply the criteria for claiming the foreign tax credit,
- Accurately compute the foreign tax credit using Form 1116 or tax preparation software, and
- Assist the taxpayer in compiling the documents necessary for a tax professional to complete the return.

INTAKE AND INTERVIEW PROCESS FORM 13614—FOREIGN TAX CREDIT

Use **Form 13614, Intake and Interview Sheet,** to engage the taxpayer in preparing an accurate return. Use the Intake and Interview Sheet as a starting point for a comprehensive interaction with the taxpayer, in combination with all the source documents provided by the taxpayer, to ensure quality and accuracy on each return.

Confirm each item on Form 13614 (or similar tool used at the site) to make sure you and the taxpayer have considered all the necessary information. Ensure that questions and issues have been addressed. If items are incorrect or incomplete, revisit the issue and make corrections to the return, as needed.

Excerpt from Form 13614

Part VII. Credits – **In 2007 did you (or your spouse) have:**

☐ Yes	☐ No	1. Child/dependent care expenses that allow you (and your spouse-if MFJ) to work
☐ Yes	☐ No	2. Educational expenses for you (or your spouse) and/or your dependents
☐ Yes	☐ No	3. Retirement Contribution to a traditional IRA, Roth IRA or 401k as shown on Form W-2

The foreign tax credit is covered in this lesson. Although, the foreign tax credit is not one of the credits specifically listed on Form 13614, to ensure accurate reporting of this credit ask the taxpayer if he or she paid any tax to a foreign country. A United States citizen may be entitled to a foreign tax credit in situations where he or she pays taxes to both the foreign country government and the United States government on the same income. You will learn more about what taxes qualify for this credit later in this lesson.

What Taxes Qualify for the Credit

There are several factors to consider when determining if a tax paid to a foreign government is eligible for the foreign tax credit. They include:

- Was the income from a foreign source?
- What type of tax was paid to the foreign government?
- Will the taxpayer receive some kind of specific economic benefit from the payment of this tax?

In this part of the lesson, we'll study the criteria for claiming the foreign tax credit.

The taxpayer must have income from a foreign country on which he or she is taxed by a foreign country. The tax imposed on the income must be similar to the income tax imposed in the United States This simply means that the income must be from a country other than the United States and that the tax paid must be similar to United States income tax. Let's look at some examples.

Example 1

Robb and Betty Grant are U.S. citizens who reside in France. Schedule B on their U.S. tax return contains the following:

$500, Lee County National Bank (U.S.)

$600, Banque National de Paris (French)

They paid income taxes on both types of interest to both countries. On their U.S. tax return, they can compute a foreign tax credit against the taxes that they pay to the U.S. on the interest received from the French bank. They would need to check with the French taxing authorities to determine if they can claim a similar tax credit on their French tax return for the interest income from the U.S. bank.

Example 2

Marie Elliott is a U.S. citizen who lives in Hong Kong. She owns a house in Hong Kong and paid $2,000 in real estate taxes for her home and $1,000 in personal property taxes. She also paid $300 in income taxes to the government of Hong Kong. She is not able to claim a foreign tax credit for either the real estate taxes paid or the personal property taxes paid since these two taxes are not income taxes. She can, however, use the $300 in income taxes paid to Hong Kong to compute a foreign tax credit. (**Note:** She can take the real estate taxes that she paid and deduct them as itemized deductions if she itemizes on her U.S. tax return. Foreign personal property taxes are deductible only if they relate to the production of income or a trade or business.)

Exercise 1

The following is a list of the income on Anne's U.S. income tax return. She is a U.S. citizen living in Canada. She also had to pay taxes on each of these types of income to Canada. Indicate on which of the following a foreign tax credit may be computed:

______ **A.** Wages from her job in the U.S.

______ **B.** Interest income from a U.S. bank.

______ **C.** Interest income from a Canadian bank.

______ **D.** Dividend income from a U.S. corporation.

______ **E.** Dividend income from a Canadian corporation.

Exercise 2

Indicate " Yes" or "No" if the following taxes paid to a foreign government can be used to compute the foreign tax credit. All taxpayers are U.S. citizens.

______ **A.** Martha pays $1,200 a year in taxes. This tax is based on the number and types of appliances which she owns and uses in her home.

______ **B.** Jean pays an inheritance tax to the Spanish government. It is based on an inheritance she received upon the death of an uncle.

______ **C.** Dorothy lives in Jamaica. She paid $1,500 to the Jamaican government for her salaried income which she earned in Jamaica.

______ **D.** Henry lives in Haiti. He paid $100 in taxes to the Haitian government. This tax was based on his type of living accommodations, the location of his residence, and the size of his family.

In addition to the requirements that the tax be paid to the foreign country on income derived from a foreign country and the tax be an income tax similar to the income tax as defined under United States law, the tax also must not be payment for a specific economic benefit. Simply put, the tax cannot actually be a payment that results in an individual receiving goods, services, or the right to use certain properties which are not available to others who are subject to the income tax that is generally imposed by the foreign country. A taxpayer cannot receive any specific benefit, directly or indirectly, from paying a tax.

Example 3

Bob lives in Country X. He owns and operates his own business in this country. This country has a two-tier income tax system. Everyone pays income tax at graduated rates depending upon their income. Bob also pays income tax based upon the profits of his business. This second level of income tax gives Bob the right to reduced fees for telephones, utilities, and rents for his business. The government of Country X calls it an income tax because it is based upon the profits of the business. If Bob did not pay this tax, he could not rent a government-owned building and he would pay significantly more for the utilities and his business telephone usage. Since Bob receives a specific economic benefit for the second tier of income tax that he pays, he cannot use those tax payments to compute a foreign tax credit on his U.S. tax return. However, the first tier of income taxes are similar to U.S. income taxes and can be used to figure his foreign tax credit.

Country Restrictions. Aside from the restrictions that we have already discussed, there are also certain countries to which a taxpayer may pay foreign income taxes but cannot claim a foreign tax credit. Generally the reason a credit may not be claimed for tax paid to one of these countries is that the Secretary of State has designated the country as one that repeatedly provides support for acts of international terrorism.

The credit can also be denied to countries with which the United States has no diplomatic relations, or countries whose government the United States does not recognize. At the time of this writing, income taxes paid to the following countries are not eligible for the foreign tax credit.

Cuba

Iran

Iraq (Sanctioned period ended June 27, 2004)

Libya (Presidential waiver granted for qualified income taxes arising after December 9, 2004)

North Korea

Sudan

Syria

A waiver can be granted to a sanctioned country if the President of the United States determines that granting a waiver is in the national interest of the United States and will expand trade and investment opportunities for United States companies in the sanctioned country.

Example 4

Ralph is a U.S. citizen who has investments in both Belgium and Iran. On these investments Ralph pays income tax to these two countries by withholding tax from his dividend checks. Ralph can claim the taxes paid to Belgium when computing the foreign tax credit. The income taxes paid to Iran do not qualify for a foreign tax credit.

TYPES OF INCOME

A separate Form 1116 must be completed for each different type of income. We will be studying only two income categories: passive category income and general category income. Remember that you can check only one income category per form and a separate Form 1116 must be submitted for each category. Your tax preparation software will do this for you.

Exhibit 1 **Form 1116**

Form **1116**
Department of the Treasury
Internal Revenue Service (99)

Foreign Tax Credit
(Individual, Estate, or Trust)
► **Attach to Form 1040, 1040NR, 1041, or 990-T.**
► **See separate instructions.**

OMB No. 1545-0121
2007
Attachment Sequence No. **19**

Name | **Identifying number** as shown on page 1 of your tax return

Use a separate Form 1116 for each category of income listed below. See **Categories of Income** on page 3 of the instructions. Check only one box on each Form 1116. Report all amounts in U.S. dollars except where specified in Part II below.

a ☐ Passive category income **c** ☐ Section 901(j) income **e** ☐ Lump-sum distributions
b ☐ General category income **d** ☐ Certain income re-sourced by treaty

Passive Category Income. Passive income generally includes the following types of income: dividends, interest, royalties, rents, annuities, and high withholding tax on interest. If you are assisting a person who has one of these types of passive income from a foreign country and he or she paid income taxes to a foreign country, you can use your tax software to compute a foreign tax credit.

Example 5

Darlene is a U.S. citizen living in Venezuela. She keeps a bank account in the Banco Nacional de Venezuela. In 2007, she received $380 in interest income from the Venezuelan bank. She also paid Venezuelan income taxes on this interest income. On her U.S. return, she would claim a foreign tax credit for the taxes paid to Venezuela on her interest income. She would check the box for "Passive category income" on Form 1116.

High withholding tax interest. Certain interest income is included in the passive category income. If the taxpayer had interest income on which at least 5 percent foreign gross income tax was withheld, then this income is high withholding tax interest and classified as passive category income.

Example 6

Michael is a U.S. citizen who lives in the United Kingdom. He maintains a bank account in a London bank. According to local law, the bank withholds a mandatory 27.5 percent of interest income as income tax. Since the withholding rate is at least 5 percent, passive category income would be checked on his Form 1116.

Example 7

Regina lives in Singapore and is a U.S. citizen. She has both dividend income and interest income from countries outside the United States. Her foreign bank withholds 15 percent of her interest income for income taxes. She also pays foreign income taxes on her dividend income. Regina will complete one Form 1116 claiming both investments income under the passive category income.

General Category Income. The second income category on Form 1116 is the general category income. If the person you are helping has foreign income that does not come under any of the other categories on Form 1116, then that foreign income comes under the general category income. Most often, this would be wages earned in a foreign country that an individual does not exclude, or excludes only part of, under the foreign earned income exclusion.

Example 8

Siegfried lives in Switzerland and is a U.S. citizen. He works in Switzerland and pays income taxes to that country on his earnings. He does not elect to claim a foreign earned income exclusion. He can claim a foreign tax credit for the taxes paid on his earnings to the Swiss government. He checks the box for the general category income on his Form 1116.

High taxed income. If the individual you are assisting has passive income which is taxed by a foreign government at a rate that is higher than the highest United States income tax rate, then the foreign tax credit for that income would be computed under the general category income. (Passive income was discussed earlier in this lesson.) In 2007, the highest United States income tax rate is 35 percent. Therefore, if the person pays more than 35 percent on the foreign source passive income for which he or she claimed the credit, then the credit is computed under the "general category income".

Example 9

Maria lives in Brazil and is a U.S. citizen. She has a bank account in Brazil and pays 45% income tax on her interest income. Even though interest income is normally passive income for purposes of the foreign tax credit, this income would be listed under the "general category income" on Form 1116 since the 45% rate is higher than the highest U.S. income tax rate.

Example 10

Bernard is a resident of Barbados and a U.S. citizen. He keeps a bank account in Barbados. In 2007, he paid 17% income tax on his interest income from his bank account in Barbados. Since 17% (the tax rate he paid) is not more than 35% (the highest U.S. income tax rate) and since the 17% that Bernard paid was not paid by withholding, this income falls into the "passive category" of Form 1116.

OTHER FOREIGN TAX CREDIT CONCEPTS

We have already discussed the income categories that are listed on separate sections of Form 1116. In addition, the top of Form 1116 has a line to indicate the name of the country of residence of the taxpayer. This will need to be entered for tax software to correctly figure the tax credit.

Part I is used to figure the taxable income from foreign sources in each income category. If the person you are helping has one type of foreign income that comes from several foreign countries, use one Form 1116. You will note that there is room on Form 1116 for up to 3 countries.

Example 11

George is both a U.S. citizen and a U.S. resident. He has interest income from both Canada and Mexico, as well as the U.S. His software will print only one Form 1116 since all the interest income is in the passive category income.

On line 1a, list all foreign income that fits under the category checked at the top of Form 1116. You will list that income separately for each foreign country.

Example 12

George had $300 in interest income from his Canadian bank and $200 in interest income from his Mexican bank. See completed Form 1116, line 1a, for his income in Exhibit 2, which follows.

Exhibit 2 **Form 1116, Line 1**

Part I **Taxable Income or Loss From Sources Outside the United States (for Category Checked Above)**

		Foreign Country or U.S. Possession				Total
		A	B	C		(Add cols. A, B, and C.)
g	**Enter the name of the foreign country or U.S. possession** . . . . ▶	Mexico	Canada			
1a	Gross income from sources within country shown above and of the type checked above (see page 13 of the instructions):	200	300		1a	500
b	Check if line 1a is compensation for personal services as an employee, your total compensation from all sources is $250,000 or more, and you used an alternative basis to determine its source (see instructions) ▶ ☐					

Note: If the taxpayer you are assisting has claimed the foreign earned income exclusion, enter only the amount of earned income not excluded, on line 1a of Form 1116 for general category income.

Example 13

Monique lives in France and is a U.S. citizen. She earned $89,700 in 2007 in France. Monique claimed the foreign earned income exclusion of $85,700 (discussed in an earlier lesson). As illustrated in Exhibit 3 below, she would enter only $4,000 on line 1 of Form 1116 ($89,700 earned Income – $85,700 exclusion).

Exhibit 3 **Form 1116, Line 1**

Part I **Taxable Income or Loss From Sources Outside the United States (for Category Checked Above)**

		Foreign Country or U.S. Possession				Total
		A	B	C		(Add cols. A, B, and C.)
g	**Enter the name of the foreign country or U.S. possession** . . . . ▶	France				
1a	Gross income from sources within country shown above and of the type checked above (see page 13 of the instructions):	4,000			1a	4,000

Lines 2–5 are probably the most difficult and confusing lines to complete on the Form 1116. Let's review the situations that we will **not** be studying because they are out of scope for the VITA/TCE program.

1. **Expenses directly allocable to the income.** If the person you are assisting has expenses that are related directly to the income claimed on line 1 such as employee business expenses, and the income claimed on line 1 was earned income, then you may recommend that this person seek professional assistance.
2. **Investment Interest Expense.** If a person borrowed money in order to purchase investment property such as stock, then some special allocations may need to be done. The taxpayer may wish to seek professional assistance.
3. **Foreign Losses.** If the person you are helping had any type of foreign losses such as net losses from selling capital assets or a net loss from being a limited partner, the taxpayer may wish to hire a tax professional to prepare the return.

Now that we have discussed what areas are beyond the scope of VITA, let's continue with the completion of Part I.

Line 3. The tax software will complete line 3a if you completed a Schedule A for the person you are assisting to itemize his or her deductions. The total of the itemized deductions not directly related to foreign or U.S. income are medical expenses, real estate taxes, and gifts to charity.

If the person you are assisting does not itemize deductions, then the standard deduction claimed on line 40 of Form 1040 would be entered on line 3a.

Example 14

Betty is claiming a foreign tax credit. She is single and had itemized deductions of $6,900 for 2007. Her Schedule A includes $6,200 of real estate taxes and $700 of charitable contributions. (See Exhibit 4.)

Exhibit 4 **Form 1116, Line 3**

3	Pro rata share of other deductions **not definitely related:**				
a	Certain itemized deductions or standard deduction (see instructions)	6,900			
b	Other deductions (attach statement)				
c	Add lines 3a and 3b	6,900			
d	Gross foreign source income (see instructions)				
e	Gross income from all sources (see instructions)				
f	Divide line 3d by line 3e (see instructions)				
g	Multiply line 3c by line 3f				

Example 15

Rebecca wishes to claim a foreign tax credit. She is single and had itemized deductions of $2,500. Since the standard deduction for a single person for 2007 is $5,350, it is more advantageous to take the standard deduction. Rebecca's Form 1116 would therefore have a $5,350 entry on line 3a. (See Exhibit 5.)

Exhibit 5 **Form 1116, Line 3**

3	Pro rata share of other deductions **not definitely related:**				
a	Certain itemized deductions or standard deduction (see instructions)	5,350			
b	Other deductions (attach statement)				
c	Add lines 3a and 3b	5,350			
d	Gross foreign source income (see instructions)				
e	Gross income from all sources (see instructions)				
f	Divide line 3d by line 3e (see instructions)				

All income from foreign sources in the category checked at the top of Form 1116 is listed on line 3d. If the foreign earned income exclusion was claimed on Form 2555 and if Form 1116 is for the general category income, then the amount of the claimed exclusion is included here as well. For example, on line 3d for Monique, from Example 13, the entry would be $89,700. That's the sum of $4,000 from line 1 plus the $85,700 exclusion she claimed. Under most circumstances, line 3d and line 1 will be the same.

Line 3e is gross income from all sources. Usually, this line will be the same as line 22 of Form 1040. If a Form 2555 was completed and the foreign earned income exclusion was claimed, then the amount of the exclusion must be added back to the gross income amount on line 22.

The software's next step is to determine the percentage of foreign source income to total income. This is done by dividing line 3d by line 3e and entering the answer on line 3f. Then it takes line 3c and multiplies it by the percentage determined on line 3f and enters this answer on line 3g. For our purposes line 6 will then be the same as line 3g. This number represents the amount of the deductions allocated to foreign income in the category.

Your software computes the rest of Part I and begins to enter figures on Part III.

Part II of Form 1116 deals with the amount of foreign taxes paid or that may be owed (accrued). Since the foreign tax credit is allowed when a United States taxpayer either pays or accrues taxes to a foreign government, the amount paid or owed to a foreign government must be indicated on the tax return in this section.

Before we can discuss how to complete Part II, we need to discuss cash-basis and accrual-basis taxpayers. A cash-basis taxpayer is one who reports income when it is actually or constructively received, and expenses when they are paid. The majority of people who file individual income tax returns are cash basis taxpayers. If the person is a cash-basis taxpayer, he or she has a choice to take foreign tax credit using the cash or accrual method.

Example 16

Marie is a U.S. citizen who resides in Argentina, where she is currently employed. She is paid every week on Thursday. Her last payday for 2007 is December 30th. She is paid based upon the time she worked in the previous week Sunday through Saturday. Since she is a cash-basis taxpayer, she claims on her 2007 tax return the income that she was paid from January 1, 2007 through December 31, 2007 no matter when she earned it or when she may have been entitled to it. She also claims as deductions, expenses for which she actually paid in 2007 even though she may have incurred the debt prior to 2007.

An accrual basis taxpayer computes income and deductions differently. A person who is on the accrual basis computes income when he or she actually earned it or became entitled to it. Therefore, his or her deductions are computed based on when those debts were incurred, but not necessarily paid.

Example 17

If Marie were an accrual-basis taxpayer instead of a cash basis taxpayer, then she would declare as her 2007 income the money she had earned from her employer through December 31, even though she would not have been paid for her last week's work until early 2008.

When computing the amount of foreign taxes for Part II of Form 1116, you will need to know if the taxpayer is on a cash basis or an accrual basis. If the person you are helping does not know, then he or she is probably on a cash basis. Taxpayers on the accrual basis should be referred to tax professionals for assistance.

A taxpayer on the cash basis may choose to use the accrual method to determine the foreign tax credit. However, once this choice has been made, the taxpayer must use the accrual method for the foreign tax credit on all future tax returns.

In the United States, we have a pay-as-you-go system. That means that we pay taxes on taxable income as we make it. When a wage-earner gets a paycheck, an amount has already been withheld by his or her employer for federal income tax. If there has not been withholding on taxable income, then estimated tax payments must be made.

Many foreign countries have a different system. In some cases, the individual simply reports his or her taxable income and the government involved computes the tax and bills the taxpayer. In other instances, taxpayers make payments in one year for income made the previous year. In these instances, cash-basis taxpayers may wish to use the accrual basis for computing the foreign tax credit because their United States tax would be based on the income made in 2007 and they would not actually pay the taxes or know the actual tax amount until after the end of the tax year. But remember that once the choice to use the accrual method has been made, it must be used on all future tax returns in computing the foreign tax credit.

On Part II of Form 1116, you must indicate if the credit is being claimed for foreign taxes actually paid in 2007 or if it is being claimed for foreign taxes accrued during 2007. Just as there is space in Part I of the form to claim income from 3 different countries, there is space in Part II for claiming payments to these 3 different countries.

Part II also has two separate sections in which you indicate the amounts withheld, paid, or accrued in the foreign currency and then convert these amounts into United States dollars.

FOREIGN EXCHANGE RATE

One of the questions that frequently arises is which currency exchange rate should be used. If you are using the cash basis, then the exchange rate that is the most accurate for the date of the payment should be used.

If the person you are helping had tax withheld throughout the year, you can use the annual average exchange rate. If the person you are assisting is using the accrual method to claim his or her foreign taxes paid, you must generally use the average exchange rate for the tax year.

Column (s) of Form 1116 Part II is a summary (in United States dollars) of all the foreign taxes paid or accrued on income in the category checked at the top of Form 1116.

Line 8 of Part II is the total of foreign taxes paid or accrued to all foreign countries. If the foreign taxes are paid or accrued on foreign income that falls into more than one separate category of income, but the tax is not specifically allocable to any one of the items of income, an allocation of the tax to each separate category must be made. This allocation is made by multiplying the total foreign income by a fraction. The numerator of the fraction is the net income of each of the separate categories. The denominator is total net foreign income.

Exercise 3

Charles is a single U.S. citizen who lives and works in the United Kingdom. He takes the foreign earned income exclusion for his wages. His only other foreign income is interest income from his London bank. Charles's British income taxes were withheld at 27.5%. In 2007, his gross interest income from his London bank was £1,200. The average exchange rate for 2007 for purposes of this exercise was £0.6 to the U.S. dollar. Charles used the single filing status on his tax return and claimed a standard deduction for 2007. He had earned income of $60,000 which he excluded. He also had U.S. interest income of $3,000 and his only other income was a short-term capital gain of $35,000 from a U.S. source. Since 27.5% is also the tax rate for interest income in the United Kingdom, he had no additional income tax due to Great Britain on his interest income. Parts of Charles's Form 1040 are reproduced in Exhibits 6 and 7. Compute the first page of Form 1116 for Charles, using Exhibit 8.

Exhibit 6 **Charles' Form 1040**

Income	7	Wages, salaries, tips, etc. Attach Form(s) W-2		7	60,000
	8a	**Taxable** interest. Attach Schedule B if required		8a	5,000
Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld.	b	**Tax-exempt** interest. **Do not** include on line 8a	8b		
	9a	Ordinary dividends. Attach Schedule B if required		9a	
	b	Qualified dividends (see page 23)	9b		
	10	Taxable refunds, credits, or offsets of state and local income taxes (see page 24)		10	
	11	Alimony received		11	
	12	Business income or (loss). Attach Schedule C or C-EZ		12	
	13	Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐		13	35,000
If you did not get a W-2, see page 23.	14	Other gains or (losses). Attach Form 4797		14	
	15a	IRA distributions	15a	b Taxable amount (see page 25) 15b	
	16a	Pensions and annuities	16a	b Taxable amount (see page 26) 16b	
Enclose, but do not attach, any payment. Also, please use **Form 1040-V.**	17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E		17	
	18	Farm income or (loss). Attach Schedule F		18	
	19	Unemployment compensation		19	
	20a	Social security benefits	20a	b Taxable amount (see page 27) 20b	
	21	Other income. List type and amount (see page 29) 2555 Form attached		21	(60,000)
	22	Add the amounts in the far right column for lines 7 through 21. This is your **total income** ▶		22	40,000
Adjusted Gross Income	23	Educator expenses (see page XX)	23		
	24	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ	24		
	25	Health savings account deduction. Attach Form 8889	25		
	26	Moving expenses. Attach Form 3903	26		
	27	One-half of self-employment tax. Attach Schedule SE	27		
	28	Self-employed SEP, SIMPLE, and qualified plans	28		
	29	Self-employed health insurance deduction (see page 29)	29		
	30	Penalty on early withdrawal of savings	30		
	31a	Alimony paid b Recipient's SSN ▶	31a		
	32	IRA deduction (see page 31)	32		
	33	Student loan interest deduction (see page 33)	33		
	34	Tuition and fees deduction. Attach Form 8917	34		
	35	Domestic production activities deduction. Attach Form 8903	35		
	36	Add lines 23 through 31a and 32 through 35		36	
	37	Subtract line 36 from line 22. This is your **adjusted gross income** ▶		37	40,000

Exhibit 7 **Charles' Form 1040**

Tax and Credits	38	Amount from line 37 (adjusted gross income)		38	40,000
	39a	Check if: ☐ **You** were born before January 2, 1943, ☐ Blind. ☐ **Spouse** was born before January 2, 1943, ☐ Blind. **Total boxes checked** ▶ 39a			
Standard Deduction for—	b	If your spouse itemizes on a separate return or you were a dual-status alien, see page 34 and check here ▶39b ☐			
	40	**Itemized deductions** (from Schedule A) **or** your **standard deduction** (see left margin)		40	5,350
• People who checked any box on line 39a or 39b **or** who can be claimed as a dependent, see page 34.	41	Subtract line 40 from line 38		41	34,650
	42	If line 38 is $117,300 or less, multiply $3,400 by the total number of exemptions claimed on line 6d. If line 38 is over $117,300, see the worksheet on page XX		42	3,400
	43	**Taxable income.** Subtract line 42 from line 41. If line 42 is more than line 41, enter -0-		43	31,250
	44	**Tax** (see page 36). Check if any tax is from: **a** ☐ Form(s) 8814 **b** ☐ Form 4972 **c** ☐ Form(s) 8889		44	4,300
	45	**Alternative minimum tax** (see page 39). Attach Form 6251		45	
• All others:	46	Add lines 44 and 45 ▶		46	4,300
Single or Married filing separately, $5,350	47	Credit for child and dependent care expenses. Attach Form 2441	47		
	48	Credit for the elderly or the disabled. Attach Schedule R	48		
	49	Education credits. Attach Form 8863	49		
Married filing jointly or Qualifying widow(er), $10,700	50	Residential energy credits. Attach Form 5695	50		
	51	Foreign tax credit. Attach Form 1116 if required	51		
	52	Child tax credit (see page XX). Attach Form 8901 if required	52		
	53	Retirement savings contributions credit. Attach Form 8880	53		

Form **1116**

Department of the Treasury
Internal Revenue Service (99)

Foreign Tax Credit

(Individual, Estate, or Trust)

▶ Attach to Form 1040, 1040NR, 1041, or 990-T.

▶ See separate instructions.

OMB No. 1545-0121

2007

Attachment Sequence No. **19**

Name	**Identifying number** as shown on page 1 of your tax return

Use a separate Form 1116 for each category of income listed below. See **Categories of Income** on page 3 of the instructions. Check only one box on each Form 1116. Report all amounts in U.S. dollars except where specified in Part II below.

a ☐ Passive category income **c** ☐ Section 901(j) income **e** ☐ Lump-sum distributions
b ☐ General category income **d** ☐ Certain income re-sourced by treaty

f Resident of (name of country) ▶ **Puerto Rico**

Note: *If you paid taxes to only one foreign country or U.S. possession, use column A in Part I and line A in Part II. If you paid taxes to* ***more than one*** *foreign country or U.S. possession, use a separate column and line for each country or possession.*

Part I Taxable Income or Loss From Sources Outside the United States (for Category Checked Above)

	Foreign Country or U.S. Possession A	B	C		Total (Add cols. A, B, and C.)
g **Enter the name of the foreign country or U.S. possession** ▶					
1a Gross income from sources within country shown above and of the type checked above (see page 13 of the instructions):				1a	
b Check if line 1a is compensation for personal services as an employee, your total compensation from all sources is $250,000 or more, and you used an alternative basis to determine its source (see instructions) ▶ ☐					
Deductions and losses (***Caution:*** *See pages 13 and 14 of the instructions*):					
2 Expenses **definitely related** to the income on line 1a (attach statement)					
3 Pro rata share of other deductions **not definitely related:**					
a Certain itemized deductions or standard deduction (see instructions)					
b Other deductions (attach statement)					
c Add lines 3a and 3b					
d Gross foreign source income (see instructions)					
e Gross income from all sources (see instructions)					
f Divide line 3d by line 3e (see instructions)					
g Multiply line 3c by line 3f					
4 Pro rata share of interest expense (see instructions):					
a Home mortgage interest (use worksheet on page 13 of the instructions)					
b Other interest expense					
5 Losses from foreign sources					
6 Add lines 2, 3g, 4a, 4b, and 5				6	
7 Subtract line 6 from line 1a. Enter the result here and on line 14, page 2 ▶				7	

Part II Foreign Taxes Paid or Accrued (see page 14 of the instructions)

Country	Credit is claimed for taxes (you must check one) (h) ☐ Paid (i) ☐ Accrued	Foreign taxes paid or accrued: In foreign currency — Taxes withheld at source on:				In U.S. dollars — Taxes withheld at source on:				
	(j) Date paid or accrued	**(k)** Dividends	**(l)** Rents and royalties	**(m)** Interest	**(n)** Other foreign taxes paid or accrued	**(o)** Dividends	**(p)** Rents and royalties	**(q)** Interest	**(r)** Other foreign taxes paid or accrued	**(s)** Total foreign taxes paid or accrued (add cols. (o) through (r))
A										
B										
C										

8 Add lines A through C, column (s). Enter the total here and on line 9, page 2 ▶ **8**

For Paperwork Reduction Act Notice, see page 18 of the instructions. Cat. No. 11440U Form **1116** (2007)

Part III. Now that we have completed the front page of Form 1116, let's go to the back of the form. Part III is the actual computation of the foreign tax credit. This is relatively simple if you just follow the form line by line. If you used tax software and entered all the types of foreign source income and the amounts of tax paid on them to a foreign country, your form is completed at this point except for lines 10, 12 and 15 (Refer to Exhibit 10).

Line 10. This line deals with carrybacks and carryovers. These occur when a taxpayer pays more to a foreign government than he or she does to the United States on income attributable to the taxable income in the separate income category. Since the tax credit is limited to the amount of United States, the surplus tax credit is available as a carryback or carryover. VITA/TCE volunteers will not be computing carrybacks or carryovers.

Line 12. A reduction to the foreign taxes paid or accrued has to be made under certain circumstances. For our purpose, we will cover the most common situation. This is the reduction for taxes allocable to income excluded under the foreign earned income exclusion. The formula for this reduction is:

$$\frac{\text{Excluded foreign earned income}}{\text{Total foreign earned income}} \times \text{Foreign tax} = \text{Reduction}$$

For our purposes, if the foreign law taxes foreign earned income and some other income (for example, earned income from United States sources or a type of income not subject to United States tax), and the taxes cannot be segregated, then the denominator of this fraction is the total amount of income subject to foreign tax.

Let's look at an example.

Example 18

Marsha is a U.S. citizen who resided in Germany for all of 2007. She had wages of $90,000, and excluded $85,700 on her U.S. tax return. She also earned $5,000 in interest from a German bank account. She paid $20,000 in income tax to Germany on this income. She will allocate the $20,000 in income tax as follows:

Step 1—Allocate the tax to passive and to general limitation income.

Passive category income: $$\frac{\$5{,}000}{\$95{,}000} \times \$20{,}000 = \$1{,}053$$

General category income: $$\frac{\$90{,}000}{\$95{,}000} \times \$20{,}000 = \$18{,}947$$

Step 2 — Calculate the credit reduction attributable to excluded income.

$$\frac{\$85{,}700 \text{ (excluded income)}}{\$90{,}000 \text{ (total foreign income)}} \times \$18{,}947 = \$18{,}042$$

Exhibit 9 **Form 1116**

Part III	**Figuring the Credit**				
9	Enter the amount from line 8. These are your total foreign taxes paid or accrued for the category of income checked above Part I . .	9	18,947		
10	Carryback or carryover (attach detailed computation)	10			
11	Add lines 9 and 10	11	18,947		
12	Reduction in foreign taxes (see page 15 of the instructions) . . .	12	18,042		
13	Subtract line 12 from line 11. This is the total amount of foreign taxes available for credit . . .			13	905

There are other reductions which can be indicated on line 12. However, they are all beyond the scope of VITA/TCE. These include taxes attributable to boycott operations or certain mineral income. It is suggested that taxpayers with these types of situations may wish to seek assistance from a tax professional.

Line 15—These adjustments are beyond the scope of VITA/TCE.

More Than One Form 1116. Part IV of Form 1116 is used as a summary of the foreign tax credit. As you can tell from our discussion thus far, there may be occasions when you will need to complete more than one Form 1116 for the same taxpayer. If this is the case, complete Part IV on only one Form 1116. It does not matter which Form 1116 you choose. Indicate in Part IV of the summary of Form 1116 the amount of the credit computed on line 21 of Part III from each Form 1116. Line 29 is then a total of all Forms 1116. Please note again that the reduction of the credit for international boycott operations (line 28) is beyond the scope of this program and will not be discussed.

Part III Figuring the Credit

9	Enter the amount from line 8. These are your total foreign taxes paid or accrued for the category of income checked above Part I	9	
10	Carryback or carryover (attach detailed computation)	10	
11	Add lines 9 and 10	11	
12	Reduction in foreign taxes (see page 15 of the instructions)	12	
13	Subtract line 12 from line 11. This is the total amount of foreign taxes available for credit		13
14	Enter the amount from line 7. This is your taxable income or (loss) from sources outside the United States (before adjustments) for the category of income checked above Part I (see page 15 of the instructions)	14	
15	Adjustments to line 14 (see pages 15 and 16 of the instructions)	15	
16	Combine the amounts on lines 14 and 15. This is your net foreign source taxable income. (If the result is zero or less, you have no foreign tax credit for the category of income you checked above Part I. Skip lines 17 through 21. However, if you are filing more than one Form 1116, you must complete line 19.)	16	
17	**Individuals:** Enter the amount from Form 1040, line 41. If you are a nonresident alien, enter the amount from Form 1040NR, line 38. **Estates and trusts:** Enter your taxable income without the deduction for your exemption	17	
	Caution: *If you figured your tax using the lower rates on qualified dividends or capital gains, see page 16 of the instructions.*		
18	Divide line 16 by line 17. If line 16 is more than line 17, enter "1"		18
19	**Individuals:** Enter the amount from Form 1040, line 44, minus any amounts from lines 47-50, and any mortgage interest credit (from Form 8396, line 13) and District of Columbia first time homebuyer credit (from Form 8859, line 13). If you are a nonresident alien, enter the amount from Form 1040NR, line 41, minus any amounts from lines 44-45, and any mortgage interest credit (from Form 8396, line 13) and District of Columbia first time homebuyer credit (from Form 8859, line 13). **Estates and trusts:** Enter the amount from Form 1041, Schedule G, line 1a, or the total of Form 990-T, lines 36 and 37		19
	Caution: *If you are completing line 19 for separate category* ***e*** *(lump-sum distributions), see page 18 of the instructions.*		
20	Multiply line 19 by line 18 (maximum amount of credit)		20
21	Enter the **smaller** of line 13 or line 20. If this is the only Form 1116 you are filing, skip lines 22 through 26 and enter this amount on line 27. Otherwise, complete the appropriate line in Part IV (see page 18 of the instructions) ▶		21

Part IV Summary of Credits From Separate Parts III (see page 18 of the instructions)

22	Credit for taxes on passive category income	22	
23	Credit for taxes on general category income	23	
24	Credit for taxes on certain income re-sourced by treaty	24	
25	Credit for taxes on lump-sum distributions	25	
26	Add lines 22 through 25		26
27	Enter the **smaller** of line 19 or line 26		27
28	Reduction of credit for international boycott operations. See instructions for line 12 on page 15		28
29	Subtract line 28 from line 27. This is your **foreign tax credit.** Enter here and on Form 1040, line 51; Form 1040NR, line 46; Form 1041, Schedule G, line 2a; or Form 990-T, line 40a ▶		29

Form **1116** (2007)

QUALITY REVIEW (QR)—FOREIGN TAX CREDIT

Use **Form 8158, Quality Review Sheet** or an approved alternative form to review all returns prepared. Apply the quality review tools in combination with the Intake and Interview Sheet and all the source documents to the returns you prepare to ensure quality and accuracy for every taxpayer.

Consider each item on the Quality Review Sheet that applies to the taxpayer's situation to confirm that all the necessary questions and issues have been addressed. If items are incorrect or incomplete, revisit the issue and make corrections to the return, as needed.

Excerpt from Form 8158

Yes	No	
☐	☐	All **adjustments, deductions and credits** indicated on the intake/interview sheet and supporting documents are included on the return.

To ensure accurate reporting of adjustments, deductions, and credits, verify that the information on the Intake and Interview Sheet and on the taxpayer's supporting documents is included on the return. Confirm that all potential adjustments, deductions, and credits have been discussed with the taxpayer and shown on the return, if applicable.

▶▶ SUMMING UP THIS INTERNATIONAL SEGMENT ◀◀

- ▶ In order to qualify for a foreign tax credit, income on which the taxes are paid must be from a foreign source.
- ▶ The tax being paid must be similar to United States income tax.
- ▶ The individual paying the tax cannot derive a specific economic benefit and still claim the foreign tax credit.
- ▶ The foreign tax credit is computed on Form 1116.
- ▶ If an individual claims the foreign earned income exclusion, the excluded amount is not shown on line 1 of Part I of Form 1116.
- ▶ A cash basis taxpayer may choose the accrual method to claim the foreign tax credit. Once the choice has been made, the taxpayer must continue to use the accrual method.
- ▶ If the accrual method of claiming the foreign tax credit is used, use the average annual currency exchange rate to convert the foreign money into United States dollars.
- ▶ If there is more than one Form 1116 for the same person, the Part IV Summary needs to be completed on only one of the forms.

FOREIGN TAX CREDIT
ANSWERS TO EXERCISES

Exercise 1
C, E

Exercise 2
A. No

B. No

C. Yes

D. No

Exercise 3
See completed Form 1116, page 1 on the next page.

Form **1116**

Department of the Treasury
Internal Revenue Service (99)

Foreign Tax Credit

(Individual, Estate, or Trust)

▶ Attach to Form 1040, 1040NR, 1041, or 990-T.

▶ See separate instructions.

OMB No. 1545-0121

2007

Attachment Sequence No. **19**

Name	**Identifying number** as shown on page 1 of your tax return
Charles Green	XXX-XX-XXXX

Use a separate Form 1116 for each category of income listed below. See **Categories of Income** on page 3 of the instructions. Check only one box on each Form 1116. Report all amounts in U.S. dollars except where specified in Part II below.

- **a** ☑ Passive category income
- **b** ☐ General category income
- **c** ☐ Section 901(j) income
- **d** ☐ Certain income re-sourced by treaty
- **e** ☐ Lump-sum distributions

f Resident of (name of country) ▶

Note: *If you paid taxes to only one foreign country or U.S. possession, use column A in Part I and line A in Part II. If you paid taxes to* ***more than one*** *foreign country or U.S. possession, use a separate column and line for each country or possession.*

Part I Taxable Income or Loss From Sources Outside the United States (for Category Checked Above)

	Foreign Country or U.S. Possession A	B	C		Total (Add cols. A, B, and C.)
g **Enter the name of the foreign country or U.S. possession** ▶	U.K				
1a Gross income from sources within country shown above and of the type checked above (see page 13 of the instructions):	2,000			1a	2,000
b Check if line 1a is compensation for personal services as an employee, your total compensation from all sources is $250,000 or more, and you used an alternative basis to determine its source (see instructions) ▶ ☐					
Deductions and losses (***Caution:*** *See pages 13 and 14 of the instructions*):					
2 Expenses **definitely related** to the income on line 1a (attach statement)					
3 Pro rata share of other deductions **not definitely related:**					
a Certain itemized deductions or standard deduction (see instructions)	5,350				
b Other deductions (attach statement)					
c Add lines 3a and 3b	5,350				
d Gross foreign source income (see instructions)	2,000				
e Gross income from all sources (see instructions)	100,000				
f Divide line 3d by line 3e (see instructions)	0.02				
g Multiply line 3c by line 3f	107				
4 Pro rata share of interest expense (see instructions):					
a Home mortgage interest (use worksheet on page 13 of the instructions)					
b Other interest expense					
5 Losses from foreign sources					
6 Add lines 2, 3g, 4a, 4b, and 5				6	107
7 Subtract line 6 from line 1a. Enter the result here and on line 14, page 2 ▶				7	1,893

Part II Foreign Taxes Paid or Accrued (see page 14 of the instructions)

Country	Credit is claimed for taxes (you must check one) (h) ☑ Paid (i) ☐ Accrued (j) Date paid or accrued	Foreign taxes paid or accrued: In foreign currency: Taxes withheld at source on: (k) Dividends	(l) Rents and royalties	(m) Interest	(n) Other foreign taxes paid or accrued	In U.S. dollars: Taxes withheld at source on: (o) Dividends	(p) Rents and royalties	(q) Interest	(r) Other foreign taxes paid or accrued	(s) Total foreign taxes paid or accrued (add cols. (o) through (r))
A	12/31/2007			330				550		550
B										
C										

8 Add lines A through C, column (s). Enter the total here and on line 9, page 2 ▶ **8** 550

For Paperwork Reduction Act Notice, see page 18 of the instructions. Cat. No. 11440U Form **1116** (2007)

ADJUSTMENTS TO INCOME

Lesson 10

INTRODUCTION AND OBJECTIVES

In this lesson you will learn about adjustments to income. There are seven adjustments covered in this lesson. They are educator expenses, traditional individual retirement arrangement (IRA) deductions, student loan interest deduction, tuition and fees deduction, penalty on early withdrawal of savings, alimony payments, and jury duty pay. Lesson 3 discusses an additional adjustment to income covered in the VITA/TCE training—one-half of self-employment tax.

The remaining adjustments—moving expenses; self-employed health insurance deduction; self-employed simplified employee pension (SEP) plan; savings incentive match plan for employees of small employers (SIMPLE); and qualified plans—are not covered in traditional VITA/TCE training. Taxpayers who need assistance with these adjustments should be referred to a paid professional tax preparer.

After completing this lesson you should be able to:

- Identify which adjustments are within the scope of the VITA/TCE programs.
- Calculate and accurately report adjustments to income.
- Calculate eligible educator expenses.
- Identify contribution limits for IRAs.
- Calculate student loan interest deduction.
- Calculate tuition and fees deductions.

ALERT

This lesson contains intermediate tax law. Your course facilitator will teach only the information required to assist taxpayers you will serve.

INTAKE AND INTERVIEW PROCESS FORM 13614—ADJUSTMENTS

Use **Form 13614, Intake and Interview Sheet,** to engage the taxpayer in preparing an accurate return. Use the Intake and Interview Sheet as a starting point for a comprehensive interaction with the taxpayer, in combination with all the source documents provided by the taxpayer, to ensure quality and accuracy on each return.

Confirm each item on Form 13614 (or a similar tool used at your site) to make sure you and the taxpayer have considered all the necessary information. Ensure that all questions and issues have been addressed.

If items are incorrect or incomplete, revisit the issue and make corrections to the return as well as the Intake and Interview Sheet, as needed.

Excerpt from Form 13614

Part V. Adjustments – In 2007 did you (or your spouse) make:

☐ Yes	☐ No	1. Contributions to IRA, 401k or other retirement account
☐ Yes	☐ No	2. Alimony payments (if yes, you must provide the name and SSN of the recipient)
☐ Yes	☐ No	3. Education related expenses

To ensure accurate reporting of adjustments, be sure to verify with the taxpayer if he or she had IRA contributions, made alimony payments, or had education related expenses.

Adjustments to Income

Adjustments are subtractions from total income. Total income minus adjustments results in **adjusted gross income (AGI)**, an important number for tax purposes. Adjusted gross income is used to figure some limitations. In addition, it is used to figure income tax in some states.

Taxpayers cannot take any adjustments to income on Form 1040EZ. On Form 1040EZ total income and adjusted gross income are the same. Form 1040A filers can take adjustments for contributions to a traditional IRA and the student loan interest deduction. Form 1040 filers can take any of the adjustments for which they are eligible.

Educator Expenses

This tax provision can be taken by qualifying taxpayers filing a Form 1040 or Form 1040A.

Deduction for Educator Expenses

If the taxpayer is an eligible educator, he or she can deduct as an adjustment to income up to $250 in qualified expenses. The taxpayer can deduct these expenses even if he or she does not itemize deductions on Form 1040, Schedule A. This adjustment to income is for expenses paid or incurred in 2007. If both the taxpayer and spouse are eligible educators and choose to file a joint tax return, they may deduct up to $500 ($250 each) of qualified expenses.

Eligible Educator

The taxpayer is an eligible educator if, for the tax year, he or she is a kindergarten through grade 12 teacher, instructor, counselor, principal, or aide, and he or she works at least 900 hours during a school year in a school that provides elementary or secondary education as determined under state law.

Qualified Expenses

Qualified expenses are the **unreimbursed expenses** paid or incurred for books, supplies, computer equipment (including related software and services), and other equipment and supplementary materials that the taxpayer uses in his or her classroom. For courses in health and physical education, expenses for supplies are qualified expenses only if they are related to athletics. To be deductible as an adjustment to income, the qualified expenses must be more than the following amounts for the tax year:

- The interest on qualified United States savings bonds that the taxpayer excluded from income because he or she paid qualified higher education expenses,
- Any distributions from a qualified tuition program that the taxpayer excluded from income, or
- Any tax-free withdrawals by the taxpayer from a Coverdell education savings account.

The educator expense can be claimed on Form 1040, line 23 or Form 1040A, line 16.

Example 1

Joe and Mary will file a joint return. Joe is a high school math teacher and incurred $500 in qualified unreimbursed expenses. Mary is a grade school principal and incurred $200 in qualified unreimbursed expenses. Both Joe and Mary meet the definition of eligible educators. They will claim $450 ($250 for Joe and $200 for Mary) as an adjustment on their tax return.

INDIVIDUAL RETIREMENT ARRANGEMENTS

An **Individual Retirement Arrangement (IRA)** is a tax-sheltered savings plan set up by the taxpayer, generally for retirement income. This lesson discusses only **traditional IRAs** (VITA/TCE does not cover Roth IRAs, SIMPLE IRAs, or Coverdell Education Savings Accounts (ESAs)). Contributions to the nontraditional IRAs are not deductible as adjustments to income. While these other forms of IRAs are outside the scope of the VITA/TCE programs, they will be considered in calculating the retirement savings contribution credit.

Information on nontraditional IRAs can be found in Publication 590, *Individual Retirement Arrangements (IRAs)*.

Contributions to a traditional IRA can be either deductible or nondeductible. Earnings and gains on the contributions are not taxed until they are withdrawn from the traditional IRA account.

Example 2

Anna contributed a total of $2,500 over the last two years to her traditional IRA account. During 2007 she earned $140 of interest on her traditional IRA. All of the interest was added to her traditional IRA savings account.

Anna will not have to pay tax on the interest until she withdraws it from her traditional IRA account.

Contributions

Anyone under 70½ years of age (at the end of the tax year) who has taxable compensation can contribute to a traditional IRA. If the taxpayer and/or spouse have compensation and both are under age 70½, each can set up an IRA. However, they cannot participate in the same IRA—they must have separate accounts.

Compensation includes wages, salaries, commissions, tips, bonuses, professional fees, and earnings from self-employment. Alimony or separate maintenance payments that are included in total income are also compensation for traditional IRA purposes. Compensation **does not include** interest, rents, dividends, pension and annuity income, deferred compensation received, or income you can exclude.

General Contribution Limits

The most that can be contributed to a traditional IRA is the **lesser of:**

- $4,000 ($5,000 if age 50 or older), or
- Compensation that is includable in gross income for the year.

If a taxpayer has more than one traditional IRA, the taxpayer must combine all of the traditional IRAs and treat them as one when figuring the amount that can be contributed for the year.

NOTE: IRA Deduction Phaseout charts can be found under the Adjustments tab of the Publication 4012.

Example 3

Dan, a college student working part time, earned $1,500 in 2007. His IRA contributions for 2007 are limited to $1,500 (the lesser of $4,000 or compensation includable in income for the year).

Example 4

George has three traditional IRA accounts. During 2007 he contributed $1,000 to each. His total IRA contributions for 2007 will be $3,000.

Deemed IRAs

Employers who provide qualified employer retirement plans can maintain a separate account or annuity under the plan to receive voluntary employee contributions. This separate account is referred to as a deemed IRA. A deemed IRA can be a traditional IRA or a Roth IRA, and the same limits apply whether they are deemed or not. If a taxpayer has both a regular IRA and a deemed IRA, the taxpayer can divide contributions between them in any manner, but total contributions to both cannot exceed the $4,000/$5,000 limit.

Spousal IRA Limit

If taxpayers file a joint return and one spouse's compensation is less than the other spouse's compensation, the most that can be contributed for that spouse is the lesser of:

1. $4,000 ($5,000 if age 50 or older), or
2. The total compensation includable in the gross income of both spouses for the year, reduced by:
    a. IRA contributions for the spouse with the greater compensation, and
    b. Any contribution for the year to a Roth IRA for the spouse with the greater compensation.

The total combined contributions to both traditional IRAs cannot exceed the lesser of:

- $8,000 ($10,000 if both individuals are age 50 or older), or
- The total taxable compensation of both spouses.

Example 5

Kristen, a 24-year-old full-time student with no taxable compensation, marries Jeremy, age 26, during the year. For the year, Jeremy has taxable compensation of $30,000. He will contribute $4,000 to a traditional IRA. If he and Kristen file a joint return, each can contribute $4,000. This is because Kristen, who has no compensation, can add Jeremy's compensation, reduced by his IRA contribution ($30,000 − $4,000 = $26,000) to her own compensation (-0-) to figure her maximum contribution. In her case, $4,000 is her contribution limit, because $4,000 is less than $26,000, which is her compensation for calculating the spousal IRA.

Example 6

Tom and Darcy are married and both are 53. They both work and each has a traditional IRA. In 2007, Tom earned $1,800 and Darcy earned $48,000. Because of the spousal IRA limit rule, even though Tom earned less than $5,000, they can contribute up to $5,000 in each of their IRAs if they file a joint return. If they file separate returns, the amount that can be contributed to Tom's IRA is limited to $1,800 (his taxable compensation).

Excess Contributions

Generally, an excess contribution is the amount contributed to a traditional IRA that is more than the lesser of the:

1. Taxable compensation for the year, or
2. $4,000 ($5,000 if age 50 or older).

This limit applies whether the contributions are deductible or nondeductible. Contributions made in the year the taxpayer reaches age 70½ and any later year are also excess contributions.

In general, if the excess contribution for a year and any earnings on it are not withdrawn by the due date of the tax return (including extensions), the taxpayer is subject to an additional 6 percent tax. The additional 6 percent tax must be paid each year on the excess amounts that remain in the traditional IRA at the end of the tax year. The tax cannot be more than 6 percent of the value of the IRA as of the end of the tax year. The excise tax is figured on **Form 5329, Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts.**

A taxpayer who has taxable compensation but can no longer contribute to a traditional IRA because of age (70½ years or older) may continue to contribute to a spouse's traditional IRA until the year in which the spouse reaches 70½.

Example 7

Eldridge is a 73-year-old attorney. He earned $12,000 during the year.

Eldridge had compensation for traditional IRA purposes, but he cannot make an IRA contribution because he is 70½ or older. If Eldridge files a joint return with his spouse who is 68 years old, he can still contribute up to $5,000 to his spouse's IRA.

Exercise 1

A. Liz receives alimony which is included in her total income. All of her other income is from interest and dividends. Can Liz make a traditional IRA contribution? Explain. _______________

B. David is 73 and works part time in a hardware store. David's wife, Mary, does not work outside of the home. Mary is 68. Can David make a traditional IRA contribution for Mary? Explain.

____

C. Carla receives all her income from a rental property, interest income, and dividends. Can Carla make a traditional IRA contribution? Explain. _______________________

____

D. Joy is 62 years old. Most of her income comes from a pension. However, Joy did earn $1,250 doing consumer testing. How much can Joy contribute to a traditional IRA? Explain.

____

Deductible IRA Contributions

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).

The actual deductible amount for a traditional IRA depends on the following:

- Whether or not the taxpayer or taxpayer's spouse is covered by a retirement plan set up by an employer for any part of the year,
- The taxpayer's **modified adjusted gross income (MAGI),** and
- The taxpayer's filing status.

Modified Adjusted Gross Income

Generally, **modified adjusted gross income** is the adjusted gross income without consideration of certain deductions. The MAGI can be figured as follows:

Adjusted gross income (AGI) plus:

- IRA deduction.
- Student loan interest deduction.
- Foreign earned income exclusion.
- Foreign housing exclusion or deduction.
- Exclusion of qualified savings bond interest shown on Form 8815.
- Exclusion of employer-paid adoption expenses shown on Form 8839.

Not Covered by an Employer Retirement Plan

A taxpayer whose filing status is single, head of household, or qualifying widow(er), and who is not covered by an employer retirement plan, can take a full traditional IRA deduction of either his or her taxable compensation or $4,000 (whichever amount is smaller). The $4,000 amount is increased to $5,000 if the taxpayer is age 50 or older.

NOTE: IRA Deduction Phaseout charts can be found under the Adjustments tab of the Publication 4012.

Example 8

Cyril is single and 40 years of age. His modified adjusted gross income and taxable compensation is $50,000. He is not covered by a retirement plan at work. Cyril's traditional IRA contribution of $4,000 is deductible.

Married taxpayers who file separate returns for a taxable year and who live apart at all times during the taxable year are treated as single and can take a full IRA deduction, if not covered by an employer plan. This is true even if the other spouse is covered by an employer retirement plan.

Married taxpayers who file jointly or separately may each be able to take the full IRA deduction of $4,000 ($5,000 if age 50 or older) or taxable compensation (whichever amount is smaller) if they had taxable compensation and both were not covered by an employer retirement plan. The total deduction for a joint return cannot exceed $8,000 ($10,000 if both individuals are age 50 or older). **When determining the allowable deduction, each spouse figures the deduction separately.**

Covered by an Employer Retirement Plan

If the taxpayer is covered by a retirement plan at work, the traditional IRA deduction will be reduced or eliminated, depending on filing status and MAGI (refer to **Publication 4012, Adjustments tab).**

Note: If box 13, Retirement Plan, on Form W-2 is checked, the taxpayer is covered by an employer retirement plan. If taxpayers do not agree with the Form W-2, they must contact their employer. Volunteers cannot make a determination on whether or not a taxpayer is covered by an employer retirement plan. Refer taxpayers with questions on their employer retirement plans to their employer or **Publication 590, Individual Retirement Arrangements (IRAs)**.

Example 9

Emily, 36 years old, is single. Her modified AGI was $54,900. She is covered by a retirement plan at work. Emily's $4,000 traditional IRA contribution will be reduced or modified on her tax return because her MAGI is between $50,000 and $60,000.

If either the taxpayer or the taxpayer's spouse is covered by an employer retirement plan, he or she may be entitled to only a partial deduction or no deduction at all, depending on filing status and modified adjusted gross income (refer to **Publication 4012, Adjustments Tab)**.

POTENTIAL PITFALLS

When determining the allowable deduction, each spouse figures the deduction separately.

Example 10

David and Ruth are filing a joint return. David earned $88,000 and is covered by his employer's retirement plan. Ruth, age 32, is a homemaker and has no compensation. David, age 36, contributed $2,800 to his traditional IRA and $3,000 to a traditional IRA for Ruth.

Because David is covered by his employer's retirement plan, the MAGI limits apply and he is not allowed a deduction for his traditional IRA contributions. Because David made traditional IRA contributions for Ruth, they can take a deduction on the tax return for her IRA contributions. Ruth is not covered by an employer's retirement plan. Their compensation for IRA purposes is $88,000 and their MAGI is not more than $156,000.

Example 11

Assume still that David earned $88,000 and is covered by his employer's retirement plan. Assume, too, that Ruth is employed; she earned $56,000 and she is not covered by her employer's retirement plan. David cannot deduct his traditional IRA contribution, but Ruth can deduct hers. Her deduction would not be reduced unless the couple's modified AGI was more than $156,000. It would not be eliminated unless their MAGI was $166,000 or more.

Exercise 2

A. Angela and Joe are married and file a joint return. Joe, age 23, is covered by a retirement plan at work, but Angela, age 25, is not. Joe earned $85,000 and Angela earned $20,000; their MAGI is $105,000. Is any portion of Angela's traditional IRA contribution deductible, and why? ________________________

____

B. Annette, age 26, is single. She earned $23,000, and her MAGI is $24,500. She made a $500 contribution to a traditional IRA. Annette is covered by a retirement plan at work. Is any portion of her contribution deductible, and why? ___________________

____

C. Richard and Lynn are married and lived together during the year. They file separate returns. Richard is covered by a retirement plan at work. Lynn is not covered by a retirement plan at work. Richard, age 40, earned $17,000 and contributed $1,400 to a traditional IRA. Lynn, age 33, worked part time and earned $4,500. She contributed $1,000 to a traditional IRA. Can Richard or Lynn deduct any of the IRA contributions, and why?____

____

When to Deduct Traditional IRA Contributions

Individuals may deduct traditional IRA contributions on their 2007 tax return if the contributions are made in 2007 or by the due date for filing their return, not including extensions. Taxpayers may not deduct on their 2007 tax return contributions made in 2007 which were deducted on the 2006 tax return. The contributions do not have to be made before the return is filed. However, if the taxpayer deducts traditional IRA contributions on the 2007 tax return but does not make the traditional IRA contributions by April 16, 2008, for the exact amount deducted, the taxpayer must file an amended tax return.

Using the Worksheet and Reporting the Deduction

Use the IRA deduction worksheet in the Form 1040A or Form 1040 instructions booklet to figure the traditional IRA deduction.

The traditional IRA deduction can be reported on Form 1040 or Form 1040A on the appropriate lines. On joint returns when both spouses are making deductible traditional IRA contributions, enter the total contribution.

Example 12

Nick and Susan file a joint return. Both work, and Nick, age 27, was covered by a retirement plan, but Susan, age 25, was not. Nick earned $12,300 and Susan earned $10,990. Their total income is $23,400. Nick and Susan each contributed $500 to a traditional IRA.

The completed worksheet is shown in Exhibit 1. The information for Nick is shown in the column for *Your IRA*. The information for Susan is shown in the column for *Spouse's IRA*.

Before you begin:
√ Be sure you have read the list on page 27.
√ Figure any write-in adjustments to be entered on the dotted line next to line 36 (see the instructions for line 36 on page 31).

		Your IRA	Spouse's IRA
1a.	Were you covered by a retirement plan (see page 27)?	**1a.** ✔ Yes ☐ No	
b.	If married filing jointly, was your spouse covered by a retirement plan?		**1b.** ☐ Yes ✔ No
	Next. If you checked "No" on line 1a (and "No" on line 1b if married filing jointly), skip lines 2 through 6, enter $4,000 ($5,000 if age 50 or older at the end of 2007) on line 7a (and 7b if applicable), and go to line 8. Otherwise, go to line 2.		
2.	Enter the amount shown below that applies to you. • Single, head of household, or married filing separately and you **lived apart** from your spouse for all of 2007, enter $62,000 • Qualifying widow(er), enter $103,000 • Married filing jointly, enter $103,000 in both columns. But if you checked "No" on either line 1a or 1b, enter $166,000 for the person who was not covered by a plan • Married filing separately and you lived with your spouse at any time in 2007, enter $10,000	**2a.** 103,000	**2b.** 166,000
3.	Enter the amount from Form 1040, line 22 . . . . **3.** 23,400		
4.	Enter the total of the amounts from Form 1040, lines 23 through 31a, plus any write-in adjustments you entered on the dotted line next to line 36 . . . . **4.**		
5.	Subtract line 4 from line 3. If married filing jointly, enter the result in both columns	**5a.** 23,400	**5b.** 23,400
6.	Is the amount on line 5 less than the amount on line 2? ☐ **No.** STOP None of your IRA contributions are deductible. For details on nondeductible IRA contributions, see Form 8606. ✔ **Yes.** Subtract line 5 from line 2 in each column. Follow the instruction below that applies to you. • If single, head of household, or married filing separately, and the result is $10,000 or more, enter $4,000 ($5,000 if age 50 or older at the end of 2007) on line 7 for that column and go to line 8. Otherwise, go to line 7. • If married filing jointly or qualifying widow(er), and the result is $20,000 or more ($10,000 or more in the column for the IRA of a person who was not covered by a retirement plan), enter $4,000 ($5,000 if age 50 or older at the end of 2007) on line 7 for that column and go to line 8. Otherwise, go to line 7.	**6a.** 79,600	**6b.** 142,600
7.	Multiply lines 6a and 6b by the percentage below that applies to you. If the result is not a multiple of $10, increase it to the next multiple of $10 (for example, increase $490.30 to $500). If the result is $200 or more, enter the result. But if it is less than $200, enter $200 • Single, head of household, or married filing separately, multiply by 40% (.40) (or by 50% (.50) in the column for the IRA of a person who is age 50 or older at the end of 2007) • Married filing jointly or qualifying widow(er), multiply by 20% (.20) (or by 25% (.25) in the column for the IRA of a person who is age 50 or older at the end of 2007). But if you checked "No" on either line 1a or 1b, then in the column for the IRA of the person who was not covered by a retirement plan, multiply by 40% (.40) (or by 50% (.50) if age 50 or older at the end of 2007).	**7a.** 4,000	**7b.** 4,000
8.	Enter the total of your (and your spouse's if filing jointly): • Wages, salaries, tips, etc. Generally, this is the amount reported in box 1 of Form W-2. See page 27 for exceptions • Alimony and separate maintenance payments reported on Form 1040, line 11 • Nontaxable combat pay. This amount should be reported in box 12 of Form W-2 with code Q **8.** 23,290		
9.	Enter the earned income you (and your spouse if filing jointly) received as a self-employed individual or a partner. Generally, this is your (and your spouse's if filing jointly) net earnings from self-employment if your personal services were a material income-producing factor, minus any deductions on Form 1040, lines 27 and 28. If zero or less, enter -0-. For more details, see Pub. 590 . . . . **9.**		
10.	Add lines 8 and 9 . . . . **10.** 23,290		
	CAUTION *If married filing jointly and line 10 is less than $8,000 ($9,000 if one spouse is age 50 or older at the end of 2007; $10,000 if both spouses are age 50 or older at the end of 2007),* ***stop here*** *and see Pub. 590 to figure your IRA deduction.*		
11.	Enter traditional IRA contributions made, or that will be made by April 15, 2008, for 2007 to your IRA on line 11a and to your spouse's IRA on line 11b	**11a.** 500	**11b.** 500
12.	On line 12a, enter the **smallest** of line 7a, 10, or 11a. On line 12b, enter the **smallest** of line 7b, 10, or 11b. This is the most you can deduct. Add the amounts on lines 12a and 12b and enter the total on Form 1040, line 32. Or, if you want, you can deduct a smaller amount and treat the rest as a nondeductible contribution (see Form 8606)	**12a.** 500	**12b.** 500

Nondeductible IRA Contributions

Although the deductible amount of traditional IRA contributions can be reduced or eliminated because of the modified adjusted gross income limitation, a taxpayer can make nondeductible contributions to new or existing traditional IRAs. Earnings and gains on these contributions are not taxed until they are distributed to the taxpayer.

The total traditional IRA contribution, whether deductible or nondeductible, cannot be more than the taxpayer's taxable compensation or $4,000 ($5,000 if age 50 or older), whichever amount is smaller.

Taxpayers must complete Form 8606, *Nondeductible IRAs*, for each year that nondeductible contributions are made.

If taxpayers do not report nondeductible contributions, all of the contributions to a traditional IRA will be treated as deductible. This means all distributions will be taxed unless the taxpayer can show, with satisfactory evidence, that nondeductible contributions were made.

Example 13

Rachel, age 35, is single and wants to contribute the maximum amount possible to her traditional IRA. She is covered by her employer's retirement plan. Her earned income, as well as her total income is $52,000. Her total basis in traditional IRAs from line 14 of her 2006 Form 8606 is $10,000. The completed *IRA Deduction Worksheet* and Form 8606 are shown in Exhibits 2 and 3.

IRA Deduction Worksheet—Line 32

Keep for Your Records

Before you begin:
- √ Be sure you have read the list on page 27.
- √ Figure any write-in adjustments to be entered on the dotted line next to line 36 (see the instructions for line 36 on page 31).

			Your IRA		Spouse's IRA
1a.	Were you covered by a retirement plan (see page 27)?	**1a.**	☑ Yes ☐ No		
b.	If married filing jointly, was your spouse covered by a retirement plan?			**1b.**	☐ Yes ☐ No
	Next. If you checked "No" on line 1a (and "No" on line 1b if married filing jointly), skip lines 2 through 6, enter $4,000 ($5,000 if age 50 or older at the end of 2007) on line 7a (and 7b if applicable), and go to line 8. Otherwise, go to line 2.				
2.	Enter the amount shown below that applies to you. • Single, head of household, or married filing separately and you **lived apart** from your spouse for all of 2007, enter $62,000 • Qualifying widow(er), enter $103,000 • Married filing jointly, enter $103,000 in both columns. But if you checked "No" on either line 1a or 1b, enter $166,000 for the person who was not covered by a plan • Married filing separately and you lived with your spouse at any time in 2007, enter $10,000	**2a.**	62,000	**2b.**	
3.	Enter the amount from Form 1040, line 22 . . . . **3.** 52,000				
4.	Enter the total of the amounts from Form 1040, lines 23 through 31a, plus any write-in adjustments you entered on the dotted line next to line 36 . . . . **4.**				
5.	Subtract line 4 from line 3. If married filing jointly, enter the result in both columns	**5a.**	52,000	**5b.**	
6.	Is the amount on line 5 less than the amount on line 2? ☐ **No.** STOP None of your IRA contributions are deductible. For details on nondeductible IRA contributions, see Form 8606. ☑ **Yes.** Subtract line 5 from line 2 in each column. Follow the instruction below that applies to you. • If single, head of household, or married filing separately, and the result is $10,000 or more, enter $4,000 ($5,000 if age 50 or older at the end of 2007) on line 7 for that column and go to line 8. Otherwise, go to line 7. • If married filing jointly or qualifying widow(er), and the result is $20,000 or more ($10,000 or more in the column for the IRA of a person who was not covered by a retirement plan), enter $4,000 ($5,000 if age 50 or older at the end of 2007) on line 7 for that column and go to line 8. Otherwise, go to line 7.	**6a.**	10,000	**6b.**	
7.	Multiply lines 6a and 6b by the percentage below that applies to you. If the result is not a multiple of $10, increase it to the next multiple of $10 (for example, increase $490.30 to $500). If the result is $200 or more, enter the result. But if it is less than $200, enter $200 • Single, head of household, or married filing separately, multiply by 40% (.40) (or by 50% (.50) in the column for the IRA of a person who is age 50 or older at the end of 2007) • Married filing jointly or qualifying widow(er), multiply by 20% (.20) (or by 25% (.25) in the column for the IRA of a person who is age 50 or older at the end of 2007). But if you checked "No" on either line 1a or 1b, then in the column for the IRA of the person who was not covered by a retirement plan, multiply by 40% (.40) (or by 50% (.50) if age 50 or older at the end of 2007).	**7a.**	4,000	**7b.**	
8.	Enter the total of your (and your spouse's if filing jointly): • Wages, salaries, tips, etc. Generally, this is the amount reported in box 1 of Form W-2. See page 27 for exceptions • Alimony and separate maintenance payments reported on Form 1040, line 11 • Nontaxable combat pay. This amount should be reported in box 12 of Form W-2 with code Q . . . **8.** 52,000				
9.	Enter the earned income you (and your spouse if filing jointly) received as a self-employed individual or a partner. Generally, this is your (and your spouse's if filing jointly) net earnings from self-employment if your personal services were a material income-producing factor, minus any deductions on Form 1040, lines 27 and 28. If zero or less, enter -0-. For more details, see Pub. 590 . . . . **9.**				
10.	Add lines 8 and 9 . . . . **10.** 52,000				
	CAUTION *If married filing jointly and line 10 is less than $8,000 ($9,000 if one spouse is age 50 or older at the end of 2007; $10,000 if both spouses are age 50 or older at the end of 2007), **stop here** and see Pub. 590 to figure your IRA deduction.*				
11.	Enter traditional IRA contributions made, or that will be made by April 15, 2008, for 2007 to your IRA on line 11a and to your spouse's IRA on line 11b	**11a.**	4,000	**11b.**	
12.	On line 12a, enter the **smallest** of line 7a, 10, or 11a. On line 12b, enter the **smallest** of line 7b, 10, or 11b. This is the most you can deduct. Add the amounts on lines 12a and 12b and enter the total on Form 1040, line 32. Or, if you want, you can deduct a smaller amount and treat the rest as a nondeductible contribution (see Form 8606)	**12a.**	4,000	**12b.**	

Form **8606**

Department of the Treasury
Internal Revenue Service (99)

Nondeductible IRAs

► See separate instructions.

► Attach to Form 1040, Form 1040A, or Form 1040NR.

OMB No. 1545-0074

2007

Attachment Sequence No. **48**

Name. If married, file a separate form for each spouse required to file Form 8606. See page 5 of the instructions.	Your social security number
Rachel	XXX XX XXXX

Fill in Your Address Only If You Are Filing This Form by Itself and Not With Your Tax Return	Home address (number and street, or P.O. box if mail is not delivered to your home)	Apt. no.
	City, town or post office, state, and ZIP code	

Part I **Nondeductible Contributions to Traditional IRAs and Distributions From Traditional, SEP, and SIMPLE IRAs**

Complete this part only if one or more of the following apply.

- You made nondeductible contributions to a traditional IRA for 2007.
- You took distributions from a traditional, SEP, or SIMPLE IRA in 2007 **and** you made nondeductible contributions to a traditional IRA in 2007 or an earlier year. For this purpose, a distribution does not include a rollover, qualified charitable distribution, one-time distribution to fund an HSA, conversion, recharacterization, or return of certain contributions.
- You converted part, but not all, of your traditional, SEP, and SIMPLE IRAs to Roth IRAs in 2007 (excluding any portion you recharacterized) **and** you made nondeductible contributions to a traditional IRA in 2007 or an earlier year.

1	Enter your nondeductible contributions to traditional IRAs for 2007, including those made for 2007 from January 1, 2008, through April 15, 2008 (see page 5 of the instructions)			1	800
2	Enter your total basis in traditional IRAs (see page 5 of the instructions)			2	10,000
3	Add lines 1 and 2			3	10,800
	In 2007, did you take a distribution from traditional, SEP, or SIMPLE IRAs, or make a Roth IRA conversion? — **No** ► Enter the amount from line 3 on line 14. Do not complete the rest of Part I. — **Yes** ► Go to line 4.				
4	Enter those contributions included on line 1 that were made from January 1, 2008, through April 15, 2008			4	
5	Subtract line 4 from line 3			5	10,800
6	Enter the value of **all** your traditional, SEP, and SIMPLE IRAs as of December 31, 2007, plus any outstanding rollovers (see page 5 of the instructions)	6			
7	Enter your distributions from traditional, SEP, and SIMPLE IRAs in 2007. **Do not** include rollovers, qualified charitable distributions, a one-time distribution to fund an HSA, conversions to a Roth IRA, certain returned contributions, or recharacterizations of traditional IRA contributions (see page 6 of the instructions)	7			
8	Enter the net amount you converted from traditional, SEP, and SIMPLE IRAs to Roth IRAs in 2007. **Do not** include amounts converted that you later recharacterized (see page 6 of the instructions). Also enter this amount on line 16	8			
9	Add lines 6, 7, and 8 — 9				
10	Divide line 5 by line 9. Enter the result as a decimal rounded to at least 3 places. If the result is 1.000 or more, enter "1.000"	10	× .		
11	Multiply line 8 by line 10. This is the nontaxable portion of the amount you converted to Roth IRAs. Also enter this amount on line 17	11			
12	Multiply line 7 by line 10. This is the nontaxable portion of your distributions that you did not convert to a Roth IRA	12			
13	Add lines 11 and 12. This is the nontaxable portion of all your distributions			13	
14	Subtract line 13 from line 3. This is **your total basis in traditional IRAs for 2007 and earlier years**			14	10,800
15	**Taxable amount.** Subtract line 12 from line 7. Also include this amount on Form 1040, line 15b; Form 1040A, line 11b; or Form 1040NR, line 16b			15	

Note: *You may be subject to an additional 10% tax on the amount on line 15 if you were under age 59½ at the time of the distribution (see page 6 of the instructions).*

For Privacy Act and Paperwork Reduction Act Notice, see page 8 of the instructions. Cat. No. 63966F Form **8606** (2007)

Exercise 3

Bill and Kathy are both employed and each earned $15,000 in 2007. Both Bill and Kathy are age 32. Bill was covered by an employer retirement plan but Kathy was not. In July 2007, Bill contributed $1,200 to his 2007 traditional IRA. In February 2008, he contributed $800 to his 2007 traditional IRA. Kathy contributed $400 to her 2007 traditional IRA. They file a joint return. Their total income is $30,000. They have no other adjustments to income.

Complete their IRA deduction worksheet (Exhibit 4).

Additional Taxes and Penalties

Taxpayers are generally subject to additional taxes and penalties for:

- Contributing more to a traditional IRA than is allowed,
- Making traditional IRA withdrawals before age 59½,
- Not withdrawing enough traditional IRA funds after age 70½,
- Investing in collectibles, and
- Prohibited transactions, such as borrowing money from one's own IRA or selling property to it.

There are also penalties for overstating the amount of nondeductible contributions and for failure to file Form 8606, if required.

Credit for Qualified Retirement Savings Contribution

Refer to Lesson 9 to determine if a taxpayer is also eligible to receive the credit for qualified retirement savings contributions based on their contributions to an IRA.

IRA Deduction Worksheet—Line 32

Keep for Your Records

Before you begin:
- √ Be sure you have read the list on page 27.
- √ Figure any write-in adjustments to be entered on the dotted line next to line 36 (see the instructions for line 36 on page 31).

			Your IRA		Spouse's IRA
1a.	Were you covered by a retirement plan (see page 27)?	**1a.**	☐ Yes ☐ No		
b.	If married filing jointly, was your spouse covered by a retirement plan?			**1b.**	☐ Yes ☐ No
	Next. If you checked "No" on line 1a (and "No" on line 1b if married filing jointly), skip lines 2 through 6, enter $4,000 ($5,000 if age 50 or older at the end of 2007) on line 7a (and 7b if applicable), and go to line 8. Otherwise, go to line 2.				
2.	Enter the amount shown below that applies to you. • Single, head of household, or married filing separately and you **lived apart** from your spouse for all of 2007, enter $62,000 • Qualifying widow(er), enter $103,000 • Married filing jointly, enter $103,000 in both columns. But if you checked "No" on either line 1a or 1b, enter $166,000 for the person who was not covered by a plan • Married filing separately and you lived with your spouse at any time in 2007, enter $10,000	**2a.**		**2b.**	
3.	Enter the amount from Form 1040, line 22 . . . . **3.**				
4.	Enter the total of the amounts from Form 1040, lines 23 through 31a, plus any write-in adjustments you entered on the dotted line next to line 36 . . . . **4.**				
5.	Subtract line 4 from line 3. If married filing jointly, enter the result in both columns	**5a.**		**5b.**	
6.	Is the amount on line 5 less than the amount on line 2? ☐ **No.** STOP None of your IRA contributions are deductible. For details on nondeductible IRA contributions, see Form 8606. ☐ **Yes.** Subtract line 5 from line 2 in each column. Follow the instruction below that applies to you. • If single, head of household, or married filing separately, and the result is $10,000 or more, enter $4,000 ($5,000 if age 50 or older at the end of 2007) on line 7 for that column and go to line 8. Otherwise, go to line 7. • If married filing jointly or qualifying widow(er), and the result is $20,000 or more ($10,000 or more in the column for the IRA of a person who was not covered by a retirement plan), enter $4,000 ($5,000 if age 50 or older at the end of 2007) on line 7 for that column and go to line 8. Otherwise, go to line 7.	**6a.**		**6b.**	
7.	Multiply lines 6a and 6b by the percentage below that applies to you. If the result is not a multiple of $10, increase it to the next multiple of $10 (for example, increase $490.30 to $500). If the result is $200 or more, enter the result. But if it is less than $200, enter $200 • Single, head of household, or married filing separately, multiply by 40% (.40) (or by 50% (.50) in the column for the IRA of a person who is age 50 or older at the end of 2007) • Married filing jointly or qualifying widow(er), multiply by 20% (.20) (or by 25% (.25) in the column for the IRA of a person who is age 50 or older at the end of 2007). But if you checked "No" on either line 1a or 1b, then in the column for the IRA of the person who was not covered by a retirement plan, multiply by 40% (.40) (or by 50% (.50) if age 50 or older at the end of 2007).	**7a.**		**7b.**	

STUDENT LOAN INTEREST DEDUCTION

If a taxpayer paid interest on a student loan in 2007, he or she may be able to deduct up to $2,500 of the interest paid.

If the taxpayer paid $600 or more in interest to a single lender, the taxpayer should receive a statement from the lender showing the amount of interest paid. This information will assist you in completing the student loan interest deduction.

Qualified Student Loan Interest

Generally, student loan interest is the interest paid during the year on a loan for qualified higher education expenses that were:

- For the taxpayer, the taxpayer's spouse, or a person who was the taxpayer's dependent when the loan was obtained,
- Paid within a reasonable period of time before or after obtaining the loan, and
- For an eligible student.

Interest can be the interest paid during the life of the loan (voluntary and required interest payments), loan origination fees, capitalized interest, interest on revolving lines of credit, and interest on refinanced student loans.

Interest does not include interest on any of the following:

- A loan from a related person,
- A loan from a qualified employer plan, or
- A loan for which the taxpayer is not legally liable.

Who Can Claim the Deduction

Generally, a taxpayer can claim the deduction if all the following requirements are met:

1. Taxpayer does not use married filing separately filing status.
2. Taxpayer is not claimed as a dependent on someone else's return.
3. The interest is on a loan to pay tuition and other qualified higher education expenses for the taxpayer, the taxpayer's spouse, or someone who the taxpayer could claim as a dependent when the loan was taken out.
4. The education expenses were paid or incurred within a reasonable period of time before or after the loan was taken out.
5. The person for whom the expenses were paid or incurred was an eligible student.

Qualified Higher Education Expenses

Generally, qualified higher education expenses include tuition and fees; room and board; books, supplies, and equipment; and other necessary expenses.

These costs must be reduced by the following:

1. Employer-provided educational assistance benefits.
2. Tax-free withdrawals from a Coverdell ESA.
3. Tax-free withdrawals from a qualified tuition program.
4. United States savings bond interest excluded from income because it is used to pay qualified higher education expenses.
5. Certain scholarships.

6. Veteran's educational assistance benefits.
7. Any other nontaxable payments (other than gifts, bequests, or inheritances) received for educational expenses.

Eligible Educational Institution

An eligible educational institution is any college, university, vocational school, or other postsecondary educational institution eligible to participate in a student aid program administered by the Department of Education. It includes virtually all accredited public, nonprofit, and privately owned profit-making postsecondary institutions.

For the student loan interest deduction only, an eligible educational institution also includes an institution conducting an internship or residency program leading to a degree or certificate from an institution of higher education, hospital, or health care facility that offers postgraduate training.

If a taxpayer does not know if the educational institution is an eligible institution, the taxpayer should contact the school.

Eligible Student

An eligible student is a student who is enrolled at least half-time in a program leading to a degree, certificate, or other recognized educational credential.

The standard for what is half the normal full-time work load is determined by each eligible educational institution.

Deduction Limits

The student loan interest deduction is generally the smaller of $2,500 or the interest payments paid in 2007.

This amount may be gradually reduced (phased out) or eliminated based on the taxpayer's filing status and modified adjusted gross income (MAGI) (refer to Publication 4012, *Adjustments Tab*).

Figuring the Deduction

Use the Student Loan Interest Deduction Worksheet found in the Form 1040 or Form 1040A instructions to figure the deduction.

Claiming the Deduction

The student loan interest deduction is entered on Form 1040, line 33, or Form 1040A, line 18.

Example 14

During 2007, Rick paid $2,650 in qualified interest on his student loan. Rick's filing status is single. His total income, Form 1040, line 22, is $35,000. He has no other adjustments to his income. His completed Student Loan Interest Deduction Worksheet, Exhibit 5, shows Rick is entitled to $2,500. Although his MAGI falls within the income limits, he is entitled only to a maximum $2,500 deduction.

Student Loan Interest Deduction Worksheet—Line 33 *Keep for Your Records*

Before you begin:
√ Figure any write-in adjustments to be entered on the dotted line next to line 36 (see the instructions for line 36 on page 31).
√ Be sure you have read the **Exception** above to see if you can use this worksheet instead of Pub. 970 to figure your deduction.

1.	Enter the total interest you paid in 2007 on qualified student loans (see above). **Do not** enter more than $2,500		**1.** 2.500
2.	Enter the amount from Form 1040, line 22	**2.** 35.000	
3.	Enter the total of the amounts from Form 1040, lines 23 through 32, plus any write-in adjustments you entered on the dotted line next to line 36	**3.**	
4.	Subtract line 3 from line 2	**4.** 35.000	
5.	Enter the amount shown below for your filing status. • Single, head of household, or qualifying widow(er)—$55,000 • Married filing jointly—$110,000	**5.** 55.000	
6.	Is the amount on line 4 more than the amount on line 5? ☑ **No.** Skip lines 6 and 7, enter -0- on line 8, and go to line 9. ☐ **Yes.** Subtract line 5 from line 4	**6.**	
7.	Divide line 6 by $15,000 ($30,000 if married filing jointly). Enter the result as a decimal (rounded to at least three places). If the result is 1.000 or more, enter 1.000		**7.**
8.	Multiply line 1 by line 7		**8.** 0
9.	**Student loan interest deduction.** Subtract line 8 from line 1. Enter the result here and on Form 1040, line 33. **Do not** include this amount in figuring any other deduction on your return (such as on Schedule A, C, E, etc.)		**9.** 2.500

TUITION AND FEES DEDUCTION

Taxpayers can deduct an amount equal to the qualified tuition and related expenses paid during the tax year as an adjustment to income.

To claim the deduction, the taxpayer must have incurred **qualified expenses** for an **eligible student** to attend an **eligible educational institution** during the tax year. In addition, the taxpayer must include on the tax return the name and taxpayer identification number of the qualified student.

Qualified Expenses

Qualified tuition and related expenses include:

- Tuition and fees required for enrollment or attendance at an eligible educational institution and
- Related expenses – Note: Student-activity fees and expenses for course-related books, supplies, and equipment are included in qualified education expenses only if the fees and expenses must be paid to the institution as a condition of enrollment or attendance.

Qualified tuition and related expenses do not include the cost of:

- Insurance,
- Medical expenses (including student health fees),
- Room and board,
- Student activities,
- Transportation or similar personal, living, or family expenses, even if the fees must be paid to the institution as a condition of enrollment or attendance,

ALERT

Qualified tuition and related expenses cannot be claimed twice. If the same expense is deducted on a different line of the return it cannot also be claimed as a Tuition and Fee Deduction.

- Athletic fees, or
- Other expenses unrelated to an individual's academic course of instruction.

Eligible Student

The deduction can be claimed for the taxpayer, the taxpayer's spouse (if filing a joint return), and any dependent (for whom the taxpayer claims a dependency exemption).

Married taxpayers who file as married filing separately cannot take the deduction.

An individual who is the dependent of another taxpayer cannot claim the deduction.

Eligible Educational Institution

An eligible educational institution is generally any accredited public, nonprofit, or private postsecondary institution eligible to participate in the student aid programs administered by the Department of Education. It includes virtually all accredited, public, nonprofit, and privately owned profit-making postsecondary institutions.

If the taxpayer does not know whether the educational institution is an eligible institution, he or she should contact the school.

Deduction Amount

The deduction amount is determined by the taxpayer's filing status and adjusted gross income.

The total amount of qualified tuition and related expenses are reduced by:

- Distributions from qualified state tuition programs,
- Distributions from Coverdell ESAs, and
- Interest from savings bonds used for higher education expenses.

Modified adjusted gross income (MAGI) for purposes of the deduction for qualified tuition and related fees is adjusted gross (AGI) income before the deduction for qualified tuition and related fees and after adding back the following:

- Foreign earned income exclusion,
- Foreign housing exclusion or deduction,
- Exclusion of income for bona fide residents of Guam, Puerto Rico, American Samoa, or the Northern Mariana Islands.

Figuring the Deduction

Use the Tuition and Fees Deduction worksheet Form 8917 found in the Form 1040 or Form 1040A instructions to figure the modified adjusted gross income and the resulting deduction amount.

Example 15

Luis and Priscilla Lopez file a joint return. Their total income is $49,620. During the year, Priscilla paid $1,300 for classes taken at the local university. She had allowable IRA deductions of $1,500. Their allowable tuition and fees deduction is $1,300, shown in Exhibit 6.

Exhibit 6 **Tuition and Fees Deduction Worksheet**

Form **8917** Department of the Treasury Internal Revenue Service

Tuition and Fees Deduction

► See Instructions.
► Attach to Form 1040 or Form 1040A.

OMB No. 1545-0074
2007
Attachment Sequence No. **63**

Name(s) shown on return: **Luis Lopez and Priscilla Lopez**
Your social security number: xxx xx xxxx

Caution: *You* ***cannot*** *take both an education credit and the tuition and fees deduction (Form 1040, line 34, or Form 1040A, line 19) for the* ***same student*** *in the same year.*

Before you begin:
√ Figure any write-in adjustments to be entered on the dotted line next to Form 1040, line 36 (see the Form 1040 instructions for line 36).
√ If you file Form 2555, 2555-EZ, or 4563, or you exclude income from sources within Puerto Rico, use the worksheet in Pub. 970 to figure your entry on line 5 below. Do not complete lines 3 and 4.

1

(a) Student's name (as shown on page 1 of your tax return) First name	Last name	(b) Student's social security number (as shown on page 1 of your tax return)	(c) Qualified expenses (see instructions)
Priscilla	Lopez	xxx xx xxxx	1300

2	Add the amounts on line 1, column (c), and enter the total			2 1300
3	Enter the amount from Form 1040, line 22, or Form 1040A, line 15	3	49620	
4	Enter the total from either: • Form 1040, lines 23 through 33, plus any write-in adjustments entered on the dotted line next to Form 1040, line 36, **or** • Form 1040A, lines 16 through 18	4	1500	
5	Subtract line 4 from line 3.* If the result is more than $80,000 ($160,000 if married filing jointly), **stop;** you cannot take the deduction for tuition and fees			5 49120
6	**Tuition and fees deduction.** Is the amount on line 5 more than $65,000 ($130,000 if married filing jointly)? ☐ **Yes.** Enter the amount from line 2, but **do not** enter more than $2,000. Also enter this amount on Form 1040, line 34, or Form 1040A, line 19. ☑ **No.** Enter the amount from line 2, but **do not** enter more than $4,000. Also enter this amount on Form 1040, line 34, or Form 1040A, line 19.			6 1300

*If you are filing Form 2555, 2555-EZ, or 4563, or you are excluding income from Puerto Rico, see Pub. 970 for the amount to enter.

NO DOUBLE BENEFITS

A taxpayer cannot:

- Deduct qualified tuition and related expenses if the same expense is deductible on a different line of the return.
- Claim the Hope credit or the lifetime learning credit for an individual in the same year as a deduction for qualified tuition and related expenses are claimed.
- Claim a credit based on expenses paid with a tax-free scholarship, grant, or an employer-provided educational assistance.

ONE-HALF OF SELF-EMPLOYMENT TAX

Report on Form 1040, line 27, the adjustment for one-half of self-employment tax from Schedule SE. This subject was covered in Lesson 3, for volunteers who will be helping self-employed taxpayers.

PENALTY ON EARLY WITHDRAWAL OF SAVINGS

Depositors may withdraw funds from ordinary savings accounts any time they wish. However, if they withdraw funds from a time deposit (such as a certificate of deposit) before the maturity date, a penalty is charged. Form 1099-INT reports the interest earned as well as any early withdrawal penalties.

As you learned in Lesson 3, taxpayers must report the total amount of interest earned. They cannot subtract the early withdrawal penalty from the interest earned and report the difference. The early withdrawal penalty can be claimed as an adjustment only on Form 1040. The entire penalty is deducted, even if it is greater than the interest income.

Example 16

Arlene has one Form W-2 and one Form 1099-INT and no other income. Her Form 1099-INT shows both interest income and an early withdrawal penalty. Arlene does not pay alimony, and she did not make a contribution to a traditional IRA. She will not itemize deductions, and she cannot claim any tax credits. Normally, she would be able to file Form 1040A.

However, Arlene must file Form 1040 to claim the adjustment for the penalty on early withdrawal of savings.

ALIMONY PAID

As you learned in Lesson 3, alimony and separate maintenance payments are taxable to the person receiving these payments. The person paying the alimony or separate maintenance can claim it as an adjustment to income. This adjustment can be claimed only on Form 1040. The amount paid during the year and the recipient's social security number are entered on the adjustment line for alimony paid. Claim the adjustment only for amounts paid during the tax year.

Child support is **not** the same as alimony or separate maintenance payments. Child support is not taxable to the recipient and cannot be claimed as an adjustment by the payer.

Jury Duty Pay Given to Employer

As you learned in Lesson 3, jury duty pay received by taxpayers is included in other income on Form 1040.

Some employees receive their regular wages from their employers when they are serving on a jury instead of working at their jobs. Often the jury duty pay the employees receive is turned over to their employers. The amount given to the employer may be claimed as an adjustment to income on Form 1040. This will be placed on the dotted line next to Line 36 of the 1040. Use “Jury Pay” to identify this adjustment from other possible write-ins. Note: This adjustment can only be made using the 1040.

Other Adjustments

The other adjustments that can be claimed on Form 1040 are beyond the scope of the VITA/TCE programs. Taxpayers who have adjustments that aren’t discussed in this lesson should be advised to seek paid professional tax assistance.

Total Adjustments and Adjusted Gross Income

Subtract the total adjustments from total income to arrive at adjusted gross income or **AGI.** Adjusted gross income is used to compute some limitations, such as the medical and dental deduction on Schedule A and the credit for child and dependent care expenses.

TaxWise® Hints

TaxWise® has all of the worksheets needed to determine adjustments to income.

There is one worksheet for student loan interest deduction. You can link to this form from Form 1040, lines 33 or 34.

Link to the deductible and nondeductible IRA worksheet from Form 1040, line 32. Once the IRA contribution is input for the taxpayer (and spouse if married), TaxWise® will complete Form 8606, if necessary, and input the entry on Form 1040, line 32.

One-half the self-employment tax will be entered automatically when completing Schedule C or Schedule C-EZ.

The penalty on withdrawal from savings should be entered by linking to the Interest Received worksheet. This worksheet is a link from Schedule B.

TaxWise® breaks out the remaining adjustments. Simply input the appropriate amount.

QUALITY REVIEW (QR)—ADJUSTMENTS

Use **Form 8158, Quality Review Sheet** or your site's approved alternative form to review all returns prepared. Apply the quality review (QR) tools in combination with the Intake and Interview Sheet and all the source documents to the returns you prepare to ensure quality and accuracy for every taxpayer.

Consider each item on the Quality Review Sheet which applies to your taxpayer's situation to confirm that all the necessary questions and issues have been addressed. If items are incorrect or incomplete, revisit each issue and make corrections to the return, as needed.

Excerpt from Form 8158

Yes	No	
☐	☐	All **adjustments, deductions and credits** indicated on the intake/interview sheet and supporting documents are included on the return.

To ensure accurate reporting of adjustments to income, verify with the taxpayer that all adjustments including IRA contributions, alimony paid, education-related expenses, penalty on early withdrawal of savings, or jury duty pay have been reflected on the return, if appropriate.

▶▶ Summing Up This Lesson ◀◀

- An adjustment is an amount subtracted from total income.

The result is adjusted gross income.

- Adjustments covered in the VITA/TCE program are:
  - ▶ Educator expenses
  - ▶ Contributions to a traditional IRA
  - ▶ Student loan interest deduction
  - ▶ Tuition and fees
  - ▶ One-half of self-employment tax paid (volunteers trained to prepare Schedule C-EZ and Schedule SE can assist taxpayers claiming this adjustment)
  - ▶ Penalty on early withdrawal of savings
  - ▶ Alimony paid
  - ▶ Jury duty pay given to employer
- The adjustments for traditional IRA contributions, student loan interest deduction, tuition and fees deduction, and educator expenses deduction can be claimed on either Form 1040 or Form 1040A. The other adjustments can be claimed on Form 1040 only.
- Persons 70½ years of age or older by the end of the tax year cannot make traditional IRA contributions for that tax year.
- Traditional IRA contributions generally cannot be more than the taxpayer's taxable compensation or $4,000 ($4,500 if age 50 or older), whichever amount is smaller.
- Individuals who are not covered by retirement plans at work may make deductible IRA contributions regardless of their modified adjusted gross income. Taxpayers who are covered by retirement plans at work may deduct all, part, or none of their traditional IRA contributions depending on their modified adjusted gross income and filing status.
- Taxpayers may be subject to additional tax for contributing more to a traditional IRA than is allowed, making traditional IRA withdrawals before age 59½, and not withdrawing enough traditional IRA funds after 70½.

ADJUSTMENTS TO INCOME

ANSWERS TO EXERCISES

Exercise 1

A. Yes; alimony is considered compensation for traditional IRA purposes.

B. Yes; but only if they file a joint return.

C. No; Carla has no compensation for traditional IRA purposes.

D. $1,250; the lesser of taxable compensation or $5,000.

Exercise 2

A. Yes; all of her contribution up to $4,000 is deductible because their combined modified adjusted gross income is not more than $156,000.

B. Yes; all of it is deductible because her modified adjusted gross income is less than $50,000.

C. Richard may not deduct any of his contribution because his modified adjusted gross income is at least $10,000. Lynn will be able to deduct a portion of her IRA contribution because she is not covered by an employer-sponsored retirement plan and her income is less than $10,000.

Exercise 3

Bill and Kathy's IRA Deduction Worksheet

Before you begin:
- √ Be sure you have read the list on page 27.
- √ Figure any write-in adjustments to be entered on the dotted line next to line 36 (see the instructions for line 36 on page 31).

			Your IRA		Spouse's IRA
1a.	Were you covered by a retirement plan (see page 27)?	**1a.**	☑ Yes ☐ No		
b.	If married filing jointly, was your spouse covered by a retirement plan?			**1b.**	☐ Yes ☑ No
	Next. If you checked "No" on line 1a (and "No" on line 1b if married filing jointly), skip lines 2 through 6, enter $4,000 ($5,000 if age 50 or older at the end of 2007) on line 7a (and 7b if applicable), and go to line 8. Otherwise, go to line 2.				
2.	Enter the amount shown below that applies to you. • Single, head of household, or married filing separately and you **lived apart** from your spouse for all of 2007, enter $62,000 • Qualifying widow(er), enter $103,000 • Married filing jointly, enter $103,000 in both columns. But if you checked "No" on either line 1a or 1b, enter $166,000 for the person who was not covered by a plan • Married filing separately and you lived with your spouse at any time in 2007, enter $10,000	**2a.**	103,000	**2b.**	166,000
3.	Enter the amount from Form 1040, line 22 . . . . **3.** 30,000				
4.	Enter the total of the amounts from Form 1040, lines 23 through 31a, plus any write-in adjustments you entered on the dotted line next to line 36 . . . . **4.**				
5.	Subtract line 4 from line 3. If married filing jointly, enter the result in both columns	**5a.**	30,000	**5b.**	30,000
6.	Is the amount on line 5 less than the amount on line 2? ☐ **No.** STOP None of your IRA contributions are deductible. For details on nondeductible IRA contributions, see Form 8606. ☑ **Yes.** Subtract line 5 from line 2 in each column. Follow the instruction below that applies to you. • If single, head of household, or married filing separately, and the result is $10,000 or more, enter $4,000 ($5,000 if age 50 or older at the end of 2007) on line 7 for that column and go to line 8. Otherwise, go to line 7. • If married filing jointly or qualifying widow(er), and the result is $20,000 or more ($10,000 or more in the column for the IRA of a person who was not covered by a retirement plan), enter $4,000 ($5,000 if age 50 or older at the end of 2007) on line 7 for that column and go to line 8. Otherwise, go to line 7.	**6a.**	73,000	**6b.**	136,000

Exercise 3 — **Bill and Kathy's IRA Deduction Worksheet**

7.	Multiply lines 6a and 6b by the percentage below that applies to you. If the result is not a multiple of $10, increase it to the next multiple of $10 (for example, increase $490.30 to $500). If the result is $200 or more, enter the result. But if it is less than $200, enter $200 • Single, head of household, or married filing separately, multiply by 40% (.40) (or by 50% (.50) in the column for the IRA of a person who is age 50 or older at the end of 2007) • Married filing jointly or qualifying widow(er), multiply by 20% (.20) (or by 25% (.25) in the column for the IRA of a person who is age 50 or older at the end of 2007). But if you checked "No" on either line 1a or 1b, then in the column for the IRA of the person who was not covered by a retirement plan, multiply by 40% (.40) (or by 50% (.50) if age 50 or older at the end of 2007).	**7a.**	4,000	**7b.**	4,000
8.	Enter the total of your (and your spouse's if filing jointly): • Wages, salaries, tips, etc. Generally, this is the amount reported in box 1 of Form W-2. See page 27 for exceptions • Alimony and separate maintenance payments reported on Form 1040, line 11 • Nontaxable combat pay. This amount should be reported in box 12 of Form W-2 with code Q	**8.**	30,000		
9.	Enter the earned income you (and your spouse if filing jointly) received as a self-employed individual or a partner. Generally, this is your (and your spouse's if filing jointly) net earnings from self-employment if your personal services were a material income-producing factor, minus any deductions on Form 1040, lines 27 and 28. If zero or less, enter -0-. For more details, see Pub. 590	**9.**			
10.	Add lines 8 and 9	**10.**	30,000		
	CAUTION *If married filing jointly and line 10 is less than $8,000 ($9,000 if one spouse is age 50 or older at the end of 2007; $10,000 if both spouses are age 50 or older at the end of 2007),* ***stop here*** *and see Pub. 590 to figure your IRA deduction.*				
11.	Enter traditional IRA contributions made, or that will be made by April 15, 2008, for 2007 to your IRA on line 11a and to your spouse's IRA on line 11b	**11a.**	2,000	**11b.**	400
12.	On line 12a, enter the **smallest** of line 7a, 10, or 11a. On line 12b, enter the **smallest** of line 7b, 10, or 11b. This is the most you can deduct. Add the amounts on lines 12a and 12b and enter the total on Form 1040, line 32. Or, if you want, you can deduct a smaller amount and treat the rest as a nondeductible contribution (see Form 8606)	**12a.**	2,000	**12b.**	400

STOP

Military/International students continue.

All others go to Lesson 11.

STUDENT NOTES

MOVING EXPENSES

INTRODUCTION AND OBJECTIVES

This segment covers the moving expenses of military personnel. When a member of the Armed Forces is transferred to a new permanent duty station, he or she may deduct certain moving expenses.

In preparing returns for the military, you will need to:

- Identify qualifying moves by assisting in determining if the move qualifies as a permanent change of station (PCS).
- Determine when allowances and reimbursements must be included in income.
- Identify deductible moving expenses.
- Compute the moving expense deduction using **Form 3903, Moving Expenses,** for moves within and outside the United States.

PERMANENT CHANGE OF STATION

For military moves, only expenses incurred as a result of a permanent change of station are deductible. A permanent change of station includes:

- A move from home to the area of the first post of duty.
- A move from one permanent post of duty to another.
- A move from the last post of duty to home or to a nearer point in the United States. The member must move within one year of ending active duty or within the period allowed under the Joint Travel Regulations.

Spouse and dependents. If a member of the Armed Forces dies, is imprisoned, or deserts, 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 Armed Forces moves a member and his or her spouse or dependents to or from separate locations, the moves are treated as a single move to the member's post of duty. The qualified expenses of both moves are combined and deducted on the same tax return.

Exercise 1

Which of the following is a permanent change of station?

A. A move by an Air Force pilot to an airbase for a 6-month detail.

B. A move by an Army sergeant to his home 2 years after he ended active duty.

C. A move by a new enlistee from her home to her first post of duty.

Answer: ____

Requirements

The moving expense deduction includes only expenses that are reasonable for the circumstances of the move. For example, the costs of any side trips for sightseeing are not deductible. The cost of lavish and extravagant lodging also is not deductible.

Although civilians must meet a distance test and a time test to deduct moving expenses, members of the military can disregard such tests for moves required by a permanent change of station.

Payments in Kind, Allowances, and Reimbursements

The service member must include in gross income any payments he or she receives from the government for a do-it-yourself (DITY) permanent change of station (PCS) move. A DITY move payment is based on government estimates of the cost to move household goods, not on actual expenses and receipts. The service member will receive a separate Form W-2 for the DITY payment. The amount in box 1 of the Form W-2 must be included on line 7 of Form 1040. He or she must also complete Form 3903 to compute total qualified moving expenses that can be deducted on line 26, Form 1040. These entries on line 7 and line 26 of Form 1040 will report the income and applicable related expenses for the move on Form 1040.

The service member does not include any of the following in his or her gross income:

- Moving or storage services furnished to the member
- Non-taxable allowances such as:
  - Dislocation allowance
  - Temporary lodging allowance
  - Mileage allowance in lieu of transportation
  - Per diem allowance

Generally, if total reimbursements or allowances received by the service member are more than his or her qualified moving expenses, the excess will be included with his or her wages in box 1 of Form W-2. However, if reimbursements or allowances (other than nontaxable allowances like the ones listed above) exceed the cost of moving and they are not included in Form W-2, the service member must still include the excess on line 7 of Form 1040.

Use Form 3903 to deduct qualified expenses that exceed reimbursements and allowances (including nontaxable allowances such as the ones listed above).

Exercise 2

A. A member of the Armed Forces must include in gross income all reimbursements, allowances, and the value of moving and storage services that the military organization furnishes. True or false?

Answer: ____

B. If a member of the Armed Forces receives reimbursements or allowances (that are not excludable from gross income) in excess of the actual moving expenses, he or she must include in income (none of the reimbursements or allowances were reported on a W-2) only the amount that exceeds actual expenses. True or false?

Answer: ____

Deductible Moving Expenses

Any qualifying moving expenses that exceed allowances or reimbursements from the government are deductible.

Members of the military will need to determine whether they have excess expenses and, if so, whether the expenses are deductible on their federal tax return.

Qualifying moving expenses are:

- **The cost of moving household goods and personal effects,** including hauling a trailer and packing, storage, and insurance. It does not include the expense of moving furniture or other goods that the taxpayer bought on the way from the old home to the new home.
- **The cost of reasonable travel and lodging expenses** from the old home to the new home, including actual automobile expenses, airfare, and lodging for the taxpayer and members of his or her household. Members cannot deduct the cost of meals while traveling from the old home to the new home.

Foreign moves. A foreign move is one from the United States or its possessions to a foreign country or from one foreign country to another. It is not a move from a foreign country to the United States or its possessions.

Exercise 3

Which of the following are deductible moving expenses for Major Boone? (Assume the member received no reimbursements from the government.)

A. Payment to Fulton Construction Company for home improvements made to Major Boone's former home.

B. Security deposit to Towner Apartments on the Boones' new apartment.

C. Commission to Mercer Real Estate for the sale of the Boones' former home.

D. Payment to Shelby Transport Company to ship a piano that the Boones bought on the way to their new home.

E. Cost of transporting Major Boone's second car to the new job location.

F. Payment for meals while on the way to the new permanent duty station.

Answer: ____

REPORTING MOVING EXPENSES

Moving expenses are deductible as an adjustment to income on Form 1040, line 26. Only deductible expenses that are more than reimbursements and allowances can be claimed.

If the service member was not reimbursed, he or she can deduct allowable moving expenses either in the year incurred or in the year the expenses were paid.

If the member was reimbursed for expenses, he or she can deduct allowable expenses either in the year incurred or in the year paid.

If the member uses the cash method of accounting, which is used by most individuals, he or she can choose to deduct moving expenses in the year of reimbursement if:

1. The expenses were paid in a year before the year of reimbursement, or
2. The expenses were paid in the year immediately after the year of reimbursement but by the due date, including extensions, for filing his or her return for the reimbursement year.

Moving expenses are reported on Form 3903, *Moving Expenses.* For more information, see Publication 521, *Moving Expenses.*

The following example illustrates applications of the rules discussed in this lesson.

Example

Captain Shirley M. Holmes (SSN xxx-xx-xxxx) transferred in 2007 from one base to another. The government reimbursed her $350 for her travel and lodging expenses on the way to her new job location. The travel and lodging reimbursements were not reported as income on Form W-2. The $5,000 expense for transporting her household goods was furnished in kind by the military. No other reimbursements or allowances were made.

Captain Holmes incurred the following expenses:

Travel and lodging en route—$500

The moving expense is computed on Form 3903 as follows:

Exhibit 1 **Form 3903**

Form **3903** — **Moving Expenses** — OMB No. 1545-0074 — **2007**

Department of the Treasury
Internal Revenue Service

▶ **Attach to Form 1040 or Form 1040NR.**

Attachment Sequence No. **62**

Name(s) shown on return | **Your social security number**

Before you begin: √ See the **Distance Test** and **Time Test** in the instructions to find out if you can deduct your moving expenses.

√ See **Members of the Armed Forces** on the back, if applicable.

1	Transportation and storage of household goods and personal effects (see instructions)	1	500 00
2	Travel (including lodging) from your old home to your new home (see instructions). **Do not** include the cost of meals	2	500 00
3	Add lines 1 and 2	3	
4	Enter the total amount your employer paid you for the expenses listed on lines 1 and 2 that is **not** included in box 1 of your Form W-2 (wages). This amount should be shown in box 12 of your Form W-2 with code **P**	4	350 00
5	Is line 3 **more than** line 4?		
	☐ **No.** You **cannot** deduct your moving expenses. If line 3 is less than line 4, subtract line 3 from line 4 and include the result on Form 1040, line 7, or Form 1040NR, line 8.		
	☐ **Yes.** Subtract line 4 from line 3. Enter the result here and on Form 1040, line 26, or Form 1040NR, line 26. This is your **moving expense deduction**	5	150 00

Note: The $5,000 expense for transporting her household goods was not included because the Armed Forces paid for this service.

The travel and lodging expenses for moving from the old home to the new home are shown on line 2 of Form 3903.

Reimbursements are shown on line 4.

To figure the moving expense deduction on Form 3903, subtract the total reimbursements on line 4 from the amount on line 3. Check the “Yes” box and enter the result on line 5 and on Form 1040, line 26.

Exercise 4

Greg T. (SSN 000-00-0000) and Diane E. Coe are filing a joint return. Greg T. Coe, an airman in the Air Force, was transferred from Maxwell Air Force Base to Scott Air Force Base. The government reimbursed Greg $400 for travel expenses incurred on the way to his new job location. He also received a $1,000 dislocation allowance. The travel and lodging reimbursements and the dislocation allowance were not reported as wages on Form W-2. Using the following information furnished by the Coes, complete Form 3903.

Dislocation expenses:	$ 1,000
Travel and lodging en route:	$ 575
Meals en route:	$ 200
Security deposit for new apartment:	$ 350

Exhibit 2 **Form 3903**

Form **3903**

Department of the Treasury
Internal Revenue Service

Moving Expenses

► **Attach to Form 1040 or Form 1040NR.**

OMB No. 1545-0074

2007

Attachment Sequence No. **62**

Name(s) shown on return | **Your social security number**

Before you begin: √ See the **Distance Test** and **Time Test** in the instructions to find out if you can deduct your moving expenses.
√ See **Members of the Armed Forces** on the back, if applicable.

1	Transportation and storage of household goods and personal effects (see instructions)	1	
2	Travel (including lodging) from your old home to your new home (see instructions). **Do not** include the cost of meals	2	
3	Add lines 1 and 2	3	
4	Enter the total amount your employer paid you for the expenses listed on lines 1 and 2 that is **not** included in box 1 of your Form W-2 (wages). This amount should be shown in box 12 of your Form W-2 with code **P**	4	
5	Is line 3 **more than** line 4? ☐ **No.** You **cannot** deduct your moving expenses. If line 3 is less than line 4, subtract line 3 from line 4 and include the result on Form 1040, line 7, or Form 1040NR, line 8. ☐ **Yes.** Subtract line 4 from line 3. Enter the result here and on Form 1040, line 26, or Form 1040NR, line 26. This is your **moving expense deduction**	5	

Exercise 1

C

Exercise 2

A. False

B. True

Exercise 3

E

Exercise 4

See completed Form 3903. The Coes are entitled to a $175 moving expense deduction. Only the travel and lodging en route can be claimed on Form 3903, line 2. The security deposit and the meals are not deductible expenses. In addition, the dislocation allowance is netted against dislocation expenses. Only if the dislocation expenses exceeded the dislocation allowance would the Coes have reported the difference as an additional moving expense on Form 3903.

▶▶ SUMMING UP THIS MILITARY SEGMENT ◀◀

In this segment you learned what moves qualify for tax benefits, what expenses are deductible, and how to use Form 3903 to compute the moving expense deduction. These expenses are deductible as an adjustment to income on Form 1040, line 26.

Form **3903**

Department of the Treasury
Internal Revenue Service

Moving Expenses

► **Attach to Form 1040 or Form 1040NR.**

OMB No. 1545-0074

2007

Attachment Sequence No. **62**

Name(s) shown on return | **Your social security number**

Before you begin: √ See the **Distance Test** and **Time Test** in the instructions to find out if you can deduct your moving expenses.
√ See **Members of the Armed Forces** on the back, if applicable.

1	Transportation and storage of household goods and personal effects (see instructions)	**1**	575	00
2	Travel (including lodging) from your old home to your new home (see instructions). **Do not** include the cost of meals	**2**	575	00
3	Add lines 1 and 2	**3**		
4	Enter the total amount your employer paid you for the expenses listed on lines 1 and 2 that is **not** included in box 1 of your Form W-2 (wages). This amount should be shown in box 12 of your Form W-2 with code **P**	**4**	400	00
5	Is line 3 **more than** line 4? ☐ **No.** You **cannot** deduct your moving expenses. If line 3 is less than line 4, subtract line 3 from line 4 and include the result on Form 1040, line 7, or Form 1040NR, line 8. ☐ **Yes.** Subtract line 4 from line 3. Enter the result here and on Form 1040, line 26, or Form 1040NR, line 26. This is your **moving expense deduction**	**5**	175	00

Pensions and Other Retirement Income

Lesson 11

Introduction and Objectives

This lesson covers pensions, annuities, social security benefits, railroad retirement benefits, and individual retirement arrangements.

After completing this lesson, you should be able to:

- Determine the taxable portion of different types of retirement income.
- Determine how to report retirement income on the tax return.
- Explain when a minimum distribution is required.
- Determine when an adjustment to withholding should be made.

This lesson will refer to forms that are used to report pension and annuity income. The most current version of each form is available at www.irs.gov (Note: Railroad Retirement, Civil Service Retirement, and Social Security forms are not available on this site.)

This lesson contains intermediate, advanced, international and military tax law course topics. Pensions, where the taxable amount has been determined, social security and Tier 1 railroad retirement benefits, and the withholding topics are included in the intermediate course. All the other pension and retirement income topics covered in this lesson are part of the advanced course.

Alert

This lesson contains intermediate, advanced, international and military law. Your course facilitator will only teach the information required to assist taxpayers you will serve.

Potential Pitfalls

While the software will do an excellent job of calculating the return, you are the key to determining the correct tax treatment of your customer's pension or annuity income. As you work through this lesson, note what questions you may need to ask the taxpayer. A thorough interview can help eliminate common errors.

Intake and Interview Process

Use **Form 13614, Intake and Interview Sheet,** to engage the taxpayer in preparing an accurate return. Use the Intake and Interview Sheet as a starting point for a comprehensive interaction with the taxpayer, in combination with all the source documents provided by the taxpayer, to ensure quality and accuracy on each return.

Confirm each item on Form 13614 (or similar tool used at your site) to make sure you and the taxpayer have considered all of the necessary information. Ensure that all questions and issues have been addressed. If items are incorrect or incomplete, revisit the issue and make corrections to the return as needed.

Excerpt from Form 13614

Part IV. Income – In 2007, did you (or your spouse) receive:

☐ Yes	☐ No	1.	Wages or Salary (include W-2s for all jobs worked during the year)
☐ Yes	☐ No	2.	Disability income
☐ Yes	☐ No	3.	Interest/Dividends from: checking or savings account, bonds, CDs, or brokerage account
☐ Yes	☐ No	4.	State tax refund (may be taxable if you itemized last year)
☐ Yes	☐ No	5.	Alimony income
☐ Yes	☐ No	6.	Tip income
☐ Yes	☐ No	7.	Pension and/or IRA distribution
☐ Yes	☐ No	8.	Unemployment (1099-G)
☐ Yes	☐ No	9.	Social Security or Railroad Retirement Benefits (1099-SSA or RRB)
☐ Yes	☐ No	10.	Self Employment Income - business, farm, hobby **(1099-Misc or any earned income not reported on W-2)**
☐ Yes	☐ No	11.	Other Income such as gambling winnings, awards, prizes and Jury Duty pay, etc.

Pensions and IRA distributions are covered in this lesson. To ensure accurate reporting of this type of income, ask the taxpayer about income or distributions from sources such as pensions, annuities, retirement or profit-sharing plans, IRAs, or insurance contracts. This income may be fully or partially taxable. Form 1099-R is the most common form used to report this income. Confirm that all income received by the taxpayer has been discussed and shown on the return, if required. You will learn more about pensions and IRA distributions later in this lesson.

POTENTIAL PITFALLS

Retirement distributions for civil service retirees may appear on Form CSA-1099. Retirement distributions for railroad retirees are reported on RRB-1099 forms (covered later in this lesson).

Social security and railroad retirement income are also covered in this lesson. To ensure accurate reporting of this type of income, ask the taxpayer about the receipt of either of these benefits. The Social Security Administration issues Form SSA-1099 to social security benefit recipients. The Railroad Retirement Board uses Form RRB-1099 or RRB-1099-R to report benefit payments. Confirm that all income received by the taxpayer has been discussed and shown on the return, if required. You will learn more about social security and railroad retirement benefits later in this lesson.

PENSIONS AND ANNUITIES

Pensions and annuities provide cash payments, usually after a person has retired. The payments may be for life or a fixed period of time. They may begin at retirement or at a specific age.

- A **pension** is generally a series of definitely determinable payments made to an employee or survivor (the beneficiary of a deceased employee's pension) after the employee retires from work. Payments are made regularly and are for past services with an employer.
- An **annuity** is a series of payments under a contract from an insurance company, a trust company, or an individual. Annuity payments are made at regular intervals over a period of more than one full year.
- A **qualified employee plan** is an employer's stock bonus, pension, or profit-sharing plan that is for the exclusive benefit of employees. The plan must meet Internal Revenue Code requirements. Most plans that you will be working with will be qualified plans.

- A **401(k) plan** is an arrangement that permits an employee to elect to have the employer contribute part of the employee's cash wages to a retirement plan on a pre-tax basis. These deferred wages are not subject to income tax withholding at the time of deferral. The deferred wages are not reflected on Form 1040 since they are not includable in taxable wages of box 1, Form W-2. (However, they are included as wages subject to social security, Medicare, and federal unemployment taxes.)

The most common form used to report pension and annuity distributions is Form 1099-R, Distributions from Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc. This lesson will help you understand how to treat the amounts listed on Form 1099-R.

Pensions and Annuities—Fully or Partially Taxable

A pension is fully or partially taxable depending on whether the employee contributed to the pension plan. Employee contributions are after-tax amounts that the employee paid into the pension fund. The employer usually deducts the contributions from wages and deposits them into the pension fund on behalf of the employee. Each year, the employee pays tax on the amount that he or she contributed to the pension that year. The employee's contributions are included on his or her Form W-2. Employee contributions are often referred to as the **cost** of the pension or as the investment in the annuity contract. For pensions discussed here, the employer will also have contributed to the pension fund.

- **Fully Taxable Pensions**

  If a taxpayer receives periodic payments of retirement benefits in the form of pension or annuity payments from a qualified employer retirement plan, the amounts received may be fully taxable or partially taxable. Periodic payments are amounts paid at regular intervals for a period of time greater than one year.

  Generally, if the taxpayer did not contribute to the cost of the pension plan, the pension benefits received are fully taxable. Military pensions are noncontributory and, therefore, fully taxable.

  (**Note:** If the taxpayer participates in the uniformed services Thrift Savings Plan, their account may include contributions from combat zone pay. This pay is tax-exempt and contributions attributable to that pay are tax-exempt when they are distributed. You may get more information from www.tsp.gov.)

  Fully taxable pension payments are reported on Form 1040, line 16b, or Form 1040A, line 12b. You should make no entry on Form 1040, line 16a, or Form 1040A, line 12a.

■ Partially Taxable Pensions and Annuities

If a taxpayer contributed to a pension plan with after-tax dollars while employed, part of the pension received is a return of the income taxed in earlier years and, therefore, is nontaxable. If the taxpayer has paid tax on the pension contribution (it was included in wages), the amount contributed to the pension is not taxed again when the pension is received.

For periodic payments that began after 1992, the payer is required to enter the taxpayer's contributions to a profit-sharing or retirement plan, or insurance premiums that the taxpayer may recover tax-free this year in box 5, Form 1099-R. See Exhibit 1 for a blank Form 1099-R.

Exhibit 1 **Form 1099-R**

☐ CORRECTED (if checked)

PAYER'S name, street address, city, state, and ZIP code		1 Gross distribution $ 2a Taxable amount $	OMB No. 1545-0119 2007 Form 1099-R	**Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.**
		2b Taxable amount not determined ☐	Total distribution ☐	**Copy B**
PAYER'S federal identification number	RECIPIENT'S identification number	3 Capital gain (included in box 2a) $	**4 Federal income tax withheld** $	**Report this income on your federal tax return. If this form shows federal income tax withheld in box 4, attach this copy to your return.**
RECIPIENT'S name		5 Employee contributions /Designated Roth contributions or insurance premiums $	6 Net unrealized appreciation in employer's securities $	
Street address (including apt. no.)		7 Distribution code(s) / IRA/ SEP/ SIMPLE ☐	8 Other $ %	This information is being furnished to the Internal Revenue Service.
City, state, and ZIP code		9a Your percentage of total distribution %	9b Total employee contributions $	
	1st year of desig. Roth contrib.	10 State tax withheld $ $	11 State/Payer's state no.	12 State distribution $ $
Account number (see instructions)		13 Local tax withheld $ $	14 Name of locality	15 Local distribution $ $

Form 1099-R Department of the Treasury — Internal Revenue Service

Example 1

Rudy retired from The Mart in 2003. He started receiving pension payments in October 2003. His 2007 Form 1099-R shows an amount of $2,043 in box 5. This is the amount of his 2007 payments that are considered a recovery of his cost. He will not include this portion of the payment in his income.

The taxpayer should verify the accuracy of the amount entered in box 5. If the taxpayer believes the amount entered is incorrect, the taxpayer should contact the payer.

If the payer is unable to reasonably obtain the data necessary to compute the taxpayer's cost, box 5 can be left blank.

Exercise 1

Wanda retired from a flour company in 2004. She receives a monthly pension of $1,000 from her former employer's pension plan. She shows you her 2007 Form 1099-R. The amount in box 5 is $892. How much of Wanda's 2007 distribution is considered a recovery of her cost in the plan? ________

In the next section, you will learn how to determine the taxable portion of a partially taxable pension or annuity when the payer has not determined the taxable portion of the payment.

Advanced, international and military students continue.

Intermediate students go to page 11-17
(Social Security and Tier 1 Railroad Retirement Benefits).

If the taxpayer has a cost to recover from the pension or annuity plan, he or she can exclude part of each pension or annuity payment from income as a recovery of cost, until all of the cost has been recovered. The tax-free part of the payment is figured when the pension or annuity starts and remains the same each year, even if the amount of the payment changes in future years.

The Simplified Method for Figuring Taxable Retirement Income

Exclusion Limit. The annuity starting date determines the total amount that can be excluded from taxable income over the years.

Exclusion Limited to Cost. If the annuity starting date is after 1986, the total amount of annuity income that can be excluded over the years as a recovery of the cost cannot exceed total cost.

Exclusion Not Limited to Cost. If the starting date is before 1987, the taxpayer can continue to take the monthly exclusion for as long as the taxpayer receives the annuity. If the taxpayer chose a joint and survivor annuity, the taxpayer's survivor can continue to take the survivor's exclusion figured as of the starting date. The total exclusion may be more than the cost.

Who Must Use the Simplified Method. If the taxpayer's pension or annuity starting date is after November 18, 1996, generally the simplified method must be used to figure the taxable portion of the payment from a qualified plan or annuity.

If the payer does not calculate the taxable portion of the distribution, you will need to complete a **Simplified Method Worksheet** if this is the first year of the distribution. The tax-free amount remains the same each month, even if the amount of the payment changes.

The Simplified Method Worksheet requires that you figure the tax-free part of each annuity payment by dividing the taxpayer's cost (or investment) by the total number of anticipated monthly payments. The number of anticipated monthly payments is based on the annuitant's age when the payments start and is determined from a table that is included in the worksheet.

Example 2

Peter, age 65, receives retirement benefits under a joint and survivor annuity, to be paid over the joint lives of Peter and his wife, Mary, age 62. Peter's annuity starting date is January 1, 2007. He contributed $31,000 to a qualified plan and did not receive any distributions before the annuity starting date. Peter receives monthly payments of $1,200 and his tax-free monthly amount is $100. Mary will receive monthly survivor benefits of $600 upon her husband's death. See Exhibit 2 for a completed Simplified Method Worksheet for Peter.

Use the simplified method for Peter because his annuity starting date is after November 18, 1996, and the payments are from a qualified plan. In addition, because his annuity is payable over the lives of more than one annuitant, you must combine his age with his wife's age in completing line 3 of the worksheet.

Exhibit 2 **Peter's Simplified Method Worksheet**

Simplified Method Worksheet—Lines 16a and 16b

Keep for Your Records

Before you begin: √ If you are the beneficiary of a deceased employee or former employee who died **before** August 21, 1996, include any death benefit exclusion that you are entitled to (up to $5,000) in the amount entered on line 2 below.

Note. If you had more than one partially taxable pension or annuity, figure the taxable part of each separately. Enter the total of the taxable parts on Form 1040, line 16b. Enter the total pension or annuity payments received in 2007 on Form 1040, line 16a.

1. Enter the total pension or annuity payments received in 2007. Also, enter this amount on Form 1040, line 16a . . . 1. 14,400

2. Enter your cost in the plan at the annuity starting date . . . 2. 31,000

Note. If you completed this worksheet last year, skip line 3 and enter the amount from line 4 of last year's worksheet on line 4 below (even if the amount of your pension or annuity has changed). Otherwise, go to line 3.

3. Enter the appropriate number from **Table 1** below. **But** if your annuity starting date was **after** 1997 **and** the payments are for your life and that of your beneficiary, enter the appropriate number from **Table 2** below . . . 3. 310

4. Divide line 2 by the number on line 3 . . . 4. 100

5. Multiply line 4 by the number of months for which this year's payments were made. If your annuity starting date was **before** 1987, skip lines 6 and 7 and enter this amount on line 8. Otherwise, go to line 6 . . . 5. 1,200

6. Enter the amount, if any, recovered tax free in years after 1986. If you completed this worksheet last year, enter the amount from line 10 of last year's worksheet . . . 6. 0

7. Subtract line 6 from line 2 . . . 7. 31,000

8. Enter the **smaller** of line 5 or line 7 . . . 8. 1,200

9. **Taxable amount.** Subtract line 8 from line 1. Enter the result, but not less than zero. Also, enter this amount on Form 1040, line 16b. If your Form 1099-R shows a larger amount, use the amount on this line instead of the amount from Form 1099-R 9. 13,200

10. Was your annuity starting date before 1987?

☐ **Yes.** STOP Leave line 10 blank.

☑ **No.** Add lines 6 and 8. This is the **amount you have recovered tax free** through 2007. You will need this number when you fill out this worksheet next year . . . 10. 1,200

Table 1 for Line 3 Above

IF the age at annuity starting date (see page 27) 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 (see page 27) were . . .	**THEN enter on line 3 . . .**
110 or under	410
111–120	360
121–130	310
131–140	260
141 or older	210

After Peter excludes $31,000 from taxable income, the remainder of his retirement benefits will be fully taxable. Because this is a joint and survivor annuity, if Peter dies before recovering all of the pension cost, his wife will also exclude $100 from her $600 monthly payment until the pension cost is fully recovered. If she dies before recovering all of the pension cost, the remaining unrecovered cost will be deducted on her final income tax return as a miscellaneous itemized deduction on Schedule A (Form 1040) (not subject to the 2 percent of adjusted-gross-income limitation).

Note: The Simplified Method Worksheet is part of the 1099-R input screen in the TaxWise® software. Scroll to the bottom of the input screen to see the worksheet.

Exercise 2

George, age 65, began receiving pension income under a joint and survivor annuity. George's annuity starting date is January 1, 2007. George had contributed $26,000 to a qualified plan and had received no distribution before 2007. George is to receive a monthly retirement benefit of $1,000 and his wife, age 68, is to receive a monthly survivor benefit of $500 upon George's death. Using Form 1099-R (Exhibit 3) for George, complete the Simplified Method Worksheet (Exhibit 4).

Exhibit 3 **George's Form 1099-R**

☐ CORRECTED (if checked)

PAYER'S name, street address, city, state, and ZIP code The Company 1 Maple Square Your City, State Zip		1 Gross distribution $ 12,000.00 2a Taxable amount $	OMB No. 1545-0119 2007 Form 1099-R	**Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.**
		2b Taxable amount not determined ☑	Total distribution ☐	**Copy B**
PAYER'S federal identification number XX-XXXXXXX	RECIPIENT'S identification number XXX-XX-XXXX	3 Capital gain (included in box 2a) $	**4 Federal income tax withheld** $	**Report this income on your federal tax return. If this form shows federal income tax withheld in box 4, attach this copy to your return.**
RECIPIENT'S name George Lincoln		5 Employee contributions /Designated Roth contributions or insurance premiums $	6 Net unrealized appreciation in employer's securities $	
Street address (including apt. no.) 123 Calhoun Ave		7 Distribution code(s) 7 — IRA/ SEP/ SIMPLE ☐	8 Other $ %	This information is being furnished to the Internal Revenue Service.
City, state, and ZIP code Your City, State Zip		9a Your percentage of total distribution %	9b Total employee contributions $ 26,000.00	
	1st year of desig. Roth contrib.	10 State tax withheld $ $	11 State/Payer's state no.	12 State distribution $ $
Account number (see instructions)		13 Local tax withheld $ $	14 Name of locality	15 Local distribution $ $

Form **1099-R** Department of the Treasury — Internal Revenue Service

Simplified Method Worksheet—Lines 16a and 16b

Keep for Your Records

Before you begin: √ If you are the beneficiary of a deceased employee or former employee who died **before** August 21, 1996, include any death benefit exclusion that you are entitled to (up to $5,000) in the amount entered on line 2 below.

Note. If you had more than one partially taxable pension or annuity, figure the taxable part of each separately. Enter the total of the taxable parts on Form 1040, line 16b. Enter the total pension or annuity payments received in 2007 on Form 1040, line 16a.

1. Enter the total pension or annuity payments received in 2007. Also, enter this amount on Form 1040, line 16a . . . . 1. ______

2. Enter your cost in the plan at the annuity starting date . . . . 2. ______

Note. If you completed this worksheet last year, skip line 3 and enter the amount from line 4 of last year's worksheet on line 4 below (even if the amount of your pension or annuity has changed). Otherwise, go to line 3.

3. Enter the appropriate number from **Table 1** below. **But** if your annuity starting date was **after** 1997 **and** the payments are for your life and that of your beneficiary, enter the appropriate number from **Table 2** below . . . . 3. ______

4. Divide line 2 by the number on line 3 . . . . 4. ______

5. Multiply line 4 by the number of months for which this year's payments were made. If your annuity starting date was **before** 1987, skip lines 6 and 7 and enter this amount on line 8. Otherwise, go to line 6 . . . . 5. ______

6. Enter the amount, if any, recovered tax free in years after 1986. If you completed this worksheet last year, enter the amount from line 10 of last year's worksheet . . . . 6. ______

7. Subtract line 6 from line 2 . . . . 7. ______

8. Enter the **smaller** of line 5 or line 7 . . . . 8. ______

9. **Taxable amount.** Subtract line 8 from line 1. Enter the result, but not less than zero. Also, enter this amount on Form 1040, line 16b. If your Form 1099-R shows a larger amount, use the amount on this line instead of the amount from Form 1099-R 9. ______

10. Was your annuity starting date before 1987?

☐ **Yes.** STOP Leave line 10 blank.

☐ **No.** Add lines 6 and 8. This is the **amount you have recovered tax free** through 2007. You will need this number when you fill out this worksheet next year . . . . 10. ______

Table 1 for Line 3 Above

IF the age at annuity starting date (see page 27) 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 (see page 27) were . . .	**THEN enter on line 3 . . .**
110 or under	410
111–120	360
121–130	310
131–140	260
141 or older	210

Disability Pension Income

If the taxpayer retired on disability, he or she generally must include in income any disability pension received under a plan that is paid for by the employer. Taxable disability payments are treated as wages (and entered on Form 1040 or Form 1040A line 7) until the taxpayer reaches the minimum retirement age. The minimum retirement age generally is the age at which the taxpayer could first receive a pension or annuity, from that employer, if the taxpayer was not disabled. (The payer may report the disability income on Form W-2 or Form 1099-R with code 3 in box 7.)

Example 3

Jason, age 41, retired on permanent and total disability in August due to multiple sclerosis. He received $700 per month (starting in August) from a plan for which his employer paid. Jason received $10,000 in wages from January 1 until his disability retirement. Jason will report the following income on line 7 of his tax return:

Wages	$10,000
Disability (5 x $700)	$3,500
Total	$13,500

When Jason reaches minimum retirement age, the monthly disability amount will no longer be treated as wages; it will be considered pension income.

Lump-Sum Distributions

A **lump-sum distribution** is the distribution or payment within one tax year of an employee's entire balance (less deductible voluntary employee contributions and certain amounts forfeited or subject to forfeiture) from all qualified pension, stock bonus, or profit-sharing plans that the employer maintains.

If the taxpayer received a lump-sum distribution from a qualified retirement plan or a qualified retirement annuity and the plan participant was born before 1936, the taxpayer may be able to elect optional methods of figuring the tax on the distribution. These optional methods can be elected only once after 1986 for any eligible plan participant. **If the plan participant was born after January 2, 1936, the elections for lump-sum distributions do not apply.**

Usually, lump-sum distributions are reported on Form 1099-R. Some lump-sum distributions qualify for special tax treatments. Code A in box 7 of Form 1099-R indicates that it is a lump-sum distribution and it may qualify for special tax treatments. The application of the special tax treatment is beyond the scope of the volunteer program. Suggest that the taxpayer seek the assistance of a paid tax preparer.

Minimum Required Distributions

To make sure that most retirement benefits are paid during the taxpayer's lifetime rather than to the taxpayer's beneficiaries, payments from qualified retirement plans (other than Roth IRAs) must begin no later than the **required beginning date.**

Generally, the required beginning date is April 1 of the year following the later of:

- The calendar year in which the taxpayer reached age 70½, or
- The calendar year in which the taxpayer retired from employment with the employer maintaining the plan.

By the required beginning date, the taxpayer must either receive his or her entire interest in the plan or begin receiving periodic distributions based on life expectancy. The amount that must be taken out is known as the **minimum required distribution.**

The minimum required distribution is:

1. The entire amount in the pension plan, or
2. Regular periodic distributions in an amount large enough to use up the entire amount in the pension plan over
    a. The taxpayer's life expectancy,
    b. The joint life expectancies of the taxpayer and a designated surviving beneficiary, or
    c. A shorter period of time than these life expectancies.

IMPORTANT! If the taxpayer does not receive the minimum required distribution, an excise tax may be imposed. The tax is 50 percent of the difference between the minimum distribution and the amount actually distributed for the tax year.

Individual Retirement Arrangement (IRA) Distributions

As a volunteer, you can complete the return of a taxpayer who received either a fully taxable or a totally tax-free distribution from an IRA. If only part of the distribution is taxable, the taxpayer should consult a paid tax preparer.

A **traditional IRA** is any IRA that is not a Roth IRA or a SIMPLE IRA. A traditional IRA is sometimes called an ordinary or regular IRA.

A **Roth IRA** is an individual retirement arrangement that is designated as a Roth when it is set up. Taxpayers cannot deduct contributions to a Roth IRA. However, if the taxpayer satisfies the requirements described later, qualified distributions are tax free.

A **Savings Incentive Match Plan for Employees (SIMPLE)** is a tax-favored retirement plan that certain small employers (including self-employed individuals) can set up for the benefit of their employees. For SIMPLE plan purposes, the term "employee" includes a self-employed individual who received earned income.

Traditional IRA—Taxation of Distributions

General Rules

In general, distributions from a traditional IRA are taxable in the year received. Taxable distributions from traditional IRAs are treated as ordinary income. The taxpayer cannot use the 10-year tax option or the capital gain treatment for a lump-sum distribution from an IRA. Most distributions from qualified retirement plans made to a taxpayer before they reach age 59½ are subject to an additional tax of 10%. This tax applies to the part of the distribution that you must include in gross income. It is reported on Line 60, Form 1040.

Reservists called for duty for more than 179 days between Sept. 11, 2001, and Dec. 31, 2007, are exempted from this 10% early withdrawal penalty under the provisions of the Pension Protection Act of 2006.

Fully Taxable

If only deductible contributions were made to a traditional IRA, the taxpayer has no basis (cost or investment) in the IRA. Because the taxpayer has no basis, any distribution from the IRA is fully taxable when received.

Partially Taxable

If the taxpayer made nondeductible contributions to a traditional IRA, he or she has a cost basis (investment in the contract) equal to the amount of those contributions. The nondeductible contributions are not taxed when they are distributed because they represent a return of the investment in the IRA. The volunteer program does not cover distributions that are partially taxable. Taxpayers with partially taxable distributions should be referred to a paid tax preparer.

If the taxpayer receives a distribution from a traditional IRA, he or she will receive Form 1099-R, or similar statement. IRA distributions are shown in boxes 1 and 2 of Form 1099-R. The IRA box to the right of box 7 should be checked.

Example 4

Tyrone contributed $500 a year to a traditional IRA. Each year he deducted his traditional IRA contribution from his income. This year he received his first distribution from the traditional IRA. It is fully taxable. Tyrone will pay income tax on the distributions he receives which represent the contributions he made and deducted as well as the money the contributions have earned over the years.

Rollovers

Generally, a rollover is a tax-free distribution to the taxpayer of cash or other assets from one retirement plan to which the taxpayer contributes to another retirement plan. The contribution to the second retirement plan is called a “rollover contribution.”

Time Limit. Generally, the rollover contribution must be made by the 60th day after the distribution from the traditional IRA or employer's plan is received by the taxpayer.

Traditional IRAs—Minimum Required Distributions

Taxpayers cannot keep funds in a traditional IRA indefinitely. Eventually, the funds must be distributed. The owner of a traditional IRA must start taking distributions from the IRA when he or she reaches age 70½. The taxpayer must take the first minimum distribution from the IRA by April 1 of the year following the year in which he or she reaches age 70½ (the required beginning date). The required minimum distribution for any year after the year the taxpayer turns 70 ½ must be made by December 31 of that later year. Therefore, the taxpayer will need to take two distributions in the same tax year if he or she postpones the first distribution until the year following the year he or she turns 70½.

If there are no distributions or the distributions are not large enough, the taxpayer may have to pay an additional 50 percent excise tax (described earlier in this lesson) on the amount not distributed.

Roth IRAs—Taxation of Distributions

In general, taxpayers do not include **qualified distributions** from Roth IRAs in gross income.

A qualified distribution is generally any payment or distribution made after the 5-year period beginning with the first taxable year for which a contribution was made to a Roth IRA, and the payment or distribution is made:

- On or after the taxpayer reaches age 59½,
- Because the taxpayer is disabled,
- To a beneficiary or an estate after the death of the taxpayer, or
- To buy, build, or rebuild a first home (up to a $10,000 lifetime limit).

Part of any distribution that is not a qualified distribution may be taxable as ordinary income and subject to the additional 10 percent tax on early distributions. Distributions of conversion contributions within a 5-year period following a conversion from a traditional IRA to a Roth IRA may be subject to the 10 percent early distribution tax, even if the contributions have been included as income in an earlier year.

Taxpayers are not required to take distributions from a 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. The amount withdrawn from a Roth IRA cannot be used to satisfy the minimum distribution requirements for the taxpayer's traditional IRA(s), if any.

Railroad Retirement Benefits and Reporting Form RRB-1099

Benefits paid under the Railroad Retirement Act fall into **two categories.** These categories are treated differently for income tax purposes.

1. The **first category** is the amount of Tier 1 railroad retirement benefits that equal the social security benefit that a railroad employee or beneficiary would have been entitled to receive under the social security system.

   This part of the Tier 1 benefit is called the "social security equivalent benefit" and is treated for tax purposes like social security benefits. It is shown on the blue part of Form RRB-1099, *Payments by the Railroad Retirement Board.* Use the amount from box 5 of Form RRB-1099.

2. The **second category** contains the rest of the Tier 1 benefits, called the "non-social security equivalent benefit," any Tier 2 benefits, vested dual benefits, and supplemental annuity benefits.

   This category of benefits, shown on the green part of Form RRB-1099-R, *Annuities or Pensions by the Railroad Retirement Board,* is treated as an amount received from a qualified employer plan. Vested dual benefits and supplemental annuity benefits are fully taxable pensions.

Example 5

David is retired from the Drake Railroad Line. He files Form 1040 jointly with his wife, Elizabeth. He received Form RRB-1099 (Exhibit 5) and Form RRB-1099-R (Exhibit 6). Elizabeth also received Form RRB-1099-R (Exhibit 7). Elizabeth had wages of $7,390 (Form 1040, line 7). They had $3,598 of interest income (Form 1040, line 8a). They also had ordinary dividends of $2,019 (Form 1040, line 9a) and $480 (Form 1040, line 13) in capital gain distributions.

Since box 3 on Form RRB-1099-R is blank, the payments shown in box 4 are fully taxable. The amount in box 6 is also fully taxable. They will include the $13,544 ($3,054 + $10,490) on Form 1040, line 16b.

The Social Security (and Tier 1 Equivalent) Benefits Worksheet (Exhibit 8) reveals that $613 of the amount on Form RRB-1099 is taxable.

Exhibit 5 – David's Form RRB-1099

PAYER'S NAME, STREET ADDRESS, CITY, STATE, AND ZIP CODE **UNITED STATES RAILROAD RETIREMENT BOARD** 844 N RUSH ST CHICAGO IL 60611-2092	2007		**PAYMENTS BY THE RAILROAD RETIREMENT BOARD**
PAYER'S FEDERAL IDENTIFYING NO. 15-6XXXXXX	3. Gross Social Security Equivalent Benefit Portion of Tier 1 Paid in 2007	12,390.00	
1. Claim Number and Payee Code X XXXXXX	4. Social Security Equivalent Benefit Portion of Tier 1 Repaid to RRB in 2007	0.00	COPY C -
2. Recipient's Identification Number XXX-XX-XXXX	5. Net Social Security Equivalent Benefit Portion of Tier 1 Paid in 2007	12,390.00	FOR RECIPIENT'S RECORDS
Recipient's Name, Street Address, City, State, and Zip Code David Yale 1900 S State St Your City, State Zip	6. Workers' Compensation Offset in 2007	0.00	
	7. Social Security Equivalent Benefit Portion of Tier 1 Paid for 2006	25.00	THIS INFORMATION IS BEING FURNISHED TO THE INTERNAL REVENUE SERVICE.
	8. Social Security Equivalent Benefit Portion of Tier 1 Paid for 2005		
	9. Social Security Equivalent Benefit Portion of Tier 1 Paid for Years Prior to 2005		
	10. Federal Income Tax Withheld 120.00	11. Medicare Premium Total 799.00	

FORM RRB-1099 **DO NOT ATTACH TO YOUR INCOME TAX RETURN**

Draft as of May 15, 2007 - Subject to Change

Exhibit 6 – David's Form RRB-1099-R

PAYERS' NAME, STREET ADDRESS, CITY, STATE, AND ZIP CODE **UNITED STATES RAILROAD RETIREMENT BOARD** 844 N RUSH ST CHICAGO IL 60611-2092	2007		**ANNUITIES OR PENSIONS BY THE RAILROAD RETIREMENT BOARD**	
PAYER'S FEDERAL IDENTIFYING NO. 15-6XXXXXX	3. Employee Contributions			
1. Claim Number and Payee Code X XXXXXX	4. Contributory Amount Paid	9,906.00	**COPY B -**	
2. Recipient's Identification Number XXX-XX-XXXX	5. Vested Dual Benefit		**REPORT THIS INCOME ON YOUR FEDERAL TAX RETURN. IF THIS FORM SHOWS FEDERAL INCOME TAX WITHHELD IN BOX 9 ATTACH THIS COPY TO YOUR RETURN.**	
Recipient's Name, Street Address, City, State, and ZIP Code David Yale 1900 S State St Your City, State, and Zip Code	6. Supplemental Annuity	584.00		
	7. Total Gross Paid	10,490.00		
	8. Repayments			
	9. Federal Income Tax Withheld	0.00	**THIS INFORMATION IS BEING FURNISHED TO THE INTERNAL REVENUE SERVICE.**	
	10. Rate of Tax		11. Country	12. Medicare Premium Total

FORM RRB-1099-R Draft as of May 15, 2007 - Subject to Change

Exhibit 7 – Elizabeth's Form RRB-1099-R

PAYERS' NAME, STREET ADDRESS, CITY, STATE, AND ZIP CODE **UNITED STATES RAILROAD RETIREMENT BOARD** 844 N RUSH ST CHICAGO IL 60611-2092	2007		**ANNUITIES OR PENSIONS BY THE RAILROAD RETIREMENT BOARD**	
PAYER'S FEDERAL IDENTIFYING NO. 15-6XXXXXX	3. Employee Contributions			
1. Claim Number and Payee Code X XXXXXX	4. Contributory Amount Paid	2,470.00	**COPY B -**	
2. Recipient's Identification Number XXX-XX-XXXX	5. Vested Dual Benefit		**REPORT THIS INCOME ON YOUR FEDERAL TAX RETURN. IF THIS FORM SHOWS FEDERAL INCOME TAX WITHHELD IN BOX 9 ATTACH THIS COPY TO YOUR RETURN.**	
Recipient's Name, Street Address, City, State, and ZIP Code Elizabeth Yale 1900 S State St Your City, State, and Zip Code	6. Supplemental Annuity	584.00		
	7. Total Gross Paid	3,054.00		
	8. Repayments			
	9. Federal Income Tax Withheld	1,280.00	**THIS INFORMATION IS BEING FURNISHED TO THE INTERNAL REVENUE SERVICE.**	
	10. Rate of Tax		11. Country	12. Medicare Premium Total

FORM RRB-1099-R Draft as of May 15, 2007 - Subject to Change

Social Security Benefits Worksheet—Lines 20a and 20b

Keep for Your Records

Before you begin:
- √ Complete Form 1040, lines 21 and 23 through 32, if they apply to you.
- √ Figure any write-in adjustments to be entered on the dotted line next to line 36 (see the instructions for line 36 on page 31).
- √ If you are married filing separately and you lived apart from your spouse for all of 2007, enter "D" to the right of the word "benefits" on line 20a.
- √ Be sure you have read the **Exception** on page 24 to see if you can use this worksheet instead of a publication to find out if any of your benefits are taxable.

1. Enter the total amount from **box 5** of **all** your **Forms SSA-1099** and **Forms RRB-1099.** Also, enter this amount on Form 1040, line 20a **1.** 12,390

2. Enter one-half of line 1 . . . . **2.** 6,195

3. Enter the total of the amounts from Form 1040, lines 7, 8a, 9a, 10 through 14, 15b, 16b, 17 through 19, and 21 . . . . **3.** 27,031

4. Enter the amount, if any, from Form 1040, line 8b **4.** 0

5. Add lines 2, 3, and 4 . . . . **5.** 33,226

6. Enter the total of the amounts from Form 1040, lines 23 through 32, and any write-in adjustments you entered on the dotted line next to line 36 . . . . **6.** 0

7. Is the amount on line 6 less than the amount on line 5?

☐ **No.** STOP None of your social security benefits are taxable. Enter -0- on Form 1040, line 20b.

☑ **Yes.** Subtract line 6 from line 5 . . . . **7.** 33,226

8. If you are:
- Married filing jointly, enter $32,000
- Single, head of household, qualifying widow(er), or married filing separately and you **lived apart** from your spouse for all of 2007, enter $25,000
- Married filing separately and you lived with your spouse at any time in 2007, skip lines 8 through 15; multiply line 7 by 85% (.85) and enter the result on line 16. Then go to line 17

. . . . **8.** 32,000

9. Is the amount on line 8 less than the amount on line 7?

☐ **No.** STOP None of your social security benefits are taxable. Enter -0- on Form 1040, line 20b. If you are married filing separately and you **lived apart** from your spouse for all of 2007, be sure you entered "D" to the right of the word "benefits" on line 20a.

☑ **Yes.** Subtract line 8 from line 7 . . . . **9.** 1,226

10. Enter: $12,000 if married filing jointly; $9,000 if single, head of household, qualifying widow(er), or married filing separately and you **lived apart** from your spouse for all of 2007 . . . **10.** 12,000

11. Subtract line 10 from line 9. If zero or less, enter -0- **11.** 0

12. Enter the **smaller** of line 9 or line 10 . . . . **12.** 1,226

13. Enter one-half of line 12 . . . . **13.** 613

14. Enter the **smaller** of line 2 or line 13 . . . . **14.** 613

15. Multiply line 11 by 85% (.85). If line 11 is zero, enter -0- **15.** 0

16. Add lines 14 and 15 . . . . **16.** 613

17. Multiply line 1 by 85% (.85) **17.** 10,532

18. **Taxable social security benefits.** Enter the **smaller** of line 16 or line 17. Also enter this amount on Form 1040, line 20b **18.** 613

TIP *If any of your benefits are taxable for 2007 **and** they include a lump-sum benefit payment that was for an earlier year, you may be able to reduce the taxable amount. See Pub. 915 for details.*

SOCIAL SECURITY AND TIER 1 RAILROAD RETIREMENT BENEFITS

This section explains the federal income tax rules for social security benefits and equivalent Tier 1 railroad retirement benefits. Social security benefits (as they are used in this lesson) include monthly survivor and disability benefits. They do not include supplemental security benefits (SSI) which are not taxable.

The Social Security Administration issues Form SSA-1099 to social security benefit recipients. The net benefit for the year is listed in box 5. The social security equivalent of the railroad retirement benefits is shown in box 5 of Form RRB-1099.

To determine whether any of the taxpayer's benefits may be taxable, you must select the **base amount** for the taxpayer. The base amounts are as follows:

- $25,000 if the filing status is single, head of household, or qualifying widow(er)
- $25,000 if the filing status is married filing separately and the taxpayer lived apart from the spouse for all of the year
- $32,000 if the filing status is married filing jointly
- $–0– if the filing status is married filing separately and the taxpayer lived with the spouse at any time during the year

Next, compare the base amount with the total of:

- One-half of the social security benefits (and equivalent Tier 1 railroad retirement benefits), plus
- All other income, including tax-exempt interest.

If the total is more than the base amount for the filing status, a portion of the taxpayer's social security benefits may be subject to federal income tax.

If part of the benefits is taxable, how much is taxable depends on the total amount of the benefits and other income. Generally, the higher that total amount, the greater the taxable part of the benefits.

The person who has the legal right to receive the benefits is the one who must consider whether the benefits are taxable.

ALERT

CSA-1099 - Information on Civil Service Retirement can be found in Publication 721. Ask your Site Coordinator if this type of retirement income is handled at your site and if your level of training is sufficient to handle this type of income.

Form SSA-1099

Social security benefits are reported to the taxpayer on Form SSA-1099, *Social Security Benefit Statement.* The amount in box 5, *Net benefits for 2007,* is entered on line 1 of the worksheet to figure if any of the benefits are taxable. If filing a joint return, include box 5 amounts from Form SSA-1099 for both spouses. Do not include a dependent's Form SSA-1099 received in the dependent's name. Neither Form SSA-1099 nor the worksheet (explained below) is attached to the income tax return. They are kept with the taxpayer's other personal records.

A worksheet to figure the taxable portion of the social security benefits (and equivalent Tier 1 railroad retirement benefits) is included in the instructions to Form 1040 and Form 1040A. If you are using software to prepare the return, you may not actually complete a worksheet. The software can make the determination of the taxable portion of the benefits based on the personal and financial information you enter for the taxpayer. Taxable portions of social security benefits (and equivalent Tier 1 railroad retirement benefits) cannot be reported on Form 1040EZ.

Exhibit 9 **Form SSA-1099**

FORM SSA-1099 – SOCIAL SECURITY BENEFIT STATEMENT

2007
- PART OF YOUR SOCIAL SECURITY BENEFITS SHOWN IN BOX 5 MAY BE TAXABLE INCOME.
- SEE THE REVERSE FOR MORE INFORMATION.

Box 1. Name		Box 2. Beneficiary's Social Security Number
Box 3. Benefits Paid in 2007	Box 4. Benefits Repaid to SSA in 2007	Box 5. Net Benefits for 2007 *(Box 3 minus Box 4)*

DESCRIPTION OF AMOUNT IN BOX 3	**DESCRIPTION OF AMOUNT IN BOX 4**
	Box 6. Voluntary Federal Income Tax Withholding
	Box 7. Address
	Box 8. Claim Number *(Use this number if you need to contact SSA.)*

Form **SSA-1099-SM** **DO NOT RETURN THIS FORM TO SSA OR IRS**

Example 6

Gilbert, age 72, is single and files Form 1040A. In addition to receiving social security payments, he received a fully taxable pension of $18,600 (line 12b), wages from a part-time job of $9,400 (line 7) and taxable interest income of $990 (line 8a), for a total of $28,990. He received a Form SSA-1099 that shows his net social security benefits of $5,980 in box 5. His completed worksheet is shown in Exhibit 10. On line 14a of his Form 1040A, Gilbert will enter $5,980. On line 14b, he will enter the taxable benefit of $2,990.

Social Security Benefits Worksheet—Lines 20a and 20b

Keep for Your Records

Before you begin:

- √ Complete Form 1040, lines 21 and 23 through 32, if they apply to you.
- √ Figure any write-in adjustments to be entered on the dotted line next to line 36 (see the instructions for line 36 on page 31).
- √ If you are married filing separately and you lived apart from your spouse for all of 2007, enter "D" to the right of the word "benefits" on line 20a.
- √ Be sure you have read the **Exception** on page 24 to see if you can use this worksheet instead of a publication to find out if any of your benefits are taxable.

1.	Enter the total amount from **box 5** of **all** your **Forms SSA-1099** and **Forms RRB-1099.** Also, enter this amount on Form 1040, line 20a **1.** 5,980		
2.	Enter one-half of line 1	**2.**	2,990
3.	Enter the total of the amounts from Form 1040, lines 7, 8a, 9a, 10 through 14, 15b, 16b, 17 through 19, and 21	**3.**	28,990
4.	Enter the amount, if any, from Form 1040, line 8b	**4.**	0
5.	Add lines 2, 3, and 4	**5.**	31,980
6.	Enter the total of the amounts from Form 1040, lines 23 through 32, and any write-in adjustments you entered on the dotted line next to line 36	**6.**	0
7.	Is the amount on line 6 less than the amount on line 5? ☐ **No.** STOP None of your social security benefits are taxable. Enter -0- on Form 1040, line 20b. ☑ **Yes.** Subtract line 6 from line 5	**7.**	31,980
8.	If you are: • Married filing jointly, enter $32,000 • Single, head of household, qualifying widow(er), or married filing separately and you **lived apart** from your spouse for all of 2007, enter $25,000 • Married filing separately and you lived with your spouse at any time in 2007, skip lines 8 through 15; multiply line 7 by 85% (.85) and enter the result on line 16. Then go to line 17	**8.**	25,000
9.	Is the amount on line 8 less than the amount on line 7? ☐ **No.** STOP None of your social security benefits are taxable. Enter -0- on Form 1040, line 20b. If you are married filing separately and you **lived apart** from your spouse for all of 2007, be sure you entered "D" to the right of the word "benefits" on line 20a. ☑ **Yes.** Subtract line 8 from line 7	**9.**	6,980
10.	Enter: $12,000 if married filing jointly; $9,000 if single, head of household, qualifying widow(er), or married filing separately and you **lived apart** from your spouse for all of 2007	**10.**	9,000
11.	Subtract line 10 from line 9. If zero or less, enter -0-	**11.**	0
12.	Enter the **smaller** of line 9 or line 10	**12.**	6,980
13.	Enter one-half of line 12	**13.**	3,490
14.	Enter the **smaller** of line 2 or line 13	**14.**	2,990
15.	Multiply line 11 by 85% (.85). If line 11 is zero, enter -0-	**15.**	0
16.	Add lines 14 and 15	**16.**	2,990
17.	Multiply line 1 by 85% (.85)	**17.**	5,083
18.	**Taxable social security benefits.** Enter the **smaller** of line 16 or line 17. Also enter this amount on Form 1040, line 20b	**18.**	2,990

TIP *If any of your benefits are taxable for 2007* ***and*** *they include a lump-sum benefit payment that was for an earlier year, you may be able to reduce the taxable amount. See Pub. 915 for details.*

Lump-Sum Social Security Benefits Payments—Figuring the Taxable Portion

Some taxpayers may have received a **lump-sum benefit payment** in 2007. This payment could be for both the current tax year and prior tax year(s). The lump-sum payment will be included in box 3 of Form SSA-1099 or Form RRB-1099 that the taxpayer receives. The form will also show the year, or years, of the payment. This type of lump-sum benefit payment should not be confused with the lump-sum death benefits that both the Social Security Administration and the Railroad Retirement Board pay to many of their beneficiaries. No part of the lump-sum death benefit is subject to tax.

When figuring the taxable portion of lump-sum social security benefits (and RRB Tier1 equivalents), two options are available.

1. The first option requires the taxpayer to report the whole payment in the year it was received. When the taxpayer chooses this option, complete the Social Security Benefits Worksheet as usual by including the entire lump-sum payment on line 1.
2. The taxpayer also has the option of treating the payment as received in the earlier year or years. This is done by making an election and figuring whether any part of these benefits is taxable, based on the earlier year's income.

If the taxpayer chooses to make the lump-sum election and spread the payments back to earlier years, only 2007 income will be adjusted. The taxpayer does not file amended returns for the earlier years. However, a special procedure **must** be used to figure the taxable portion of the benefits assigned to the earlier years. If the taxpayer wants to make this election, he or she should consult a paid tax preparer.

Reporting Retirement Income

It is important that you enter the retirement income on the correct line of the tax return. Tax software will make the correct entries if you input the income information correctly.

Type of Retirement Income	Form 1040A Line(s)	Form 1040 Line(s)
Fully taxable IRA distribution	11b	15b
Nontaxable IRA rollover	11a & 11b (zero)	15a & 15b (zero)
Fully taxable pension or annuity	12b	16b
Partially taxable pension or annuity	12a & 12b	16a & 16b
Social Security and RRB Tier 1 No portion subject to tax	14b (zero) if filing separately and did not live with spouse	20b (zero) if filing separately and did not live with spouse
Partially taxable social security and RRB Tier 1	14a & 14b	20a & 20b

Pension Withholding and Estimated Tax Payments

Income tax is normally withheld from the taxable part of a pension or annuity. The taxpayer can adjust the withholding amount or stop the withholding completely by notifying the payer. The taxpayer usually communicates these changes by completing Form W-4P, *Withholding Certificate for Pension or Annuity Payments,* and providing it to the payer of the pension.

A taxpayer who chooses not to have tax withheld (or has too little tax withheld) may have to make estimated tax payments. Taxpayers who owe more than $1,000 when they file their tax return may be penalized for failure to estimate (and pay) the proper amount of tax. Point out that they can submit a new W-4P to correct the withholding for the next tax year.

Summary Exercise

Using the concepts you learned in this lesson, complete the following summary exercise:

Bart, age 66, and Mildred, age 56, are filing a joint return. They want to file their return on a Form 1040 because that is what they have always done. They had the following income:

Mildred's wages	$9,500
Interest (joint)	$500
Dividends	$2,000
Bart's pension	$20,900
Bart's traditional IRA distribution	$3,400
Bart's social security	$9,500

Bart never made any after-tax contributions to his pension plan.

All of Bart's IRA contributions were tax-deductible when made.

A) How much of the pension income is taxable? ___________

B) What line(s) will you list the pension income on? ___________

C) How much of the IRA distribution is taxable?___________

D) What line(s) will you list the IRA distribution on? ___________

E) Will any portion of the social security benefits be taxable? Use Exhibit 11, Social Security Benefits Worksheet, to assist with Answer:. ___________

Social Security Benefits Worksheet—Lines 20a and 20b

Keep for Your Records

Before you begin:

√ Complete Form 1040, lines 21 and 23 through 32, if they apply to you.
√ Figure any write-in adjustments to be entered on the dotted line next to line 36 (see the instructions for line 36 on page 31).
√ If you are married filing separately and you lived apart from your spouse for all of 2007, enter "D" to the right of the word "benefits" on line 20a.
√ Be sure you have read the **Exception** on page 24 to see if you can use this worksheet instead of a publication to find out if any of your benefits are taxable.

1. Enter the total amount from **box 5** of **all** your **Forms SSA-1099** and **Forms RRB-1099.** Also, enter this amount on Form 1040, line 20a . . . . . . **1.** ______
2. Enter one-half of line 1 . . . . **2.** ______
3. Enter the total of the amounts from Form 1040, lines 7, 8a, 9a, 10 through 14, 15b, 16b, 17 through 19, and 21 . . . . **3.** ______
4. Enter the amount, if any, from Form 1040, line 8b . . . . **4.** ______
5. Add lines 2, 3, and 4 . . . . **5.** ______
6. Enter the total of the amounts from Form 1040, lines 23 through 32, and any write-in adjustments you entered on the dotted line next to line 36 . . . . **6.** ______
7. Is the amount on line 6 less than the amount on line 5?
   - ☐ **No.** STOP None of your social security benefits are taxable. Enter -0- on Form 1040, line 20b.
   - ☐ **Yes.** Subtract line 6 from line 5 . . . . **7.** ______
8. If you are:
   - Married filing jointly, enter $32,000
   - Single, head of household, qualifying widow(er), or married filing separately and you **lived apart** from your spouse for all of 2007, enter $25,000
   - Married filing separately and you lived with your spouse at any time in 2007, skip lines 8 through 15; multiply line 7 by 85% (.85) and enter the result on line 16. Then go to line 17

   } . . . . **8.** ______
9. Is the amount on line 8 less than the amount on line 7?
   - ☐ **No.** STOP None of your social security benefits are taxable. Enter -0- on Form 1040, line 20b. If you are married filing separately and you **lived apart** from your spouse for all of 2007, be sure you entered "D" to the right of the word "benefits" on line 20a.
   - ☐ **Yes.** Subtract line 8 from line 7 . . . . **9.** ______
10. Enter: $12,000 if married filing jointly; $9,000 if single, head of household, qualifying widow(er), or married filing separately and you **lived apart** from your spouse for all of 2007 . . . **10.** ______
11. Subtract line 10 from line 9. If zero or less, enter -0- . . . . **11.** ______
12. Enter the **smaller** of line 9 or line 10 . . . . **12.** ______
13. Enter one-half of line 12 . . . . **13.** ______
14. Enter the **smaller** of line 2 or line 13 . . . . **14.** ______
15. Multiply line 11 by 85% (.85). If line 11 is zero, enter -0- . . . . **15.** ______
16. Add lines 14 and 15 . . . . **16.** ______
17. Multiply line 1 by 85% (.85) . . . . **17.** ______
18. **Taxable social security benefits.** Enter the **smaller** of line 16 or line 17. Also enter this amount on Form 1040, line 20b . . . . **18.** ______

TIP *If any of your benefits are taxable for 2007* ***and*** *they include a lump-sum benefit payment that was for an earlier year, you may be able to reduce the taxable amount. See Pub. 915 for details.*

HEROES EARNED RETIREMENT OPPORTUNITIES (HERO) ACT

Under the Heroes Earned Retirement Opportunities (HERO) Act taxpayers can count tax-free combat pay when determining whether they qualify to contribute to either a Roth or traditional IRA. Before this change, members of the military whose earnings came entirely from tax-free combat pay were generally barred from using IRAs to save for retirement.

Members of the military serving in Iraq, Afghanistan and other combat zone localities can now put money into an individual retirement account, even if they received tax-free combat pay.

In addition, the HERO Act allows military personnel who received tax-free combat pay in either 2004 or 2005 to go back and make IRA contributions for those years. Eligible military members will have extra time, until May 28, 2009, to make these special back-year contributions.

For those under the age of 50, the IRA contribution limit was $3,000 for 2004 and $4,000 for 2005. For those 50 and over, the limit was $3,500 for 2004 and $4,500 for 2005.

Taxpayers choosing to put money into a Roth IRA don't need to report these contributions on their individual tax return. Roth contributions are not deductible, but distributions, usually after retirement, are normally tax-free. Income limits and other special rules apply.

On the other hand, contributions to a traditional IRA are often, though not always, deductible, and distributions are generally taxable. Deductible or not, contributions to a traditional IRA must be reported on the return for the year made. Deductible contributions are claimed on Form 1040, 1040A or 1040NR. Nondeductible contributions are reported on Form 8606, which is normally attached to one of these individual return Forms.

If a return has already been filed for a particular year, contributions should be reported on an amended return, Form 1040x. Depending upon the circumstances, military personnel who choose to put money into a traditional IRA for 2004 or 2005 may qualify for additional tax refunds.

QUALITY REVIEW (QR)

Use **Form 8158, Quality Review Sheet,** or a approved alternative form to review all returns prepared. Apply the quality review tools in combination with the Intake and Interview Sheet and all the source documents to the returns you prepare to ensure quality and accuracy for every taxpayer.

Consider each item on the Quality Review Sheet which applies to the taxpayer's situation to confirm that all the necessary questions and issues have been addressed. If items are incorrect or incomplete, revisit the issue and make corrections to the return, as needed.

Excerpt from Form 8158

Yes	No	
☐	☐	All **income** indicated on the intake/interview sheet, taxpayer's interview and/or supporting documents are included on the return.

To ensure accurate reporting of income, verify that the taxpayer's wages are accurate and that all income from Form(s) W-2 and other income documents, such as Form 1099, has been included. Confirm that all income received by the taxpayer has been discussed and shown on the return, if required.

▶▶ SUMMING UP THIS LESSON ◀◀

In this lesson, you learned about the taxability of several types of retirement income.

- ▶ Pension benefits are fully taxable if the taxpayer did not contribute to the cost of the pension plan.
- ▶ Pension benefits are partially taxable if the taxpayer made after-tax contributions to the pension plan.
- ▶ The Simplified Method Worksheet is used to compute the taxable portion of a partially taxable pension or annuity.
- ▶ A portion of social security benefits may be taxable if total income exceeds a specified base amount.
- ▶ The Social Security Benefits Worksheet is used to calculate the taxable portion of social security benefits received.
- ▶ Distributions from a traditional IRA are fully taxable if the taxpayer does not have basis in the IRA.
- ▶ Distributions from a traditional IRA are partially taxable if the taxpayer made nondeductible contributions to the IRA.
- ▶ The scope of the volunteer program does not include partially taxable IRA distributions.
- ▶ Qualified Roth IRA distributions are not taxable.
- ▶ Some taxpayers may need to make estimated tax payments or adjust their W-4P.

Exercise 1

$892.00

The amount in box 5 of Form 1099R is the amount of the current year's pension distribution that is considered a recovery of cost or investment.

Exercise 2

Please see Exhibit 12 on the following page for George's completed Simplified Method Worksheet.

Answer to Summary Exercise

A. $20,900

Since Bart did not make any after-tax contributions to the pension plan, the entire distribution is taxable.

B. 16b

The pension is fully taxable; no entry should be made on 16a.

C. $3,400

Bart was able to deduct all of his contributions to the traditional IRA; the distribution is fully taxable.

D. 15b

The distribution is fully taxable; no entry should be made on 15a.

E. Yes.

The joint income (with half the social security benefits added) is $41,050. This exceeds the base amount for a married filing jointly taxpayer. A portion of the social security benefits will be subject to tax. See Exhibit 13 for Bart and Mildred's completed Social Security Benefits Worksheet.

Simplified Method Worksheet—Lines 16a and 16b

Keep for Your Records

Before you begin: √ If you are the beneficiary of a deceased employee or former employee who died **before** August 21, 1996, include any death benefit exclusion that you are entitled to (up to $5,000) in the amount entered on line 2 below.

Note. If you had more than one partially taxable pension or annuity, figure the taxable part of each separately. Enter the total of the taxable parts on Form 1040, line 16b. Enter the total pension or annuity payments received in 2007 on Form 1040, line 16a.

1. Enter the total pension or annuity payments received in 2007. Also, enter this amount on Form 1040, line 16a 1. 12,000

2. Enter your cost in the plan at the annuity starting date 2. 26,000

Note. If you completed this worksheet last year, skip line 3 and enter the amount from line 4 of last year's worksheet on line 4 below (even if the amount of your pension or annuity has changed). Otherwise, go to line 3.

3. Enter the appropriate number from **Table 1** below. **But** if your annuity starting date was **after** 1997 **and** the payments are for your life and that of your beneficiary, enter the appropriate number from **Table 2** below 3. 260

4. Divide line 2 by the number on line 3 . . . . . 4. 100

5. Multiply line 4 by the number of months for which this year's payments were made. If your annuity starting date was **before** 1987, skip lines 6 and 7 and enter this amount on line 8. Otherwise, go to line 6 . . . . . 5. 1,200

6. Enter the amount, if any, recovered tax free in years after 1986. If you completed this worksheet last year, enter the amount from line 10 of last year's worksheet 6. 0

7. Subtract line 6 from line 2 . . . . . 7. 26,000

8. Enter the **smaller** of line 5 or line 7 . . . . . 8. 1,200

9. **Taxable amount.** Subtract line 8 from line 1. Enter the result, but not less than zero. Also, enter this amount on Form 1040, line 16b. If your Form 1099-R shows a larger amount, use the amount on this line instead of the amount from Form 1099-R 9. 10,800

10. Was your annuity starting date before 1987?

☐ **Yes.** STOP Leave line 10 blank.

☑ **No.** Add lines 6 and 8. This is the **amount you have recovered tax free** through 2007. You will need this number when you fill out this worksheet next year 10. 1,200

Table 1 for Line 3 Above

IF the age at annuity starting date (see page 27) 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 (see page 27) were . . .	**THEN enter on line 3 . . .**
110 or under	410
111–120	360
121–130	310
131–140	260
141 or older	210

Social Security Benefits Worksheet—Lines 20a and 20b

Keep for Your Records

Before you begin:

- √ Complete Form 1040, lines 21 and 23 through 32, if they apply to you.
- √ Figure any write-in adjustments to be entered on the dotted line next to line 36 (see the instructions for line 36 on page 31).
- √ If you are married filing separately and you lived apart from your spouse for all of 2007, enter "D" to the right of the word "benefits" on line 20a.
- √ Be sure you have read the **Exception** on page 24 to see if you can use this worksheet instead of a publication to find out if any of your benefits are taxable.

1.	Enter the total amount from **box 5** of **all** your **Forms SSA-1099** and **Forms RRB-1099.** Also, enter this amount on Form 1040, line 20a **1.** 9,500		
2.	Enter one-half of line 1	**2.**	4,750
3.	Enter the total of the amounts from Form 1040, lines 7, 8a, 9a, 10 through 14, 15b, 16b, 17 through 19, and 21	**3.**	36,300
4.	Enter the amount, if any, from Form 1040, line 8b	**4.**	0
5.	Add lines 2, 3, and 4	**5.**	41,050
6.	Enter the total of the amounts from Form 1040, lines 23 through 32, and any write-in adjustments you entered on the dotted line next to line 36	**6.**	0
7.	Is the amount on line 6 less than the amount on line 5? ☐ **No.** STOP None of your social security benefits are taxable. Enter -0- on Form 1040, line 20b. ☑ **Yes.** Subtract line 6 from line 5	**7.**	41,050
8.	If you are: • Married filing jointly, enter $32,000 • Single, head of household, qualifying widow(er), or married filing separately and you **lived apart** from your spouse for all of 2007, enter $25,000 • Married filing separately and you lived with your spouse at any time in 2007, skip lines 8 through 15; multiply line 7 by 85% (.85) and enter the result on line 16. Then go to line 17	**8.**	32,000
9.	Is the amount on line 8 less than the amount on line 7? ☐ **No.** STOP None of your social security benefits are taxable. Enter -0- on Form 1040, line 20b. If you are married filing separately and you **lived apart** from your spouse for all of 2007, be sure you entered "D" to the right of the word "benefits" on line 20a. ☑ **Yes.** Subtract line 8 from line 7	**9.**	9,050
10.	Enter: $12,000 if married filing jointly; $9,000 if single, head of household, qualifying widow(er), or married filing separately and you **lived apart** from your spouse for all of 2007	**10.**	12,000
11.	Subtract line 10 from line 9. If zero or less, enter -0-	**11.**	0
12.	Enter the **smaller** of line 9 or line 10	**12.**	9,050
13.	Enter one-half of line 12	**13.**	4,525
14.	Enter the **smaller** of line 2 or line 13	**14.**	4,525
15.	Multiply line 11 by 85% (.85). If line 11 is zero, enter -0-	**15.**	0
16.	Add lines 14 and 15	**16.**	4,525
17.	Multiply line 1 by 85% (.85)	**17.**	8,075
18.	**Taxable social security benefits.** Enter the **smaller** of line 16 or line 17. Also enter this amount on Form 1040, line 20b	**18.**	4,525

TIP *If any of your benefits are taxable for 2007* ***and*** *they include a lump-sum benefit payment that was for an earlier year, you may be able to reduce the taxable amount. See Pub. 915 for details.*

STUDENT NOTES

Sale of Stock and Other Investment Property

Lesson 12

Introduction and Objectives

This lesson discusses gains and losses on the sale (or redemption) of stock or other investment property, including how to figure the basis.

After completing this lesson you should be able to:

- Compute the adjusted basis of stock or other investment property.
- Determine if an asset's holding period is long-term or short-term.
- Calculate the taxable gain or deductible loss using Schedule D.
- Calculate the correct tax liability.

The forms mentioned in this lesson are used in the exercise at the end of the lesson. The exercise can be completed using tax preparation software.

Alert

This lesson contains advanced tax law. Your course facilitator will teach only the information required to assist taxpayers you will serve.

Intake and Interview Process

Use **Form 13614, Intake and Interview Sheet,** to engage the taxpayer in preparing an accurate return. Use the Intake and Interview Sheet as a starting point for a comprehensive interaction with the taxpayer, in combination with all the source documents provided by the taxpayer, to ensure quality and accuracy on each return.

Confirm each item on Form 13614 (or approved equivalent used at your site) to make sure you and the taxpayer have considered all the necessary information. Ensure that all questions and issues have been addressed. If items are incorrect or incomplete, revisit the issue and make corrections to the return, as needed.

Excerpt from Form 13614

Part IV. Income – **In 2007, did you (or your spouse) receive:**

- ☐ Yes ☐ No 1. Wages or Salary (include W-2s for all jobs worked during the year)
- ☐ Yes ☐ No 2. Disability income
- ☐ Yes ☐ No 3. Interest/Dividends from: checking or savings account, bonds, CDs, or brokerage account
- ☐ Yes ☐ No 4. State tax refund (may be taxable if you itemized last year)
- ☐ Yes ☐ No 5. Alimony income
- ☐ Yes ☐ No 6. Tip income
- ☐ Yes ☐ No 7. Pension and/or IRA distribution
- ☐ Yes ☐ No 8. Unemployment (1099-G)
- ☐ Yes ☐ No 9. Social Security or Railroad Retirement Benefits (1099-SSA or RRB)
- ☐ Yes ☐ No 10. Self Employment Income - business, farm, hobby **(1099-Misc or any earned income not reported on W-2)**
- ☐ Yes ☐ No 11. Other Income such as gambling winnings, awards, prizes and Jury Duty pay, etc.

Sale of stock and other investment property is covered in this lesson. To ensure accurate reporting of this type of income, ask the taxpayer if he or she sold any stock, securities, or other property. To determine the gain or loss on the sale of these types of assets, you will need to know the adjusted basis of the property sold. Confirm that all income received by the taxpayer has been discussed and shown on the return, if required. You will learn more about the sale of stock and other investment property including how to calculate the taxable gain or deductible loss later in this lesson.

Investment Property Definition

Investment property is property that produces investment income. Investment income includes interest, dividends, and capital gains derived from the sale of the property. Some examples of investment property are stocks, bonds, mutual funds, Treasury bills and notes, and land bought and sold as an investment. Property used in a trade or business is not investment property.

Example 1

Arthur owns shares in a mutual fund and some shares of corporate stock. He also holds several municipal bonds. All of these items are considered investment property.

A capital gain exists when a **capital asset** is sold for a profit. (Of course, money can be lost when a capital asset is sold, resulting in a **capital loss**.) Any asset held as an investment (stocks, bonds, mutual funds, for example) is a capital asset.

The resulting gain or loss is determined by deducting the **adjusted basis** of the asset from the **amount realized** from the sale. This lesson will provide guidance on how to assist the taxpayer in determining the adjusted basis of the investment property. It will also provide instruction on how to determine the amount realized from the sale. Then you will learn how to report the sale on the tax return.

General Information on the Basis of Investment Property

Gain or loss on the sale of investment property is usually determined by comparing the adjusted basis to the sales price. Thus, the **adjusted basis** is crucial in determining the correct gain or loss on the sale of investment property.

Unfortunately, many taxpayers have not maintained the records that are needed to determine the adjusted basis of their investment property. This lesson will provide you with basic information to help a taxpayer determine the adjusted basis of his or her investment property.

It may be necessary for the taxpayer to consult a broker or a financial advisor for additional assistance in determining the adjusted basis of the investment property. Keep in mind that if the taxpayer can't determine the basis, the IRS could deem the basis to be zero, thus resulting in a fully taxable sale.

General Rule

The **basis** of property is usually its cost. Some ways of determining the basis are old broker's statements and historical stock prices available on the Internet. The basis may also include amounts paid for commissions and fees to acquire and dispose of the property. The original basis of property is adjusted (increased or decreased) by certain events. This results in an **adjusted basis** for the property. For example, when a stock dividend or stock split is declared, the stockholder receives additional shares of stock. This changes the basis per share of the original shares.

Example 2

Betty paid $1,100 for 100 shares of ABC, Inc. stock. She received 10 additional shares of ABC's stock as a tax-free stock dividend. Her $1,100 basis must be spread over 110 shares (100 original shares plus the 10-share stock dividend). Her basis decreases from $11 to $10 per share.

Dividend Reinvestment

Another frequent adjustment to the basis of **stock** results from a **dividend reinvestment program** (sometimes referred to as a DRIP). This plan lets the taxpayer choose to use his or her dividends to buy more shares of stock in the corporation instead of receiving the dividends in cash. Since the dividends are included as income in the year they are earned, they increase the basis of the investment property.

Dividends (and capital gain distributions) from **mutual funds** are often reinvested unless the shareholder has specifically instructed the payor otherwise. Thus, it is very common to have shares bought with such distributions as part of the basis of a mutual fund account. Later in this lesson, you will learn how to calculate the basis of mutual fund shares.

Example 3

Charlie bought 100 shares of DEF stock for $1,000 on March 1, 2004 and chose to participate in the dividend reinvestment program. He handed you the following information that provided details of all his transactions. On November 3, 2007 he sold all of his DEF stock for $1,560. His adjusted basis was $1300 (the original $1,000 plus the $300 of reinvested dividends).

DEF STOCK

Date	Transaction	No of Shares	Total Shares	TOTAL
03/01/04	BOUGHT 100 @ $10/share	100	100	$1000
12/31/04	Reinvested Dividends $100	10	110	$1100
12/31/05	Reinvested Dividends $100	10	120	$1200
12/31/06	Reinvested Dividends $100	10	130	$1300
11/03/07	SOLD 130 @ $12/share			

Received as a Gift

To figure the basis of property received as a gift, taxpayers must know its adjusted basis to the donor just before it was given to the taxpayer. Taxpayers will also need to know the fair market value (FMV) at the time of the donation and the amount of any gift tax paid on the donation. Determination of the adjusted basis of property received by gift can be very complex. It is outside the scope of VITA/TCE. Advise the taxpayer to seek professional assistance.

Inherited Property

The basis of inherited property is generally the FMV of the property at the date of the decedent's death. However, this can vary if the personal representative of the estate elects to use an alternate valuation date. Alternate valuation issues can be complex and the taxpayer may need to seek professional assistance.

To determine the FMV of inherited stock, the taxpayer may need to go to the local library or do some research on the Internet. Generally, the taxpayer will take the average of the high and low prices on the date of death. Taxpayers **should not wait** until they sell the stock to try to determine the basis.

Example 4

Debbie inherited some stock from her grandmother. The FMV on the date of her grandmother's death was $62 per share. No alternate valuation date was elected. She inherited 100 shares, so her total basis in the stock is $6,200.

Bonds and Other Tax-Exempt Obligations

Many individual investors limit their bond holdings to tax-exempt bonds. They may purchase the bonds individually. Alternatively, they may invest in a mutual fund that holds tax-exempt bonds.

Any capital gain on these assets is taxable. The basis is usually the purchase price. The basis may need to be adjusted for original issue discount, if applicable. This adjustment can be complex. If such an adjustment is necessary, the taxpayer may be able to get the basis from his or her broker or financial advisor. If not available, he or she should seek professional assistance.

Also, if the taxpayer holds bonds that were bought at a premium or a market discount, he or she may need to seek professional assistance. The calculation of the amortization of the bond premium is outside the scope of the volunteer program.

Employee Stock Option Plans

Corporations may grant their employees the option to purchase stock in the corporation. Stock options may be given to employees. However, options may also be sold to employees. Basically, a stock option is an agreement under which the employee who holds the option has the right, but not the obligation, to purchase corporate shares at a fixed price on a fixed date or within a range of dates.

Determining the basis of stock that was acquired through stock options can be complex. If taxpayers need help with determining the basis of these types of shares, they will need to seek professional assistance.

Recordkeeping

The value of good recordkeeping is perhaps one of the most useful suggestions that you can pass on to the taxpayers who visit your site. Indeed, your job and their job will be much easier if good records have been maintained. Something as simple as a spiral notebook can be used to record dates and amounts of purchase, stock splits, reinvested dividends, etc. Retaining information related to spin-offs and splits will help determine the correct basis when the stock is sold. Sometimes, a trip to the local library or Internet research can be useful in trying to reconstruct the taxpayer's basis. He or she can look up the company in question and trace all of the capital changes over the years. Ultimately, it is the taxpayer's responsibility to determine the basis of the investment property.

Exercise 1

Zelda has 150 shares of ZYX stock that she purchased for $20 per share. The stock has never split and she has never reinvested her dividends. What is Zelda's basis in the ZYX stock? ____________

Exercise 2

Yosef bought $200 worth of WVU stock in 2005. He received $20 in dividends in 2005 and $40 of dividends in both 2006 and 2007. He reinvested his dividends. What is his adjusted basis in the WVU stock at the end of this year? __________________________

Exercise 3

Xavier inherited 400 shares of TSR stock from his grandmother. His grandmother purchased the stock ten years ago, for $2 per share. On the date of his grandmother's death, the stock traded for an average price of $10 per share. No alternate valuation method was elected. What is Xavier's basis in his stock? _______
____

What Is a Sale of Investment Property?

When investment property is sold or exchanged, a gain or loss is usually realized. This section explains certain transactions and events that are treated as sales of investment property. A sale is generally a transfer of property for money or for a mortgage, note, or other promise to pay. Even though some taxpayers may state that they "traded their stock in," the event was most likely a sale. See the following sections for more information.

Redemption of Stock or Bonds

Generally, redemption of stock or the calling of a bond for early redemption is treated as a sale and is subject to the capital gain or loss provisions (covered later in this lesson). If the redemption was considered a sale, the taxpayer should receive a Form 1099-B, *Proceeds From Broker and Barter Exchange Transactions,* or equivalent statement from the broker. The form will show the proceeds, or amount realized, from the sale. The IRS will also get a copy of Form 1099-B from the broker. See Exhibit 8 at the end of this lesson to view a blank copy of Form 1099-B.

Mutual Fund Shares

When a taxpayer sells or exchanges mutual fund shares, he or she will generally have a taxable gain or deductible loss. It is important to note that if a taxpayer exchanges one fund for another in the same fund family, this is still considered a sale. The taxpayer should receive a Form 1099-B, *Proceeds From Broker and Barter Exchange Transactions,* or equivalent statement from the broker. The form will show the proceeds, or the amount realized, from the sale. The IRS will also get a copy of Form 1099-B from the broker.

Example 5

Eldon owned 50 shares of GHI Discovery Fund. In July, Eldon told his broker to "move" his GHI Discovery Fund shares to GHI International Fund. The "move" is actually considered a sale for tax purposes. Eldon should receive a Form 1099-B (or equivalent) from his broker.

Exercise 4

Walter owned 100 shares of QPO Mutual Investors Fund. In January, he transferred his holdings to QPO Energy Fund. Is this considered a sale of investment property?

____

Worthless Securities

Stocks, stock rights, and bonds (other than those held for sale by a securities dealer) that become worthless during the tax year are treated as though they were sold on the last day of the tax year. Just because a company is in bankruptcy or its stock isn't trading, doesn't mean that it's worthless. Even if it is worth only a few pennies per share, it still has value. To qualify as worthless, there must be no reasonable hope investors will ever get anything for their holdings. It is best if this position can be supported by written information provided by the company or broker. Determining "worthlessness" can be very complex. Taxpayers with this issue may need to seek professional assistance.

Example 6

On August 23, 2007, Francine received a letter from JKL, a dot-com business. The letter stated that the company had finalized its bankruptcy proceedings and that investors would receive two cents per share in 2008. This would be the only payment that the investors would receive. Francine had invested $12,000 ($1 per share) in the company five years ago. Francine can't take a loss on her 2007 tax return because the stock still has some value. She may be able to take a loss in the year payment is received.

Other Sales and Trades

There are many other ways in which taxpayers trade or sell investment property. Those transactions are outside of the scope of the volunteer program. They include trading investment property for an annuity, constructive sales, and market–to–market transactions. If your taxpayer was involved with these types of transactions, he or she needs to seek professional assistance.

Example 7

Greg comes to your site for help with his tax return. He tells you that he has some losses from commodities trading. He says that he had Section 1256 contracts. You explain that his tax issue is outside the scope of the volunteer program and suggest that he seek professional assistance.

Identifying What Was Sold and Its Basis

When a taxpayer sells less than his or her entire investment, it is necessary to identify which shares were sold. This will affect how much of the basis is allocated to the sale.

Specific Identification

If the taxpayer can adequately identify the shares of stock sold during the tax year, the basis is the cost or other basis of those particular shares. If the taxpayer told the broker or other agent the particular stock to be sold and the taxpayer received a written confirmation of the sale, the stock is considered to have been specifically identified.

Example 8

Hilda comes to your site and tells you that she sold some of her MNO stock. She had bought stock in MNO as follows:

2000	100 shares for $1,000
2002	200 shares for $2,300
2004	150 shares for $1,100

Hilda told her broker to sell the shares she acquired in 2002. The broker did so and provided written confirmation of the sale. Hilda has a sale of 200 shares with a basis of $2,300.

Exercise 5

Victor comes to your site for help with his stock sale. He had purchased NML stock as follows:

2001	300 shares for $5,000
2003	100 shares for $7,500
2005	200 shares for $1,000

Victor told his broker that he wanted to sell the 100 shares he purchased in 2003. The broker sold the stock for $890 and sent the written confirmation along with the check. What is the basis of the 100 shares that were sold? ____________________________

Identification Not Possible

If the taxpayer buys and sells investment property at various times in varying quantities and he or she cannot adequately identify the shares that were sold, the securities acquired first are generally considered sold first. This is sometimes referred to as the **FIFO method** or **F**irst **I**n **F**irst **O**ut. (Except for certain mutual fund shares discussed later, the taxpayer cannot use the average price per share to figure the gain or loss on the sale of the shares.)

Example 9

Isabella bought 100 shares of stock of PQR Corporation in 1992 for $10 a share. In January 1993, Isabella bought another 200 shares for $11 a share. In December 1995, she bought 100 shares for $9 per share. This year, she sold 150 shares. She cannot identify the shares that she sold. She is considered to have sold the 100 shares that she purchased in 1992 and 50 of the shares that she purchased in 1993. Her total basis in the stock she sold is $1,550 (100 shares at $10 per share and 50 shares at $11 per share).

Exercise 6

Ursula sold some stock in 2007 and she doesn't know how to report it on her return. She has a Form 1099-B that shows she received $1,600 from the sale of KJI stock. She tells you that she sold 16 shares. She had bought 20 shares at $90 per share in 2000. She also bought 10 shares at $100 per share in 2004. She did not specifically identify which stock was to be sold. What is the basis of the stock she sold? ______________________________

Mutual Fund Sales

Mutual fund shares are generally acquired at various times, in various quantities, and at various prices. Therefore, figuring the basis of the shares sold can be more difficult. The taxpayer can choose either a **cost basis** or **average basis**. Once a sale is made using one method, the method **cannot** change for that particular fund.

To use the **cost basis** calculation, the taxpayer must use either the specific share identification method or the FIFO method to identify which shares were sold. These methods were discussed above.

Example 10

Jack sold 100 shares of STU International Fund. He did not specify which shares were to be sold. He had bought 150 shares at $10 per share in 2002. He bought additional shares each year through dividend reinvestment. He is not electing to use the average basis. His basis method is FIFO. The basis of the shares sold is $1,000 (100 shares at $10).

The taxpayer can use the **average basis** if he or she acquired the mutual fund shares at various times and prices. Once the average basis is elected, it must be used for all accounts in the same fund. The actual calculation of the average basis is beyond the scope of the volunteer program; **however,** many investment companies provide the average basis figures to the taxpayers. If the taxpayer has the information for the average basis, you can prepare the return.

Example 11

Kendra sold 130 shares of VWX High-Yield fund. She originally bought 120 shares of this fund in 1990. She has been letting her dividends reinvest over the years. She shows you the combined Form 1099-B from her broker, and you see the following information:

Date	Description	Price/share	Gross proceeds	Average basis	Gain/Loss
6-22-07	130 shares High-Yield	$40	$5,200	$4,900	$300

Since she has the information for the average basis, you can complete her return. The average basis for the stock she sold is $4,900. If she had not had this information and she still wanted to elect to use the average basis method, she would need to seek professional assistance.

Holding Period

If investment property is sold, you must determine the holding period for the property. The holding period determines whether any capital gain or loss is short-term or long-term.

In General

If investment property is held for more than one year, any capital gain or loss is considered long-term. Property held by the taxpayer one year or less has a short-term holding period. To determine how long the taxpayer held the property, begin counting on the day after the acquisition and end on the date the property was sold. The day that the property is sold is counted as part of the holding period.

For securities traded in an established securities market, the holding period begins the day after the trade date for the purchase of the securities and ends on the trade date they were sold. Do not confuse the trade date with the settlement date, which is the date by which the securities must be delivered and payment must be made.

Example 12

Nathan bought 400 shares of HIJ in 2007. His trade date for the purchase was 8-15 and his settlement date was 8-19. His holding period begins on 8-16, the day after the trade date for the shares.

Example 13

Luther sold stock at a gain on December 29, 2007. Under the rules of the stock exchange, the sale was closed by delivery of the stock three trading days after the sale (on January 4, 2008). The taxpayer received the payment on January 4. The gain is reported the on the 2007 tax return, even though the payment was received in 2008.

Inherited Property

If investment property is inherited, the capital gain or loss is treated as long-term. This is true regardless of how long the property is held.

Example 14

Michael inherited 200 shares of EFG stock from his grandfather's estate on August 23. He sold the shares on September 20 of the same year. His holding period is long-term even though he held the stock for less than a month.

Stock Dividends

The holding period for new stock received as a nontaxable stock dividend begins on the same day as the holding period of the original stock. This rule also applies to stock acquired in a "spinoff," which is a distribution of stock or securities in a controlled corporation.

Exercise 7

Tom bought 100 shares of HGF. His trade date for the purchase was May 2. His settlement date was May 5. What date does he use for the beginning of his holding period? ______________________

Exercise 8

Shameka inherited 50 shares of EDC stock from her grandmother in July. She sold the shares in September of the same year. Is her holding period short-term or long-term? ______________________

How To Determine Gain or Loss

We have discussed how to determine the adjusted basis of investment property. Remember, it is the taxpayer's responsibility to know the basis of the property that was sold. If a taxpayer cannot determine his or her adjusted basis in the investment property sold, the IRS can deem it to be zero. We have covered what types of transactions are considered sales and how to identify the property that was sold. We have also discussed how to determine if the holding period is long-term or short-term. It is now time to pull all of that information together and determine if the sale resulted in a gain or a loss.

In General

As we stated at the beginning of this lesson, the gain or loss on a sale of investment property is computed by comparing the amount realized to the adjusted basis of the property. If the amount realized from the sale is more than the adjusted basis of the property, then the difference is a gain. If the adjusted basis of the property is more than the amount realized, then the difference is a loss.

Example 15

Oscar had 100 shares of EFG stock with an adjusted basis of $400. He sold the stock for $500. Since the sales price (amount realized) is more than his adjusted basis, he has a gain (of $100) on the sale.

Example 16

Phyllis had 300 shares of HIJ Index Fund with an adjusted basis of $964. She sold her shares for $300. Since the sales price (amount realized) is less than her adjusted basis, she has a loss (of $664) on the sale.

If stock is bought and sold at the same price, the sale still needs to be reflected on the tax return. The IRS is notified of the sale amount but not the basis. The IRS will inquire about the basis eventually.

Commissions and Fees

Often, the taxpayer has to pay a commission or fee to acquire or sell investment property. These charges affect the taxpayer's basis in the property and thus become part of the calculation of the gain or loss. Amounts paid to acquire the property adjust (increase) the basis of the investment property.

Example 17

Quentin bought 100 shares of KLM stock for $200. He had to pay a $10 fee to acquire the stock. His adjusted basis in the stock is $210.

Amounts paid to sell the property may be considered an adjustment to the basis. Form 1099-B requires the issuer to indicate whether the amount reported on the form is gross proceeds or gross proceeds less commissions (net proceeds). If the gross amount has been reported on the form, then any commissions or fees paid on the sale are added to the basis of property. If net proceeds are reflected on the Form 1099-B, no basis adjustment is needed.

Example 18

Ruth sold her NOP stock for $2,300. Her Form 1099-B reports this as her gross proceeds. She did not have to pay a fee when she bought the stock for $2,000. She had to pay a $50 fee when she sold the stock. Her adjusted basis is $2,050 (the original $2,000 plus the $50 selling fee). Her gain on the sale is $250.

Wash Sales

A wash sale occurs when the taxpayer sells stock or securities and, within 30 days before or after the sale, buys substantially identical stock or securities. Taxpayers cannot deduct losses from wash sales; however, gains from wash sales are required to be reported. Wash sales are outside the scope of the volunteer program. Taxpayers with these types of transactions may need to seek professional assistance.

Exercise 9

Ruth owned 100 shares of BZZ stock with an adjusted basis of $500. She sold the stock for $700. She did not have any fees or other costs when she bought the stock nor when she sold it.

a. Does she have a gain or a loss? ______________

b. How much is her gain or loss? _______________

Exercise 10

Quavidas owned 100 shares of YXW stock with an adjusted basis of $780. She sold the stock for $600. There were no fees or other costs when the stock was purchased nor when it was sold.

a. Is there a gain or a loss on the sale? ______________

b. How much is the gain or loss? ___________________

Exercise 11

Penelope bought 200 shares of VUT stock for $600. She also paid a $50 fee to acquire the shares. She sold all of the shares for $900. She paid a 5% ($45) commission to sell the shares. Her Form 1099-B lists gross proceeds of $900.

a. What is the adjusted basis of her shares? ____________________

b. Does she have a gain or a loss? _____________________________

c. How much is the gain or loss? ______________________________

Reporting the Transaction on the Tax Return

This section discusses how to report capital gains and losses. Enter capital gains and losses on Schedule D (Form 1040), *Capital Gains and Losses,* in the proper section for holding periods, as described below. Include all capital gain and loss transactions even if the taxpayer did not receive a reporting document (Form 1099-B).

Information for Schedule D

Schedule D is divided into three sections. Use Part I to report short-term transactions. Use Part II to report long-term transactions. Use Part III to determine the net taxable gain or the net deductible loss.

Both Part I and Part II ask for detailed information about the transaction. Use the following table to determine where to find the information needed to complete these lines.

Schedule D columns on line 1 and line 8	Where to find the information:
(a) Description of property	Form 1099-B (or its equivalent) box 7
(b) Date acquired	Taxpayer's records
(c) Date sold	Form 1099-B (or its equivalent) box 1a
(d) Sales price	Form 1099-B (or its equivalent) box 2
(e) Cost or other basis	Taxpayer's records
(f) Gain or loss	Mathematical calculation

See Exhibit 8 included with the Comprehensive Exercise at the end of this lesson for a sample Form 1099-B.

Schedule D—Date Acquired column. Enter the date the asset was acquired in this column.

If the property was acquired by inheritance, enter "INHERITED" in this column.

If the property was acquired through several different purchases, write "VARIOUS" in this column. The short-term gain or (loss) and the long-term gain or (loss) on the sale must still be reported separately in Part I and Part II of Schedule D.

Schedule D—Date Sold column. Enter the date the asset was sold in this column.

If the property is determined to be worthless during the year, write "WORTHLESS" in this column.

For more information about how to report a transaction on the tax return, see the instructions for Schedule D.

Carryover Losses

Capital losses are used first to offset capital gains. If the taxpayer has capital losses that are more than his or her capital gains, a capital loss deduction can be claimed. The amount of loss that can be claimed in one year is limited to the lesser of:

1. $3,000 ($1,500 if married filing separately), or
2. The total net loss

If the total net losses exceed the yearly limit, the taxpayer may carry over the unused portion to the next year and treat it as if he or she had incurred it in that next year. If part of the loss is still unused, it can be carried over to later years until it is completely used up. When a loss is carried over, it remains long-term or short-term. Use the Capital Loss Carryover Worksheet (Exhibit 9) to figure the carryover amount to the next year. A short-term capital loss carryover is listed in Part I of Schedule D; a long-term capital loss carryover is listed in Part II of Schedule D.

If the carryover is not claimed in any year (e.g., income is below filing requirement), the unused portion is still decreased (considered to be used) by the applicable amount. If there are any capital gains or losses during the year, Schedule D and the Carryover Worksheet need to be completed (**even if not filed**) to calculate the carryover for the following year. It is recommended that a tax return be filed each year until the carryover is exhausted.

It is important to ask the taxpayer if he or she has a capital loss carryover from the previous year. Sometimes, the taxpayer will forget to tell you. If available, inspect a copy of the previous year's return for a possible carryover.

Example 19

In 2006, Ted had a $4,000 capital gain and a capital loss of $11,400. He used $4,000 of the capital loss to offset the capital gain. That left a net capital loss of $7,400. He claimed $3,000 of the loss in the 2006 return. The effect was to reduce his taxable income by $3,000. The remaining $4,400 of capital loss carries over to the 2007 return.

In 2007, he has a $500 capital gain and no capital losses except for the carryover. So he uses $500 of the $4,400 carryover to offset the gain, leaving a capital loss of $3,900. Once again, Ted deducts $3,000 of the loss—and carries over the remaining $900 to 2008.

Example 20

Last year Stan and Tina sold stock that resulted in a net long-term capital loss of $7,000. They took $3,000 of the loss on last year's return. The remaining $4,000 is listed on Schedule D, line 14, as a carryover and netted with the current year gains or losses.

When the capital loss carryover is figured, use the short-term capital losses first even if they were incurred after the long-term losses. If the limit on the capital loss deduction hasn't been reached after using the short-term capital losses, use the long-term capital losses until the maximum is reached.

Schedule D Not Always Required

If the taxpayer had only capital gain distributions (reported on Form 1099-DIV), then Schedule D is not required. The distributions can be reported directly on Form 1040A or Form 1040. If the taxpayer had other capital transactions (such as stock sales), the capital gain distributions are reported on Schedule D, line 13, and become part of the net capital gain or loss.

Capital Gains and Qualified Dividends Tax Rates

The tax rates that apply to a net long-term capital gain are generally lower than the tax rates that apply to other income. If the capital gain is short-term, it will be taxed as ordinary income. The lower rates are called the maximum capital gain rates. "Net capital gain" means the amount by which the net long-term capital gain for the year is more than the net short-term capital loss, if any.

If you are preparing a tax return manually, you will need to complete a worksheet to determine the correct amount of tax for the return. The worksheet, which is in the tax form (1040/1040A) instruction book, is used to calculate the correct tax on the net capital gain (and qualified dividends) and the correct tax for the remainder of the income. If you are using tax software to prepare the return, properly entering the income information should result in the correct tax computation.

DAY TRADING AND E-TRADING

The Internet has opened up the possibility of individual taxpayers initiating electronic stock purchases and sales. These transactions are treated the same as "traditional" transactions. Each sales transaction is listed separately on Schedule D. If the number of transactions exceeds the space on the Schedule D, use as many Schedule D-1 continuation sheets as needed.

A day trader is a taxpayer with trading activity that is substantial, frequent, regular, and continuous. This type of activity may be considered self-employment. Preparation of a day trader's return is outside the scope of the volunteer program.

SUMMARY EXAMPLE AND EXERCISE

Example 21

Thelma Emerson is single and, in addition to wages from her job, she has income from investments. Thelma has all of her investments in the same brokerage service. Her consolidated Form 1099 and her completed Schedule D are presented at the end of this example. Her broker kept track of the stock that she purchased.

Thelma sold stock in two different companies that she held for less than a year. In June, she sold 100 shares of Car Co. stock that she bought on February 23 of the same year. She had an adjusted basis of $650 for the stock and sold it for $900, for a gain of $250. On July 5, she sold 25 shares of Technology Co. that she bought on June 22 of the same year. 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.

Thelma had two other stock sales that she reports as long-term transactions on line 8 in Part II of Schedule D. On February 23, she sold 20 shares of Tractor Co. for $2,100. She had inherited the Tractor 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.

On June 22, she sold 500 shares of Couch Co. stock for $14,000. She bought 100 of those shares in 1993 for $1,000. She bought 100 more shares in 1995 for $2,200 and an additional 300 shares in 1998 for $1,500. Her total basis in the stock is $4,700. She has a $9,300 ($14,000 – $4,700) gain on the sale.

Thelma has a capital loss carryover to the current year of $800, of which $300 is short-term capital loss and $500 is long-term capital loss.

See the next two pages (Exhibits 1 and 2) for her consolidated Form 1099 and her completed Schedule D. This year, she has a net short-term loss of $550 and a net long-term gain of $10,101.

Thelma Emerson 123 Any Street Your City, State Zip Account Number: 1234-5678-9012 SSN: XXX-XX-XXXX	**ABC Investments** **456 Main Street** **Your City, State Zip** **Phone (XXX) XXX-XXXX** **FEIN: XX-XXXXXXX**	2007 12-31-07

Substitute 1099-B

Date of Sale Box 1a	Stocks, Bonds-Proceeds Box 2 (less commission)	Description Box 7	Federal Income Tax Withheld Box 4
2-23-07	$ 2,100.00	20 shares Tractor Company	$0.00
6-1-07	$ 900.00	100 shares Car Company	$0.00
6-22-07	$14,000.00	500 shares Couch Company	$0.00
7-5-07	$ 2,000.00	25 shares Technology Company	$0.00

Substitute 1099-DIV

Payer	Ord. Div. Box 1a	Qual. Div. Box 1b	Cap. Gain. Dist. Box 2a	FIT Withheld Box 4	Foreign Tax Box 6
Car Company	$ 45.00	$ 45.00	$ 0.00	$0.00	$ 0.00
Couch Company	$910.00	$910.00	$ 0.00	$0.00	$ 0.00
Technology Company	$ 26.00	$ 26.00	$ 0.00	$0.00	$ 0.00
BCD High Yield Fund	$ 53.00	$ 49.00	$714.00	$0.00	$39.00
BCD International Fund	$ 29.00	$ 29.00	$987.00	$0.00	$64.00

Additional Information
Sales/Trades

Description	Date Bought	Date Sold	Sales Price	Basis	Gain/(Loss)	ST/LT
20 sh Tractor Co.	undetermined	2-23-07	$ 2,100	undetermined	undetermined	undetermined
100 sh Car Co.	2-23-07	6-1-07	$ 900	$ 650	$ 250	ST
500 sh Couch Co	various	6-22-07	$14,000	$4,700	$9,300	LT
25 sh Tech. Co	6-22-07	7-5-07	$ 2,000	$2,500	($500)	ST

SCHEDULE D (Form 1040)
Department of the Treasury
Internal Revenue Service (99)

Capital Gains and Losses

▶ Attach to Form 1040 or Form 1040NR. ▶ See Instructions for Schedule D (Form 1040).
▶ Use Schedule D-1 to list additional transactions for lines 1 and 8.

OMB No. 1545-0074
2007
Attachment Sequence No. 12

Name(s) shown on return: **Thelma Emerson**
Your social security number: **XXX XX XXXX**

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-6 of the instructions)	(e) Cost or other basis (see page D-7 of the instructions)	(f) Gain or (loss) Subtract (e) from (d)
1						
	100 shares Car Co.	02/23/2007	06/01/2007	900	650	250
	25 shares Technology Co.	05/22/2006	07/05/2007	2,000	2,500	(500)

2	Enter your short-term totals, if any, from Schedule D-1, line 2	2	
3	**Total short-term sales price amounts.** Add lines 1 and 2 in column (d)	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 10 of your **Capital Loss Carryover Worksheet** on page D-7 of the instructions	6	(300)
7	**Net short-term capital gain or (loss).** 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-6 of the instructions)	(e) Cost or other basis (see page D-7 of the instructions)	(f) Gain or (loss) Subtract (e) from (d)
8						
	20 shares Tractor Co.	Inherited	02/23/2007	2,100	2,500	(400)
	500 shares Couch Co.	Various	06/22/2007	14,000	4,700	9,300

9	Enter your long-term totals, if any, from Schedule D-1, line 9	9	
10	**Total long-term sales price amounts.** Add lines 8 and 9 in column (d)	10	16,100
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-2 of the instructions	13	1,701
14	Long-term capital loss carryover. Enter the amount, if any, from line 15 of your **Capital Loss Carryover Worksheet** on page D-7 of the instructions	14	(500)
15	**Net long-term capital gain or (loss).** Combine lines 8 through 14 in column (f). Then go to Part III on the back	15	10,101

For Paperwork Reduction Act Notice, see Form 1040 or Form 1040NR instructions. Cat. No. 11338H **Schedule D (Form 1040) 2007**

Exercise 12

Donald Judson needs your help with his tax return. Use the following information to complete his federal income tax return. You may complete the return on the forms provided or by using tax software.

- Donald is single and he does not want to contribute to the presidential election campaign. He has no dependents.
- Donald's address is 123 Any Street, Your City, State, Zip.
- His birthday is 3-16-1942.
- Donald had wages from his job as a machinist. His Form W-2 is displayed below.
- His only other income is from dividends and the sale of stock. See the Triple A Investments combined Form 1099 on the next page for more information.
- Donald inherited the Kitchen Co. shares from his father. The fair market value on the date of death was $1,700. (No alternate valuation date was elected.)
- Donald did not make any contributions to a retirement plan and he did not make any estimated payments.

Exhibit 3 **Donald's Form W-2**

a Employee's social security number XXX-XX-XXXX	OMB No. 1545-0008	Safe, accurate, FAST! Use IRS e-file. Visit the IRS website at *www.irs.gov/efile*.
b Employer identification number (EIN) XX-XXXXXXX	**1** Wages, tips, other compensation $50,000	**2** Federal income tax withheld $7,836
c Employer's name, address, and ZIP code Remco Industries 100 Main Street Your City, State, Zip	**3** Social security wages $50,000	**4** Social security tax withheld $3,100
	5 Medicare wages and tips $50,000	**6** Medicare tax withheld $725.00
	7 Social security tips	**8** Allocated tips
d Control number	**9** Advance EIC payment	**10** Dependent care benefits
e Employee's first name and initial / Last name / Suff. Donald Judson 123 Any Street Your City, State Zip	**11** Nonqualified plans	**12a** See instructions for box 12 Code
	13 Statutory employee / Retirement plan / Third-party sick pay	**12b** Code
	14 Other	**12c** Code
f Employee's address and ZIP code		**12d** Code

15 State	Employer's state ID number	**16** State wages, tips, etc.	**17** State income tax	**18** Local wages, tips, etc.	**19** Local income tax	**20** Locality name
XX	XX-XXXXXXX	$50,000				

Form **W-2** **Wage and Tax Statement** 2007

Department of the Treasury—Internal Revenue Service

Copy B—To Be Filed With Employee's FEDERAL Tax Return.
This information is being furnished to the Internal Revenue Service.

Donald Judson	Triple A Investments	2007
123 Any Street	456 Main Street	12-31-07
Your City, State Zip	Your City, State Zip	
Account Number: 1234-5678-9012	Phone (XXX) XXX-XXXX	
SSN: XXX-XX-XXXX	FEIN: XX-XXXXXXX	

Substitute 1099-B

Date of Sale Box 1a	Stocks, Bonds-Proceeds Box 2 (less commission)	Description Box 7	Federal Income Tax Withheld Box 4
3-17-07	$1,900	20 shares Kitchen Co.	$0.00
6-20-07	$2,700	50 shares Den Co.	$0.00
7-28-07	$4,300	100 shares ABC High Yield Fund	$0.00
9-14-07	$1,200	10 shares XYZ International Fund	$0.00

Substitute 1099-DIV

Payor	Ord. Div. Box 1a	Qual. Div. Box 1b	Cap. Gain Dist. Box 2a	FIT Withheld Box 4	Foreign Tax Paid Box 6
Den Co.	$ 9.00	$ 9.00	$0.00	$0.00	$0.00
ABC High Yield	$26.00	$26.00	$0.00	$0.00	$0.00
XYZ International Fund	$31.00	$31.00	$7.00	$0.00	$3.00
JKL Energy Fund	$79.00	$79.00	$283.00	$0.00	$9.00

Additional Information
Sales/Trades

Description	Date Bought	Date Sold	Sales Price	Basis	Gain/(Loss)	ST/LT
20 sh Kitchen Co.	undetermined	3-17-07	1900.00	undetermined	undetermined	undetermined
50 sh Den Co.	3-17-07	6-20-07	2700.00	2800.00	(100.00)	ST
100 sh ABC HYF	various	7-28-07	4300.00	3900.00 (average)	400.00	LT
10 sh XYZ IF	various	9-14-07	1200.00	500.00	700.00	LT

Form **1040** Department of the Treasury—Internal Revenue Service
U.S. Individual Income Tax Return 2007 (99) IRS Use Only—Do not write or staple in this space.

For the year Jan. 1–Dec. 31, 2007, or other tax year beginning , 2007, ending , 20 OMB No. 1545-0074

Label (See instructions on page 16.) **Use the IRS label.** Otherwise, please print or type.

LABEL HERE

Your first name and initial	Last name	**Your social security number**
If a joint return, spouse's first name and initial	Last name	**Spouse's social security number**
Home address (number and street). If you have a P.O. box, see page 16.	Apt. no.	▲ You **must** enter your SSN(s) above. ▲
City, town or post office, state, and ZIP code. If you have a foreign address, see page 16.		Checking a box below will not change your tax or refund.

Presidential Election Campaign ▶ Check here if you, or your spouse if filing jointly, want $3 to go to this fund (see page 16) ▶ ☐ **You** ☐ **Spouse**

Filing Status

Check only one box.

1 ☐ Single
2 ☐ Married filing jointly (even if only one had income)
3 ☐ Married filing separately. Enter spouse's SSN above and full name here. ▶
4 ☐ Head of household (with qualifying person). (See page 17.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶
5 ☐ Qualifying widow(er) with dependent child (see page 17)

Exemptions

6a ☐ **Yourself.** If someone can claim you as a dependent, **do not** check box 6a
b ☐ **Spouse**

Boxes checked on 6a and 6b ____
No. of children on 6c who:
• **lived with you** ____
• **did not live with you due to divorce or separation (see page 20)** ____
Dependents on 6c not entered above ____
Add numbers on lines above ▶ ☐

c **Dependents:**

(1) First name	Last name	(2) Dependent's social security number	(3) Dependent's relationship to you	(4) ✓ if qualifying child for child tax credit (see page 19)
				☐
				☐
				☐
				☐

If more than four dependents, see page 19.

d Total number of exemptions claimed

Income

Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld.

If you did not get a W-2, see page 23.

Enclose, but do not attach, any payment. Also, please use **Form 1040-V.**

7	Wages, salaries, tips, etc. Attach Form(s) W-2		7	
8a	**Taxable** interest. Attach Schedule B if required		8a	
b	**Tax-exempt** interest. **Do not** include on line 8a	8b		
9a	Ordinary dividends. Attach Schedule B if required		9a	
b	Qualified dividends (see page 23)	9b		
10	Taxable refunds, credits, or offsets of state and local income taxes (see page 24)		10	
11	Alimony received		11	
12	Business income or (loss). Attach Schedule C or C-EZ		12	
13	Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐		13	
14	Other gains or (losses). Attach Form 4797		14	
15a	IRA distributions 15a	b Taxable amount (see page 25)	15b	
16a	Pensions and annuities 16a	b Taxable amount (see page 26)	16b	
17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E		17	
18	Farm income or (loss). Attach Schedule F		18	
19	Unemployment compensation		19	
20a	Social security benefits 20a	b Taxable amount (see page 27)	20b	
21	Other income. List type and amount (see page 29)		21	
22	Add the amounts in the far right column for lines 7 through 21. This is your **total income** ▶		22	

Adjusted Gross Income

23	Educator expenses (see page XX)	23			
24	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ	24			
25	Health savings account deduction. Attach Form 8889	25			
26	Moving expenses. Attach Form 3903	26			
27	One-half of self-employment tax. Attach Schedule SE	27			
28	Self-employed SEP, SIMPLE, and qualified plans	28			
29	Self-employed health insurance deduction (see page 29)	29			
30	Penalty on early withdrawal of savings	30			
31a	Alimony paid b Recipient's SSN ▶	31a			
32	IRA deduction (see page 31)	32			
33	Student loan interest deduction (see page 33)	33			
34	Tuition and fees deduction. Attach Form 8917	34			
35	Domestic production activities deduction. Attach Form 8903	35			
36	Add lines 23 through 31a and 32 through 35			36	
37	Subtract line 36 from line 22. This is your **adjusted gross income** ▶			37	

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see page 80. Cat. No. 11320B Form **1040** (2007)

Form 1040 (2007) Page **2**

Tax and Credits

38	Amount from line 37 (adjusted gross income)			38	
39a	Check if: ☐ **You** were born before January 2, 1943, ☐ Blind. ☐ **Spouse** was born before January 2, 1943, ☐ Blind. } **Total boxes checked ▶ 39a**				
b	If your spouse itemizes on a separate return or you were a dual-status alien, see page 34 and check here ▶39b ☐				
40	**Itemized deductions** (from Schedule A) **or** your **standard deduction** (see left margin)			40	
41	Subtract line 40 from line 38			41	
42	If line 38 is $117,300 or less, multiply $3,400 by the total number of exemptions claimed on line 6d. If line 38 is over $117,300, see the worksheet on page XX			42	
43	**Taxable income.** Subtract line 42 from line 41. If line 42 is more than line 41, enter -0-			43	
44	**Tax** (see page 36). Check if any tax is from: **a** ☐ Form(s) 8814 **b** ☐ Form 4972 **c** ☐ Form(s) 8889			44	
45	**Alternative minimum tax** (see page 39). Attach Form 6251			45	
46	Add lines 44 and 45 ▶			46	
47	Credit for child and dependent care expenses. Attach Form 2441	47			
48	Credit for the elderly or the disabled. Attach Schedule R	48			
49	Education credits. Attach Form 8863	49			
50	Residential energy credits. Attach Form 5695	50			
51	Foreign tax credit. Attach Form 1116 if required	51			
52	Child tax credit (see page XX). Attach Form 8901 if required	52			
53	Retirement savings contributions credit. Attach Form 8880	53			
54	Credits from: **a** ☐ Form 8396 **b** ☐ Form 8859 **c** ☐ Form 8839	54			
55	Other credits: **a** ☐ Form 3800 **b** ☐ Form 8801 **c** ☐ Form ____	55			
56	Add lines 47 through 55. These are your **total credits**			56	
57	Subtract line 56 from line 46. If line 56 is more than line 46, enter -0- ▶			57	

Standard Deduction for—

- People who checked any box on line 39a or 39b **or** who can be claimed as a dependent, see page 34.
- All others:

Single or Married filing separately, $5,350

Married filing jointly or Qualifying widow(er), $10,700

Head of household, $7,850

Other Taxes

58	Self-employment tax. Attach Schedule SE	58	
59	Unreported social security and Medicare tax from: **a** ☐ Form 4137 **b** ☐ Form 8919	59	
60	Additional tax on IRAs, other qualified retirement plans, etc. Attach Form 5329 if required	60	
61	Advance earned income credit payments from Form(s) W-2, box 9	61	
62	Household employment taxes. Attach Schedule H	62	
63	Add lines 57 through 62. This is your **total tax** ▶	63	

Payments

64	Federal income tax withheld from Forms W-2 and 1099	64			
65	2007 estimated tax payments and amount applied from 2006 return	65			
66a	**Earned income credit (EIC)**	66a			
b	Nontaxable combat pay election ▶ 66b				
67	Excess social security and tier 1 RRTA tax withheld (see page 60)	67			
68	Additional child tax credit. Attach Form 8812	68			
69	Amount paid with request for extension to file (see page 60)	69			
70	Payments from: **a** ☐ Form 2439 **b** ☐ Form 4136 **c** ☐ Form 8885	70			
71	Refundable credit for prior year minimum tax from Form 8801, line 27	71			
72	Add lines 64, 65, 66a, and 67 through 71. These are your **total payments** ▶			72	

If you have a qualifying child, attach Schedule EIC.

Refund

Direct deposit? See page 61 and fill in 74b, 74c, and 74d, or Form 8888.

73	If line 72 is more than line 63, subtract line 63 from line 72. This is the amount you **overpaid**	73	
74a	Amount of line 73 you want **refunded to you.** If Form 8888 is attached, check here ▶ ☐	74a	
▶ b	Routing number ▶ **c** Type: ☐ Checking ☐ Savings		
▶ d	Account number		
75	Amount of line 73 you want **applied to your 2008 estimated tax** ▶ 75		

Amount You Owe

76	**Amount you owe.** Subtract line 72 from line 63. For details on how to pay, see page 62 ▶	76	
77	Estimated tax penalty (see page 62) 77		

Third Party Designee

Do you want to allow another person to discuss this return with the IRS (see page 63)? ☐ **Yes.** Complete the following. ☐ **No**

Designee's name ▶ Phone no. ▶ ( ) Personal identification number (PIN) ▶

Sign Here

Joint return? See page 17.

Keep a copy for your records.

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.

Your signature	Date	Your occupation	Daytime phone number ( )
Spouse's signature. If a joint return, **both** must sign.	Date	Spouse's occupation	

Paid Preparer's Use Only

Preparer's signature	Date	Check if self-employed ☐	Preparer's SSN or PTIN
Firm's name (or yours if self-employed), address, and ZIP code		EIN	
		Phone no.	( )

Form **1040** (2007)

SCHEDULE D (Form 1040)

Department of the Treasury
Internal Revenue Service (99)

Capital Gains and Losses

▶ Attach to Form 1040 or Form 1040NR. ▶ See Instructions for Schedule D (Form 1040).
▶ Use Schedule D-1 to list additional transactions for lines 1 and 8.

OMB No. 1545-0074
2007
Attachment Sequence No. 12

Name(s) shown on return

Your social security number

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-6 of the instructions)	(e) Cost or other basis (see page D-7 of the instructions)	(f) Gain or (loss) Subtract (e) from (d)
1						

2	Enter your short-term totals, if any, from Schedule D-1, line 2	2		
3	**Total short-term sales price amounts.** Add lines 1 and 2 in column (d)	3		
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 10 of your **Capital Loss Carryover Worksheet** on page D-7 of the instructions		6	( )
7	**Net short-term capital gain or (loss).** Combine lines 1 through 6 in column (f)		7	

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-6 of the instructions)	(e) Cost or other basis (see page D-7 of the instructions)	(f) Gain or (loss) Subtract (e) from (d)
8						

9	Enter your long-term totals, if any, from Schedule D-1, line 9	9		
10	**Total long-term sales price amounts.** Add lines 8 and 9 in column (d)	10		
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-2 of the instructions		13	
14	Long-term capital loss carryover. Enter the amount, if any, from line 15 of your **Capital Loss Carryover Worksheet** on page D-7 of the instructions		14	( )
15	**Net long-term capital gain or (loss).** Combine lines 8 through 14 in column (f). Then go to Part III on the back		15	

For Paperwork Reduction Act Notice, see Form 1040 or Form 1040NR instructions. Cat. No. 11338H **Schedule D (Form 1040) 2007**

Schedule D (Form 1040) 2007 Page **2**

Part III **Summary**

16 Combine lines 7 and 15 and enter the result **16**

If line 16 is:

- A **gain**, enter the amount from line 16 on Form 1040, line 13, or Form 1040NR, line 14. Then go to line 17 below.
- A **loss**, skip lines 17 through 20 below. Then go to line 21. Also be sure to complete line 22.
- **Zero**, skip lines 17 through 21 below and enter -0- on Form 1040, line 13, or Form 1040NR, line 14. Then go to line 22.

17 Are lines 15 and 16 **both** gains?

☐ **Yes.** Go to line 18.

☐ **No.** Skip lines 18 through 21, and go to line 22.

18 Enter the amount, if any, from line 7 of the **28% Rate Gain Worksheet** on page D-8 of the instructions . . . . ▶ **18**

19 Enter the amount, if any, from line 18 of the **Unrecaptured Section 1250 Gain Worksheet** on page D-9 of the instructions . . . . ▶ **19**

20 Are lines 18 and 19 **both** zero or blank?

☐ **Yes.** Complete Form 1040 through line 43, or Form 1040NR through line 40. Then complete the **Qualified Dividends and Capital Gain Tax Worksheet** on page 38 of the Instructions for Form 1040 (or in the Instructions for Form 1040NR). **Do not** complete lines 21 and 22 below.

☐ **No.** Complete Form 1040 through line 43, or Form 1040NR through line 40. Then complete the **Schedule D Tax Worksheet** on page D-10 of the instructions. **Do not** complete lines 21 and 22 below.

21 If line 16 is a loss, enter here and on Form 1040, line 13, or Form 1040NR, line 14, the **smaller** of:

- The loss on line 16 or
- ($3,000), or if married filing separately, ($1,500)

} . . . . **21** ( )

Note. When figuring which amount is smaller, treat both amounts as positive numbers.

22 Do you have qualified dividends on Form 1040, line 9b, or Form 1040NR, line 10b?

☐ **Yes.** Complete Form 1040 through line 43, or Form 1040NR through line 40. Then complete the **Qualified Dividends and Capital Gain Tax Worksheet** on page 38 of the Instructions for Form 1040 (or in the Instructions for Form 1040NR).

☐ **No.** Complete the rest of Form 1040 or Form 1040NR.

Schedule D (Form 1040) 2007

Qualified Dividends and Capital Gain Tax Worksheet—Line 44

Keep for Your Records

Before you begin:
- √ See the instructions for line 44 that begin on page 33 to see if you can use this worksheet to figure your tax.
- √ If you do not have to file Schedule D and you received capital gain distributions, be sure you checked the box on line 13 of Form 1040.

1. Enter the amount from Form 1040, line 43 . . . . **1.** ______

2. Enter the amount from Form 1040, line 9b . . . . **2.** ______

3. Are you filing Schedule D?
☐ **Yes.** Enter the **smaller** of line 15 or 16 of Schedule D. If either line 15 or line 16 is a loss, enter -0-
☐ **No.** Enter the amount from Form 1040, line 13 } **3.** ______

4. Add lines 2 and 3 . . . . **4.** ______

5. If you are claiming investment interest expense on Form 4952, enter the amount from line 4g of that form. Otherwise, enter -0- . . . . **5.** ______

6. Subtract line 5 from line 4. If zero or less, enter -0- . . . . **6.** ______

7. Subtract line 6 from line 1. If zero or less, enter -0- . . . . **7.** ______

8. Enter the **smaller** of:
- The amount on line 1, or
- $31,850 if single or married filing separately, $63,700 if married filing jointly or qualifying widow(er), $42,650 if head of household.

} . . . . **8.** ______

9. Is the amount on line 7 equal to or more than the amount on line 8?
☐ **Yes.** Skip lines 9 through 11; go to line 12 and check the ''No'' box.
☐ **No.** Enter the amount from line 7 . . . . **9.** ______

10. Subtract line 9 from line 8 . . . . **10.** ______

11. Multiply line 10 by 5% (.05) . . . . **11.** ______

12. Are the amounts on lines 6 and 10 the same?
☐ **Yes.** Skip lines 12 through 15; go to line 16.
☐ **No.** Enter the **smaller** of line 1 or line 6 . . . . **12.** ______

13. Enter the amount from line 10 (if line 10 is blank, enter -0-) . . . . **13.** ______

14. Subtract line 13 from line 12 . . . . **14.** ______

15. Multiply line 14 by 15% (.15) . . . . **15.** ______

16. Figure the tax on the amount on line 7. Use the Tax Table or Tax Computation Worksheet, whichever applies . . . . **16.** ______

17. Add lines 11, 15, and 16 . . . . **17.** ______

18. Figure the tax on the amount on line 1. Use the Tax Table or Tax Computation Worksheet, whichever applies . . . . **18.** ______

19. **Tax on all taxable income.** Enter the **smaller** of line 17 or line 18. Also include this amount on Form 1040, line 44 . . . . **19.** ______

☐ VOID ☐ CORRECTED

PAYER'S name, street address, city, state, ZIP code, and telephone no.	**1a** Date of sale or exchange **1b** CUSIP no.	OMB No. 1545-0715 **2007** Form **1099-B**	**Proceeds From Broker and Barter Exchange Transactions**
	2 Stocks, bonds, etc. $	Reported to IRS ☐ Gross proceeds ☐ Gross proceeds less commissions and option premiums	
PAYER'S federal identification number / RECIPIENT'S identification number	**3** Bartering $	**4** Federal income tax withheld $	
RECIPIENT'S name	**5** No. of shares exchanged	**6** Classes of stock exchanged	**Copy C** **For Payer** For Privacy Act and Paperwork Reduction Act Notice, see the **2007 General Instructions for Forms 1099, 1098, 5498, and W-2G.**
Street address (including apt. no.)	**7** Description		
City, state, and ZIP code	**8** Profit or (loss) realized in 2007 $	**9** Unrealized profit or (loss) on open contracts—12/31/2006 $	
CORPORATION'S name	**10** Unrealized profit or (loss) on open contracts–12/31/2007 $	**11** Aggregate profit or (loss) $	
Account number (see instructions) / 2nd TIN not. ☐	**12** Check the box if recipient cannot take a loss on their tax return based on the amount in box 2 . . . . . ☐		

Form **1099-B** Department of the Treasury - Internal Revenue Service

Capital Loss Carryover Worksheet—Lines 6 and 14

Keep for Your Records

Exhibit 9 Capital Loss Carryover Worksheet

Use this worksheet to figure your capital loss carryovers from 2006 to 2007 if your 2006 Schedule D, line 21, is a loss and **(a)** that loss is a smaller loss than the loss on your 2006 Schedule D, line 16, **or (b)** the amount on your 2006 Form 1040, line 41 (or your 2006 Form 1040NR, line 38, if applicable), reduced by any amount on your 2006 Form 8914, line 6, is less than zero. Otherwise, you do not have any carryovers.

1. Enter the amount from your 2006 Form 1040, line 41, or Form 1040NR, line 38. If a loss, enclose the amount in parentheses . . . . . **1.** ______

2. Did you file Form 8914 (to claim an exemption amount for housing someone displaced by Hurricane Katrina) for 2006?
☐ **No.** Enter -0-.
☐ **Yes.** Enter the amount from your 2006 Form 8914, line 6 . . . . . **2.** ______

3. Subtract line 2 from line 1. If the result is less than zero, enclose it in parentheses . . . . . **3.** ______

4. Enter the loss from your 2006 Schedule D, line 21, as a positive amount . . . . . **4.** ______

5. Combine lines 3 and 4. If zero or less, enter -0- . . . . . **5.** ______

6. Enter the **smaller** of line 4 or line 5 . . . . . **6.** ______

If line 7 of your 2006 Schedule D is a loss, go to line 7; otherwise, enter -0- on line 7 and go to line 11.

7. Enter the loss from your 2006 Schedule D, line 7, as a positive amount . . . . . **7.** ______

8. Enter any gain from your 2006 Schedule D, line 15. If a loss, enter -0- . . . . . **8.** ______

9. Add lines 6 and 8 . . . . . **9.** ______

10. Short-term capital loss carryover for 2007. Subtract line 9 from line 7. If zero or less, enter -0-. If more than zero, also enter this amount on Schedule D, line 6 . . . . . **10.** ______

If line 15 of your 2006 Schedule D is a loss, go to line 11; otherwise, skip lines 11 through 15.

11. Enter the loss from your 2006 Schedule D, line 15, as a positive amount . . . . . **11.** ______

12. Enter any gain from your 2006 Schedule D, line 7. If a loss, enter -0- . . . . . **12.** ______

13. Subtract line 7 from line 6. If zero or less, enter -0- . . . . . **13.** ______

14. Add lines 12 and 13 . . . . . **14.** ______

15. Long-term capital loss carryover for 2007. Subtract line 14 from line 11. If zero or less, enter -0-. If more than zero, also enter this amount on Schedule D, line 14 . . . . . **15.** ______

QUALITY REVIEW (QR)

Use **Form 8158, Quality Review Sheet** or your site's apprpved alternative form to review all returns prepared. Apply the quality review tools in combination with the Intake and Interview Sheet and all the source documents to the returns you prepare to ensure quality and accuracy for every taxpayer.

Consider each item on the Quality Review Sheet which applies to your taxpayer's situation to confirm that all the necessary questions and issues have been addressed. If items are incorrect or incomplete, revisit the issue and make corrections to the return, as needed.

Excerpt from Form 8158

Yes	No	
☐	☐	All **income** indicated on the intake/interview sheet, taxpayer's interview and/or supporting documents are included on the return.

To ensure accurate reporting of income, verify that the taxpayer's wages are accurate and that all income from Form(s) W-2 and other income documents, such as Form(s) 1099, have been included. Confirm that all income received by the taxpayer has been discussed and shown on the return, if required.

▶▶ SUMMING UP THIS LESSON ◀◀

- ▶ The gain or loss on the sale of investment property is calculated by comparing the adjusted basis to the amount realized.
- ▶ The basis of investment property is generally its cost.
- ▶ The adjusted basis of investment property reflects the original cost plus or minus any required adjustments (such as commissions).
- ▶ Schedule D is used to report capital gains and losses.

I have investment property. What does the term "basis" mean? Basis is your investment in property for tax purposes. Before you can figure any gain or loss on a sale, exchange, or other disposition of property, you must determine the basis. Your original basis is usually your cost to acquire the asset. Adjusted basis is the result of increasing or decreasing your original basis according to certain events.

How do I figure the cost basis of stock that has split, giving me more of the same stock, so I can figure my capital gain (or loss) of the sale of the stock? When the old stock and the new stock are identical, the basis of the old shares must be allocated to the old and the new shares. Thus, you generally divide the adjusted basis of the old stock by the number of shares of stock held after the split. The result is your new basis per share of stock.

How do I figure the cost basis when the stocks I'm selling were purchased at various times and at different prices? If you can identify which shares of stock you sold, your basis is what you paid for the shares sold (plus sales commissions). If you sell a block of the same kind of stock, you can report all the shares sold at the same time as one sale, writing VARIOUS in the "date acquired" column of Schedule D. What you enter in the "cost or other basis" column is the total of all the acquisition costs of the shares sold. If you cannot adequately identify the shares you sold, and you bought the shares at various times for different prices, the basis of the stock sold is the basis of the shares you acquired first (first-in first-out). Except for mutual fund shares, you cannot use the average price per share to figure gain or loss.

How do we show on our tax form that dividends are reinvested? Some corporations and most mutual funds allow investors to choose to use their dividends to buy more shares instead of receiving the dividend in cash. If you are a member of this type of plan, you must still report the dividend payment as income on your return. You do not actually show that the dividends were reinvested on your return. Keep good records of the dollar amount of the reinvested dividends, the number of additional shares purchased, and the purchase date. You will need this information when you sell the shares.

How do I compute the basis for stock I sold, when I received the stock over several years through a dividend reinvestment plan? The basis of the stock you sold is the cost of the shares plus any adjustments, such as sales commissions. If you have not kept detailed records of your dividend reinvestments, you may be able to reconstruct those records with the help of public records from sources such as the media, your broker, or the company that issued the dividends. If you cannot specifically identify which shares were sold, you must use the first-in first-out rule. This means that you deem that you sold the oldest shares first, then the next oldest, then the next-to-the-next oldest, until you have accounted for the number of shares in the sale. To establish the basis of these shares, you need to have kept adequate documentation of all your purchases, including those that were through the dividend reinvestment plan. You may not use an average cost basis. Only mutual fund shares may have an average cost basis.

How do I report an employee stock purchase plan on my tax return? If your stock option is granted under an employee stock purchase plan, you do not include any amount in your gross income as a result of the grant or exercise of your option. When you sell the stock that you purchased by exercising the option, you should report compensation and capital gain or capital loss.

Do I need to pay taxes on stock I gained as a result of a split? No, you generally do not need to pay tax on the additional shares of stock you received due to the stock split. You will need to adjust your per-share cost of the stock. Your overall cost basis has not changed, but your per-share cost has changed. You will have to pay taxes if you have gain when you sell the stock. Gain is the amount of the proceeds from the sale, minus sales commissions, that exceeds the adjusted basis of the stock sold.

I bought stock for $1,000 and sold it for $1,200. My gain was only $200, but my broker reported $1,200 on my Form 1099-B. What should I do? Brokers generally do not report the amount of the gain. They report the amount you received on the sale. By reporting the sale on Schedule D (Form 1040), you will end up including only the $200 in your income.

Sale of Stock and Other Investment Property

How do return-of-principal payments affect my cost basis when I sell mutual funds? A return of principal (or return of capital) reduces your basis in your mutual fund shares. This is also sometimes referred to as a nontaxable distribution. Unlike a dividend or a capital gain distribution, a return of capital is a return of part of your investment (cost). However, basis cannot be reduced below zero. Once your basis reaches zero, any return of principal is capital gain and must be reported on Form 1040, Schedule D, Capital Gains and Losses.

If I used an average basis method for shares of one mutual fund I sold, do I have to use it for all mutual funds I sell? No, you may use a different method, as long as you have not used an average basis method for that fund previously. Once you have elected to use an average basis method to compute the gain or loss on shares in a mutual fund, you must use that same method for the sale of shares from any account in that same fund.

Is a capital gain on the sale of my tax-exempt bond fund taxable? While dividend income from tax-exempt funds is exempt from federal income tax, capital gains are subject to taxation.

I received a Form 1099-DIV showing a capital gain. Why do I have to report capital gains from my mutual funds if I never sold any shares? A mutual fund is a regulated investment company that pools funds of investors, allowing them to take advantage of a diversity of investments and professional asset management. You own shares in the fund, but the fund owns assets such as shares of stock, corporate bonds, government obligations, etc. One of the ways the fund makes money for its investors is to sell these assets at a gain. If the asset was held by the mutual fund for more than one year, the nature of the income is capital gain, which gets passed on to you. These are called capital gain distributions. Capital gain distributions are taxed as long-term capital gains regardless of how long you have owned the shares in the mutual fund. If your capital gains distribution is automatically reinvested, the reinvested amount is the basis of the additional shares purchased.

My stocks went up but I didn't sell yet. How much gain should I report? You don't report capital gain or loss until you sell the stock.

My mutual fund reported that I sold shares even though I didn't take any money out! Why? If you move money from one fund to another within the same family of funds, you're selling one fund and buying another. The sale results in a reportable event. All of your sales transactions should be reported on Form 1040 Schedule D. If the first fund sold for more than your adjusted basis in the fund, you will have a capital gain.

I own stock which became worthless last year. Can I take a bad-debt deduction on my tax return? If you own securities and they become totally worthless, you can take a deduction for a loss, but not for a bad debt. The worthless securities are treated as though they were capital assets sold on the last day of the tax year if they were capital assets in your hands. Report worthless securities on line 1 or line 8 of Form 1040, Schedule D, whichever applies. In columns (c) and (d), write "Worthless."

I had a major loss on my investments. How can I put this on my tax form? Can I divide this loss over the next five years on my tax forms? If you actually sold investments and had a capital loss you can deduct this using Form 1040, Schedule D. A maximum of $3,000 in losses may be taken in one year. Any remainder is carried over until the following year. If you had only "paper losses," i.e., you did not actually sell any investments, they are not deductible.

I inherited 160 shares of stock from my mother. On the date of her death, the stock was worth $23 per share. Since her death, the stock had split; doubling the shares (320). I sold the stock last year at $6 per share. Is this sale a capital gain or loss? Your basis in the 320 shares of stock is $3,680 (160 x $23), the fair market value of the stock when you inherited it. The subsequent split does not affect your total basis, just the per-share basis, which after the split became $11.50 (1/2 of $23 per share). So, by selling all 320 of your shares at $6, or $1,920, you have a capital loss of $1,760 ($3,680 basis minus $1,920 proceeds). Gains or losses on all inherited investment property are considered long-term, no matter how long it has been since you inherited it. Report the sale transaction on line 8 of Schedule D.

Does a capital loss reduce my income? As a general rule, you can deduct capital losses up to the full amount of your capital gain plus $3,000. If your capital losses exceed your capital gains by more than $3,000, the excess is carried forward to the next year.

I had a $14,000 net capital loss in 2006. I deducted $3,000 on line 13 of my 2006 Form 1040. I didn't buy or sell anything in 2007. Can I just put my $3,000 loss on line 13 and skip the Schedule D? No, you will need to complete a Schedule D to properly record the carryover of the loss. You will then transfer the allowable loss to line 13 of Form 1040.

I have a large capital loss carryover, but this year I do not have enough income to file a return. Can I just save my capital loss and deduct it when I have income? The calculation of the allowable loss must be made each year. Use Schedule D and the Capital Loss Carryover Worksheet to determine the amount. When you figure 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.

My traditional IRA is invested in stocks and last year my account value went down. How do I report this? Losses in your IRA portfolio are usually not deductible. Your basis in traditional IRAs is the total of all your nondeductable contributions to traditional IRAs minus the total of all your nontaxable distributions.

I had capital gains in my IRA. How much tax is owed? Until you take the money out of your IRA, nothing is taxed. But, when money comes out of a traditional IRA, at least a portion of the distribution will be taxable. Of course, if you have a Roth IRA and meet all of the requirements, you will pay no tax even when the distribution occurs.

Sale of Stock and Other Investment Property — Answers to Exercises

Exercise 1

$3,000 (150 shares × $20)

Exercise 2

$300 ($200 + $20 + $40 + $40)

Exercise 3

$4,000 (400 shares × $10)

Exercise 4

yes

Exercise 5

$7,500

Exercise 6

$1,440 (16 shares × $90)

Exercise 7

5-3, the day after the trade date

Exercise 8

long-term

Exercise 9

A. gain

B. $200

Exercise 10

A. loss

B. $180

Exercise 11

A. $695 ($600 + $50 + $45)

B. gain

C. $205 ($900 – $695)

Exercise 12

Please see the completed Form 1040 and Schedule D on the following pages.

Form **1040** Department of the Treasury—Internal Revenue Service
U.S. Individual Income Tax Return **2007** (99) IRS Use Only—Do not write or staple in this space.

For the year Jan. 1–Dec. 31, 2007, or other tax year beginning , 2007, ending , 20 OMB No. 1545-0074

Label			
(See instructions on page 16.) **Use the IRS label.** Otherwise, please print or type. LABEL HERE	Your first name and initial: **Donald**	Last name: **Judson**	**Your social security number**: xxx xx xxxx
	If a joint return, spouse's first name and initial	Last name	**Spouse's social security number**
	Home address (number and street). If you have a P.O. box, see page 16.: **123 Any Street**	Apt. no.	▲ You **must** enter your SSN(s) above. ▲
	City, town or post office, state, and ZIP code. If you have a foreign address, see page 16.: **Your City, State Zip**		Checking a box below will not change your tax or refund.

Presidential Election Campaign ▶ Check here if you, or your spouse if filing jointly, want $3 to go to this fund (see page 16) ▶ ☐ **You** ☐ **Spouse**

Filing Status

Check only one box.

1 ☑ Single
2 ☐ Married filing jointly (even if only one had income)
3 ☐ Married filing separately. Enter spouse's SSN above and full name here. ▶
4 ☐ Head of household (with qualifying person). (See page 17.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶
5 ☐ Qualifying widow(er) with dependent child (see page 17)

Exemptions

6a ☑ **Yourself.** If someone can claim you as a dependent, **do not** check box 6a — **Boxes checked on 6a and 6b**: 1
b ☐ **Spouse** — **No. of children on 6c who:**
c **Dependents:**

(1) First name Last name	(2) Dependent's social security number	(3) Dependent's relationship to you	(4) ✓ if qualifying child for child tax credit (see page 19)
			☐
			☐
			☐
			☐

If more than four dependents, see page 19.

- **lived with you**
- **did not live with you due to divorce or separation (see page 20)**

Dependents on 6c not entered above

d Total number of exemptions claimed — **Add numbers on lines above ▶** 1

Income

Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld.

If you did not get a W-2, see page 23.

Enclose, but do not attach, any payment. Also, please use **Form 1040-V.**

7	Wages, salaries, tips, etc. Attach Form(s) W-2		7	50,000
8a	**Taxable** interest. Attach Schedule B if required		8a	
b	**Tax-exempt** interest. **Do not** include on line 8a	8b		
9a	Ordinary dividends. Attach Schedule B if required		9a	145
b	Qualified dividends (see page 23)	9b 145		
10	Taxable refunds, credits, or offsets of state and local income taxes (see page 24)		10	
11	Alimony received		11	
12	Business income or (loss). Attach Schedule C or C-EZ		12	
13	Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐		13	1,490
14	Other gains or (losses). Attach Form 4797		14	
15a	IRA distributions	15a	b Taxable amount (see page 25) 15b	
16a	Pensions and annuities	16a	b Taxable amount (see page 26) 16b	
17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E		17	
18	Farm income or (loss). Attach Schedule F		18	
19	Unemployment compensation		19	
20a	Social security benefits	20a	b Taxable amount (see page 27) 20b	
21	Other income. List type and amount (see page 29)		21	
22	Add the amounts in the far right column for lines 7 through 21. This is your **total income** ▶		22	51,635

Adjusted Gross Income

23	Educator expenses (see page XX)	23		
24	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ	24		
25	Health savings account deduction. Attach Form 8889	25		
26	Moving expenses. Attach Form 3903	26		
27	One-half of self-employment tax. Attach Schedule SE	27		
28	Self-employed SEP, SIMPLE, and qualified plans	28		
29	Self-employed health insurance deduction (see page 29)	29		
30	Penalty on early withdrawal of savings	30		
31a	Alimony paid b Recipient's SSN ▶	31a		
32	IRA deduction (see page 31)	32		
33	Student loan interest deduction (see page 33)	33		
34	Tuition and fees deduction. Attach Form 8917	34		
35	Domestic production activities deduction. Attach Form 8903	35		
36	Add lines 23 through 31a and 32 through 35		36	
37	Subtract line 36 from line 22. This is your **adjusted gross income** ▶		37	51,635

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see page 80. Cat. No. 11320B Form **1040** (2007)

Form 1040 (2007) Page **2**

Tax and Credits

Standard Deduction for—

- People who checked any box on line 39a or 39b **or** who can be claimed as a dependent, see page 34.
- All others:

Single or Married filing separately, $5,350

Married filing jointly or Qualifying widow(er), $10,700

Head of household, $7,850

38	Amount from line 37 (adjusted gross income)		51,635
39a	Check if: ☐ **You** were born before January 2, 1943, ☐ Blind. ☐ **Spouse** was born before January 2, 1943, ☐ Blind. **Total boxes checked** ▶ 39a		
b	If your spouse itemizes on a separate return or you were a dual-status alien, see page 34 and check here ▶39b ☐		
40	**Itemized deductions** (from Schedule A) **or** your **standard deduction** (see left margin)		5,350
41	Subtract line 40 from line 38		46,285
42	If line 38 is $117,300 or less, multiply $3,400 by the total number of exemptions claimed on line 6d. If line 38 is over $117,300, see the worksheet on page XX		3,400
43	**Taxable income.** Subtract line 42 from line 41. If line 42 is more than line 41, enter -0-		42,885
44	**Tax** (see page 36). Check if any tax is from: **a** ☐ Form(s) 8814 **b** ☐ Form 4972 **c** ☐ Form(s) 8889		6,988
45	**Alternative minimum tax** (see page 39). Attach Form 6251		
46	Add lines 44 and 45 ▶		6,988
47	Credit for child and dependent care expenses. Attach Form 2441		
48	Credit for the elderly or the disabled. Attach Schedule R		
49	Education credits. Attach Form 8863		
50	Residential energy credits. Attach Form 5695		
51	Foreign tax credit. Attach Form 1116 if required	12	
52	Child tax credit (see page XX). Attach Form 8901 if required		
53	Retirement savings contributions credit. Attach Form 8880		
54	Credits from: **a** ☐ Form 8396 **b** ☐ Form 8859 **c** ☐ Form 8839		
55	Other credits: **a** ☐ Form 3800 **b** ☐ Form 8801 **c** ☐ Form____		
56	Add lines 47 through 55. These are your **total credits**		12
57	Subtract line 56 from line 46. If line 56 is more than line 46, enter -0- ▶		6,976

Other Taxes

58	Self-employment tax. Attach Schedule SE		
59	Unreported social security and Medicare tax from: **a** ☐ Form 4137 **b** ☐ Form 8919		
60	Additional tax on IRAs, other qualified retirement plans, etc. Attach Form 5329 if required		
61	Advance earned income credit payments from Form(s) W-2, box 9		
62	Household employment taxes. Attach Schedule H		
63	Add lines 57 through 62. This is your **total tax** ▶		6,976

Payments

If you have a qualifying child, attach Schedule EIC.

64	Federal income tax withheld from Forms W-2 and 1099	7,836	
65	2007 estimated tax payments and amount applied from 2006 return		
66a	**Earned income credit (EIC)**		
b	Nontaxable combat pay election ▶ 66b		
67	Excess social security and tier 1 RRTA tax withheld (see page 60)		
68	Additional child tax credit. Attach Form 8812		
69	Amount paid with request for extension to file (see page 60)		
70	Payments from: **a** ☐ Form 2439 **b** ☐ Form 4136 **c** ☐ Form 8885		
71	Refundable credit for prior year minimum tax from Form 8801, line 27		
72	Add lines 64, 65, 66a, and 67 through 71. These are your **total payments** ▶		7,836

Refund

Direct deposit? See page 61 and fill in 74b, 74c, and 74d, or Form 8888.

73	If line 72 is more than line 63, subtract line 63 from line 72. This is the amount you **overpaid**		860
74a	Amount of line 73 you want **refunded to you.** If Form 8888 is attached, check here ▶ ☐		860
▶ b	Routing number ▶ **c** Type: ☐ Checking ☐ Savings		
▶ d	Account number		
75	Amount of line 73 you want **applied to your 2008 estimated tax** ▶		

Amount You Owe

76	**Amount you owe.** Subtract line 72 from line 63. For details on how to pay, see page 62 ▶		
77	Estimated tax penalty (see page 62)		

Third Party Designee

Do you want to allow another person to discuss this return with the IRS (see page 63)? ☐ **Yes.** Complete the following. ☒ **No**

Designee's name ▶ Phone no. ▶ ( ) Personal identification number (PIN) ▶

Sign Here

Joint return? See page 17. Keep a copy for your records.

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.

Your signature | Date | Your occupation | Daytime phone number ( )

Spouse's signature. If a joint return, **both** must sign. | Date | Spouse's occupation

Paid Preparer's Use Only

Preparer's signature ▶ | Date | Check if self-employed ☐ | Preparer's SSN or PTIN

Firm's name (or yours if self-employed), address, and ZIP code ▶ | EIN | Phone no. ( )

Form **1040** (2007)

SCHEDULE D (Form 1040)
Department of the Treasury
Internal Revenue Service (99)

Capital Gains and Losses

► Attach to Form 1040 or Form 1040NR. ► See Instructions for Schedule D (Form 1040).
► Use Schedule D-1 to list additional transactions for lines 1 and 8.

OMB No. 1545-0074
2007
Attachment Sequence No. 12

Name(s) shown on return: Donald Judson
Your social security number: XXX XX XXXX

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-6 of the instructions)	(e) Cost or other basis (see page D-7 of the instructions)	(f) Gain or (loss) Subtract (e) from (d)
1						
	50 Shares Den Co.	03/17/2007	06/20/2007	2,700	2,800	(100)

2	Enter your short-term totals, if any, from Schedule D-1, line 2 . . .	2	
3	**Total short-term sales price amounts.** Add lines 1 and 2 in column (d) . . .	3	2,700
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 10 of your **Capital Loss Carryover Worksheet** on page D-7 of the instructions . . .	6	( )
7	**Net short-term capital gain or (loss).** Combine lines 1 through 6 in column (f) . . .	7	(100)

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-6 of the instructions)	(e) Cost or other basis (see page D-7 of the instructions)	(f) Gain or (loss) Subtract (e) from (d)
8						
	20 shares Kitchen Co.	Inherited	03/17/2007	1,900	1,700	200
	100 shares ABC High Yield	Various	07/28/2007	4,300	3,900	400
	100 shares XYZ International	Various	09/14/2007	1,200	500	700

9	Enter your long-term totals, if any, from Schedule D-1, line 9 . . .	9	
10	**Total long-term sales price amounts.** Add lines 8 and 9 in column (d) . . .	10	7,400
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-2 of the instructions . . .	13	290
14	Long-term capital loss carryover. Enter the amount, if any, from line 15 of your **Capital Loss Carryover Worksheet** on page D-7 of the instructions . . .	14	( )
15	**Net long-term capital gain or (loss).** Combine lines 8 through 14 in column (f). Then go to Part III on the back . . .	15	1,590

For Paperwork Reduction Act Notice, see Form 1040 or Form 1040NR instructions. Cat. No. 11338H **Schedule D (Form 1040) 2007**

Schedule D (Form 1040) 2007 Page 2

Part III **Summary**

16 Combine lines 7 and 15 and enter the result **16** 1,490

If line 16 is:

- A **gain**, enter the amount from line 16 on Form 1040, line 13, or Form 1040NR, line 14. Then go to line 17 below.
- A **loss**, skip lines 17 through 20 below. Then go to line 21. Also be sure to complete line 22.
- **Zero**, skip lines 17 through 21 below and enter -0- on Form 1040, line 13, or Form 1040NR, line 14. Then go to line 22.

17 Are lines 15 and 16 **both** gains?

☒ **Yes.** Go to line 18.

☐ **No.** Skip lines 18 through 21, and go to line 22.

18 Enter the amount, if any, from line 7 of the **28% Rate Gain Worksheet** on page D-8 of the instructions . . . . ▶ **18**

19 Enter the amount, if any, from line 18 of the **Unrecaptured Section 1250 Gain Worksheet** on page D-9 of the instructions . . . . ▶ **19**

20 Are lines 18 and 19 **both** zero or blank?

☒ **Yes.** Complete Form 1040 through line 43, or Form 1040NR through line 40. Then complete the **Qualified Dividends and Capital Gain Tax Worksheet** on page 38 of the Instructions for Form 1040 (or in the Instructions for Form 1040NR). **Do not** complete lines 21 and 22 below.

☐ **No.** Complete Form 1040 through line 43, or Form 1040NR through line 40. Then complete the **Schedule D Tax Worksheet** on page D-10 of the instructions. **Do not** complete lines 21 and 22 below.

21 If line 16 is a loss, enter here and on Form 1040, line 13, or Form 1040NR, line 14, the **smaller** of:

- The loss on line 16 or
- ($3,000), or if married filing separately, ($1,500)

} . . . . **21** ( )

Note. When figuring which amount is smaller, treat both amounts as positive numbers.

22 Do you have qualified dividends on Form 1040, line 9b, or Form 1040NR, line 10b?

☐ **Yes.** Complete Form 1040 through line 43, or Form 1040NR through line 40. Then complete the **Qualified Dividends and Capital Gain Tax Worksheet** on page 38 of the Instructions for Form 1040 (or in the Instructions for Form 1040NR).

☐ **No.** Complete the rest of Form 1040 or Form 1040NR.

Schedule D (Form 1040) 2007

Qualified Dividends and Capital Gain Tax Worksheet—Line 44

Keep for Your Records

Before you begin:

√ See the instructions for line 44 that begin on page 33 to see if you can use this worksheet to figure your tax.

√ If you do not have to file Schedule D and you received capital gain distributions, be sure you checked the box on line 13 of Form 1040.

1.	Enter the amount from Form 1040, line 43	**1.**		42,885	
2.	Enter the amount from Form 1040, line 9b	**2.**	145		
3.	Are you filing Schedule D? ☑ **Yes.** Enter the **smaller** of line 15 or 16 of Schedule D. If either line 15 or line 16 is a loss, enter -0- ☐ **No.** Enter the amount from Form 1040, line 13	**3.**	1,490		
4.	Add lines 2 and 3	**4.**	1,635		
5.	If you are claiming investment interest expense on Form 4952, enter the amount from line 4g of that form. Otherwise, enter -0-	**5.**	-0-		
6.	Subtract line 5 from line 4. If zero or less, enter -0-	**6.**		1,635	
7.	Subtract line 6 from line 1. If zero or less, enter -0-	**7.**		41,250	
8.	Enter the **smaller** of: • The amount on line 1, or • $31,850 if single or married filing separately, $63,700 if married filing jointly or qualifying widow(er), $42,650 if head of household.	**8.**		31,850	
9.	Is the amount on line 7 equal to or more than the amount on line 8? ☑ **Yes.** Skip lines 9 through 11; go to line 12 and check the ''No'' box. ☐ **No.** Enter the amount from line 7	**9.**			
10.	Subtract line 9 from line 8	**10.**			
11.	Multiply line 10 by 5% (.05)	**11.**			
12.	Are the amounts on lines 6 and 10 the same? ☐ **Yes.** Skip lines 12 through 15; go to line 16. ☑ **No.** Enter the **smaller** of line 1 or line 6	**12.**		1,635	
13.	Enter the amount from line 10 (if line 10 is blank, enter -0-)	**13.**		-0-	
14.	Subtract line 13 from line 12	**14.**		1,635	
15.	Multiply line 14 by 15% (.15)	**15.**			245
16.	Figure the tax on the amount on line 7. Use the Tax Table or Tax Computation Worksheet, whichever applies	**16.**			6,743
17.	Add lines 11, 15, and 16	**17.**			6,988
18.	Figure the tax on the amount on line 1. Use the Tax Table or Tax Computation Worksheet, whichever applies	**18.**			7,143
19.	**Tax on all taxable income.** Enter the **smaller** of line 17 or line 18. Also include this amount on Form 1040, line 44	**19.**			6,988

STUDENT NOTES

SALE OF HOME

Lesson 13

INTRODUCTION AND OBJECTIVES

In this lesson we will learn the simplified rules that apply to homeowners who sell their principal residence or main home during the tax year. Taxpayers who meet all of the eligibility requirements may exclude up to $250,000 ($500,000 if married filing jointly) of gain from their taxable income.

After completing this lesson, you will be able to:

- Determine whether a home is the taxpayer's main home.
- Determine whether a taxpayer meets the ownership and use tests.
- Determine the amount of gain an eligible taxpayer may exclude if a primary residence is sold.
- Determine when the 5-year ownership/use test period is suspended.

The sale of a main home used as **rental property or partially for business is outside the scope of the volunteer program.**

ALERT

This lesson contains *advanced tax law.* Your course facilitator will teach only the information required to assist taxpayers you will serve.

INTAKE AND INTERVIEW PROCESS FORM 13614—INCOME (SALE OF HOME)

Use **Form 13614, Intake and Interview Sheet** or your site's approved equivalent, to engage the taxpayer in preparing an accurate return. Use the Intake and Interview Sheet as a starting point for a comprehensive interaction with the taxpayer, in combination with all the source documents provided by the taxpayer, to ensure quality and accuracy on each return.

Confirm each item on Form 13614 (or similar tool used at your site) to make sure you and the taxpayer have considered all the necessary information. Ensure that all questions and issues have been addressed. If items are incorrect or incomplete, revisit the issue and make corrections to the return, as needed.

Excerpt from Form 13614

Part IV. Income – In 2007, did you (or your spouse) receive:

☐ Yes	☐ No	1. Wages or Salary (include W-2s for all jobs worked during the year)
☐ Yes	☐ No	2. Disability income
☐ Yes	☐ No	3. Interest/Dividends from: checking or savings account, bonds, CDs, or brokerage account
☐ Yes	☐ No	4. State tax refund (may be taxable if you itemized last year)
☐ Yes	☐ No	5. Alimony income
☐ Yes	☐ No	6. Tip income
☐ Yes	☐ No	7. Pension and/or IRA distribution
☐ Yes	☐ No	8. Unemployment (1099-G)
☐ Yes	☐ No	9. Social Security or Railroad Retirement Benefits (1099-SSA or RRB)
☐ Yes	☐ No	10. Self Employment Income - business, farm, hobby **(1099-Misc or any earned income not reported on W-2)**
☐ Yes	☐ No	11. Other Income such as gambling winnings, awards, prizes and Jury Duty pay, etc.

Sale of a taxpayer's principal residence is covered in this lesson. The Intake and Interview Sheet does not specifically address sale of home, so you should inquire, especially if the home address has changed. To ensure accurate reporting of all income, ask the taxpayer if he or she bought or sold anything **during the year,** including his principal residence or main home. The taxpayer may be eligible to exclude all or part of the gain from taxable income. Confirm that all income received by the taxpayer has been discussed and shown on the return, if required. You will learn more about the sale of a principal residence and the eligibility requirements for the exclusion of the gain later in this lesson.

Eligibility Requirements for the Exclusion

To be eligible for the $250,000 ($500,000 if married filing jointly) exclusion, taxpayers must:

1. Meet the ownership test,
2. Meet the use test, and
3. Not have excluded gain in the two years before the current sale of the home.

Ownership and Use Tests

To exclude the gain from the sale of a home, the taxpayer must meet the ownership and use tests. This means that during the 5-year period ending on the date of the sale, the taxpayer must have:

1. Owned the home for at least 2 years (the ownership test), and
2. Lived in the home as his or her main home (defined later) for at least 2 years (the use test).

In addition, during the 2-year period ending on the date of the sale, the taxpayer must not have claimed exclusion of a gain from the sale of another home.

The taxpayer meets the ownership and use tests if he or she can show that they owned and lived in the property as their main home for either 24 full months or 730 days during the 5-year period. Short, temporary absences, even if the property is rented during those absences, are counted as periods of use.

Ownership and use tests can be met during different 2-year periods. However, a taxpayer **must meet both tests** during the 5-year period ending on the date of the sale.

Example 1

In 1998, Helen Jones lived in a rented apartment. The apartment building was later changed to a condominium, and she bought her apartment on December 1, 2004. Helen became ill and on April 14, 2005 she moved into her daughter's home. On July 10, 2007, while still living in her daughter's home, she sold her apartment.

Helen can exclude all the gain on the sale of her apartment because she met the ownership and use tests. Her 5-year period is from July 11, 2002, to July 10, 2007, the date she sold the apartment. She owned her apartment from December 1, 2004, to July 10, 2007 (over 2 years). She lived in the apartment until April 14, 2005 (over 2 years).

Definition of Main Home

It is important to have a clear understanding of what is and what is not the taxpayer's main home. **Only a gain from the sale of a taxpayer's main home is eligible to be excluded from the taxpayer's income.**

A gain from a sale of a home that is not the taxpayer's main home will generally have to be reported as income. Any gain that must be reported as income is a taxable gain and is reported on Schedule D, Form 1040, Capital Gains and Losses. **The sale of a home that is not the taxpayer's main home is outside the scope of the Volunteer Return Preparation Program.**

A taxpayer's main home does not have to be a traditional house. It simply has to be the residence where the taxpayer lives most of the time and must have cooking, sleeping, and bathroom facilities. A taxpayer's main home can be a house, boat, mobile home, cooperative apartment, or condominium (house or apartment).

> **ALERT**
>
> Never assume that a house sold during the year was the taxpayer's main home, even if the house was the only one owned by the taxpayer. Be sure to check that the house was, in fact, the individual's main home.

More than One Home

Taxpayers who have more than one home cannot choose which home to designate as their main home. If a taxpayer has more than one home, you must determine which home he or she lives in most of the time.

In most cases, taxpayers own and live in one home. You still have to be sure that the owner of a single home meets the requirement of living in the home most of the time.

Example 2

Lucille owns a home in a Colorado ski area (the ski home). She stays at the ski home most weekends and spends the entire months of December, January, and February there. When she is not at the ski home, she lives in a four-room apartment that she rents in Denver. For over half the year, she lives in Denver.

Lucille's main home is her rental apartment in Denver, because she lives there most of the time, **even though she does not own the apartment in Denver.**

Example 3

Christopher owns two homes. One residence is located in St. Louis, where he works, and the other is located in a resort area approximately 100 miles away. Christopher lives in his St. Louis home during the week (Monday through Friday) and travels to his weekend home on the weekends. Christopher's main home is his St. Louis home, because he lives there Monday through Friday, traveling to his weekend home only on Saturdays and Sundays.

Other Factors Used to Determine Main Home

In addition to the amount of time a taxpayer lived in each home, other factors are relevant in determining which home is his or her main home. Those factors include but are not limited to the following:

> **ALERT** ⚠
>
> Weigh all of these items to help make the determination of the taxpayer's main home.

1. Taxpayer's place of employment.
2. The location of other family members' main home.
3. The property location where the "homestead exemption" is claimed for county and/or city property tax purposes.
4. The mailing address for bills and correspondence.
5. The address listed on:

   a. Federal and state tax returns,

   b. Driver's license,

   c. Car registration, and

   d. Voter registration card.
6. The location of banks used.
7. The location of recreational club and religious organization memberships.

Married Homeowners

The ownership and use tests are applied somewhat differently to married homeowners. Married homeowners can exclude up to $500,000 if they meet all the following conditions:

- They file a joint return,
- Either spouse meets the ownership test,
- Both individuals meet the use test, and
- Neither spouse excluded gain from the sale of another home in the two years before the current sale of the home

If either spouse does not satisfy all these requirements, they cannot claim the maximum $500,000 exclusion. The most that can be claimed by the couple is the total of the maximum exclusions that each spouse would qualify for if not married and if the amounts were figured separately. For this purpose, each spouse is treated as owning the property during the period that either spouse owned the property. **This calculation is outside of the scope of the volunteer program.**

Reduced Exclusion

Taxpayers who owned and used a home for less than 2 years (and therefore do not meet the ownership and use tests) may be able to claim a reduced exclusion, if the taxpayer sold the home due to:

1. A change in place of employment,
2. Health, or
3. Unforeseen circumstances.

The calculation of the reduced exclusion is outside of the scope of the volunteer program.

Reporting the Exclusion

Taxpayers do not have to report the sale of a home on their tax return **unless** they have a gain and at least part of it is taxable (i.e., the gain exceeds the exclusion amount of $250,000 or $500,000). The amount of the taxable gain (total gain less exclusion) from the sale of the residence should be reported on Schedule D and combined with other gains and losses before entering on Form 1040.

A loss on the sale of the taxpayer's main home cannot be deducted on his or her tax return.

5-Year Test Period Suspension—Armed Forces Personnel

The taxpayer can choose to have the 5-year test period for ownership and use suspended during any period when he or she or his or her spouse serves on **qualified official extended duty** as a member of the Armed Forces. This means that the taxpayer may be able to meet the 2-year use test even if, because of his or her service, he or she did not actually live in the home for at least the required 2 years during the 5-year period ending on the date of sale. The period of suspension cannot last more than 10 years. The suspension cannot be used on more than one property at a time.

The taxpayer is on **qualified official extended duty** if he or she serves on extended duty either at a duty station at least 50 miles from his or her main home or while he or she lives in government quarters under government order. The taxpayer is considered on extended duty when he or she is called or ordered to active duty for a period of more than 90 days or for an indefinite period.

Example 4

Peter bought a home in 1998. He lived in it as his main home for 2½ years (1998–2000). Beginning in 2001 he was on qualified official extended duty in the US Army. He sold his home in 2007 and had a $12,000 gain. Under the general sale of home rules, Peter would have to include the gain on his tax return because he did not meet the use test (2 out of the last 5 years). Peter chooses to suspend the 5-year test period for the 6 years he was on qualifying official extended duty. Therefore, Peter's 5-year test period consists of the 5 years before he went on qualifying official extended duty. He meets the ownership and use tests and can exclude the gain from his tax return.

Gain on Sale of Main Home

If the selling price of the taxpayer's home is less than the exclusion amount ($250,000 or $500,000 if married filing jointly) the taxpayer is entitled to, you do not need to calculate the gain on the sale of the home.

Example 5

Jason and Elizabeth sold their home for $126,000. They had owned and lived in this home from 1972 until they sold it. They had made many improvements over the years. Since their sales price ($126,000) is less than the amount ($500,000) that they can exclude, you do not need to calculate the gain on the sale of their home.

If you are assisting a taxpayer who may have a gain that exceeds the exclusion amount, use the following information to determine the gain on the sale. **Be sure to keep in mind that this sale may be outside of the scope of the volunteer program.**

To figure the gain (or loss) on the sale of a taxpayer's main home, you must know the following about the home:

1. **The selling price.** The selling price is the total amount the taxpayer (seller) received for his or her main home. It includes money, all notes, mortgages, or other debts taken over by the buyer as part of the sale, and the fair market value of any other property or services that the seller received. If the taxpayer received a Form 1099-S, box 2 (gross proceeds) will generally show the total amount received from the sale of the home.
2. **The amount realized.** The amount realized is the selling price minus selling expenses. Selling expenses include commissions, advertising fees, legal fees, and loan charges paid by the seller, such as points.
3. **Basis.** The basis in a home is determined by how the taxpayer obtained the home. If the home was bought or built, the basis is its cost. If the home was obtained in some other way (inheritance, gift, etc.), the basis is either its fair market value when it was inherited or gifted, or the adjusted basis established by the person the taxpayer obtained it from.

   The basis of inherited property is generally the fair market value of the property at the date of the decedent's death. However, this can vary if the personal representative of the estate elects to use an alternate valuation date. **Alternate valuation issues can be complex, and the taxpayer may need to seek professional assistance.**

   Determination of the adjusted basis of property received as a gift can be very complex. It is outside the scope of the volunteer program. **Advise the taxpayer to seek the assistance of a tax professional.**
4. **The adjusted basis.** The adjusted basis is the result of any adjustments (increases or decreases) made to the home's basis. Increases include additions or improvements to the home such as adding on rooms or finishing a basement. In order to be considered an increase, an addition or improvement must have a useful life of more than one year. Repairs that maintain the home in good condition are not considered improvements and should not be added to the basis of the property. Decreases to basis include deductible casualty losses if the loss exceeds the insurance reimbursement. **Casualty losses are beyond the scope of the volunteer program.**

Figuring the Gain

To determine whether a taxpayer has a gain or a loss on the sale of a home, compare the amount realized with the adjusted basis. If the amount realized is more than the adjusted basis, the difference is a gain and the taxpayer may be able to exclude all or part of it. If the amount realized is less than the adjusted basis, the difference is a loss. **A loss on the sale of the taxpayer's main home cannot be deducted.**

REPORTING REAL ESTATE PROCEEDS (FORM 1099-S)

If the taxpayer received **Form 1099-S, Proceeds From Real Estate Transactions,** use it to figure the selling price for the taxpayer's home. Box 1 shows the date of sale (closing), and box 2 shows the gross proceeds received from the sale of his or her main home. If the taxpayer can exclude the entire gain from a sale, the person responsible for closing the sale (for example, a real estate broker or settlement agent) generally will not have to report it on Form 1099-S. For taxpayers who did not receive Form 1099-S, use sale documents and other records.

Example 6

Joe and Sarah Blackhawk bought their main home on September 3, 1993, and sold it on July 7 in the current year. They will not be able to exclude the entire gain from income (they had an adjusted basis of $226,000 for the home; their gain exceeds $500,000). The Lincoln Title Company provided them with a Form 1099-S (Exhibit 1). The gain from the sale of their main home is reported in Part II of Schedule D (Exhibit 2). Schedule D is used whenever there is any nonexcluded gain.

Exhibit 1 **Blackhawk Form 1099-S**

7575 ☐ VOID ☐ CORRECTED

FILER'S name, street address, city, state, ZIP code, and telephone no. Lincoln Title Company 123 Lincoln Avenue Your City, State Zip	1 Date of closing 07/07/2007 2 Gross proceeds $ 789,000	OMB No. 1545-0997 2007 Form 1099-S	**Proceeds From Real Estate Transactions**
FILER'S federal identification number xx-xxxxxxx	TRANSFEROR'S identification number xxx-xx-xxxx	3 Address or legal description (including city, state, and ZIP code) 84 Northeast St. Your City, State Zip	**Copy A** **For Internal Revenue Service Center** **File with Form 1096.** For Privacy Act and Paperwork Reduction Act Notice, see the **2007 General Instructions for Forms 1099, 1098, 5498, and W-2G.**
TRANSFEROR'S name Joe and Sarah Blackhawk			
Street address (including apt. no.) 91 Yale Dr.			
City, state, and ZIP code Your City, State Zip		4 Check here if the transferor received or will receive property or services as part of the consideration. ▶ ☐	
Account or escrow number (see instructions)		5 Buyer's part of real estate tax $	

Form **1099-S** Cat. No. 64292E Department of the Treasury - Internal Revenue Service

SCHEDULE D (Form 1040)

Department of the Treasury Internal Revenue Service (99)

Capital Gains and Losses

► Attach to Form 1040 or Form 1040NR. ► See Instructions for Schedule D (Form 1040).

► Use Schedule D-1 to list additional transactions for lines 1 and 8.

OMB No. 1545-0074

2007

Attachment Sequence No. 12

Name(s) shown on return: Joe and Sarah Blackhawk

Your social security number: XXX | XX | XXXX

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-6 of the instructions)	(e) Cost or other basis (see page D-7 of the instructions)	(f) Gain or (loss) Subtract (e) from (d)
1						

2	Enter your short-term totals, if any, from Schedule D-1, line 2	2	
3	**Total short-term sales price amounts.** Add lines 1 and 2 in column (d)	3	
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 10 of your **Capital Loss Carryover Worksheet** on page D-7 of the instructions	6	( )
7	**Net short-term capital gain or (loss).** Combine lines 1 through 6 in column (f)	7	

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-6 of the instructions)	(e) Cost or other basis (see page D-7 of the instructions)	(f) Gain or (loss) Subtract (e) from (d)
8						
	Main Home	09/03/1993	07/07/2007	789,000	226,000	563,000
	Exclusion					(500,000)

9	Enter your long-term totals, if any, from Schedule D-1, line 9	9	
10	**Total long-term sales price amounts.** Add lines 8 and 9 in column (d)	10	789,000
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-2 of the instructions	13	
14	Long-term capital loss carryover. Enter the amount, if any, from line 15 of your **Capital Loss Carryover Worksheet** on page D-7 of the instructions	14	( )
15	**Net long-term capital gain or (loss).** Combine lines 8 through 14 in column (f). Then go to Part III on the back	15	63,000

For Paperwork Reduction Act Notice, see Form 1040 or Form 1040NR instructions. Cat. No. 11338H **Schedule D (Form 1040) 2007**

Exercise 1

Mary bought a home in 1995. She lived in the home full time until September 1999, when she decided to rent an apartment closer to her place of employment. She was in the apartment until September 2006, when her lease was up. She asked her brother to keep an eye on her house by living there and paying the utilities while she was gone. This arrangement would not constitute rent, as there was no written agreement and they did not negotiate fair rental value. She moved back into the house in September of 2006 and sold the house the following March.

A. Does Mary meet the ownership test? ___________________

B. Does Mary meet the use test? ___________________

Exercise 2

Mary, in Exercise 1 above, bought her house for $180,000. In 1996 she spent $20,000 enclosing her carport and putting a new roof on the house. She spent approximately $1,200 on general maintenance over the years.

A. What is Mary's basis? _____________________

B. What is Mary's adjusted basis? _______________________

Exercise 3

When Mary decided to sell her home, she listed it with a broker only after advertising in the local paper for 2 months for a cost of $100. She paid commissions and points at closing in the amount of $5,000. The house sold for $280,000.

A. What is Mary's amount realized? _______________________

B. Does Mary have a gain or a loss?_______________________

Exercise 4

Does Mary have to report the sale of her home on her current year's tax return? ___________________________________

Exercise 5

Consider the same scenario as above, except that Mary was on qualified official extended duty with the military. She was out of the country for 5 years instead of in an apartment in the United States. The only months or years she did not live in her home were when she was on duty.

A. Does Mary meet the use test? ____________________________

B. Does Mary have a sale to report on her current year's tax return? __________

QUALITY REVIEW (QR)—INCOME (SALE OF HOME)

Use **Form 8158, Quality Review Sheet** or your site's approved alternative form to review all returns prepared. Apply the quality review tools in combination with the Intake and Interview Sheet and all the source documents to the returns you prepare to ensure quality and accuracy for every taxpayer.

Consider each item on the Quality Review Sheet that applies to your taxpayer's situation to confirm that all the necessary questions and issues have been addressed. If items are incorrect or incomplete, revisit the issue and make corrections to the return, as needed.

Excerpt from Form 8158

Yes	No	
☐	☐	All **income** indicated on the intake/interview sheet, taxpayer's interview and/or supporting documents are included on the return.

To ensure accurate reporting of income, verify that the taxpayer's wages are accurate and that all income from Form(s) W-2 and other income documents, such as Form(s) 1099, have been included. Confirm that all income received by the taxpayer has been discussed and shown on the return, if required.

▶▶ SUMMING UP THIS LESSON ◀◀

In this lesson you learned the simplified rules that apply to homeowners who sell their principal residence.

Taxpayers who have a gain from the sale of their main home may exclude up to $250,000 of the gain from their taxable income ($500,000 if married filing jointly), if the eligibility requirements are met.

To qualify for the exclusion on the gain from the sale of a home, the taxpayer must meet the ownership and use tests during the 5-year period ending on the date of the sale. The taxpayer must meet all three of the following conditions:

1. They must have owned the home for at least 2 years (the ownership test),
2. They must have lived in the home as their main home for at least 2 years (the use test), and
3. They cannot have excluded any gain on the sale of a residence in either of the previous two years.

A loss on the sale of a taxpayer's main home (principal residence) is not deductible.

Exercise 1

A. Yes, Mary does meet the ownership test.

B. No, Mary does not meet the use test; she lived in the house only six months in the previous 5 years.

Exercise 2

A. Mary's basis is $180,000, her cost.

B. Her adjusted basis is $200,000, her cost plus major repairs that extend the life of the structure.

Exercise 3

A. Mary's amount realized is $274,900 ($280,000 − $5,100 = $274,900).

B. Mary has a gain ($274,900 − $200,000 = $74,900).

Exercise 4

Yes, Mary has to report the entire gain on Schedule D of her Form 1040 because she does not meet the use test. She must meet the ownership and use tests to exclude any gain.

Exercise 5

A. Yes, Mary meets the use test because her 5-year test period does not consider the 5 years on military duty.

B. No, she does not have to report the sale because she meets both the use and ownership tests and the gain is less than $250,000.

FINISHING THE RETURN

Lesson 14

INTRODUCTION AND OBJECTIVES

In this lesson you will learn how to report federal income tax payments and figure the overpayment or balance due. You will also learn how to determine if estimated taxes should be paid. Additionally, you will learn how to finish the return. If a paper return is prepared, the taxpayer(s) must sign the return. For electronically filed returns most taxpayers can sign by using an electronic signature.

After completing this lesson, you should be able to:

- Calculate and report federal income tax withheld from all sources.
- Calculate and report estimated tax payments.
- Calculate the refund or amount due.
- Determine if estimated taxes should be paid.
- Determine who qualifies for an extension of time to file.
- Determine if changes to the taxpayer's Form W-4 or W-4P should be suggested.

This lesson will provide detailed information on how to finish the tax return. The following checklist is provided as a quick reference of the steps needed to finish the return.

CHECKLIST FOR FINISHING THE RETURN

Withholdings, Payments, and Other Credits:

- Add all federal income tax withholding from Form W-2, box 2 or other income statement(s), and include on return.
- Add all federal income tax withholding from box 4 of Forms 1099-R, 1099-INT, 1099-DIV, and 1099-G. Include in the payments section of the return.
- Include all estimated tax payments in the payment section.
- Include the amount of last year's refund that was applied to this year in the payment section.

Note: If you need assistance with how to do this with TaxWise®, ask your site coordinator or computer specialist.

ALERT

This lesson contains tax law and information relating to all courses of training. Your course facilitator will teach only the information required to assist taxpayers you will serve.

POTENTIAL PITFALLS

Form W-2, box 4, shows social security tax withheld, and box 6 shows Medicare tax withheld. These are not the same as federal income tax withheld. Do not report the amounts in box 4 and box 6 as federal income tax withheld.

POTENTIAL PITFALLS

Be aware of "Excess Social Security or Tier 1 railroad retirement." For 2007, if the taxpayer worked for more than one employer and the total wages are more than $97,500, then add the amounts in box 4 of Forms W-2. If the total exceeds $6,045, the taxpayer can claim a credit equal to the excess tax withheld. Refer to the worksheet in Pub. 505, *Tax Withholding and Estimated Tax.*

- Calculate all of the refundable credits (covered in other lessons) that the taxpayer is entitled to and include them in the payments section of the return. Using TaxWise® software will help you determine which credits the taxpayer is entitled to.
- Add all payments together and enter them on the total payments line. TaxWise® will do this step for you.
- Subtract the total payments from the total tax. TaxWise® will also complete this step for you.
- Record the account number and the routing number for taxpayers who want their refund direct deposited.

Note: TaxWise® will ask you for this information on the main information screen and on the tax form. This is to help ensure that you have keyed in the correct information.

- Complete the line to apply part of the refund to next year, if the taxpayer wishes to use this option.

Paying Taxes or Adjusting Withholding Taxes if Balance Due:

- Explain the payment options (check, credit card, electronic funds withdrawal, and installment agreement) to a taxpayer who owes money. The Electronic Federal Tax Payment System (EFTPS) is a free tax payment system that can be used but requires prior enrollment. For more details refer to Publication 17 or call EFTPS customer service at 1-800-316-6541.
- Inform the taxpayer about the identifying information to include on payments made by check.
- Explain that interest and penalties continue to accrue on the unpaid balance even if the taxpayer has a valid installment agreement.
- Explain estimated taxes to taxpayers who expect to owe tax in 2008.
- Assist the taxpayer with completing Form 1040-ES for 2008. TaxWise® can do this for you. It will even print the vouchers for the payments.
- Provide the taxpayer with the mailing address for the estimated payments. (Some sites provide unstamped envelopes for the taxpayers.)
- Encourage taxpayers to consider adjusting their withholding (on Form W-4 or Form W-4P) if they have a large refund or owe more than $1,000 on the return.

Advance Earned Income Tax Credit (AEIC):

- Inform taxpayers about the AEIC, if they were eligible for EIC this year and have at least one qualifying child. Be prepared to give the taxpayer Form W-5, if he or she requests it.

Name, Address, and Taxpayer Identification Section of Return:

- Complete the name and address section of the tax return. Use the taxpayer's label (if available) on a return prepared by hand. For computer-generated returns, this section will be completed based on the information you entered in the main information section of the TaxWise® software.
- Make sure that you include the taxpayer identification number for all taxpayers and dependents listed on the return. **Note:** If you are using TaxWise®, you will get an error when you run diagnostics if you have not included the identifying number. TaxWise® also has a diagnostic feature that helps you check the accuracy of the identifying number by comparing it to a database of information from the Social Security Administration. This does not guarantee that the name and social security number match. You should always look at the actual social security cards if possible. To validate the identity of the taxpayer, you should also ask for proof of identity.
- Mark the *you and/or spouse box(es)* if the taxpayer elects to designate $3.00 to the Presidential Election Campaign Fund.

Return Assembly and Copy:

- Assemble the return. If filing a paper return for the taxpayer, forms should be in the order of the attachment sequence number in the upper right corner. Procedures on assembling electronic returns may vary from site to site. Please ask your site coordinator for this information.
- Retain an electronic copy of all returns e-filed. Remember that you are not allowed to retain copies of the tax returns at your site past the end of the filing season. The retained copies should be forwarded to your local IRS territory office, where they will be retained until the end of the calendar year (as prescribed by the electronic filing regulations). For exceptions, see **Publication 4299, Privacy and Confidentiality.**

Site Identification Number on Forms 1040, 1040A, 1040EZ

Congress annually asks the IRS to provide the number of returns that were filed by volunteer tax assistance sites. For statistical purposes, the IRS requests that all federal returns be identified with a site identification number. The site identification number is entered in the paid preparer's section of the tax return. The Internal Revenue Service Submission Processing Center will count each return processed using this data.

More about this topic is covered later in this lesson.

On-Site Quality Review

The purpose of the quality return review process is to ensure that every return is accurate. A return is considered accurate when the tax law is correctly applied based on the taxpayer interview and all supporting documentation. The goal is to complete a tax return free from error.

A quality review process should contain the following critical components for an effective and thorough quality review of every tax return:

- Customer interaction: Involving the customer in the entire process creates not only a learning experience for the customer but also a better opportunity to prepare an accurate return.
- Standardized process to confirm the information provided by the customer (e.g., Form 8158, Quality Review Sheet, or an IRS approved partner developed alternative form).
- Source documents to confirm identity, income, adjustments, deductions, credits, and direct deposit information on the return.

Quality review takes many forms (e.g., self-review, exchange with another preparer, or dedicated quality reviewer). Although it is strongly recommended that a dedicated quality reviewer conduct the quality review, at least a different pair of eyes should complete the return review.

The quality return reviewer must ensure that all source documents, the completed tax return and the taxpayer are included in the review process.

Third-Party Designation and Signing the Return:

- Complete the third-party designee section of the return if the taxpayer wishes to allow someone else to discuss the return with the IRS. **(You cannot designate yourself.)**
- Mark the area where the taxpayer should sign if you are preparing a paper return for the taxpayer.
- For e-file returns, taxpayers sign electronically with the Practitioner PIN or Self-Select PIN.

ALERT

For the 2008 filing season, VITA/TCE sites will use either the Practitioner PIN or the Self-Select PIN method for electronic signatures for e-filed returns.

Personal Identification Number (PIN) Guidelines

Beginning with the 2008 filing season there are new electronic signature requirements. For e-filed returns VITA/TCE sites will use the **Practitioner PIN** or the **Self-Select PIN.**

ALERT

Form 8453 will no longer be used as a signature document to e-file a return.

Form 8453 will no longer be used as a signature document. Revisions are being made to Form 8453 to allow it to continue to be used as a transmittal document for specific supporting documents to the Individual tax return.

Note: Refer to the Finishing the Return tab in **Publication 4012, Volunteer Resource Guide,** for the detailed information on Practitioner PIN and Self-Select PIN.

Filing the Return:

- Ask the taxpayer if they have questions.

E-Filed Returns:

- Electronically filed returns are automatically transmitted to the correct IRS processing center.

Where to Mail Paper Returns:

- Tell the taxpayer where to mail the return (if filing by paper). Paper tax returns must be mailed by the taxpayer to the IRS processing center for the area (state) where the taxpayer resides. Each IRS tax return package contains a pre-addressed envelope for a particular area based on the last address filed with the IRS. If the taxpayer has moved or does not have a pre-addressed envelope, the address and other mailing information are located in the individual federal tax package or Form 1040 Instruction booklet. Some sites provide unstamped pre-addressed envelopes for their taxpayers. You might be able to get the envelopes donated from a local office supply store. Your site receptionist could address the envelopes, or you could print computer labels to use on them.

PAYMENTS

The federal government has a pay-as-you-earn tax system. The information for the payments section of the return has three sources: federal income tax withholdings, estimated tax payments, and refundable credits.

Income tax withheld can appear on:

- Form W-2, *Wage and Tax Statement,* in box 2
- Form 1099-R, *Distributions from Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.,* in box 4
- Form 1099-INT, *Interest Income,* in box 4
- Form 1099-DIV, *Dividends and Distributions,* in box 4
- Form W-2G, *Certain Gambling Winnings,* in box 2
- Form 1099-G, *Certain Government and Qualified State Tuition Program Payments,* in box 4
- SSA-1099, *Social Security Benefits*
- RRB-1099, *Railroad Retirement Benefits Tier 1*
- RRB-1099R, *Railroad Retirement Benefits Tier 2*
- Form 1099B, *Proceeds from Broker and Barter Exchange Transactions*

Example 1

Morgan has one Form W-2 (Exhibit 1).

The entry in box 2 of Form W-2 goes on the **Federal income tax withheld** line of the return.

Exhibit 1 **Morgan's Form W-2**

a Employee's social security number XXX-XX-XXXX	OMB No. 1545-0008	Safe, accurate, FAST! Use IRS e-file	Visit the IRS website at *www.irs.gov/efile*.
b Employer identification number (EIN) XX-XXXXXXX		1 Wages, tips, other compensation $12,350	2 Federal income tax withheld $988
c Employer's name, address, and ZIP code XYZ Associates 2112 Third Street Tampa, FL 22621		3 Social security wages $12,350	4 Social security tax withheld $766
		5 Medicare wages and tips $12,350	6 Medicare tax withheld $179
		7 Social security tips	8 Allocated tips
d Control number		9 Advance EIC payment	10 Dependent care benefits
e Employee's first name and initial / Last name / Suff. Morgan A. Howard 134 Dawes Blvd. Tampa, FL 33621		11 Nonqualified plans	12a See instructions for box 12 Code
		13 Statutory employee / Retirement plan / Third-party sick pay	12b Code
		14 Other	12c Code
f Employee's address and ZIP code			12d Code

15 State	Employer's state ID number	16 State wages, tips, etc.	17 State income tax	18 Local wages, tips, etc.	19 Local income tax	20 Locality name

Form **W-2** **Wage and Tax Statement** 2007

Department of the Treasury—Internal Revenue Service

Copy B—To Be Filed With Employee's FEDERAL Tax Return.
This information is being furnished to the Internal Revenue Service.

Example 2

Kourtney has a Form 1099-INT (Exhibit 2), a Form 1099-R (Exhibit 3), and a Form 1099-DIV (Exhibit 4). His total income tax withheld is entered on the **Federal income tax withheld** line of Form 1040A. It is $1,247.

Exhibit 2 **Kourtney's Form 1099-INT**

☐ CORRECTED (if checked)

PAYER'S name, street address, city, state, ZIP code, and telephone no. Second Federal Bank 210 Miller Avenue Denver, CO 86011		Payer's RTN (optional) 1 Interest income $ 2 Early withdrawal penalty $	OMB No. 1545-0112 2007 Form 1099-INT	**Interest Income**
PAYER'S federal identification number XX-XXXXXXX	RECIPIENT'S identification number XXX-XX-XXXX	3 Interest on U.S. Savings Bonds and Treas. obligations $ 935.00		**Copy B** **For Recipient**
RECIPIENT'S name Kourtney B. George		4 Federal income tax withheld $ 187.00	5 Investment expenses $	This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported.
Street address (including apt. no.) 1360 Shannon Ave.		6 Foreign tax paid $	7 Foreign country or U.S. possession	
City, state, and ZIP code Denver, CO 86011		8 Tax-exempt interest	9 Specified private activity bond interest	
Account number (see instructions)		$	$	

Form **1099-INT** (keep for your records) Department of the Treasury - Internal Revenue Service

Exhibit 3 — Kourtney's Form 1099-R

☐ CORRECTED (if checked)

PAYER'S name, street address, city, state, and ZIP code	APEX Triangles 213 Hickory Meadows Denver, CO 86011
1 Gross distribution	$ 12,000.00
2a Taxable amount	$ 12,000.00
OMB No. 1545-0119	2007 Form **1099-R**
2b Taxable amount not determined ☐	Total distribution ☐
PAYER'S federal identification number	XX-XXXXXXX
RECIPIENT'S identification number	XXX-XX-XXXX
3 Capital gain (included in box 2a)	$
4 Federal income tax withheld	$ 960.00
RECIPIENT'S name	Kourtney B. George
5 Employee contributions /Designated Roth contributions or insurance premiums	$
6 Net unrealized appreciation in employer's securities	$
Street address (including apt. no.)	1360 Shannon Avenue
7 Distribution code(s)	7
IRA/ SEP/ SIMPLE	☐
8 Other	$ %
City, state, and ZIP code	Denver, CO 86011
9a Your percentage of total distribution	%
9b Total employee contributions	$
1st year of desig. Roth contrib.	
10 State tax withheld	$ $
11 State/Payer's state no.	
12 State distribution	$ $
Account number (see instructions)	
13 Local tax withheld	$ $
14 Name of locality	
15 Local distribution	$ $

Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.

Copy B
Report this income on your federal tax return. If this form shows federal income tax withheld in box 4, attach this copy to your return.

This information is being furnished to the Internal Revenue Service.

Form **1099-R** Department of the Treasury — Internal Revenue Service

Exhibit 4 — Kourtney's Form 1099-DIV

☐ CORRECTED (if checked)

PAYER'S name, street address, city, state, ZIP code, and telephone no.	Denver Sheet Metal 214 16th Street Denver, CO 86013
1a Total ordinary dividends	$ 500.00
1b Qualified dividends	$
OMB No. 1545-0110	2007 Form **1099-DIV**
2a Total capital gain distr.	$
2b Unrecap. Sec. 1250 gain	$
PAYER'S federal identification number	XX-XXXXXXX
RECIPIENT'S identification number	XXX-XX-XXXX
RECIPIENT'S name	Kourtney B. George
2c Section 1202 gain	$
2d Collectibles (28%) gain	$
3 Nondividend distributions	$
4 Federal income tax withheld	$ 100.00
Street address (including apt. no.)	1360 Shannon Avenue
5 Investment expenses	$
City, state, and ZIP code	Denver, CO 86011
6 Foreign tax paid	$
7 Foreign country or U.S. possession	
Account number (see instructions)	
8 Cash liquidation distributions	$
9 Noncash liquidation distributions	$

Dividends and Distributions

Copy B
For Recipient

This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported.

Form **1099-DIV** (keep for your records) Department of the Treasury - Internal Revenue Service

Estimated Tax Payments

Add all estimated tax payments made by the taxpayer for the year. Be sure to include:

- Payment made from last year's overpayment (see last year's tax return).
- Quarterly payments made using Form 1040ES, including the one made in January of the current tax year.

Record **current tax year estimated tax payments and amount applied from prior year return** in the **payments section** of Form 1040 or Form 1040A.

Refundable Credits

Make sure that any refundable credits you have calculated are entered on the proper lines. Refundable credits lines are located in the payments section of Form 1040, the tax, credits, and payments section of Form 1040A, and the payments and tax section of Form 1040EZ.

The credits include the earned income credit, any refundable child tax credit, and excess social security tax withheld. If excess social security tax was withheld because of multiple employers, that amount is shown on the **Excess social security and tier 1 RRTA tax withheld** line of Form 1040.

Total Payments

Add the total of withholdings, estimated tax payments made, and refundable credits together. Enter these amounts on the total payments line of the tax form. The lines are found in the payment area of the form.

See Exhibit 5 below to review the payments section.

Exhibit 5

Payments	64	Federal income tax withheld from Forms W-2 and 1099 . .	64				
	65	2007 estimated tax payments and amount applied from 2006 return	65				
If you have a qualifying child, attach Schedule EIC.	66a	**Earned income credit (EIC)**	66a				
	b	Nontaxable combat pay election ▶ 66b					
	67	Excess social security and tier 1 RRTA tax withheld (see page 60)	67				
	68	Additional child tax credit. Attach Form 8812	68				
	69	Amount paid with request for extension to file (see page 60)	69				
	70	Payments from: **a** ☐ Form 2439 **b** ☐ Form 4136 **c** ☐ Form 8885 .	70				
	71	Refundable credit for prior year minimum tax from Form 8801, line 27	71				
	72	Add lines 64, 65, 66a, and 67 through 71. These are your **total payments** . . . . ▶				72	

Overpayments

If there have been more tax payments made than the amount of total tax, this is considered an overpayment. **Total tax** amounts are found in the tax credits/payment section of the return.

A taxpayer may wish to have a portion of the overpayment applied to next year's taxes. If so, then enter the amount to be applied to the following year on the proper line. Subtract this amount from the total overpayment and enter the remainder on the amount to be refunded line.

The option to have all or part of a tax refund applied to next year's estimated taxes is not available on Form 1040EZ.

Example 3

Exhibit 6 shows the tax, credits, payments, and refund sections of page 2 of Form 1040A for Christopher. His total tax is $3,491. His total payments are $5,000. Christopher overpaid and wants $900 to be applied to his 2008 estimated tax. Note that the total refund amount plus the amount to be applied to the next year's estimated tax equals the amount overpaid.

Exhibit 6 **Christopher's 1040A, page 2**

dependent, see page 32.	28	**Tax,** including any alternative minimum tax (see page 32).				28	3,491	00
• All others:	29	Credit for child and dependent care expenses. Attach Schedule 2.	29					
Single or Married filing separately, $5,350	30	Credit for the elderly or the disabled. Attach Schedule 3.	30					
Married filing jointly or Qualifying widow(er), $10,700	31	Education credits. Attach Form 8863.	31					
	32	Child tax credit (see page 37). Attach Form 8901 if required.	32					
Head of household, $7,850	33	Retirement savings contributions credit. Attach Form 8880.	33					
	34	Add lines 29 through 33. These are your **total credits.**				34	0	00
	35	Subtract line 34 from line 28. If line 34 is more than line 28, enter -0-.				35	3,491	00
	36	Advance earned income credit payments from Form(s) W-2, box 9.				36	0	00
	37	Add lines 35 and 36. This is your **total tax.**				▶ 37	3,491	00
	38	Federal income tax withheld from Forms W-2 and 1099.	38	2,600	00			
If you have a qualifying child, attach Schedule EIC.	39	2007 estimated tax payments and amount applied from 2006 return.	39	2,400	00			
	40a	**Earned income credit (EIC).**	40a					
	b	Nontaxable combat pay election. 40b						
	41	Additional child tax credit. Attach Form 8812.	41					
	42	Add lines 38, 39, 40a, and 41. These are your **total payments.**				▶ 42	5,000	00
Refund	43	If line 42 is more than line 37, subtract line 37 from line 42. This is the amount you **overpaid.**				43	1,509	00
Direct deposit? See page 53 and fill in 44b, 44c, and 44d or Form 8888.	44a	Amount of line 43 you want **refunded to you.** If Form 8888 is attached, check here ▶ ☐				44a	609	00
	▶ b	Routing number ▶ **c** Type: ☐ Checking ☐ Savings						
	▶ d	Account number						
	45	Amount of line 43 you want **applied to your 2008 estimated tax.**	45	900	00			
Amount you owe	46	**Amount you owe.** Subtract line 42 from line 37. For details on how to pay, see page 54.				▶ 46		
	47	Estimated tax penalty (see page 54).	47					

Refunds

If the taxpayer wants an overpayment refunded, advise the taxpayer that a check should be mailed within 6–8 weeks after the return is filed. Remind the taxpayer of the option to have the refund deposited directly into a financial account, such as a bank account.

Direct Deposit

Instead of getting a paper check, taxpayers may choose to have their refund deposited directly into their account at a bank or other financial institution such as a mutual fund, brokerage firm, or credit union.

Split Refunds

> **ALERT**
>
> Taxpayers requesting direct deposit will be able to split their refunds and direct their funds into up to three separate accounts. Taxpayers will attach Form 8888 to their returns indicating amounts and account information for each account.

Taxpayers may split their refunds. They can request direct deposit of part of their refund to checking and part of the refund into savings accounts for future use. This is true for both paper or electronically filed returns.

This ability to split or allocate their direct deposit refunds among multiple accounts will be available to all individual filers, whether they file Form 1040, Form 1040A, Form 1040EZ, Form 1040NR, or any of the other 1040 series forms.

Taxpayers must attach **Form 8888, Direct Deposit of Refund,** to their returns indicating amounts for each allocation along with the account information. See the form below in Exhibit 7. The refund amount is shown in the Refund section of the tax form, including amounts to be direct deposited into more than one account. To split the direct deposit of a refund among two or three accounts, check the appropriate box on Form 1040, Form 1040A, or Form 1040EZ and attach Form 8888.

> **ALERT**
>
> Caution! Make sure you enter the correct bank account routing transit and account information on the return. IRS is not responsible for a lost refund if the information is entered incorrectly.

A taxpayer may not split the refund if Form 8379, Injured Spouse Allocation, is filed with the return.

Use this form if the taxpayer wants the refund deposited into more than one bank account.

> **ALERT**
>
> Savings account deposit slips, in particular, are not a dependable source for routing numbers.

Exhibit 7 **Form 8888**

Form **8888**
Department of the Treasury
Internal Revenue Service

Direct Deposit of Refund to More Than One Account
► See instructions below and on back.
► Attach to Form 1040, Form 1040A, Form 1040EZ, Form 1040NR, Form 1040NR-EZ, Form 1040-SS, or Form 1040-PR.

OMB No. 1545-0074
2007
Attachment Sequence No. 56

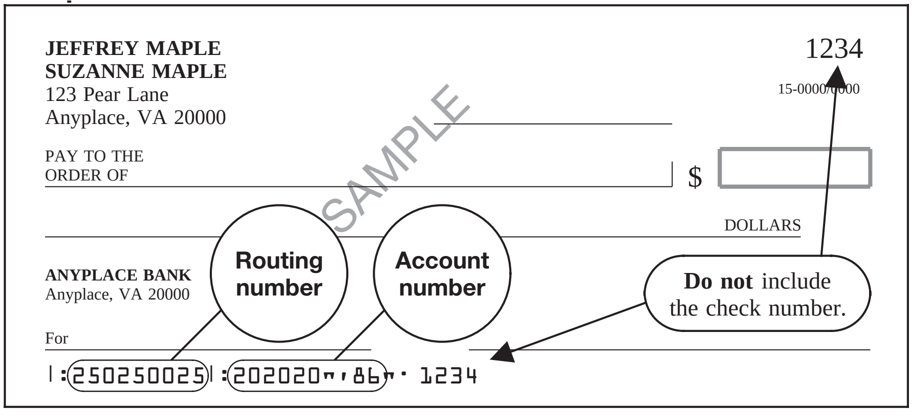
Name(s) shown on return | Your social security number

1a Amount to be deposited in first account	**1a**	
b Routing number	► **c** ☐ Checking ☐ Savings	
d Account number		
2a Amount to be deposited in second account	**2a**	
b Routing number	► **c** ☐ Checking ☐ Savings	
d Account number		
3a Amount to be deposited in third account	**3a**	
b Routing number	► **c** ☐ Checking ☐ Savings	
d Account number		
4 **Total amount to be directly deposited.** Add lines 1a, 2a, and 3a. The total must equal the amount shown on Form 1040, line 74a; Form 1040A, line 44a; Form 1040EZ, line 11a; Form 1040NR, line 72a; Form 1040NR-EZ, line 23a; Form 1040-SS, line 12a; or Form 1040-PR, line 12a	**4**	

Note: Taxpayers should check with their financial institution to make sure their direct deposit will be accepted and to get the correct routing and account number.

Exhibit 8 shows the general location of the routing and account number on a sample check. The routing number must be nine digits (the first two digits must be 01 through 12 or 21 through 32; otherwise, the direct deposit will be rejected and a check sent instead). The account number can be up to 17 characters (both numbers and letters). It can include hyphens but not spaces or special symbols. The number should be entered from left to right with any unused boxes left blank.

Exhibit 8



Tax Due

If the tax payments are less than the amount of tax liability, then there is tax due to be paid with the return. Advise the taxpayer to make the check or money order payable to the United States Treasury. Encourage a 1040 filer to voluntarily send **Form 1040-V, Payment Voucher,** with his or her payment. The instructions for completing the voucher appear on the form. The taxpayer should write his or her name, address, social security number, daytime telephone number, and "2007 Form 1040 (or Form 1040A or Form 1040EZ, whichever applies)" on the check or money order. The payment and Form 1040-V should be enclosed with, but not attached to the tax return. Taxpayers should not mail cash with their returns.

Electronic Payment Options

If the taxpayer owes an amount on his or her return, he or she can make the payment electronically. To pay by credit card, the taxpayer must use one of the service providers listed in the instructions for Form 1040, Form 1040A, or Form 1040EZ. The taxpayer can also pay by authorizing an electronic funds withdrawal out of his or her checking or savings account by April 15, 2008. The credit card option is available to taxpayers filing electronically or on paper. The electronic funds withdrawal is available only to taxpayers filing electronically.

If the taxpayer cannot pay the full amount owed shown on his or her return, the taxpayer may request to make monthly installment payments. To request an installment agreement, the taxpayer should file **Form 9465, Installment Agreement Request,** with the tax return. Form 9465 can be e-filed. A $105 fee will be assessed when the installment agreement is approved. The fee may be reduced to $48 for those with incomes below a certain level.

> **POTENTIAL PITFALLS**
>
> When figuring estimated tax, be sure to include all taxes, such as tax on lump-sum distributions and self-employment tax.

Estimated Tax Penalty. If the amount owed is $1,000 or more and it is more than 10 percent of the tax shown on the return, or if the taxpayer underpaid his or her current tax year estimated tax liability, the taxpayer may owe a penalty for underpayment of estimated tax.

The total entered on the amount you owe line should include the amount owed with the return plus the penalty reported from the estimated tax penalty line.

> **ALERT**
>
> Preparation of Form 2210 is beyond the scope of VITA/TCE.

Because **Form 2210, Underpayment of Estimated Tax by Individuals, Estates, and Trusts,** used to compute estimated tax penalty, is complicated, the IRS encourages taxpayers to let the IRS figure the penalty for them. The IRS will figure the penalty for underpayment of estimated tax and, if a penalty is owed, the taxpayer will be sent a bill. If taxpayers want the IRS to figure the penalty for them, the taxpayers should leave the penalty line on their return blank and **should not** complete Form 2210. The IRS will not charge interest on the penalty if the bill is paid by the date specified on the bill.

EXTENSIONS

Taxpayers can receive extensions of time to file their returns. Different rules apply to taxpayers who live in the United States and those who live outside the United States.

The extension does not extend the time to pay taxes. The IRS will charge interest on taxes not paid by the regular due date. The taxpayer may also be charged penalties.

Within the United States

A taxpayer living in the United States can receive an automatic 6-month extension of time to file his or her federal tax return. The taxpayer can get the automatic extension by:

1. Using IRS *e-file* (electronic filing), or
2. Filing a paper form.

E-File Options

There are two ways the taxpayer can use *e-file* to get an extension of time to file. Complete **Form 4868, Application for Automatic Extension of Time To File United States Individual Income Tax Return,** to use as a worksheet. If the taxpayer thinks he or she may owe tax when they file their return, use *Part II* of the form to estimate their balance due. If the taxpayer *e-files* Form 4868 to the IRS, do not also send a paper Form 4868.

E-file using a personal computer or a tax professional

The taxpayer can use a tax software package with a personal computer or a tax professional to file Form 4868 electronically. The taxpayer will need to provide certain information from his or her tax return for 2006. If the taxpayer wishes to make a payment by electronic funds withdrawal, see *Electronic payment options* in Publication 17.

E-file and pay by credit card

The taxpayer can get an extension by paying part or all of their estimate of tax due by using a credit card. The taxpayer can do this by phone or over the Internet. Do not file Form 4868. For more details See *Credit card,* under *How To Pay* in Chapter 1 of Publication 17.

Filing a paper Form 4868

The taxpayer can get an extension of time to file by filing a paper Form 4868. Use the address shown in the form instructions. If the taxpayer wants to make a payment with the form, advise the taxpayer to make the check or money order payable to the "United States Treasury." Advise the taxpayer to write their SSN, daytime phone number, and "2007 Form 4868" on the check or money order.

The taxpayer must request the automatic extension by the due date for their return. The taxpayer can file their return any time before the 6-month extension period ends.

When the tax return is filed be sure to enter any payment made with the request for extension on the appropriate line.

The taxpayer is not required to pay any of the tax due when submitting the form. However, the taxpayer will owe interest on any tax that is owed but not paid by the due date. Interest will be charged from the due date to the date of payment. In addition, the taxpayer may be charged a late-payment penalty if the amount of tax paid before the due date (from withheld taxes or estimated tax payments) is less than 90 percent of the actual tax owed.

For more details on penalties, refer to filing information in Publication 17.

If Form 4868 is filed late, the request for an extension will be denied. The Internal Revenue Service will inform the taxpayer if the request is denied.

Taxpayers **cannot** use the automatic extension if they:

- Choose to have the IRS figure their tax, or
- Are under a court order to file their returns by the regular due date.

Outside the United States and Puerto Rico

Taxpayers are allowed an automatic 2-month extension (until June 16, 2008, if calendar year taxpayer) to file the 2007 return and pay any federal income tax due if:

1. You are a United States citizen or resident, and
2. On the due date of your return:
   a. You are living outside 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 the taxpayer pays the tax due after the regular due date (generally, April 15), interest will be charged from that date until the date the tax is paid.

If the taxpayer served in a combat zone or qualified hazardous duty area, they may be eligible for a longer extension of time to file. For more information refer to *Individuals Serving in Combat Zone* in Publication 17, Chapter 1.

Note: Traveling outside the United States and Puerto Rico on the due date does not qualify the taxpayer for an automatic 2-month extension.

Taxpayers using this automatic extension must attach a statement to their return stating that they were living outside the United States and Puerto Rico on the due date and that their main place of business or their assigned tour of duty is outside the United States and Puerto Rico.

Joint Returns. For married persons who file jointly, only one spouse needs to meet the requirements to take advantage of the automatic extension to June 15. (For 2007 tax year the extended due date is June 16, 2008, since the 15th falls on a Sunday.)

Separate Returns. For married persons who file separately, only the spouse who meets the requirements qualifies for the automatic extension. If both spouses meet the requirements, each may take advantage of the extension.

Extensions beyond 2 months. If the taxpayers cannot file their return within the automatic 2-month extension period, they may be able to get an additional 4-month extension, for a total of 6 months. Advise the taxpayer to file Form 4868 and check the box on line 8.

This additional 4-month extension of time to file is not a further extension of time to pay. The taxpayer can use a credit card to pay the estimate of tax due. For details see *How To Pay*, Chapter 1, Publication 17.

No further extension. An extension of more than 6 months will generally not be granted. However, if the taxpayer is outside the United States and meets certain tests, they may be granted a longer extension. For more information, see *Further extensions* under *When To File and Pay* in Publication 54.

FIGURING ESTIMATED TAX FOR NEXT YEAR

Estimated tax is the amount a taxpayer expects to owe for the year after deducting any tax credits or federal income tax withheld. In other words, it is the amount the taxpayer anticipates will be owed on his or her **2008** federal income tax return.

If a taxpayer is an employee, the taxpayer's employer generally must withhold income, Medicare, and social security taxes on the wages paid. In addition, most payers of taxable pensions withhold income tax on the pension income. However, a taxpayer may receive many types of taxable income that are not subject to having tax withheld.

A taxpayer who receives interest, dividends, alimony, unemployment compensation, rent, or gains from the sale of assets, prizes, or awards generally will have no income tax withheld on the payments. As a result, the taxpayer may find that he or she owes estimated tax. Most self-employed taxpayers will also find they are required to pay estimated tax.

Who Must Pay Estimated Tax

Estimated tax payments are required if certain conditions are met. Generally, a taxpayer must make payments of estimated tax if:

1. He or she expects to owe $1,000 or more in tax for 2008 after subtracting federal income tax withheld and credits from taxable income; and
2. He or she expects the 2008 tax withheld and credits to be less than the smaller of:
   - **a.** 90 percent of the tax to be shown on his or her 2008 tax return; or
   - **b.** 100 percent of the tax shown on his or her 2007 tax return. The return must cover all 12 months.

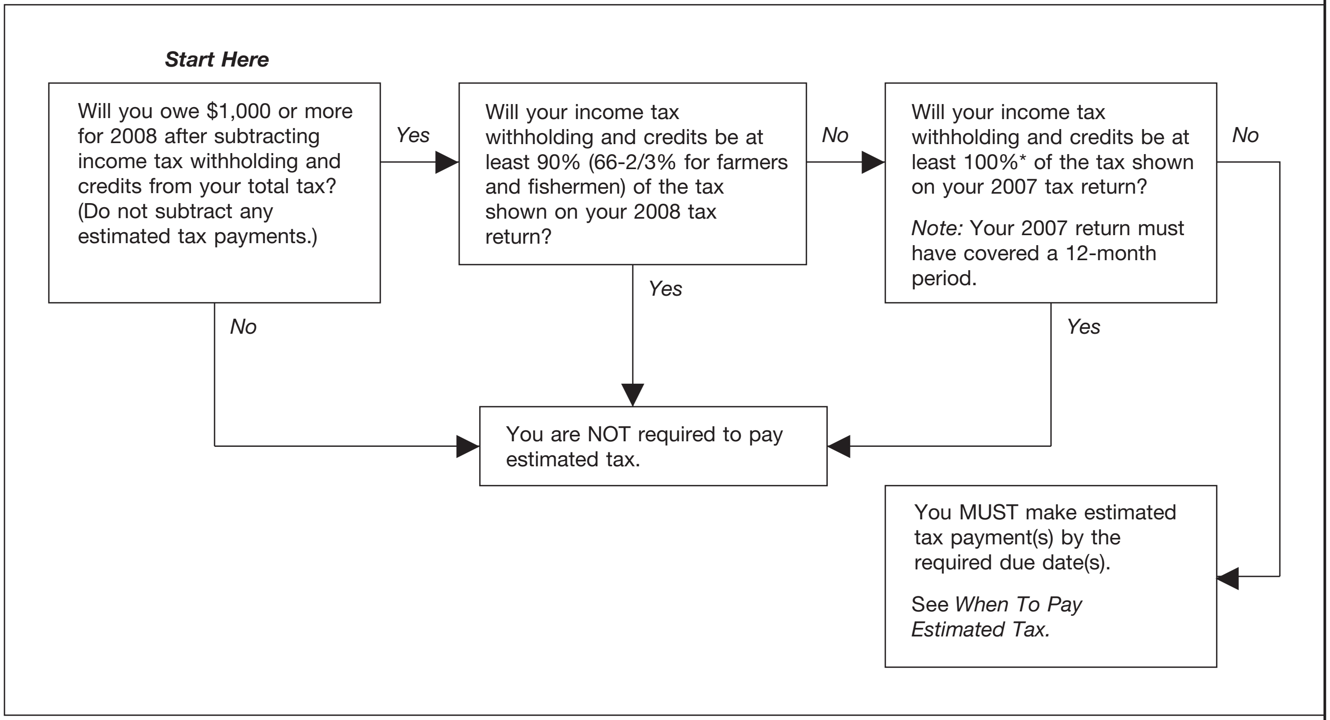
Married taxpayers can pay estimated tax either separately or jointly. How they pay their estimated tax will not affect their choice of filing a joint return or separate returns for the year. Joint estimated tax payments may be divided between the spouses if they later choose to file separate returns. Exhibit 9 illustrates if a taxpayer has to pay estimated taxes.

ALERT

If the taxpayer's adjusted gross income for 2007 was more than $150,000 ($75,000 if the taxpayer's filing status for 2008 is married filing separately) substitute 110% for 100% in item 2(b). This rule does not apply to farmers or fishermen. For more information refer to Publication 505, Tax Withholding and Estimated Tax.

Exhibit 9

Do You Have To Pay Estimated Tax?



* 110% if less than two-thirds of your gross income for 2007 and 2008 is from farming or fishing and your 2007 adjusted gross income was more than $150,000 ($75,000 if your filing status for 2008 is married filing a separate return).

Example 4

Jayne is single and retired. She works part time as an usher in a movie theater. She estimates her 2008 income will be $26,421, which includes $3,500 of interest income from which there will be no tax withheld. Jayne calculates that she expects to owe $1,008 (after taking into account her expected tax withheld and credits). Jayne meets condition 1 (mentioned earlier) and may have to pay estimated tax. Further checking tells Jayne that her expected 2008 tax withheld will be less than 100 percent of the tax shown on her 2007 return and less than 90 percent of the tax she will show on her 2008 tax return. Since Jayne also meets condition 2 (mentioned earlier), she is required to pay estimated tax.

> **POTENTIAL PITFALLS**
>
> Advise the taxpayer to use the pre-addressed envelopes that came with his or her Form 1040-ES package, or mail payment vouchers to the address shown in Form 1040-ES Instructions for the place where he or she lives. Do not use the address shown in Form 1040 or Form 1040A instructions.

How to Figure Estimated Tax

Form 1040-ES, Estimated Tax for Individuals includes a worksheet, instructions, and payment vouchers to make estimated payments. The taxpayer should keep the worksheet for his or her records.

To figure the estimated tax, the taxpayer must first figure his or her expected adjusted gross income, taxable income, taxes, and credits for 2008. All available facts that will affect those items during the year must be taken into account. Use the 2007 tax return as a starting point for estimating 2008 income, deductions, and credits. However, be careful to make adjustments both for anticipated changes in the taxpayer's situation and for recent changes in the tax law.

Form 1040-ES contains both the 2008 tax rate schedules and the 2008 standard deduction and exemption amounts. Be sure to use the 2008 figures when figuring the estimated tax.

When to Pay Estimated Tax

For estimated tax purposes, the year is divided into four payment periods. Each period has a specific due date. See Exhibit 10 to help determine when to pay estimated taxes.

Exhibit 10

For the period:	Due date:
Jan. 1* through Mar. 31	Apr. 15
April 1 through May 31	June 15
June 1 through Aug. 31	Sept. 15
Sept. 1 through Dec. 31	Jan. 15 next year**

*If your tax year does not begin on January 1, see the Form 1040-ES instructions.
**See January payment, later.

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 Sept. 15 Jan. 15 next year*
After Mar. 31 and before June 1	June 15	Sept. 15 Jan. 15 next year*
After May 31 and before Sept. 1	Sept. 15	Jan. 15 next year*
After Aug. 31	Jan. 15 next year*	(None)

*See January payment, and Saturday, Sunday, holoday rule under When To Pay Estimated Tax, earlier.

ALERT

If the taxpayer has a balance due, advise the taxpayer to carefully review estimated tax and withholding options using Form 1040-ES or Form W-4.

Most of the taxpayers that you assist will pay their estimated tax in four equal installments. However, a taxpayer does not have to make estimated tax payments until he or she has income on which tax is owed. The minimum payment due for the first period when the income is received between January 1 and March 31 is one-fourth of the total estimated payment for the year. If additional income is received after the first period, use Form 1040-ES to figure out the amount of tax due for each remaining period. If a taxpayer receives income after one or more of the payment periods have passed, he or she will begin making payments during the period when the income is received.

The taxpayer also has the option of paying all the estimated tax at once. Instead of paying by installments, he or she may choose to pay the entire amount by the due date of the period during which the income is received.

Some taxpayers choose to pay all of their estimated tax with the first payment, April 15, 2008. It alleviates the need for them to remember to make the remaining payments.

ALERT

The IRS withholding calculator at www.irs.gov is an excellent tool to use or recommend to the taxpayers to compute the correct withholding allowances.

Also, a taxpayer can apply all or part of an overpayment from his or her current tax year Form 1040 or Form 1040A to the estimated tax for the next tax year. The overpayment amount to be credited is entered on **the amount you want applied to your next year's estimated tax** line. All of the credit can be applied to the first payment, or it can be spread out among any or all of the payments.

If any due date falls on a Saturday, Sunday, or legal holiday, the payment is due on the next business day.

If a taxpayer files his or her 2008 Form 1040, Form 1040A or Form 1040EZ by February 2, 2009, and pays the entire amount of tax owed at that time, he or she is not required to make the estimated tax payment that would be due on January 15, 2009.

How Much Estimated Tax to Pay

The computed estimated tax is based on expected income and deductions and should take into account all facts known at the time the estimate is made. If the taxpayer is unsure about the accuracy of the estimate, he or she may want to pay more than the required minimum 90 percent of the 2008 estimated tax. Taxpayers who do not pay enough tax by the due date of each payment period may be charged a penalty, even if the filed 2008 return shows a refund. Generally, the simplest and safest procedure is to make sure that the total of tax withheld plus the amount of estimated tax for each payment period during 2008 is at least one-fourth of the tax shown on the 2007 return. For more information, see Publication 505.

How to Pay Estimated Tax

There are four options available to taxpayers to make their estimated tax payments:

1. Taxpayers can pay by check or money order using the estimated tax payment voucher from Form 1040-ES. The due date is noted on each voucher. Be sure to use the correct voucher for each payment.
2. Estimated tax payments can be sent electronically to the IRS through the Electronic Federal Tax Payment System (EFTPS). To use EFTPS, a taxpayer must enroll. Specific information about this option is available online at www.eftps.gov.
3. Taxpayers can also pay their estimated payments by using their American Express Card, Discover Card, MasterCard, or Visa Card. There are two service providers available. More information about this option is available on Form 1040-ES.

4. Taxpayers can authorize an electronic funds withdrawal to make up to four 2008 estimated tax payments, respectively: April 15, 2008; June 16, 2008; September 15, 2008; and January 15, 2009, when they electronically file their 2007 tax return.

If the taxpayer paid estimated tax in 2007, he or she should have received a Form 1040-ES package containing preprinted vouchers. These vouchers show the taxpayer's preprinted name, address, and social security number. To use them, enter the amount of the payment on the appropriate line. If a taxpayer does not have the preprinted forms, use a set of blank vouchers from Form 1040-ES and enter the information on the appropriate lines. Advise the taxpayer to write his or her social security number and "2008 Form 1040-ES" on the check or money order (payable to the United States Treasury) when paying estimated tax.

Form W-4 and Form W-4P

An employer withholds tax based on wages paid and information the employee provides on **Form W-4, Employee's Withholding Allowance Certificate.** The employee uses his or her expected income, deductions, adjustments to income, and credits to figure the total withholding allowances to claim on Form W-4. In addition, an employee can claim extra allowances in certain situations.

A taxpayer who receives distributions from a pension, an annuity, an IRA, a stock bonus plan, or certain deferred compensation plans should use **Form W-4P, Withholding Certificate for Pension or Annuity Payments,** to notify the payer whether, and how much, income tax should be withheld.

Income, deductions, and credits should be estimated carefully. Taxpayers who do not have enough federal income tax withheld can be subject to interest and penalties. Taxpayers who have a large refund or who owe additional taxes should consider adjusting their withholding.

Some taxpayers want their withholding to be high enough to ensure that they receive a tax refund. They do not want to pay an additional amount when filing their tax return. If a taxpayer wishes, it is legal to claim fewer allowances than he or she is allowed. More tax than required will be withheld each pay period and, at the end of the year, the taxpayer should be eligible for a refund of overpaid taxes.

Form W-4 and Form W-4P also contain:

- Instructions
- Personal allowances worksheet
- Deductions and adjustments worksheet
- Two-earner/two-job, multiple pension/more than one income worksheets
- Tables

The worksheets incorporate the number of allowances, adjustments, deductions, and credits that the employee expects on his or her 2008 income tax return. Some or all of these additional worksheets will then be used by the employee in completing the allowance certificate.

If an employee has a working spouse or income from two jobs, only one set of Form W-4 worksheets should be completed. Complete the Form W-4 worksheets using the combined expected income (from all sources and for both spouses if filing a joint return), adjustments, deductions, and exemptions. The number of total allowances from this Form W-4 can then be divided among all jobs. Withholding will usually be the most accurate when an employee claims zero allowances on all jobs except for the highest paying one.

Reminder: A separate Form W-4 is needed for each job.

Certain events can occur during the year that can change an employee's marital status, exemptions, allowances, deductions, or credits. When this happens, the employee may have to change his or her withholding allowances by submitting a new Form W-4 to the employer. The original Form W-4 remains in effect until the employee changes it.

For more information on withholding, refer to **Publication 919, How Do I Adjust My Tax Withholding?**

Form W-5, Advance Earned Income Credit (AEIC)

At this time, you as the preparer have the opportunity and the means to assist the taxpayer with **Form W-5, Earned Income Credit Advance Payment Certificate.** The amount of the AEIC payments is based on wages by payroll cycle. Only persons with at least one qualifying child can get AEIC payments. If the taxpayer qualifies for the Earned Income Credit for 2007, refer him or her to **Publication 596, Earned Income Credit,** or Form W-5 for additional information.

Completing and Assembling the Return

After all the decisions have been made regarding payments, overpayments, and estimated taxes, you should complete the taxpayer identification section, assemble the return, and submit it for quality review. Although self-review is an acceptable review process, it is recommended that a different pair of eyes review the tax return with the taxpayer, the intake and interview document(s), the source documents, and the standardized review document. The taxpayer should be involved to ensure that the tax law was correctly applied based on the interview and source documents. When the review is completed, have the taxpayer sign the return, and provide instructions on where and when to send it to the IRS if a paper return is filed. If the return is being e-filed, use either the Practitioner PIN or Self-Select PIN method for the electronic signature.

Use the steps below for completing and assembling the return.

Taxpayer Identification Section

If a taxpayer received a tax package a pre-addressed label is enclosed.

For Paper Returns

Peel off the label and place it in the address area of the return. Mark through any errors on the label, and print the correct information on the label. Be sure to enter the social security number(s) or Individual Taxpayer Identification Number (ITIN) to the right of the label area.

If a taxpayer did not receive a forms package or does not have a pre-addressed label, PRINT the required information. Enter the taxpayer's name and social security number (or ITIN) on the first line. If married taxpayers are filing a joint return, enter one spouse's complete name and social security number (or ITIN) on the first line and the other spouse's complete name and social security number (or ITIN) on the second line. Be sure that each taxpayer's name and social security number (or ITIN) appear on one line, separate from the spouse's information. If you enter the husband's name and the wife's social security number (or ITIN) on the same line, there can be a considerable delay in processing the return.

Enter the address where any refund or notices should be sent. If the post office delivers mail to a post office box rather than to a street address, enter the post office box number on the line for the home address.

The Presidential Election Campaign Fund appears in the name and address area of Form 1040EZ, Form 1040A, or Form 1040. Check the box if the taxpayer wishes to have $3 go to the Presidential Election Campaign Fund. Checking the box will not change the tax or reduce the refund. On a joint return, each taxpayer chooses whether or not $3 should go to the fund.

POTENTIAL PITFALLS ⚠

Using the pre-addressed label reduces processing time. However, to protect the taxpayer's privacy, the peel-off label that he or she received in the mail with the tax return booklet does not have his or her SSN (or that of his or her spouse, if filing a joint return) printed on it. Therefore, be sure the taxpayer's SSN (and spouse's, if applicable) is entered in the space provided on the tax form (1040, 1040A, 1040EZ).

Further, if the taxpayer filed a joint return for 2006 and is filing a joint return for 2007 with the same spouse, be sure the taxpayer's and spouse's names and SSNs are entered in the same order as on the 2006 tax return.

Assembling the Return

Make sure that all forms, schedules, and attachments show the taxpayer's name and social security number. List the names in the same order that they appear on the front of the return and use the first social security number (or ITIN) that appears on the front of the return.

Attach forms and schedules behind Form 1040 according to the attachment sequence number shown in the upper right corner of the form or schedule. Items without an attachment sequence number should be placed at the end. For Form 1040A, attach any forms or schedules in order by number with Schedule EIC last.

Attach Form(s) W-2 to the left margin of the return. When any Form 1099 shows federal income tax withheld, attach a copy of Form 1099 to the return, along with any Form(s) W-2.

IDENTIFYING RETURNS

- If taxpayers ask about the site identification number designation at the bottom of the return in the paid preparer's section, explain that this is entered for statistical purposes. Inform the taxpayers that the site identification number does not affect the likelihood of an IRS examination (audit) of the return.
- If you prepare over 50 percent of the tax return and you are reasonably sure that the return will be filed as you prepared it, enter the site identification number at the bottom of the return in the paid preparer section in the PTIN/SSN field.
- Most sites will have forms preprinted with the site identification number format entered in the paid preparer section of the return.
- If you do not have forms with the preprinted site identification number format, print the appropriate site identification number for that site in the paid preparer section of the return.
- The e-file administrator will set up computers to default to the SIDN in the paid preparer section of the return. (e-file administrators should refer to **Publication 3189, e-file Administrator Guide,** for detailed instructions.)

ALERT ⚠

It is critical for you to enter the correct site identification number in the paid preparer's signature section of the return. The number goes in the designated area on the forms with the preprinted "S" followed by 8 digits or in the PTIN/SSN field of the return.

SITE IDENTIFICATION NUMBER

The IRS will capture statistical information using the Individual Master File (IMF) report and the Electronic Tax Administration (ETA) report. The IMF report is extracted based on the site identification number.

The following procedures must be used when returns are prepared at a VITA or TCE site:

- The site identification number should be entered in the paid preparer section of the return. (See Exhibit 11.)

1. Paper Returns

- All sites will enter the letter "S" followed by an 8-digit site identification number that is provided by the territory office. Sites should use the overprint form with the bold S format indicated in the paid preparer section. Each of the numbers represents a certain area determined by the territory office. For instance, the fourth digit of the number will be 1 for VITA, 2 for Military VITA, 3 for Co-located Site, 4 for TCE, and 5 for AARP.

- If you use a return without the bold S format for the number, enter the assigned number including the "S" in the space provided in the paid preparer section of the return. Form 1040EZ, Form 1040A, and Form 1040 with the bold "S" format are available from the IRS and will be ordered by each site coordinator.

2. Electronically Filed Returns

- E-file administrators will set up computers to default to the proper location on the return where the number will already be entered. Ensure the default number has been entered for the site you are working.

Exhibit 11 illustrates a site identification number in the paid preparer's section of Form 1040EZ.

> **ALERT**
> When using computer software, enter the SIDN without hyphens or dashes.

Exhibit 11 Site Identification Number **Form 1040 Series**

Paid preparer's use only	Preparer's signature	Date	Check if self-employed ☐	Preparer's SSN or PTIN **S10-05-1234**
	Firm's name (or yours if self-employed), address, and ZIP code		EIN	
			Phone no.	( )

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see page 22. Cat. No. 11329W Form **1040EZ** (2007)

Site Identification Number

QUALITY SERVICE

The goal of the TCE and VITA programs is to provide high-quality service.

On-Site Quality Review Program

Accuracy and quality of return preparation have always been important aspects of the VITA/TCE programs. The purpose of the quality return review process is to ensure that every return is accurate. A return is considered accurate when the tax law is correctly applied based on the taxpayer interview and all supporting documentation. The goal is to complete a tax return free from error.

Every return prepared at a VITA or TCE site must be quality reviewed using a Form 8158 or approved alternate. 100 percent with no exceptions, using designated, peer or self review. Every return must be checked for accuracy and completeness.

This quality review is in addition to any and all diagnostics reviews available in TaxWise® or other software programs used.

Achieving widespread adherence to accuracy and quality of return preparation demands a consistent and detailed process. Every site must have a quality review process that includes the following quality initiatives:

- **Pre-tax preparation** includes Volunteer Certification and Standards of Conduct as covered earlier in the Introduction and Administrative Guidelines lesson.
- **Tax preparation** includes Form 13614, *Intake and Interview Sheet,* an approved alternative form, or software worksheets containing the same information, and a probing, comprehensive interview.
- **Quality review (QR)** includes interaction with the customer and volunteer.

  Use **Form 8158, Quality Review Sheet** (Exhibit 12), or your site's approved alternative form to review all returns prepared. Apply the quality review tools in combination with the Interview and Intake Sheet mentioned above and all the source documents to the returns you prepare to ensure quality and accuracy for every taxpayer.

  Consider each item on the Quality Review Sheet that applies to the taxpayer's situation to confirm that all the necessary questions and issues have been addressed. If items are incorrect or incomplete, revisit the issue and make corrections to the return, as needed.

Volunteer Quality Alerts (VQA) are considered to be an excellent tool used to provide volunteers with educational messages on tax law subject matters that are updated, corrected, or more clearly defined. Contact your site coordinator if you are not receiving Volunteer Quality Alerts in a timely manner.

Exhibit 12

Form **8158 (EN/SP)** (Rev. July 2007)	Department of the Treasury – **Internal Revenue Service** **Quality Review Sheet**	

Instructions: This form is to be completed by certified volunteers responsible for reviewing the accuracy of the taxpayer's return **prior to obtaining the taxpayers' signature**. The taxpayer should be involved in the Quality Review process. The reviewer should compare the return with the Intake and Interview Sheet and all available supporting documents. **Supporting documents include** Forms W-2 and 1099, taxpayer's banking information for direct deposit or debit, taxpayer proof of identity, prior year return, etc. When performing a Quality Review, if you are unsure or it is not clear whether the return is accurate (based on available information) you should notify the Site Coordinator.

Yes	No	**CERTIFIED QUALITY REVIEWER** Check each item as you verify that the review step is complete.
		Intake sheet was fully completed and used to prepare this tax return. **Note:** If an intake & interview sheet was not used or was not fully completed, ask the volunteer to fully complete the intake sheet with the taxpayer prior to the Quality Review process.
		Names and social security numbers (SSN) or individual taxpayer identification numbers (ITIN) on the return match the intake sheet and supporting documents.
		Taxpayer's **address** on the return matches the intake sheet.
		Filing status on the return was determined based on the interview with the taxpayer and the intake and interview sheet.
		Dependency exemptions on the return were determined based on the interview with the taxpayer and the intake and interview sheet.
		All **income** indicated on the intake/interview sheet, taxpayer's interview and/or supporting documents are included on the return.
		All **adjustments, deductions and credits** indicated on the intake/interview sheet and supporting documents are included on the return.
		All **withholding** and/or estimated tax payment information provided or shown on the supporting documents have been included on the return.
		Direct deposit or Debit information on the return matches the customer's checking/saving routing/account information.
		If return was software generated, all **overridden entries** have been verified.
		Site Identification Number (SIDN) is correct and entered on the return.

Quality Review Results

Check one:

☐ Ready for taxpayer's signature(s)

☐ Errors found, corrections needed.

Comments/Errors:

Catalog Number 61027D | Form **8158 (EN/SP)** (Rev. 7-2007)

Other IRS Quality Initiatives

IRS representatives may visit volunteer tax preparation sites to assist with any site coordination issues. The goal is to work closely with volunteers and site coordinators to help ensure the best customer service possible. Listed below is a brief description of the types of visits/reviews that will take place.

- **Form 6729, Site Review.** The site review is conducted by an IRS SPEC relationship manager and is pre-scheduled with the site coordinator to help determine adherence to standard operating procedures and guidelines as outlined in Publications 1084 and 3189.
- **Form 6729B, Shopping Review.** A limited number of shopping reviews will be conducted by a neutral party to measure the accuracy of return preparation provided by volunteers.
- **Form 6729C, Return Review.** While conducting the site review, the same relationship manager will review completed returns and cross check them against corresponding intake sheets to help determine the accuracy of return preparation. Return reviews are not designed to involve the taxpayer(s), so it is essential that an intake sheet has been completed and retained. In all cases, this review should be conducted before the taxpayer leaves the site. If errors are identified, the return must not be filed until corrected.

With quality tools and processes in place, volunteers can more effectively ensure that they have all the facts and information to accurately prepare the returns. Accuracy and quality of return preparation are the cornerstones of the VITA/TCE programs.

Signature Section

Make sure the taxpayer signs and dates the return before mailing. An unsigned return cannot be processed and may be sent back to the taxpayer. On a joint return, both spouses must sign, even if only one spouse had income. Also, make sure the occupation(s) of the taxpayer (or of both spouses, if married filing jointly) are entered.

> **ALERT**
>
> Publication 4012, *Volunteer Resource Guide,* contains a section entitled Return Signature to assist you with completing the tax return.

Decedents

If a taxpayer died before filing a return for 2007, the taxpayer's spouse or personal representative may have to file and sign a return for that taxpayer. A personal representative can be an executor, administrator, or anyone who is in charge of the deceased taxpayer's property. If the deceased taxpayer did not have to file a return but had tax withheld, a return must be filed to get a refund. The person who files the return should enter "DECEASED," the deceased taxpayer's name, and the date of death across the top of the return.

If the taxpayer's spouse died in 2007, and the taxpayer did not remarry in 2007, the taxpayer can file a joint return. (The taxpayer can also file a joint return if his or her spouse dies in 2008, before filing a 2007 return.) A joint return should show the taxpayer's spouse's 2007 income before death and the taxpayer's income for all of 2007. The taxpayer should enter "Filing as surviving spouse" in the area where the taxpayer signs the return. If someone else is the personal representative, he or she must also sign.

The surviving spouse or personal representative should promptly notify all payers of income, including financial institutions, of the taxpayer's death. This will ensure the proper reporting of income earned by the taxpayer's estate or heirs. A deceased taxpayer's social security number should not be used for tax years after the year of death, except for estate tax return purposes.

Third-Party Designee

If the taxpayer wants to allow a friend, family member, or any other person he or she chooses to discuss his or her 2007 tax return with the IRS, the taxpayer should check the "Yes" box in the third-party designee area of the return. Also, the taxpayer should enter the designee's name, phone number, and any five numbers the designee chooses as his or her personal identification number (PIN).

If the taxpayer checks the "Yes" box, he or she, and his or her spouse if filing a joint return, is authorizing the IRS to call the designee to answer any questions that may arise during the processing of the return. The taxpayer is also authorizing the designee to:

- Give the IRS any information that is missing from the return,
- Call the IRS for information about the processing of the return or the status of the taxpayer's refund or payment(s), and
- Respond to certain IRS notices that the taxpayer has shared with the designee about math errors, offsets, and return preparation. The notices will not be sent to the designee.

The taxpayer is not authorizing the designee to receive any refund check, bind the taxpayer to anything (including any additional tax liability), or otherwise represent the taxpayer before the IRS. If the taxpayer wants to expand the designee's authorization, he or she should see **Publication 947, Practice Before the IRS and Power of Attorney.**

The authorization cannot be revoked. However, the authorization will automatically end no later than the due date (without regard to extensions) for filing the taxpayer's 2008 tax return. This is April 15, 2009, for most people.

As a volunteer preparer, you may not be designated as a third-party designee.

Information to Provide Customers Prior to Their Departure from Sites

As a volunteer, it is your job to ensure that the taxpayer leaves the site with all the information he or she needs. You should answer any questions that the taxpayer has and advise him or her that a copy of the return is not kept at the site.

Here are some suggested items to give your customers:

1. Copy of the return with attachments and a reminder to bring them to the site next year
2. **Publication 730, Important Tax Records,** envelope
3. All documents given to the volunteer to prepare the return, including social security cards and photo identification
4. If the return is e-filed:
   - Information on direct deposit vs. paper check
   - Explanation of the e-file process
   - Explanation that nothing needs mailing
5. If a paper return is filed:
   - Signed return (with attached Form W-2 and Form 1099 if any withholding) for mailing, for federal and state or knowledge of where to sign
   - Envelope or address to mail return
6. Contact information if the taxpayer has problems with the return
7. If a refund is expected:
   - Expected receipt date according to the refund cycle chart if the return was e-filed
   - Contacts if the refund is not received (www.irs.gov; 1-800-829-1954; 1-800-829-4477)
   - Form W-4 information if the refund is too high and it is not related to EIC
8. If a balance is due:
   - Form 1040V Payment Voucher if the tax return is e-filed or if the client chooses to mail in the return
   - Address to send the voucher
   - Information to show on the check: payable to United States Treasury; SSN, daytime telephone number, tax year, and form number (1040, 1040EZ, 1040A)
   - Payment options: Refer to Publication 4012 or Publication 17
   - W-4 information if the balance due is caused by not having enough tax withheld
   - Information on estimated payments if the balance is not due to withholding
   - If applicable, advise taxpayer they may be subject to an estimated tax penalty and IRS will send a notice.
9. Information regarding how long to keep records and what to retain
10. If the return is e-filed: **Inform all taxpayers who e-file their return,** that they will not receive a tax package in the mail the following year. Forms and publications may be ordered by calling the IRS forms number at 1-800-829-3676 or accessed via the Internet at: www.irs.gov/formspubs.

Exercise 1

A. Helen paid $500 in estimated tax to the U.S. Treasury. Where is this reported on Form 1040A? ______________________________

____

B. Shirley paid $200 in April 2007, the amount owed on her 2006 income tax return. Is this $200 in 2007 an estimated tax payment for this year's income tax return? __________________

C. Elmer wants his refund deposited in his checking account. What information should you enter in the routing number space?

____

D. Jennifer had tax withheld from her wages on Form W-2. She also had some withholding on her Form 1099-R. Can these items be combined and listed on one line on her tax return?

____

Exercise 2

Look at the completed Form 1040EZ shown in Exhibit 13 and identify at least 3 areas that have not been properly completed.

Exhibit 13

Form **1040EZ**

Department of the Treasury—Internal Revenue Service

Income Tax Return for Single and Joint Filers With No Dependents (99) 2007

OMB No. 1545-0074

Label

(See page 11.)
Use the IRS label. Otherwise, please print or type.

LABEL HERE

Your first name and initial	Last name	Your social security number
Jorge	Mendez	XXX XX XXXX
If a joint return, spouse's first name and initial	Last name	Spouse's social security number
Lucinda	Mendez	

Home address (number and street). If you have a P.O. box, see page 11. Apt. no.
10490 Main Street

City, town or post office, state, and ZIP code. If you have a foreign address, see page 11.
Anywhere USA 99999

▲ You **must** enter your SSN(s) above. ▲

Presidential Election Campaign (page 11)

Checking a box below will not change your tax or refund.

Check here if you, or your spouse if a joint return, want $3 to go to this fund . . . . ▶ ☑ You ☑ Spouse

Income

Attach Form(s) W-2 here.

Enclose, but do not attach, any payment.

1	Wages, salaries, and tips. This should be shown in box 1 of your Form(s) W-2. Attach your Form(s) W-2.	1	14,900	00
2	Taxable interest. If the total is over $1,500, you cannot use Form 1040EZ.	2	2	00
3	Unemployment compensation and Alaska Permanent Fund dividends (see page 13).	3		
4	Add lines 1, 2, and 3. This is your **adjusted gross income.**	4		
5	If someone can claim you (or your spouse if a joint return) as a dependent, check the applicable box(es) below and enter the amount from the worksheet on back. ☐ You ☐ Spouse If no one can claim you (or your spouse if a joint return), enter $8,750 if **single;** $17,500 if **married filing jointly.** See back for explanation.	5		
6	Subtract line 5 from line 4. If line 5 is larger than line 4, enter -0-. This is your **taxable income.** ▶	6	14,900	00

Payments and tax

7	Federal income tax withheld from box 2 of your Form(s) W-2.	7	1,700	00
8a	**Earned income credit (EIC).**	8a		
b	Nontaxable combat pay election. 8b			
9	Add lines 7 and 8a. These are your **total payments.** ▶	9	1,700	00
10	**Tax.** Use the amount on **line 6 above** to find your tax in the tax table on pages 24–32 of the booklet. Then, enter the tax from the table on this line.	10	1,490	00

Refund

Have it directly deposited! See page 18 and fill in 11b, 11c, and 11d or Form 8888.

11a	If line 9 is larger than line 10, subtract line 10 from line 9. This is your **refund.** If Form 8888 is attached, check here ▶ ☐	11a	2	00

▶ **b** Routing number ▶ **c** Type: ☐ Checking ☐ Savings

▶ **d** Account number

Amount you owe

12	If line 10 is larger than line 9, subtract line 9 from line 10. This is the **amount you owe.** For details on how to pay, see page 19. ▶	12	

Third party designee

Do you want to allow another person to discuss this return with the IRS (see page 20)? ☐ **Yes.** Complete the following. ☐ **No**

Designee's name ▶ Phone no. ▶ ( ) Personal identification number (PIN) ▶

Sign here

Joint return? See page 11.

Keep a copy for your records.

Under penalties of perjury, I declare that I have examined this return, and to the best of my knowledge and belief, it is true, correct, and accurately lists all amounts and sources of income I received during the tax year. Declaration of preparer (other than the taxpayer) is based on all information of which the preparer has any knowledge.

Your signature	Date	Your occupation	Daytime phone number ( )
Spouse's signature. If a joint return, **both** must sign.	Date	Spouse's occupation	

Paid preparer's use only

Preparer's signature	Date	Check if self-employed ☐	Preparer's SSN or PTIN
Firm's name (or yours if self-employed), address, and ZIP code		EIN	
		Phone no. ( )	

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see page 22. Cat. No. 11329W Form **1040EZ** (2007)

▶▶ Summing Up This Lesson ◀◀

The information for the payment section of the return comes from these sources:

- Federal income tax withheld by the employer
- Form 1099
- Estimated tax payments paid by the taxpayer (cannot be reported on Form 1040EZ), and/or
- Refundable credits

If the amount owed is $1,000 or more, the taxpayer may have to pay an estimated tax penalty. If there is an overpayment, the taxpayer can take one of the following courses of action:

- Receive a complete refund
- Apply the overpayment to the next year's estimated tax, or
- Receive a partial refund and apply the remainder of the overpayment to the next year's estimated tax.

Estimated tax payments must be made if a taxpayer:

- Expects to owe $1,000 or more in tax for 2008 after subtracting income tax withheld and credits, and
- Expects his or her 2008 tax withheld and credits to be less than the smaller of: 90 percent of the tax to be shown on his or her 2008 tax return or, generally, 100 percent of the tax shown on his or her 2007 tax return.

Withholding allowances for employees are reported on Form W-4. Allowances for pension or annuity recipients are reported on Form W-4P. They are figured by taking into account:

- Expected income
- Deductions
- Credits
- Adjustments to income

▶▶ SUMMING UP THIS LESSON ◀◀
(CONTINUED)

To finish the return:

- ▶ Consider the taxpayer's possible eligibility for advance earned income credit.
- ▶ Complete the taxpayer's identification section after you have finished the rest of the return.
- ▶ Enter the site identification number in the paid preparer's section.
- ▶ Assemble the return correctly, attaching any Form(s) W-2 and Forms 1099 showing federal income tax withholding.
- ▶ Check each return for completeness and accuracy.
- ▶ Submit each return for on-site quality review.
- ▶ Have the taxpayer(s) sign and date the return if a paper return is prepared.

Lesson 14

Finishing the Return— Final Steps

Answers to Exercises

Exercise 1

A. Estimated tax payments and amount applied from prior year return

B. No

C. The routing number for his bank account

D. Yes

Exercise 2

- Wife's SSN is missing.
- Husband's signature is missing.
- Spouse's signature is missing.
- The Site Identification Number is missing in the preparer's SSN/PTIN section of the form.
- The adjusted gross income line is blank.
- The line for determining if someone else can claim you or your spouse as a dependent is blank.
- The tax is entered incorrectly.
- The refund amount is incorrect.
- Occupations are missing.

Military/International students continue.

All others complete problem and exercises in Publication 678-W.

FINISHING AND FILING THE RETURN

Lesson 14
Military Segment

INTRODUCTION AND OBJECTIVES

General rules for filing returns may be found in the basic segment of this lesson. This segment addresses special concerns of members of the Armed Forces and includes information for combat zone participants.

At the end of this lesson, you should be able to:

- Determine where and when to file a federal tax return.
- Determine who qualifies for an extension of deadline.
- Identify special tax benefits that are available to persons who die in a combat zone or from a terrorist or military action.
- Explain how to file claims for tax forgiveness for these individuals.

TAXPAYER IDENTIFICATION

A member of the Armed Forces should include his or her name, social security number, and permanent home address on his or her return. A member who is due a refund and does not want it mailed to his or her permanent home address should enter a current address on the return. If the postal service does not deliver to the member's street address and the member has a post office box, he or she should enter the post office box number on the line for the present home address. A military person living overseas should use an APO or FPO address.

CHANGE OF ADDRESS

If a taxpayer changes his or her mailing address during the year, the taxpayer should notify the Internal Revenue Service of the change on **Form 8822, Change of Address.** Form 8822 should be mailed to the Internal Revenue Service Center where his or her returns were previously filed. Addresses for the service centers are listed on the back of the form.

WHERE TO FILE

Taxpayers should send their federal returns to the campus for the place where they reside. For example, Sergeant Keene, who is stationed in Maine but whose permanent home address is in California, should send her federal return to the campus in Maine. The tax form instructions give the addresses for the campuses, including the Philadelphia Campus for APO and FPO addresses.

When to File

Most individual tax returns cover a calendar year, January through December. Taxpayers who live in the United States or Puerto Rico and who use the calendar-year period should file their individual tax returns by April 15 of the following year. If April 15 falls on a Saturday, Sunday, or legal holiday, the due date is the next business day. (For 2007 tax returns, the due date is April 15, 2008.)

If a taxpayer has a balance due, he or she can pay by check, money order, direct debit (automatic withdrawal), or credit card. See Form 1040, Form 1040A, or Form 1040EZ instructions for complete details.

Taxpayers who cannot pay the tax due with their tax return should attach **Form 9465, Installment Agreement Request.** The IRS will try to arrange an installment payment agreement that reflects the taxpayer's ability to pay the tax owed. However, taxpayers should pay as much as possible with their return to reduce the amount of interest and penalties that will be charged on the unpaid balance.

Extensions

Taxpayers can receive extensions of time to file their returns. Different rules apply to taxpayers who live in the United States and those who live outside the United States. Deadline extensions are also available to members of the Armed Forces who served in a combat zone and Armed Forces on deployment outside the United States participating in a contingency operation.

If an extension of time to file is granted, the IRS will charge interest on taxes not paid by the due date. However there are exceptions if the combat zone extension is applicable.

Within the United States

A taxpayer living in the United States can receive an automatic 6-month extension of time to file his or her federal tax return. The taxpayer can get the automatic extension by:

1. Using IRS *e-file* (electronic filing), or
2. Filing a paper form.

> **Alert**
>
> Form 4868 is now used to obtain an automatic 6-month extension. Prior to this change, it was used to receive a 4-month extension. Be sure to review Form 4868 instructions and Publication 17 for information on filing for an extension if the taxpayer is out of the country.

E-file options

There are two ways the taxpayer can use e-file to get an extension of time to file. Complete Form 4868, Application for Automatic Extension of Time To File United States Individual Income Tax Return, to use as a worksheet. If the taxpayer thinks they may owe tax when they file the return, use *Part II* of the form to estimate the balance due. If the taxpayer e-files Form 4868 to the IRS, do not also send a paper Form 4868.

E-file using a personal computer or a tax professional. The taxpayer can use a tax software package with a personal computer or a tax professional to file Form 4868 electronically. The taxpayer will need to provide certain information from the tax return for

2006. To make a payment by electronic funds withdrawal, see *Electronic payment options,* under *How To Pay,* later in Chapter 1 of Publication 17.

E-file and pay by credit card. A taxpayer can get an extension by paying part or all of the estimate of tax due by using a credit card. This can be done by phone or over the Internet. Do not file Form 4868. See *Credit card,* under *How To Pay* in Chapter 1 of Publication 17 for more information.

Filing a paper Form 4868

The taxpayer can get an extension of time to file by filing a paper Form 4868. Mail it to the address shown in the form instructions.

To make a payment with the form, advise the taxpayer to make the check or money order payable to the "United States Treasury." Write the SSN, daytime phone number, and "2007 Form 4868" on the check or money order.

The taxpayer must request the automatic extension by the due date for their return. They can file the return any time before the 6-month extension period ends.

Enter any payment made related to the extension of time to file on Form 1040, line 69. If you file Form 1040EZ or Form 1040A, include that payment in your total payments on Form 1040EZ, line 10, or Form 1040A, line 43. Also enter "Form 4868" and the amount paid in the space to the left of line 10 or line 43.

The taxpayer is not required to pay any of the tax due when submitting the form. However, the taxpayer will owe interest on any tax that is owed but not paid by the due date. Interest will be charged from the due date to the date of payment. In addition, the taxpayer may be charged a late-payment penalty if the amount of tax paid before the due date (from withheld taxes or estimated tax payments) is less than 90 percent of the actual tax owed.

For more details on penalties, refer to the filing information in Publication 17.

If Form 4868 is filed late, the request for an extension will be denied. The IRS will inform the taxpayer if the request is denied.

Taxpayers **cannot** use the automatic extension if they:

- Choose to have the IRS figure their tax, or
- Are under a court order to file their returns by the regular due date.

Outside the United States and Puerto Rico

Taxpayers are allowed an automatic 2-month extension (until June 16, 2008, if you use the calendar year) to file your 2007 return and pay any federal income tax due if:

1. You are a United States citizen or resident, and
2. On the due date of your return:

a. You are living outside 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 the taxpayer pays the tax due after the regular due date (generally, April 15), interest will be charged from that date until the date the tax is paid.

If the taxpayer served in a combat zone or qualified hazardous duty area, they may be eligible for a longer extension of time to file. See *Tax Oprions for Combat Zone Participants,* later, for special rules that apply.

Note: Traveling outside the United States and Puerto Rico on the due date does not qualify the taxpayer for an automatic 2-month extension.

Taxpayers using this automatic extension must attach a statement to their return stating that they were living outside the United States and Puerto Rico on the due date and that their main place of business or their assigned tour of duty is outside the United States and Puerto Rico.

Joint Returns. For married persons who file jointly, only one spouse needs to meet the requirements to take advantage of the automatic extension to June 15.

Separate Returns. For married persons who file separately, only the spouse who meets the requirements qualifies for the automatic extension. If both spouses meet the requirements, each may take advantage of the extension.

Extensions beyond 2 months. If the taxpayer cannot file the return within the automatic 2-month extension period, they may be able to get an additional 4-month extension, for a total of 6 months. File Form 4868 and check the box on line 8.

This additional 4-month extension of time to file is not a further extension of time to pay. You can use a credit card to pay your estimate of tax due. See How To Pay, later in this Chapter 1, Publication 17.

No further extension. An extension of more than 6 months will generally not be granted. However, if the taxpayer is outside the United States and meets certain tests, they may be granted a longer extension. For more information, see *Further extensions* under *When To File and Pay* in Publication 54.

TAX OPTIONS FOR COMBAT ZONE PARTICIPANTS

Members of the Armed Forces who served in a combat zone are allowed additional time to take care of tax matters. This extension also applies to any individual who is deployed from his or her permanent duty station in support of operations in a qualified hazardous duty area, or performing qualifying service outside the qualified hazardous duty area. The law provides that certain periods of time are disregarded when determining whether certain tax matters have been taken care of on time. For ease of understanding, **Publication 3, Armed Forces Tax Guide,** refers to these provisions as "extensions of deadlines." These deadline extensions should not be confused with other parts of the tax law that refer to extensions of time for performing acts.

The deadline for filing tax returns, paying taxes, filing claims for refund, and taking other actions with the IRS is automatically extended if the taxpayer serves in the Armed Forces in a combat zone. The deadline for the IRS to take certain actions, such as collection and examination actions, is also extended.

Additionally, if members of the Armed Forces are deployed overseas away from their permanent duty station in support of operations in a qualified hazardous duty area but outside the qualified hazardous duty area, they also receive these extensions (but not other combat zone benefits). The deadline for IRS to take certain actions, such as collection and examination actions, is also extended. See Lesson 3 for the beginning dates for the Afghanistan area combat zone, the Kosovo area combat zone, the Persian Gulf area combat zone, and the qualified hazardous duty areas.

The deadline for taking actions with the IRS is extended for 180 days after the later of:

1. The last day the taxpayer is in a combat zone or a qualified hazardous duty area or has qualifying service outside of the combat zone or a qualified hazardous duty area (or the last day the area qualifies as a combat zone or a qualified hazardous duty area), or
2. The last day of any continuous qualified hospitalization (defined later) for injury from service in the combat zone or the qualified hazardous duty area or while performing qualifying service outside of the combat zone or the qualified hazardous duty area.

In addition to the 180 days, the deadline is also extended by the number of days remaining for the member to take the action with the IRS when he or she entered a combat zone or a qualified hazardous duty area (or began performing qualifying service outside the combat zone or the qualified hazardous duty area). If a taxpayer entered the combat zone or the qualified hazardous duty area (or began performing qualifying service outside the combat zone or the qualified hazardous duty area) before the period of time to take the action began, the deadline is extended by the entire period of time he or she has to take the action.

Example 1

Captain Kristina Jones entered a designated combat zone on December 1, 2005. She remained there through March 31, 2007, when she departed for the United States. She was not injured and did not return to the combat zone. The deadlines for filing Captain Jones's 2005, 2006, and 2007 returns are figured as follows.

- **The 2005 tax return.** The deadline is January 10, 2008. This deadline is 285 days (180 plus 105) after Captain Jones's last day in the combat zone (March 31, 2007). The 105 additional days are the number of days in the 3½-month filing period that were left when she entered the combat zone (January 1–April 15, 2006).
- **The 2006 tax return.** The deadline is January 10, 2008. The deadline is 285 days (180 plus 105) after Captain Jones's last day in the combat zone (March 31, 2007).
- **The 2007 tax return.** The deadline is not extended because the 180-day extension period after March 31, 2007 ends on September 27, 2007, which is before the start of the filing period for her 2007 return (January 1–April 15, 2008).

Missing Status. Time in a missing status (missing in action or prisoner of war) counts as time in a combat zone or a qualified hazardous duty area.

Support Personnel. The deadline extension provision also applies if a taxpayer is serving in a combat zone or a qualified hazardous duty area in support of the Armed Forces. This includes Red Cross personnel, accredited correspondents, and civilian personnel acting under the direction of the Armed Forces in support of those forces.

Qualified Hospitalization. The hospitalization must be the result of an injury received while serving in a combat zone or a qualified hazardous duty area. Qualified hospitalization means:

1. Any hospitalization outside the United States, and
2. Up to 5 years of hospitalization in the United States.

Example 2

Petty Officer Leonard Brown's ship entered the Persian Gulf on January 5, 2006. On February 15, 2006, Leonard was injured and was flown to a U.S. hospital. He remained in the hospital through April 21, 2007. The deadlines for filing Petty Officer Brown's 2005, 2006, and 2007 returns are figured as follows.

- **The 2005 tax return.** The deadline is January 26, 2008. Petty Officer Brown has 280 days (180 plus 100) after his last day in the hospital (April 21, 2007) to file his 2005 return. The 100 additional days are the number of days in the 3½-month filing period that were left when he entered the combat zone (January 5–April 15).
- **The 2006 tax return.** The deadline is January 31, 2008. Petty Officer Brown has 285 days (180 plus 105) after April 21, 2007, to file his 2006 tax return.
- **The 2007 tax return.** The deadline is not extended, because the 180-day extension period after April 21, 2007 ends on October 18, 2007, which is before the start of the filing period for his 2007 return (January 1–April 15, 2008).

Actions Extended

The actions to which the deadline extension provision applies include:

- Filing any return of income, estate, or gift tax (except employment and withholding taxes),
- Paying any income, estate, or gift tax (except employment and withholding taxes),
- Filing a petition with the Tax Court for redetermination of a deficiency or for review of a Tax Court decision,
- Filing a claim for credit or refund of any tax,
- Bringing suit for any claim for credit or refund,
- Making a qualified retirement contribution to an IRA,
- Allowing a credit or refund of any tax by the IRS,
- Assessment of any tax by the IRS,
- Giving or making any notice or demand by the IRS for the payment of any tax or for any liability for any tax,
- Collection by the IRS of any tax due, and
- Bringing suit by the United States for any tax due.

If the IRS takes any actions covered by these provisions or sends the taxpayer a notice of examination before learning that he or she is entitled to an extension of the deadline, the taxpayer should contact the legal assistance office. No penalties or interest will be imposed for failure to file a return or pay taxes during the extension period.

Example 3

A taxpayer generally has 3 years from April 15, 2004, to file a claim for refund against his or her timely filed 2003 tax return. This means that the claim normally must be filed by April 15, 2007. However, if he or she served in a combat zone from November 1, 2006, through March 23, 2007, and was not injured, the deadline for filing that claim is extended 346 days (180 plus 166) after he or she leaves the combat zone. This extends the deadline to March 5, 2008. The 166 additional days are the number of days in the 3-year period for filing the refund claim that were left when he or she entered the combat zone on November 1 (November 1, 2006–April 15, 2007).

Spouses. Spouses of individuals who served in a combat zone are entitled to the same deadline extension, with two exceptions:

1. The extension does not apply to a spouse for any tax year beginning more than 2 years after the date the area ceases to be a combat zone.
2. The extension does not apply to a spouse for any period the qualifying individual is hospitalized in the United States for injuries incurred in a combat zone.

Not in a Combat Zone. Reservists called to active duty or regular military members who are not in a combat zone may still qualify to defer the payment of back taxes. To qualify, these individuals must:

- Be serving their initial period of service, and
- Show that their ability to pay the back taxes has been materially impaired.

Initial Period of Service. The initial period of service is defined as the period of active duty following recall to active duty from an inactive reserve or National Guard unit. For regular military personnel, it is the period following induction or first enlistment in the Armed Forces or the first period of reenlistment for a person who has been out of the service for a year or more. For an officer, the initial period of service is limited to two years of active service after one of the above occurrences.

Material Impairment. To indicate material impairment, the taxpayer must show that his or her income dropped as a result of going into military service.

Request for Deferment. Military members who have a current payment agreement or who have received a notice requesting payment must make a written request for deferment to the IRS office where they have the agreement.

Information Needed. The request for deferment must include the member 's name, social security number, monthly income and source of income before military service, current monthly income, military rank, date of entry into the military service, and date the member is eligible for discharge. Enclosing a copy of the military orders is helpful.

The IRS will review each request and advise the taxpayer in writing of its decision. Should the taxpayer need further assistance, he or she can call the IRS at **1-800-829-1040** to discuss his or her situation. If the IRS grants the request for deferment, the taxpayer will be able to defer payment of back taxes until 6 months after the end of his or her initial period of service.

Third-Party Designee. If the taxpayer wants to allow a friend, family member, or any other person he or she chooses to discuss his or her 2007 tax return with the IRS, the taxpayer should check the "Yes" box in the Third-party designee section of the return. Also, the taxpayer should enter the designee's name, phone number, and any five numbers the designee chooses as his or her personal identification number (PIN). These procedures are the same as those covered in the non-military part of Lesson 14.

Power of Attorney. Use **Form 2848, Power of Attorney and Declaration of Representative,** to grant authority to an individual to represent the taxpayer before the IRS and to receive tax information. If an individual is acting on behalf of a taxpayer serving in the combat zone and does not have a power of attorney specifying that he or she can handle federal tax matters, the IRS will accept a general power of attorney or other statement signed by the person for whom the individual is acting. The general power of attorney or statement must authorize the individual to act on the other person's behalf even though federal tax matters are not specified. A copy must be attached to the tax return.

Signature. If it is not possible for the spouse of someone serving in a combat zone to obtain that person's signature on a joint return, power of attorney, or other signed authorization to act on his or her behalf, the IRS will accept a written statement explaining that the husband or wife is serving in a combat zone.

The statement must be signed by the spouse filing the tax return and attached to the return.

Forgiveness of Tax Liability

Special tax forgiveness provisions apply to individuals who:

- Die while serving in a combat zone or from wounds, disease, or injury incurred while serving in a combat zone, or
- Die from wounds or injury incurred in a terrorist or military action while a member of the U.S. Armed Forces.

Combat Zone Forgiveness

Federal income tax liability is forgiven for United States military personnel who die while serving in a combat zone or as a result of wounds, disease, or injury incurred while so serving. The forgiveness of tax applies for the year of death and for any prior year ending on or after the first day that the individual served in a combat zone in active service. Any forgiven tax liability that has already been paid will be refunded, and any unpaid tax liability at the date of death will be forgiven.

This forgiveness provision also applies to a member of the Armed Forces serving outside the combat zone if the service:

1. Was in direct support of military operations in the zone, and
2. Qualified the member for special military pay for duty subject to hostile fire or imminent danger.

Missing Status. The date of death for a member of the Armed Forces who was in a missing status (missing in action or prisoner of war) is the date his or her name is removed from missing status for military pay purposes. This is true even if death actually occurred earlier.

Tax Forgiveness for Deaths Due to Military or Terroristic Actions

A decedent 's income tax liability may be forgiven if his or her death was due to service in a combat zone or to military or terroristic actions.

The Victims of Terrorism Tax Relief Act of 2001 provides tax relief for those injured or killed as a result of terrorist attacks, certain survivors of those killed as a result of terrorist attacks, and others who were affected by terrorist attacks. For information on that Act, see Publication 3920.

Military or Terroristic Actions

The decedent 's income tax liability is forgiven if, at death, he or she was a military or civilian employee of the United States who died because of wounds or injury incurred:

- While a United States employee, and
- In a military or terroristic action.

For tax years ending after September 10, 2001, tax liability is forgiven for an individual who dies from wounds or injury incurred while a United States employee in a terroristic or military action regardless of where the action occurred.

The forgiveness applies to the tax year in which the death occurred and for any prior tax year in the period beginning with the year before the year in which the wounds or injury occurred.

Military or Terroristic Action Defined. A military or terroristic action means the following:

- Any terroristic activity that most of the evidence indicates was directed against the United States or any of its allies.
- Any military action involving the United States Armed Forces and resulting from violence or aggression against the United States or any of its allies, or the threat of such violence or aggression.

Military action does not include training exercises. Any multinational force in which the United States is participating is treated as an ally of the United States.

Claims for Credit or Refund

If any of these tax-forgiveness situations applies to a prior year tax, any tax paid for which the period for filing a claim has not ended will be credited or refunded. If any tax is still due, it will be canceled. The normal period for filing a claim for credit or refund is 3 years after the return was filed or 2 years after the tax was paid, whichever is later.

If death occurred in a combat zone or from wounds, disease, or injury incurred in a combat zone, the period for filing the claim is extended by:

- The amount of time served in the combat zone (including any period in which the individual was in missing status), plus
- The period of continuous qualified hospitalization for injury from service in the combat zone, if any, plus
- The next 180 days.

Qualified hospitalization means any hospitalization outside the United States and any hospitalization in the United States of not more than 5 years.

Filing a Claim. Use the following procedures to file a claim.

- File Form 1040, Form 1040A, or Form 1040EZ if an income tax return has not been filed for the tax year. Form W-2, *Wage and Tax Statement*, must accompany all returns.
- File Form 1040X if an income tax return has been filed. A separate Form 1040X must be filed for each year in question.

These returns and claims must be filed with the IRS, P.O. Box 4053, Woburn, MA 01888.

All returns and claims must be identified by writing "Enduring Freedom—KIA," "Kosovo Operation—KIA," "Desert Storm—KIA," or "Former Yugoslavia—KIA" in bold letters on the top of page 1 of the return or claim. On Form 1040 and Form 1040X, the phrase "Enduring Freedom—KIA," "Kosovo Operation—KIA," "Desert Storm—KIA," or "Former Yugoslavia—KIA" must be written on the line for total tax. If the individual was killed in a terroristic or military action, put "KITA" on the front of the return and on the line for total tax.

An attachment should accompany any return or claim that includes a computation of the decedent's tax liability before any amount is forgiven and the amount that is to be forgiven. For joint returns, see **Joint Returns,** later.

Necessary Documents. The following documents must accompany all returns and claims for refund:

- **Form 1310, Statement of Person Claiming Refund Due a Deceased Taxpayer,** and
- A certification from the Department of Defense or the Department of State that the death was due to a military or terroristic action.

For military and civilian employees of the Department of Defense, certification must be made by that department on Form DOD 1300, Report of Casualty. For other civilian employees who die as a result of wounds or injury incurred outside the United States, certification must be a letter signed by the Director General of the Foreign Service, Department of State, or his or her delegate. The certification must include the individual's name and social security number, the date of injury, the date of death, and a statement that the individual died as the result of a military or terroristic action outside the United States and was an employee of the United States at the date of injury and at the date of death.

If the certification has been received but you do not have enough tax information to file a timely claim for refund, file Form 1040X. Attach Form 1310 and a statement that an amended claim will be filed as soon as the required tax information is available. For returns and claims relating to individuals who died as a result of a terrorist attack, see Publication 3920.

Joint Returns. Only the decedent's part of the joint income tax liability is eligible for the refund or tax forgiveness. To determine the part for the decedent, the person filing the claim must complete the following steps:

1. Figure the income tax for which the decedent would have been liable if a separate return had been filed.
2. Figure the income tax for which the spouse would have been liable as if a separate return had been filed.
3. Multiply the joint tax liability by a fraction. The top number of the fraction is the amount in (1) above. The bottom number of the fraction is the total of (1) and (2).

The amount in (3) is the decedent 's tax liability that is eligible for the refund or tax forgiveness. If a taxpayer is unable to complete this process, he or she should attach a statement of all income and deductions indicating the part that belongs to each spouse. The IRS will make the proper allocation.

Residents of Community Property States. If the decedent's legal residence was in a community property state and the spouse reported half the military pay on a separate return, the spouse can get a refund of taxes paid on his or her share of the pay for the years involved. The forgiveness of unpaid tax on the military pay would also apply to the half owed by the spouse for the years involved.

The Julian calendar may also be used in the calculation of “extension of deadlines.”

Perpetual Leap Year Julian Calendar

JULIAN DATE CALENDAR
Leap Year, 366 Days

DAY	JAN	FEB	MAR	APR	MAY	JUN	JUL	AUG	SEP	OCT	NOV	DEC
1	001	032	061	092	122	153	183	214	245	275	306	336
2	002	033	062	093	123	154	184	215	246	276	307	337
3	003	034	063	094	124	155	185	216	247	277	308	338
4	004	035	064	095	125	156	186	217	248	278	309	339
5	005	036	065	096	126	157	187	218	249	279	310	340
6	006	037	066	097	127	158	188	219	250	280	311	341
7	007	038	067	098	128	159	189	220	251	281	312	342
8	008	039	068	099	129	160	190	221	252	282	313	343
9	009	040	069	100	130	161	191	222	253	283	314	344
10	010	041	070	101	131	162	192	223	254	284	315	345
11	011	042	071	102	132	163	193	224	255	285	316	346
12	012	043	072	103	133	164	194	225	256	286	317	347
13	013	044	073	104	134	165	195	226	257	287	318	348
14	014	045	074	105	135	166	196	227	258	288	319	349
15	015	046	075	106	136	167	197	228	259	289	320	350
16	016	047	076	107	137	168	198	229	260	290	321	351
17	017	048	077	108	138	169	199	230	261	291	322	352
18	018	049	078	109	139	170	200	231	262	292	323	353
19	019	050	079	110	140	171	201	232	263	293	324	354
20	020	051	080	111	141	172	202	233	264	294	325	355
21	021	052	081	112	142	173	203	234	265	295	326	356
22	022	053	082	113	143	174	204	235	266	296	327	357
23	023	054	083	114	144	175	205	236	267	297	328	358
24	024	055	084	115	145	176	206	237	268	298	329	359
25	025	056	085	116	146	177	207	238	269	299	330	360
26	026	057	086	117	147	178	208	239	270	300	331	361
27	027	058	087	118	148	179	209	240	271	301	332	362
28	028	059	088	119	149	180	210	241	272	302	333	363
29	029	060	089	120	150	181	211	242	273	303	334	364
30	030		090	121	151	182	212	243	274	304	335	365
31	031		091		152		213	244		305		366

For use in 2004, 2008, 2012 and 2016.

Perpetual Non Leap Year Julian Calendar

JULIAN DATE CALENDAR
Perpetual, 365 Days

DAY	JAN	FEB	MAR	APR	MAY	JUN	JUL	AUG	SEP	OCT	NOV	DEC
1	001	032	060	091	121	152	182	213	244	274	305	335
2	002	033	061	092	122	153	183	214	245	275	306	336
3	003	034	062	093	123	154	184	215	246	276	307	337
4	004	035	063	094	124	155	185	216	247	277	308	338
5	005	036	064	095	125	156	186	217	248	278	309	339
6	006	037	065	096	126	157	187	218	249	279	310	340
7	007	038	066	097	127	158	188	219	250	280	311	341
8	008	039	067	098	128	159	189	220	251	281	312	342
9	009	040	068	099	129	160	190	221	252	282	313	343
10	010	041	069	100	130	161	191	222	253	283	314	344
11	011	042	070	101	131	162	192	223	254	284	315	345
12	012	043	071	102	132	163	193	224	255	285	316	346
13	013	044	072	103	133	164	194	225	256	286	317	347
14	014	045	073	104	134	165	195	226	257	287	318	348
15	015	046	074	105	135	166	196	227	258	288	319	349
16	016	047	075	106	136	167	197	228	259	289	320	350
17	017	048	076	107	137	168	198	229	260	290	321	351
18	018	049	077	108	138	169	199	230	261	291	322	352
19	019	050	078	109	139	170	200	231	262	292	323	353
20	020	051	079	110	140	171	201	232	263	293	324	354
21	021	052	080	111	141	172	202	233	264	294	325	355
22	022	053	081	112	142	173	203	234	265	295	326	356
23	023	054	082	113	143	174	204	235	266	296	327	357
24	024	055	083	114	144	175	205	236	267	297	328	358
25	025	056	084	115	145	176	206	237	268	298	329	359
26	026	057	085	116	146	177	207	238	269	299	330	360
27	027	058	086	117	147	178	208	239	270	300	331	361
28	028	059	087	118	148	179	209	240	271	301	332	362
29	029		088	119	149	180	210	241	272	302	333	363
30	030		089	120	150	181	211	242	273	303	334	364
31	031		090		151		212	243		304		365

For use in 2001, 2002, 2003, 2005, 2006, 2007, 2009, 2010, 2011, 2013, 2014, and 2015.

Exercise 1

Private Franklin, a U.S. citizen, is a calendar-year taxpayer. What would be the due date for him to file a return if his assigned tour of duty were in the following places?

A. Puerto Rico

Answer: ____________________

B. Germany

Answer: ____________________

C. United States

Answer: ____________________

Exercise 2

Captain Regis is stationed in England on April 15. He is concerned about when he should file his federal tax return. Answer the following questions for Captain Regis.

A. What extensions of time are available to him?

Answer: ____________________

B. How can he get those extensions?

Answer: ____________________

Exercise 3

Major Joe Wells entered Afghanistan on January 6, 2005. He remained there through April 7, 2007, when he departed for the United States. He was not injured and did not return to the combat zone.

What is the deadline for filing Major Wells' 2005 tax return?

____

Answer: ____________________

Exercise 4

Mr. Tim Morris, a civilian employee of the United States, died in 2008 as a result of injuries he suffered during a terrorist attack in 2006.

What years are Mr. Morris' income liabilities forgiven?

____

Answer: ____________________

▶▶ Summing Up This Military Segment ◀◀

In this lesson you have learned:

- ▶ Where members of the Armed Forces should file their returns.
- ▶ When the returns are due for taxpayers who live both inside and outside the United States or Puerto Rico and how extensions can affect the due date.
- ▶ The deadline for filing tax returns, paying taxes, and taking other actions with the IRS is automatically extended if an individual serves in a combat zone.
- ▶ The income tax liability of a member of the Armed Forces is forgiven if a member dies as a result of service in a combat zone or from a terrorist or military action outside the United States.
- ▶ The terrorist or military action forgiveness also applies to an individual who is a United States employee at death and dies from wounds or injury incurred while a United States employee in a terrorist or military action regardless of where the action occurred.

Exercise 1

A. April 15

B. June 16 if he attached a statement to his return indicating that he was on an assigned tour of duty in Germany on the due date.

C. April 15

Exercise 2

A. An automatic 2-month extension of time to June 16 and an additional 4-month extension to October 15, (for a total of 6 months)

B. Captain Regis can obtain the automatic 2-month extension by attaching a statement to his tax return indicating that he was on an assigned tour of duty outside the United States and Puerto Rico on April 15. If Captain Regis needs an additional extension of time, he should file Form 4868 by the automatic extension date of June 16 and check the box on line 8 of Form 4868.

Exercise 3

January 17, 2008. The deadline is 285 days (180 plus 105) after Major Wells's last day in the combat zone (April 7, 2007). The 105 additional days are the number of days in the 3½-month filing period that were left when he entered the combat zone (January 1–April 15).

Exercise 4

2005, 2006, 2007, and 2008

Complete problem and exercises in Publication 678-W.

Index

A

B

C

D

E

F

G

H

I

J K L

M

N O P

STUDENT NOTES

PBT is coming nationwide in 2008

Providing consistency, accuracy, and quality in all taxpayer services

PROCESS BASED TRAINING

"Another Step Towards Quality"

Interested in taking steps to strengthen your Community?

Together, we can strengthen communities across America by sharing ideas and resources to reach common goals

Visit us on the web at www.irs.gov Keyword: Community Network

Community Network

...It's Your Resource

Visit the Community Network on **IRS.gov** where you'll find Web pages created specifically for IRS partners and volunteers. These pages are your one-stop resource to help you serve taxpayers in your community.

On I**RS.gov,** search keyword ***Community Network,*** where you'll find:

- Training Materials
- Asset Building Strategies
- Volunteer Opportunity Information
- Partner Opportunity Information
- Tips on helping taxpayers in these categories:
  - Disabled
  - Military
  - Low-income
  - Older Americans
  - Employees
  - Students
  - Limited English Proficiency
  - Native Americans
  - Rural Areas