Department of the Treasury

Internal Revenue Service

Your Federal Income Tax

For Individuals

Publication 17
Cat. No. 10311G

For use in preparing

1997

Returns

TAX GUIDE 1997

FOR INDIVIDUALS

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Your Federal Income Tax
For Individuals

Contents

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

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

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

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

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

Introduction

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

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

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

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

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

- List of where to report certain items listed on information documents,
- List of mailing addresses for where to file returns,
- List of recorded tax information topics (TeleTax), and
- List of phone numbers for calling the IRS.

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

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

For information on how you can get free IRS publications and forms, see *Where To Go for Help* in the back of this publication. Also see the front cover of this publication for information on using your computer or fax machine to get forms.

We welcome your suggestions for future editions of this publication. Please send your ideas to:

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

■

Important Changes for 1997

This section summarizes important tax changes that took effect in 1997. These changes are discussed in more detail throughout this publication.

Changes are also discussed in Publication 553, *Highlights of 1997 Tax Changes.*

Lower tax rate on certain capital gains. For individuals, the maximum long-term capital gain tax rate for sales or exchanges of property after May 6, 1997, is generally reduced to 20% (10% for taxpayers in the 15% tax bracket). See chapter 17.

Capital gain distributions. If you receive a capital gain distribution, you now must report it on Schedule D (Form 1040). This is true even if you have no other capital gains or losses.

Sale or exchange of a principal residence. For a sale or exchange of a principal residence after May 6, 1997, you can generally exclude from gross income up to $250,000 of gain ($500,000 for married couples filing a joint return). See chapter 16.

Adoption tax credit. You may be able to claim a tax credit for qualified adoption expenses paid in 1997. The credit can be as much as $5,000 for each child ($6,000 for a child with special needs). See chapter 36.

Adoption assistance. If your employer has an adoption assistance program and pays or incurs qualified expenses on your behalf, you may be able to exclude from your gross income up to $5,000 ($6,000 for a child with special needs) of these benefits. See Publication 968, *Tax Benefits for Adoption.*

Taxpayer identification numbers. You must provide the taxpayer identification number for each person for whom you claim certain tax benefits. This applies even if the person was born in 1997. Generally, this number is the person's social security number (SSN). See chapter 1.

Individual taxpayer identification number (ITIN). A resident or nonresident alien who does not have and is not eligible to get an SSN can file Form W–7, *Application for IRS Individual Taxpayer Identification Number,* with the IRS to apply for an ITIN. An ITIN is for tax purposes only, but it cannot be used for purposes of the earned income credit.

Adoption taxpayer identification number (ATIN). If a child is placed in your home by an authorized adoption agency, you may be able to claim the child as your dependent and also claim the child and dependent care credit. Generally, if you cannot get an SSN for the child until the adoption is final, use Form W–7A, *Application for Taxpayer Identification Number for Pending U.S. Adoptions,* to get an ATIN for the child. However, you cannot use an ATIN for purposes of the earned income credit.

Earned income credit. The maximum amount of earned income credit you can receive and the amount of income you can earn and still get the credit have both increased. Generally, you ***cannot*** claim the credit if your investment income for 1997 is more than $2,250.

If the IRS determines that you should not have claimed the earned income credit for a tax year beginning after 1996, you may not be eligible to claim the credit for the next 2 years (10 years if you are denied the credit based on fraud). See chapter 35.

Individual retirement arrangement (IRA) for spouse. A married couple filing a joint return can contribute up to $2,000 to each of their IRAs, even if one spouse had little or no income. See chapter 18.

Penalty-free IRA distributions to pay medical expenses and medical insurance. You generally pay a 10% penalty if you withdraw funds from your IRA before age $59\frac{1}{2}$. However, you may not have to pay the penalty if the withdrawals are not more than the amount you paid for unreimbursed medical expenses that are more than $7\frac{1}{2}$% of your adjusted gross income.

If you lose your job, you may not have to pay the penalty if the withdrawals are not more than the amount paid for medical insurance for you and your family. See chapter 18.

Medical savings accounts (MSAs). If you are covered only under a high deductible health plan, you may be able to participate in an MSA program. You can deduct contributions to your MSA even if you do not itemize your deductions. See chapter 23.

Long-term care expenses. You can include with your medical expenses your payments for qualified long-term care insurance premiums (up to certain limits) and unreimbursed costs for qualified long-term care of a chronically ill individual. See chapter 23.

Generally, benefits you receive under a long-term care insurance contract can be excluded from your income. See chapter 13.

Accelerated death benefits. Certain payments received under a life insurance contract on the life of a terminally or chronically ill individual before death can be excluded from income. This also applies to amounts received on the sale or assignment of the contract to a viatical settlement provider. See chapter 13.

Survivor benefits of public safety officers. Generally, survivor annuities paid to the spouse, former spouse, or child of a public safety officer killed in the line of duty can be excluded from income. This applies to officers dying after 1996. See chapter 13.

Qualified state tuition programs. For purposes of qualified state tuition programs, the term "qualified higher education expenses" has been expanded. These expenses now include the reasonable costs for room and board if the student is carrying at least half of the normal full-time workload for his or her course of study. See chapter 13.

Certain expiring tax benefits extended. Some benefits that were scheduled to expire have been extended.

Donations of appreciated stock. The special rule allowing a deduction for the full fair market value of qualified appreciated stock given to certain private foundations is extended through June 30, 1998. See chapter 26.

Employer-provided educational assistance benefits. The exclusion from gross income for up to $5,250 of qualified employer-provided educational assistance benefits is extended to undergraduate courses beginning before June 1, 2000. See chapter 29.

Certain amounts increased. Some tax items indexed for inflation are increased for 1997.

Exemption amount. For 1997, you are allowed a $2,650 deduction for each exemption to which you are entitled. However, your exemption amount could be phased out if you have high income. See chapter 3.

Limit on itemized deductions. Some of your itemized deductions may be limited if your adjusted gross income is more than a certain dollar amount. For 1997, the amount is $121,200 ($60,600 if you are married filing separately). See chapter 22.

Social security and Medicare taxes. The maximum wages subject to social security tax (6.2%) has increased to $65,400. All wages are subject to Medicare tax (1.45%).

Employee business expenses. Certain employee business expense deductions have been increased or modified for 1997. Employee business expenses are discussed in chapter 28.

The ***standard mileage rate*** for the cost of operating your car increased to 31½ cents a mile for all business miles.

The ***standard meal allowance*** for most areas in the United States increased to $30. For the days you depart and return when you travel away from home, you can claim ¾ of the standard meal allowance amount.

Tax on excess distributions repealed. The 15% tax on excess distributions from IRAs and qualified plans has been repealed. See chapters 11 and 18.

Changes for self-employed persons. The part of your ***self-employed health insurance premiums*** that you can deduct as an adjustment to income increased to 40% for 1997. See chapter 23.

The maximum net earnings subject to the social security tax portion of ***self-employment tax*** (12.4%) has increased to $65,400. All net earnings of at least $400 ($108.28 for church employees) are subject to the Medicare tax portion (2.9%). Use Schedule SE (Form 1040) to figure the tax due. See Publication 533, *Self-Employment Tax.* ■

Important Changes for 1998

This section summarizes important tax changes that take effect in 1998 and that could affect your estimated tax payments for 1998. More information on these and other changes can be found in Publication 553, *Highlights of 1997 Tax Changes.*

Dependent child credit. You may be able to claim a tax credit of $400 ($500 beginning in 1999) for each of your qualifying children under the age of 17.

Education benefits. There are various new tax benefits that relate to education.

HOPE credit. You may be able to claim a tax credit of up to $1,500 for each eligible student. The HOPE credit is allowed for the first 2 years of postsecondary education and is based on the qualified higher tuition and related expenses paid during the tax year.

Lifetime learning credit. For expenses paid after June 30, 1998, you may be able to claim a tax credit of up to $1,000 for the total qualified tuition and related expenses paid during the tax year. There is no maximum period for which the lifetime learning credit can be claimed.

Education IRAs. You may be able to make nondeductible contributions to an education IRA for a designated beneficiary. Distributions are not included in income if they are not more than the beneficiary's qualified higher education expenses.

Interest on student loans. You may be able to claim a deduction for interest paid on a qualified student loan. For 1998, the maximum deduction is $1,000.

Individual retirement arrangement (IRA) changes. There are various new tax benefits that relate to IRAs. Generally, more taxpayers can benefit from IRAs.

Income limits. The phaseout amounts for deducting contributions to an IRA when you are covered under an employer retirement plan have increased for most taxpayers. The amounts are based on your filing status and adjusted gross income. The phaseout amounts for 1998 are:

- $50,000–60,000 for married persons filing jointly and qualifying widow(er)s,
- $0–10,000 for married persons filing separately, and
- $30,000–40,000 for all other filers.

Spouse covered by plan. Even if your spouse is covered by an employer-sponsored retirement plan, you may be able to deduct a contribution into your IRA account if you are not covered by an employer plan. In this situation, the phaseout amount for 1998 is $150,000–160,000 for married persons filing jointly.

New Roth IRA. You may be able to establish a Roth IRA. In this new type of IRA, your contributions are not deductible and qualified distributions you receive are not taxable.

New investment opportunities allowed. Your IRA can invest in certain platinum coins and certain gold, silver, platinum, and palladium bullion.

Penalty-free distributions. You generally pay a 10% penalty if you withdraw funds from your IRA before age 59½. However, you may not have to pay the penalty if the distribution is:

- Not more than your qualified higher education expenses, or
- A qualified first-time homebuyer distribution.

Increased standard deduction for dependents. The standard deduction for dependents for whom an exemption can be claimed by another taxpayer is increased to the lesser of the regular standard deduction amount or the greater of:

1) $700, or
2) The dependent's earned income ***plus $250.***

Increased standard mileage rate for charitable purposes. The standard mileage rate for the cost of operating your car for charitable purposes is increased to 14 cents a mile.

Self-employed health insurance. The part of your self-employed health insurance premiums that you can deduct as an adjustment to income increases to 45% for 1998.

Foreign earned income exclusion. The amount of foreign earned income that you can exclude increases to $72,000.

Travel and transportation expenses increased for certain individuals. If you are subject to the Department of Transportation's ***hours of service limits,*** you may be able to deduct 55% of your qualified meal and beverage expenses while traveling away from your tax home.

If you are a ***rural mail carrier*** who receives qualified reimbursements for business car expenses, you may be able to treat the amount of such reimbursement as your allowable car expense. The higher standard mileage rate that previously applied to rural mail carriers is repealed.

Changes to estimated tax rules. In figuring your estimated tax payments or tax withholding for 1998, you must include any expected ***employment taxes for household workers*** that you will owe.

You will not be subject to the ***estimated tax penalty*** unless the amount you owe with your 1998 return is $1,000 or more (up from $500). See chapter 5.

Important Reminders

Listed below are important reminders and other items that may help you file your 1997 tax return. Many of these items are explained in more detail later in this publication.

Punitive damages and damages for nonphysical injuries or nonphysical sickness. Generally, amounts received after August 20, 1996, as punitive damages or as damages for nonphysical injuries or nonphysical sickness are taxable. See chapter 13.

Qualified campus lodging extended to academic health centers. The exclusion from gross income for the value of qualified campus lodging applies to lodging provided on or near academic health centers. These are certain medical research institutions that engage in and teach basic and clinical medical science and research. See Publication 525, *Taxable and Nontaxable Income.*

Annuity distributions. If you start receiving annuity payments from a qualified plan after November 18, 1996, you generally must use a simplified method to recover your basis (investment) in the annuity. See chapter 11.

Advance earned income credit. If a qualifying child lives with you and you expect to qualify for the earned income credit in 1998, you may be able to get part of the credit paid to you in advance throughout the year (by your employer) instead of waiting until you file your tax return. See chapter 35.

Social security taxes for household employees. If you pay a domestic employee (such as a nurse, babysitter, or housekeeper) cash wages of $1,000 ($1,100 in 1998) or more to work in your home, you generally will have to withhold and pay social security and Medicare taxes. You pay these taxes with your income tax return. As a household employer, you will need an employer identification number (EIN) for the Forms W–2 and Schedule H that you must file. For more information, see Publication 926, *Household Employer's Tax Guide.*

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

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

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

- IRS *e-file* (electronic filing),
- TeleFile, and
- 1040PC returns.

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

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

Tax return preparers. Choose your preparer carefully. If you pay someone to prepare your return, the preparer is required, under the law, to sign the return and fill in the other blanks in the Paid Preparer's area of your return. Remember, however, that you are still responsible for the accuracy of every item entered on your return. If there is any underpayment, you are responsible for paying it, plus any interest and penalty that may be due. Therefore, you should be careful to choose someone who understands tax matters and will prepare a complete and accurate tax return.

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

Part One.

The Income Tax Return

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

1. Filing Information

Important Changes for 1997

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

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

Important Reminders

Change of address. If you change your address for any reason, you should use Form 8822, *Change of Address,* to notify the IRS. See *Change of Address,* later, under *What Happens After I File?*

Computerized returns. You may want to prepare your return on a personal computer. See *Computerized Returns,* later, under *Does My Return Have To Be On Paper?*

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

Electronic filing. You may want to use IRS *e-file* to file your return electronically instead of on a paper form. This can shorten the time for processing returns. See *IRS e-file,* later, under *Does My Return Have To Be On Paper?*

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

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

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

TeleFile. If you receive a TeleFile tax package, you may be able to file your tax return over the phone. See *IRS e-file Using a Telephone (TeleFile)* under *Does My Return Have To Be On Paper?*

Introduction

This chapter discusses:

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

Do I Have To File a Return?

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

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

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

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

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

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

Individuals—In General

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

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

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

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

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

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

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

Age. If you are 65 or older at the end of the year, you generally can have a higher amount of gross income than other taxpayers before you must file. See *Table 1–1.* You are considered 65 on the day before your 65th birthday. For example, if your 65th birthday was on January 1, 1998, you are considered 65 for 1997.

Surviving Spouses, Executors, Administrators, or Legal Representatives

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

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

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

U.S. Citizens Living Outside the U.S.

If you are a U.S. citizen living outside the United States, you must file a return if you meet the filing requirements. For information on special tax rules that may apply to you, get Publication 54, *Tax Guide for U.S. Citizens and Resident Aliens Abroad.* It is available at most U.S. embassies and consulates, or you can order it using the order blank at the end of this publication.

Residents of Puerto Rico

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

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

Individuals With Income From U.S. Possessions

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

Table 1-1. **1997 Filing Requirements for Most Taxpayers**

To use this table, first find your marital status at the end of 1997. Then, read across the line that shows your filing status and age at the end of 1997. You must file a return if your gross income was at least the amount shown in the last column.

Gross income means all income you received in the form of money, goods, property, and services that is not exempt from tax, including any gain on the sale of your main home (even if you can exclude or postpone part or all of the gain).

When using this table, do not include social security benefits as gross income unless you are married filing a separate return and lived with your spouse at any time in 1997. (If you must include the benefits, see chapter 12 for the amount to include.)

Also, see *Table 1-2* and *Table 1-3* for other situations when you must file a return.

Marital Status	Filing Status	Age*	Gross Income
Single (including divorced and legally separated)	Single	under 65 65 or older	$6,800 $7,800
	Head of household	under 65 65 or older	$8,700 $9,700
Married, with a child, living apart from your spouse during the last 6 months of 1997	Head of household	under 65 65 or older	$8,700 $9,700
Married, living with your spouse at end of 1997 (or on the date your spouse died)	Married, joint return	under 65 (both spouses) 65 or older (one spouse) 65 or older (both spouses)	$12,200 $13,000 $13,800
	Married, separate return	any age	$2,650
Married, not living with your spouse at end of 1997 (or on the date your spouse died)	Married, joint or separate return	any age	$2,650
Widowed before 1997 and not remarried in 1997	Single	under 65 65 or older	$6,800 $7,800
	Head of household	under 65 65 or older	$8,700 $9,700
	Qualifying widow(er) with dependent child	under 65 65 or older	$9,550 $10,350

**If you turned age 65 on January 1, 1998, you are considered to be age 65 at the end of 1997.*

Dependents

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

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

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

Child Under Age 14

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

Self-Employed Persons

You are self-employed if you:

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

Table 1-2. **1997 Filing Requirements for Dependents**
See chapter 3 to find out if someone can claim you as a dependent.

If your parents (or someone else) can claim you as a dependent, and any of the situations below apply to you, you must file a return. (See *Table 1-3* for other situations when you must file.)

In this table, **earned income** includes salaries, wages, tips, and professional fees. It also includes taxable scholarship and fellowship grants (see *Scholarship and Fellowship Grants* in chapter 13). **Unearned income** includes investment-type income such as interest, dividends, and capital gains. It also includes unemployment compensation, taxable social security benefits, pensions, annuities, and distributions of unearned income from a trust.

Caution: If your gross income was $2,650 or more, you generally cannot be claimed as a dependent unless you were under age 19 **or** a full-time student under age 24. For details, see *Gross Income Test* in chapter 3.

Single dependents—Were you either age 65 or older or blind?

☐ **No.** You must file a return if either of the following apply.
- Your unearned income was $1 or more, and the total of that income plus your earned income was more than $650.
- You had no unearned income, and your earned income was more than $4,150.

☐ **Yes.** You must file a return if any of the following apply.
- Your earned income was more than $5,150 ($6,150 if 65 or older **and** blind).
- Your unearned income was more than $1,650 ($2,650 if 65 or older **and** blind).
- Your gross income was more than:
  1) The larger of $650 or your earned income (up to $4,150), plus
  2) $1,000 ($2,000 if 65 or older **and** blind).

Married dependents—Were you either age 65 or older or blind?

☐ **No.** You must file a return if any of the following apply.
- Your gross income was at least $5 and your spouse files a separate return on Form 1040 and itemizes deductions.
- You had no unearned income, and your earned income was more than $3,450.
- Your unearned income was $1 or more, and the total of that income plus your earned income was more than $650.

☐ **Yes.** You must file a return if any of the following apply.
- Your gross income was at least $5 and your spouse files a separate return on Form 1040 and itemizes deductions.
- Your earned income was more than $4,250 ($5,050 if 65 or older **and** blind).
- Your unearned income was more than $1,450 ($2,250 if 65 or older **and** blind).
- Your gross income was more than:
  1) The larger of $650 or your earned income (up to $3,450), plus
  2) $800 ($1,600 if 65 or older **and** blind).

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

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

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

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

Foreign governments or international organizations. If you are a U.S. citizen who works in the United States for an international organization, a foreign government, or a wholly owned instrumentality of a foreign government, and if your work is exempt from social security and Medicare taxes, you must include your earnings from services performed in the United States when figuring your net earnings from self-employment.

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

Aliens

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

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

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

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

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

Joint return. If you are an alien and you were married to a person who was a U.S. citizen or resident on the last day of the tax year, you may be able to file a joint return with your spouse. See Publication 519.

Who Should File

TIP *Even if you do not have to file, you should file a federal income tax return to get money back if:*

1) *You had income tax withheld from your pay, or*
2) *You qualify for the earned income credit. See chapter 35 for more information.*

Which Form Should I Use?

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

Form 1040EZ

Form 1040EZ is the simplest form to use.

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

1) Your filing status is single or married filing jointly.
2) You (and your spouse if married filing a joint return) were under age 65 on January 1, 1998, and not blind at the end of 1997.
3) You do not claim any dependents.
4) Your taxable income is less than $50,000.
5) Your income is only from wages, salaries, tips, unemployment compensation, Alaska Permanent Fund dividends, taxable scholarship and fellowship grants, and taxable interest of $400 or less.
6) You did not receive any advance earned income credit (EIC) payments.
7) If you were a nonresident alien at any time in 1997, your filing status is married filing jointly.
8) You do not owe any household employment taxes on wages you paid to a household employee.

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

Table 1-3. **Other Situations When You Must File a 1997 Return**

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

1. You owe any special taxes, such as:
   - Social security or Medicare tax on tips you did not report to your employer. (See chapter 7.)
   - Uncollected social security, Medicare, or railroad retirement tax on tips you reported to your employer. (See chapter 7.)
   - Uncollected social security, Medicare, or railroad retirement tax on your group-term life insurance.
   - Alternative minimum tax. (See chapter 31.)
   - Tax on a qualified retirement plan, including an individual retirement arrangement (IRA). (See chapter 18.)
   - Tax on a medical savings account (MSA). (See Publication 969, *Medical Savings Accounts (MSAs).)*
   - Tax from recapture of investment credit or a low-income housing credit you claimed in a previous year. (See the instructions for Form 4255, *Recapture of Investment Credit*, or Form 8611, *Recapture of Low-Income Housing Credit.)*
   - Recapture tax on the disposition of a home purchased with a federally-subsidized mortgage. (See chapter 16.)
   - Recapture of the qualified electric vehicle credit. (See chapter 36.)
2. You received any advance earned income credit (EIC) payments from your employer. This amount should be shown in box 9 of your Form W-2. (See chapter 35.)
3. You had net earnings from self-employment of as least $400. (See *Self-Employed Persons* in this chapter.)
4. You had wages of $108.28 or more from a church or qualified church-controlled organization that is exempt from employer social security and Medicare taxes. (See Publication 533.)

Form 1040A

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

You can use Form 1040A if:

1) Your income is ***only*** from wages, salaries, tips, IRA distributions, pensions and annuities, taxable social security and railroad retirement benefits, taxable scholarship and fellowship grants, interest, dividends (including Alaska Permanent Fund dividends), and unemployment compensation.
2) Your taxable income is less than $50,000.
3) Your only adjustment to income is the deduction for contributions to an IRA.
4) You do not itemize your deductions.
5) Your only taxes are:
   a) The amount from the Tax Table.
   b) Alternative minimum tax (see chapter 31).
   c) Employment taxes on wages you paid to a household employee (see Publication 926, *Household Employer's Tax Guide).*
   d) Advance earned income credit (EIC) payments, if you received any (see chapter 35).
6) Your only credits are:
   a) The credit for child and dependent care expenses (see chapter 33).
   b) The credit for the elderly or the disabled (see chapter 34).
   c) The earned income credit (see chapter 35).
   d) The adoption credit (see chapter 36).

If you file Form 1040A, you can claim estimated tax payments for 1997 and the exclusion of interest from Series EE U.S. savings bonds issued after 1989.

If you do not meet all of the above requirements, you cannot use Form 1040A. For example, if you claim itemized deductions, you cannot use Form 1040A.

Form 1040

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

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

You must use Form 1040 if:

1) Your taxable income is $50,000 or more.
2) You itemize your deductions.
3) You received or paid accrued interest on securities transferred between interest payment dates.
4) You received nontaxable dividends or capital gain distributions.
5) You have to complete Part III of Schedule B (Form 1040) because:
   a) You received a distribution from a foreign trust, or
   b) You had a bank, securities, or other financial account in a foreign country at any time during the year. ***Note:*** If the combined value of the foreign account(s) was $10,000 or less during all of 1997, or if the account(s) was with a U.S. military banking facility operated by a U.S. financial institution, you may be able to use Form 1040A or Form 1040EZ.
6) You had income that cannot be reported on Form 1040EZ or Form 1040A. This includes gain from the sale of your home or other property, barter income, alimony income, taxable refunds of state and local income taxes, and self-employment income (including farm income).
7) You sold or exchanged capital assets or business property.
8) You claim adjustments to gross income for payments to a medical savings account; moving expenses; one-half of your self-employment tax; payments for self-employed health insurance; payments to a Keogh, SEP, or SIMPLE plan; the penalty on early withdrawal of savings; alimony paid; certain required repayments of supplemental unemployment benefits; jury pay turned over to your employer; qualified performing artists' expenses; or other allowable adjustments to income.
9) Your Form W–2 shows uncollected employee tax (social security and Medicare tax) on tips or group-term life insurance in box 13. See chapter 7.
10) You received $20 or more in tips in any one month and did not report all of them to your employer. See chapter 7.
11) You must pay tax on self-employment income. See Schedule SE (Form 1040), *Self-Employment Tax.*
12) You have to recapture an investment credit, a low-income housing credit, a qualified electric vehicle credit, or an Indian employment credit you claimed in a previous year.
13) You have to recapture tax on the disposition of a home purchased with a federally-subsidized mortgage. See chapter 16.
14) You have to pay tax on an excess golden parachute payment.
15) You claim credits against your tax for any of the following:

a) Mortgage interest credit

b) Foreign tax credit

c) Any general business credit

d) Credit for prior year minimum tax

e) Credit for fuel from a nonconventional source

f) Credit for federal tax on fuels

g) Qualified electric vehicle credit

h) Regulated investment company credit

16) You file any of the following:

a) Form 2119, *Sale of Your Home* (when filed in the year of sale)

b) Form 2555, *Foreign Earned Income*

c) Form 2555–EZ, *Foreign Earned Income Exclusion*

d) Form 4563, *Exclusion of Income for Bona Fide Residents of American Samoa*

e) Form 4970, *Tax on Accumulation Distribution of Trusts*

f) Form 4972, *Tax on Lump-Sum Distributions* (See chapter 11.)

g) Form 5329, *Additional Taxes Attributable to Qualified Retirement Plans (Including IRAs), Annuities, Modified Endowment Contracts, and MSAs*

Note: Do not file Form 1040 only because you have to file Form 5329. File Form 5329 by itself. (See chapters 11 and 18.)

h) Form 8271, *Investor Reporting of Tax Shelter Registration Number*

i) Form 8814, *Parents' Election To Report Child's Interest and Dividends*

j) Form 8853, *Medical Savings Accounts and Long-Term Care Insurance Contracts*

Does My Return Have To Be On Paper?

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

1) IRS *e-file* (electronic filing):

a) Using a tax professional,

b) Using your personal computer, or

c) Using a telephone (TeleFile), and

2) Computerized returns.

IRS *e-file*

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

Table 1-4. **Benefits of IRS *e-file***

Accuracy	• Computer program quickly checks for errors or missing information
Acknowledgment	• IRS provides an acknowledgement within 48 hours that your return has been accepted for processing
File Now, Pay Later	• File early and pay the balance due by April 15
Fast Refunds	• Expect to receive it in half the time as when filing on paper - even faster with direct deposit
Simultaneous Federal/State Filing	• File both federal and state returns with the IRS at the same time (available in over 30 states)

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

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

State returns. In most states, you can file an electronic state return simultaneously with your federal return. For more information, check with your local IRS office, state tax agency, or tax professional.

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

With IRS *e-file,* your refund will be issued in half the time as when filing on paper (even faster if you choose direct deposit). Most refunds are issued within 3 weeks. In many cases, you can receive your refund in about 14 days, particularly if you choose direct deposit. However, some refunds may be temporarily delayed as a result of compliance checks. These checks make sure that returns are filed accurately and the refund is correct.

Direct deposit. To choose direct deposit of your refund, complete Part II of Form 8453 (discussed later) and check the appropriate box in Part III.

CAUTION

Errors in direct deposit information will cause delays in processing your refund. Review the information carefully. Make sure the "routing transit number" (RTN) of your financial institution contains 9 digits. Your return will be rejected if there are fewer than 9 digits.

Once an *e-file* return has been accepted by IRS, you cannot cancel the direct deposit election nor can you change your RTN or bank account number.

Offset against debts. As with a paper return, you will not get all of your refund if you owe federal tax, a student loan, child support, or other debts to federal agencies. Instead, part or all of your refund will be used to pay the debt.

Refund inquiries. If you do not receive your refund within 3 weeks after your return was accepted by IRS, you can call TeleTax Refund Information. The TeleTax number for your area is listed in your tax forms package. Before you call TeleTax, please have the following information from your return available:

1) The first social security number shown on the return,

2) Your filing status, and

3) The exact amount of your refund.

If the TeleTax recording tells you the date your refund was issued, you should receive the refund within a week of that date. If you do not receive the refund by the end of that week, contact your IRS office. See the telephone numbers listed under *Calling the IRS* in your tax forms package.

If TeleTax has no information on your return, contact your tax professional or electronic return transmitter for the date IRS accepted your return. If your return was accepted more than 3 weeks ago, contact your local IRS office. Explain that you filed your return electronically and that TeleTax has no information on it. Also, provide the first social security number shown on your return and the date the IRS accepted your return.

Balance due. If you have a balance due with your return, you must pay it by April 15, 1998, to avoid penalties and interest. Mail your payment with either:

1) The **Form 1040–V,** *Payment Voucher,* included in some tax forms packages (or provided by your tax professional or electronic return transmitter), or

2) The tear-off stub from the appropriate payment reminder notice.

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

IRS *e-file* Using a Tax Professional

Many tax professionals file returns electronically for their clients. You can prepare your own return and have a professional transmit it electronically, or you can have a professional both prepare it and transmit it. Look for the "Authorized IRS *e-file* Provider" sign. Tax professionals may charge a fee to *e-file* your return.

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

IRS *e-file* Using a Personal Computer

If you have a computer, a modem and tax preparation software, you can *e-file* your return electronically from your home. Tax preparation software offering the IRS *e-file* option is available at your local computer retailer or through various web sites over the Internet. Using your personal computer, you can file 24 hours a day, 7 days a week. You may be charged a fee for having your return transmitted to the IRS. Your electronic return transmitter will inform you if your return is accepted by the IRS.

What to send to IRS. You will then have to send the IRS Form 8453–OL, *U.S. Individual Income Tax Declaration for On-line Filing,* along with your Forms W–2 and supporting documents. Form 8453–OL is available through your electronic return transmitter.

IRS *e-file* Using a Telephone (TeleFile)

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

The call takes about 10 minutes. To file using TeleFile, you must use a touch-tone phone. Your filing status must be single or married filing jointly, you must live at the address printed on your TeleFile Tax Record, and you cannot claim any dependent. In addition, you must meet the other requirements explained in the TeleFile tax package.

To use TeleFile, fill in the TeleFile Tax Record. Then call the number listed in the TeleFile tax package. Use your touch-tone phone to enter the information requested. TeleFile will figure your tax and will tell you the amount of your refund or the amount you owe.

CAUTION *Do not hang up until TeleFile gives you a confirmation number, which guarantees your return has been accepted and filed. Write this number on the TeleFile Tax Record, and keep it for your records.*

No paper tax return. You will not have to mail a paper tax return or Forms W–2 to the IRS. But if you owe additional tax, send your payment with Form 8855–V, *TeleFile Payment Voucher,* which is in your TeleFile package.

Refund. If you are due a refund, you should get it in half the time as when filing on paper — even faster if you request direct deposit.

Computerized Returns

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

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

If you need to list more items than fit on a regular tax return (nine dependents, for example), you can list them all on the 1040PC and print them in order, without the need for attaching an additional statement.

Tax preparation software that includes the 1040PC print option is checked and accepted by the IRS and has the 1040PC logo. It can be processed faster and more accurately than the regular tax return. Software packages are available at many computer software stores. They are not available from the IRS. For more information, call the TeleTax number for your area listed in your tax forms package.

When Do I Have To File?

April 15, 1998, is the due date for filing your 1997 income tax return if you use the calendar year. For a quick view of due dates for filing a return with or without an extension of time to file (discussed later), see *Table 1–5.*

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

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

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

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

The IRS publishes a list of designated private delivery services in September of each year. The list published in September 1997 is as follows:

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

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

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

Nonresident alien. If you are a nonresident alien and earn wages subject to U.S. income tax withholding, your 1997 U.S. income tax return (Form 1040NR or Form 1040NR–EZ) is due by:

- April 15, 1998, if you use a calendar year, or
- The 15th day of the 4th month after the end of your fiscal year if you use a fiscal year.

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

- June 15, 1998, if you use a calendar year, or
- The 15th day of the 6th month after the end of your fiscal year, if you use a fiscal year.

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

Filing for a decedent. If you must file a final return as an executor, administrator, legal representative, or surviving spouse of a taxpayer who died during the year (a decedent), the income tax return is due by the 15th day of the 4th month after the end of the decedent's normal tax year. In most cases, for a 1997 return, this will be April 15, 1998. See *Final Return for the Decedent* in chapter 4.

Extensions of Time To File

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

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

These rules are discussed separately.

Form 4868. If you cannot file your 1997 return by the due date, you may be able to get an automatic 4–month extension of time to file. To get the automatic extension, you must file Form 4868, *Application for Automatic Extension of Time To File U.S. Individual Income Tax Return.*

Example. If your return is due on April 15, 1998, you will have until August 17, 1998, to file.

Table 1-5. **When To File Your 1997 Return** (For U.S. citizens and residents who file returns on a calendar year)

	For Most Taxpayers	For Certain Taxpayers Outside the U.S.
No extension requested	April 15, 1998	June 15, 1998
Form 4868 filed (1st extension)	August 17, 1998	August 17, 1998
Form 2688 filed after filing Form 4868 (2nd extension)	October 15, 1998	October 15, 1998

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

When to file. You must file Form 4868 by April 15, 1998. If you are filing a fiscal year return, file Form 4868 by the regular due date for your return. You can file Form 1040EZ, Form 1040A, or Form 1040 any time before the 4–month extension period ends.

Time to pay not extended. An extension of time to file is not an extension of time to pay. You must make an accurate estimate of your tax for 1997 and send any necessary payment with your Form 4868. If you find you cannot pay the full amount due with Form 4868, you can still get the extension. You will owe interest on the unpaid amount.

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

Interest and penalties are assessed (charged) from the original due date of the return, which, for most taxpayers, is April 15, 1998.

When you file your return. Enter any payment you made with Form 4868 on line 57, Form 1040. If you file Form 1040EZ or Form 1040A, include any payment you made with Form 4868 in your total payments on line 9 of Form 1040EZ or line 29e of Form 1040A. Also print “Form 4868” and the amount paid in the space to the left of line 9 or line 29e.

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

You can apply for an extension beyond the 4–month extension either by writing a letter to the IRS or by filing **Form 2688,** *Application for Additional Extension of Time To File U.S. Individual Income Tax Return.* You should ask for the extension early so that, if it is not approved, you still will be able to file on time. Except in cases of undue hardship, a request for additional time will not be approved unless you have first used Form 4868 to get an automatic 4–month extension. Form 2688 or your letter will not be considered if you file it after the extended due date.

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

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

You must sign the request for this extension, or it may be signed by your attorney, CPA, enrolled agent, or a person with a power of attorney. If you are unable to sign the request because of illness or for another good reason, a person with a close personal or business relationship to you can sign for you, stating why you could not sign the request.

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

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

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

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

Individuals Outside the United States

You are allowed an automatic 2–month extension (until June 15, 1998, if you use the calendar year) to file your 1997 return and pay any federal income tax due if:

1) You are a U.S. citizen or resident, and
2) On the regular due date of your return (April 15, 1998, if you use the calendar year):
   a) You are living outside of the United States and Puerto Rico, and your main place of business or post of duty is outside the United States and Puerto Rico, ***or***
   b) You are in military or naval service on duty outside the United States and Puerto Rico.

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

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

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

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

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

Extensions beyond 2 months. If you cannot file your return within the automatic 2–month extension period, you may be able to get an additional 2–month extension, for a total of 4 months. You must file Form 4868 by the end of the automatic extension period (usually June 15, 1998) to get this additional 2–month extension.

This additional 2–month extension of time to file is ***not*** an extension of time to pay. See *Time to pay not extended,* earlier.

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

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

Individuals Serving in Combat Zone

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

Combat zone. For purposes of the automatic extension, the term “combat zone” includes:

1) The Persian Gulf Area, effective August 2, 1990, and
2) The qualified hazardous duty area of Bosnia and Herzegovina, Croatia, and Macedonia, effective November 21, 1995.

See Publication 3 for information about other tax benefits available to military personnel serving in a combat zone.

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

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

In addition to the 180 days, your deadline is also extended by the number of days you had left to file when you entered the combat zone. For example, you have 3½ months (January 1 – April 15, 1998) to file your 1997 tax return. Any days left in this period when you entered the combat zone (or the entire 3½ months if you entered it before January 1, 1998) are added to the 180 days.

How Do I Prepare My Return?

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

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

If you do not receive a tax return package in the mail, or if you need other forms, you can order them. You can get most forms and publications by using the order blank at the end of this publication or by calling 1–800–TAX–FORM (1–800–829–3676).

Table 1-6. **6 Steps for Preparing Your Return**

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

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

If you do not receive Form W–2 by February 2, 1998, contact your employer. If you still do not get the form by February 15, the IRS can help you by requesting the form from your employer. For more information, see *Form W–2* under *Credit for Withholding and Estimated Tax* in chapter 5.

Form 1099. If you received certain types of income, you may receive a Form 1099. For example, if you received taxable interest of $10 or more, the payer generally must give you a Form 1099–INT. If you have not received it by February 2, 1998, contact the payer. If you still do not get the form by February 15, call the IRS for help.

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

When Do I Report My Income and Expenses?

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

Accounting Periods

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

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

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

Accounting Methods

Your accounting method is the way you account for your income and expenses. Most taxpayers use either the cash method or an accrual method. You choose a method when you first file a return.

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

Constructive receipt. You constructively receive income when it is credited to your account or set apart in any way that makes it available to you. You do not need to have physical possession of it. For example, interest credited to your bank account on December 31, 1997, is taxable income to you in 1997 if you could have withdrawn it in 1997 (even if the amount is not entered in your passbook or withdrawn until 1998).

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

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

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

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

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

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

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

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

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

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

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

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

Social Security Number

You must show your social security number (SSN) on your return. Be sure the SSN on your return is the same as the SSN on your social security card. If the address label in your tax return package shows the wrong SSN, correct it on the label. If you did not receive a tax return package with a label, enter your SSN in the space provided on the return.

If you are married and did not receive a tax return package with a label, enter the SSNs for both you and your spouse, whether you file jointly or separately.

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

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

Exception. If your child was born and died in 1997 and you do not have an SSN for the child, you may attach a copy of the child's birth certificate instead. If you do, enter “DIED” in column 2 of line 6c. Enter “12” in column 4.

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

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

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

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

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

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

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

- You have a child living with you who was placed in your home for legal adoption by an authorized placement agency.
- You cannot get the child's existing SSN even though you have made a reasonable attempt to get it from the birth parents, the placement agency, and other persons.
- You cannot get an SSN for the child from the SSA because, for example, the adoption is not final.
- You cannot get an ITIN for the child.
- You are eligible to claim the child as a dependent on your tax return.

After the adoption is final, do not continue using the ATIN.

See Form W–7A for more information.

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

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

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

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

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

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

Presidential Election Campaign Fund

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

Rounding Off Dollars

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

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

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

Additional Schedules

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

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

Form 1040A. If you file Form 1040A, you must complete and attach any of the following schedules that apply.

- Schedule 1 to report your interest income or dividend income if either amount is more than $400 or if certain conditions apply. Those conditions are listed under *How To Report Interest Income* in chapter 8.
- Schedule 2 to take the credit for child and dependent care expenses.
- Schedule 3 to take the credit for the elderly or the disabled.
- Schedule EIC to take the earned income credit.
- Schedule H to figure employment taxes on wages you paid to a household employee.

Form 1040. If you file Form 1040, attach the necessary schedules or forms, such as:

- Schedule A to itemize your deductions.
- Schedule B to report over $400 in interest or dividends (including capital gain and nontaxable distributions), to answer the foreign accounts and for-

eign trusts questions, or to report interest or dividend income (even if $400 or less) if certain conditions apply. Those conditions are listed under *How To Report Interest Income* in chapter 8.

- Schedule C or Schedule C–EZ to report profit or loss from a business you operated or a profession you practiced as a sole proprietor, and to report wages and expenses you had as a statutory employee. You may also need to file Schedule SE.
- Schedule D to report capital gains and losses.
- Schedule E to report income or loss from rental real estate, royalties, partnerships, estates, trusts, S corporations, and REMICs (residual interests).
- Schedule EIC to take the earned income credit.
- Schedule F to report farm income and expenses.
- Schedule H to figure employment taxes on wages you paid to a household employee.
- Schedule R to take the credit for the elderly or the disabled.
- Schedule SE to figure self-employment tax.

Foreign accounts and trusts. You must complete Part III of Schedule B (Form 1040) if:

1) You received more than $400 in interest or dividends,
2) You had a foreign account, or
3) You received a distribution from or were a grantor of, or transferor to, a foreign trust.

If you checked *Yes* to the question on line 11a, Part III of Schedule B, you must file Form TD F 90–22.1, *Report of Foreign Bank and Financial Accounts,* by June 30, 1998, with the Department of the Treasury at the address shown on the form. Form TD F 90–22.1 is not a tax return, so do not attach it to your Form 1040. Be sure to file your Form 1040 with the IRS. You can get Form TD F 90–22.1 by using the order blank at the end of this publication.

For more information, see the instructions for Part III of Schedule B (Form 1040).

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

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

Signatures

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

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

Enter your occupation in the space provided in the signature section. If you file a joint return, enter both your occupation and your spouse's occupation.

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

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

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

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

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

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

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

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

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

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

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

Child's return. If a child has to file a tax return but cannot sign the return, the child's parent, guardian, or another legally responsible person must sign the child's name, followed by the words “By (signature), parent (or guardian) for minor child.”

Refunds

When you complete your return, you will determine if you paid more income tax than you owed. If so, you can get a refund of the amount you overpaid or, if you file Form 1040 or Form 1040A, you can choose to apply all or part of the overpayment to your next year's (1998) estimated tax.

CAUTION *If you choose to have a 1997 overpayment applied to your 1998 estimated tax, you cannot change your mind and have any of it refunded to you after the due date of your 1997 return.*

You cannot have your overpayment applied to your 1998 estimated tax if you file Form 1040EZ.

Follow the instructions in your tax forms package to complete the entries to claim your refund and/or to apply your overpayment to your 1998 estimated tax.

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

You cannot have your refund deposited directly into your account if any of the following are true.

1) You claim a refund that is from filing a prior year return.
2) You ask to have the refund deposited into a foreign bank account.
3) A legal document, such as a power of attorney, allows the refund to go to someone other than the taxpayer named on the return.

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

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

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

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

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

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

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

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

Amount You Owe

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

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

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

Interest

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

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

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

Interest due to IRS error or delay. All or part of any interest you were charged can be forgiven if the interest is due to an unreasonable error or delay by an officer or employee of the IRS in performing a ministerial or managerial act.

A ministerial act is a procedural or mechanical act that occurs during the processing of a taxpayer's case. A managerial act includes personnel transfers and extended personnel training.

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

How To Pay

If you pay by check or money order, make it out to the “Internal Revenue Service” (not “IRS”). Please show your correct name, address, social security number, daytime telephone number, and the tax year and form number on the front of your check or money order.

For example, if you file Form 1040 for 1997 and you owe additional tax, show your name and address, social security number, daytime telephone number, and “1997 Form 1040” on the front of your check or money order. If you file an amended return (Form 1040X) for 1996 and you owe tax, show your name and address, social security number, daytime telephone number, and “1996 Form 1040X” on the front of your check or money order.

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

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

Payment voucher. If you have a balance due on line 64 of your 1997 Form 1040 and you receive **Form 1040–V,** *Payment Voucher,* use it to send your payment to the IRS. This will help us process your payment more accurately and efficiently. Follow the instructions that come with the form.

Estimated tax payments. Do not include any 1998 estimated tax payment in your check or money order for your 1997 income tax return. Mail the estimated tax payment separately to the address shown in the Form 1040–ES instructions. The address for mailing estimated tax payments is different from the address for sending your tax return.

Payment not honored. If your check or money order is not honored by your bank (or other financial institution) and the IRS does not receive the funds, you still owe the tax.

Installment Agreement

If you cannot pay the full amount due with your return, you can ask to make monthly installment payments. However, you will be charged interest and may be charged a late payment penalty on the tax not paid by April 15, 1998, even if your request to pay in installments is granted. If your request is granted, you must also pay a fee. To limit the interest and penalty charges, pay as much of the tax as possible with your return. But before requesting an installment agreement, you should consider other less costly alternatives, such as a bank loan.

To ask for an installment agreement, use **Form 9465,** *Installment Agreement Request.* You can get Form 9465 by calling 1–800–TAX–FORM (1–800–829–3676). You should receive a response to your request within 30 days. But if you file your return after March 31, it may take longer for a reply.

Gift To Reduce the Public Debt

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

Bureau of the Public Debt
Department G
Washington, DC 20239–0601.

Or, you can enclose the check in the envelope with your income tax return. Please do not add this gift to any tax you owe. If you owe tax, include a separate check for the tax payable to “Internal Revenue Service.”

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

Peel-Off Address Label

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

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

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

If you are due a refund, the IRS will send it to the address shown on the return you file (unless you choose direct deposit). Notices or other correspondence will also be sent to that address. So if you move, please let the IRS know. See *Change of Address,* later, under *What Happens After I File?*

Correcting the label. Make necessary name and address changes on the label. If you have an apartment number that is not shown on the label, please write it in. If the label is for a joint return and the social security numbers are not listed in the same order as the first names, change the numbers to show the correct order. If your social security number is not correct, or if you changed your name, see the discussion under *Social Security Number,* earlier.

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

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

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

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

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

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

Where Do I File?

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

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

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

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

What Happens After I File?

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

What Records Should I Keep?

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

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

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

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

If you did not report income that you should have reported on your return, and it is more than 25% of the income shown on the return, the period of limitations does not run out until 6 years after you filed the return. If a return is false or fraudulent with intent to evade tax, or if no return is filed, an action can generally be brought at any time.

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

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

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

Transcript. You can also use Form 4506 to ask for a transcript of your return filed this year or during the 2 preceding years. It will show most lines from your original return, including accompanying forms and schedules.

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

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

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

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

Interest on Refunds

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

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

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

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

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

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

Offset Against Debts

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

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

To be considered an injured spouse, you must:

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

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

Change of Address

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

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

Past-Due Refund

If you do not get your refund within 4 weeks after filing your return, you can call TeleTax. For details on how to use this telephone service, see *What Is TeleTax?* in your tax forms package. Please wait at least 4 weeks after filing your 1997 tax return before using this service. In some cases, TeleTax may not have refund information until 6 weeks after you file.

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

What If I Made a Mistake?

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

Amended Returns and Claims for Refund

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

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

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

Form 1040X. Use Form 1040X, *Amended U.S. Individual Income Tax Return,* to correct the Form 1040, Form 1040A, or Form 1040EZ you have already filed.

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

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

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

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

File a separate form for each tax year involved.

Time for filing a claim for refund. Generally, you must file your claim for a credit or refund within 3 years after the date you filed your original return or within 2 years after the date you paid the tax, whichever is later. Returns filed before the due date (without regard to extensions) are considered filed on the due date (even if the due date was a Saturday, Sunday, or legal holiday).

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

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

Note. If you did not file an original return when it was due, you generally can claim a refund by filing your return within 3 years from the time the tax was paid. See *Tax paid* in the discussion that follows.

Limit on amount of refund. If you file your claim within 3 years after the date you filed your return, the credit or refund cannot be more than the part of the tax paid within the 3–year (plus any extension of time for filing your return) period immediately before you filed the claim.

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

Example 1. You made estimated tax payments of $500 and got an automatic extension of time to August 15, 1994, to file your 1993 income tax return. When you filed your return on that date, you paid an additional $200 tax. On August 15, 1997, you filed an amended return and claimed a refund of $700. Because you filed your claim within 3 years after you filed your return, you can get a refund of up to $700, the tax paid within the 3 years plus the 4–month extension period immediately before you filed the claim.

Example 2. The situation is the same as in Example 1, except you filed your return on October 31, 1994, 2½ months after the extension period ended. You paid an additional $200 on that date. On October 27, 1997, you filed an amended return and claimed a refund of $700. Although you filed your claim within 3 years from the date you filed your original return, the refund was limited to $200, the tax paid within the 3 years plus the 4–month extension period immediately before you filed the claim. The estimated tax of $500 paid before that period cannot be refunded or credited.

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

Example. You filed your 1993 tax return on April 15, 1994. You paid taxes of $500. On November 3, 1995, after an examination of your 1993 return, you had to pay an additional tax of $200. On May 9, 1997, you file a claim for a refund of $300. However, because you filed your claim more than 3 years after you filed your return, your refund will be limited to the $200 you paid during the 2 years immediately before you filed your claim.

Exceptions for special types of refunds. If you file a claim for one of the items listed below, the dates and limits discussed earlier (under *Time for filing a claim for refund* and *Limit on amount of refund*) may not apply. These items, and where to get more information, are:

- A bad debt (see *Nonbusiness Bad Debts* in chapter 15).
- A worthless security (see *Worthless securities* in chapter 15).
- Foreign tax paid or accrued (see Publication 514, *Foreign Tax Credit for Individuals).*
- Net operating loss carryback (see Publication 536, *Net Operating Losses).*
- Carryback of certain business tax credits (see Form 3800, *General Business Credit).*
- A claim based on an agreement with the Service extending the period for assessment of tax.
- An injured spouse claim (see *Offset Against Debts,* earlier).

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

Taking your claim to court. You can sue for a refund in court, but you must first file a timely claim with the IRS. If the IRS does not act on your claim within 6 months after you file it, you can then take your claim to court.

Fast method. The IRS provides a fast method (no 6-month waiting period) to move your claim to court if:

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

When you file your claim with the IRS, you get the fast method by requesting in writing that your claim be immediately rejected. A notice of claim disallowance will then be promptly sent to you. You have 2 years from the date of mailing of the notice of disallowance to file a refund suit in the United States District Court having jurisdiction or in the United States Court of Federal Claims.

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

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

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

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

Penalties

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

Civil Penalties

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

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

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

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

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

Paying tax late. You will have to pay a ***failure-to-pay*** penalty of ½ of 1% of your unpaid taxes for each month, or part of a month, after the due date that the tax is not paid. This penalty does not apply during the extension period available by filing Form 4868, *Application for Automatic Extension of Time To File U.S. Individual Income Tax Return,* if you paid at least 90% of your actual tax liability before the original due date of your return through withholding on wages, estimated tax payments, or a payment sent in with Form 4868.

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

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

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

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

1) You underpay your tax because of either “negligence” or “disregard” of rules or regulations, or

2) You substantially understate your income tax.

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

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

The term “disregard” includes any careless, reckless, or intentional disregard.

The penalty is based on the part of the underpayment due to negligence or disregard of rules or regulations, not on the entire underpayment on the return.

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

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

1) Substantial authority, or

2) Adequate disclosure and a reasonable basis.

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

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

In cases of substantial understatement only, items that meet the requirements of Revenue Procedure 96-58 (or later update) are considered adequately disclosed on your return without filing Form 8275.

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

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

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

You will have to pay the penalty if you filed this kind of return because of a frivolous position on your part or a desire to delay or interfere with the administration of federal income tax laws. This includes altering or striking out the preprinted language above the space provided for your signature.

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

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

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

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

Failure to supply social security number. If you do not include your social security number (SSN) or the SSN of another person where required on a return, statement, or other document, you will be subject to a penalty of $50 for ***each*** failure. You will also be subject to the penalty of $50 if you do not give your SSN to another person when it is required on a return, statement, or other document.

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

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

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

Criminal Penalties

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

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

2. Filing Status

Introduction

This chapter discusses which filing status you should use. There are five filing statuses to choose from:

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

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

Your filing status is an important factor in determining whether you must file a return (see chapter 1), the amount of your standard deduction (see chapter 21), and your correct amount of tax (see chapter 31). Your filing status is also important in determining whether you can take other deductions and credits.

Useful Items

You may want to see:

Publication

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

Marital Status

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

Unmarried persons. You are considered unmarried for the whole year if, on the last day of your tax year, you are unmarried or separated from your spouse by a divorce or a separate maintenance decree.

Divorced persons. State law governs whether you are married, divorced, or legally separated under a decree of separate maintenance. If you are divorced under a final decree by the last day of the year, you are considered unmarried for the whole year. If you obtain a divorce in one year for the sole purpose of filing tax returns as unmarried individuals, and at the time of divorce you intended to and did remarry each other in the next tax year, you and your spouse must file as married individuals.

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

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

Married persons. If you are considered married for the whole year, you and your spouse can file a joint return, or you can file separate returns. You are considered married for the whole year if on the last day of your tax year you and your spouse meet any one of the following tests.

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

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

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

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

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

Single

Your filing status is ***single*** if you are unmarried or separated from your spouse by a divorce or separate maintenance decree, and you do not qualify for another filing status.

Your filing status may be single if you were widowed before January 1, 1997, and did not remarry in 1997. However, you may be able to use another filing status that will give you a lower tax. See *Head of Household* and *Qualifying Widow(er) With Dependent Child* to see if you qualify.

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

Married Filing Jointly

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

If you and your spouse decide to file a joint return, your tax may be lower than your combined tax for the other filing statuses. Also, your standard deduction (if you do not itemize deductions) may be higher, and you may qualify for tax benefits that do not apply to other filing statuses. You can file a joint return even if one of you had no income or deductions. If you and your spouse each have income, you may want to figure your tax both on a joint return and on separate returns (using the filing status of married filing separately). Choose the method that gives the two of you the lower combined tax.

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

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

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

Filing a Joint Return

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

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

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

Innocent spouse exception. Under certain circumstances, you may not have to pay the tax, interest, and penalties on a joint return. You must establish that you did not know, and had no reason to know, that there was a substantial understatement of tax that resulted because your spouse:

1) Omitted a gross income item, or
2) Claimed a deduction, credit, or property basis in an amount for which there is no basis in fact or law.

The facts and circumstances must also indicate that it is unfair for you to pay the tax due. One consideration is whether you significantly benefited from the substantial understatement of tax. Normal support received from your spouse is not a significant benefit. Another consideration may be whether you were later divorced or deserted by your spouse.

This exception applies only if your spouse's action resulted in an understatement of tax of more than $500. In addition, if the tax understatement resulted from claiming a deduction, credit, or basis, the exception applies only if the additional tax, interest, and penalties are more than:

1) 10% of your adjusted gross income (AGI) for the preadjustment year, if your AGI was $20,000 or less, or
2) 25% of your AGI for the preadjustment year, if your AGI was more than $20,000.

Your preadjustment year is your most recent tax year ending before a deficiency notice was mailed. If you were married to a different person at the end of the preadjustment year, your AGI includes your new spouse's income, whether or not you filed a joint return for that year.

For purposes of this exception, community property rules do not apply to items of gross income (other than gross income from property).

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

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

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

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

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

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

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

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

Married Filing Separately

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

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

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

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

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

Separate Returns

Special rules apply if you file a separate return.

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

If you file a separate return:

1) Your spouse should itemize deductions if you itemize deductions, because he or she cannot claim the standard deduction.
2) You cannot take the credit for child and dependent care expenses in most instances.
3) You cannot take the earned income credit.
4) You cannot exclude any interest income from series EE U.S. Savings Bonds that you used for higher education expenses.
5) You cannot take the credit for the elderly or the disabled unless you lived apart from your spouse for the entire year.
6) You cannot take the credit for adoption expenses in most instances.
7) You may have to include in income more of your social security benefits (or equivalent railroad retirement benefits) than you would on a joint return.

Individual retirement arrangements (IRAs). If:

1) You and your spouse lived together during the year,
2) You file separate returns, and
3) Either of you was covered by an employer retirement plan during the year,

you may not be able to deduct contributions to your individual retirement arrangement (IRA). See *Deductible Contributions* in chapter 18.

Rental activity losses. If your rental of real estate is a passive activity, you can generally offset a loss of up to $25,000 against your nonpassive income if you actively participate in the activity. However, married persons filing separate returns who lived together at any time during the year cannot claim this offset. Married persons filing separate returns who lived apart at all times during the year are each allowed a $12,500 maximum offset for passive real estate activities. See *Limits on Rental Losses* in chapter 10.

Joint Return After Separate Returns

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

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

Separate Returns After Joint Return

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

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

Head of Household

You may be able to file as ***head of household*** if you are unmarried or considered unmarried on the last day of the year. In addition, you must have paid more than half the cost of keeping up a home for you and a qualifying person for more than half the year.

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

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

Considered Unmarried

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

1) You file a separate return.
2) You paid more than half the cost of keeping up your home for the tax year.
3) Your spouse did not live in your home during the last 6 months of the tax year. Your spouse is considered to live with you if he or she is temporarily absent due to special circumstances. See *Temporary absences,* later.
4) Your home was, for more than half the year, the main home of your child, stepchild, adopted child, or foster child for whom you can claim an exemption. (See *Home of qualifying person,* later.) However, you can still meet this test if you cannot claim an exemption for your child only because:
   a) You state in writing to the noncustodial parent that he or she may claim an exemption for the child, or
   b) The noncustodial parent provides at least $600 support for the dependent and claims an exemption for the dependent under a pre-1985 divorce or separation agreement.

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

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

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

Qualifying Person

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

Home of qualifying person. Generally, the relative must live with you for more than half the year to be a qualifying person.

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

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

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

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

Keeping Up a Home

You are keeping up a home only if you pay more than half of the cost of its upkeep. You can determine whether you paid more than half of the cost of keeping up a home by using the *Cost of Maintaining a Household* worksheet, shown later.

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

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

Cost of Maintaining a Household

	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 you paid more than half the total cost, you meet the requirement of maintaining a household.

Qualifying Widow(er) With Dependent Child

If your spouse died in 1997, you can use married filing jointly as your filing status for 1997 if you would otherwise qualify to use that status. The year of death is the last year for which you can file jointly with your deceased spouse. See *Married Filing Jointly,* earlier.

You may be eligible to use ***qualifying widow(er) with dependent child*** as your

Table 2-1. **Qualifying Person**

*Each of the following individuals can be a qualifying person.**

<table>
<tr><td>Your child, grandchild, stepchild, or adopted child. If he or she is . . .</td><td>Your foster child. If he or she is . . .</td><td>Your parent, grandparent, brother, sister, stepbrother, stepsister, stepmother, stepfather, mother-in-law, father-in-law, half brother, half sister, brother-in-law, sister-in-law, or daughter-in-law. If . . .</td><td>Your uncle, aunt, nephew, or niece. If . . .</td></tr>
<tr><td>Single, he or she is a qualifying person even if you cannot claim an exemption for the child.</td><td>Single, he or she is not a qualifying person unless you can claim an exemption for the child.</td><td rowspan="2">You can claim an exemption for the relative, he or she is a qualifying person.</td><td rowspan="2">He or she is related to you by blood and you can claim an exemption for him or her. (You are related by blood to an uncle or aunt if he or she is the brother or sister of your mother or father. You are related by blood to a nephew or niece if he or she is the child of your brother or sister.)</td></tr>
<tr><td colspan="2">Married you must be able to claim an exemption for the child unless the child's other parent claims the exemption under the special rules for a noncustodial parent discussed under Support Test for Divorced or Separated Parents in chapter 3.</td></tr>
</table>

*A person cannot qualify more than one taxpayer to use the head of household filing status for any tax year.
If you can only claim an exemption for a person under a multiple support agreement, that person cannot be a qualifying person. See *Multiple Support Agreement* in chapter 3.

filing status for 2 years following the year of death of your spouse. For example, if your spouse died in 1996, and you have not remarried, you may be able to use this filing status for 1997 and 1998.

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

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

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

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

Example. John Reed's wife died in 1995. John has not remarried. He has continued during 1996 and 1997 to keep up a home for himself and his child (for whom he can claim an exemption). For 1995 he was entitled to file a joint return for himself and his deceased wife. For 1996 and 1997 he can file as qualifying widower with a dependent child. After 1997 he can file as head of household if he qualifies.

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

3. Personal Exemptions and Dependents

Important Changes for 1997

Social security number for dependents. You must list either the social security number or individual taxpayer identification number of **every** person for whom you claim an exemption. See *Social Security Number for Dependents,* later.

Exemption amount. The amount you can deduct for each exemption has increased from $2,550 in 1996 to $2,650 in 1997.

Exemption phaseout. You will lose all or part of the benefit of your exemptions if your adjusted gross income is above a certain amount. The amount at which this phaseout begins depends on your filing status. For 1997, the phaseout begins at $90,900 for married persons filing separately; $121,200 for unmarried individuals; $151,500 for heads of household; and at $181,800 for married persons filing jointly. See *Phaseout of Exemptions,* later.

Introduction

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

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

Exemptions reduce your taxable income. Generally, you can deduct $2,650 for each exemption you claim in 1997. How you claim an exemption on your tax return depends on which form you file.

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

If you file Form 1040A or Form 1040, follow the instructions for the form. The total number of exemptions you can claim is the total in the box on line 6d. Also complete line 21 (Form 1040A) or line 37 (Form 1040) by multiplying the total number of exemptions shown in the box on line 6d by $2,650.

Note. If your adjusted gross income is $90,900 or more, see *Phaseout of Exemptions,* later.

Useful Items

You may want to see:

Form (and Instructions)

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

Exemptions

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

Personal Exemptions

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

Your Own Exemption

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

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

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

Your Spouse's Exemption

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

Joint return. If your spouse had ***any gross income,*** as defined in chapter 1, you can claim his or her exemption only if you file a joint return.

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

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

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

If you are a surviving spouse without gross income and you remarry, you can be claimed as an exemption on both the final separate return of your deceased spouse and the separate return of your new spouse whom you married in the same year. If you file a joint return with your new spouse, you can be claimed as an exemption only on that return.

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

Exemptions for Dependents

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

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

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

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

Death of dependent. If your dependent died during the year and otherwise qualified as your dependent, you can take an exemption for your dependent.

Example. Your dependent mother died on January 15. You can take a full exemption for her on your return.

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

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

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

Member of Household or Relationship Test

To meet this test, a person must live with you for the entire year as a member of your household or be related to you. If at any time during the year the person was your spouse, that person cannot be your dependent. However, see *Personal Exemptions,* earlier.

Temporary absences. You and another person live together even if either (or both) of you are temporarily absent due to special circumstances. Temporary absences due to special circumstances include absences because of illness, education, business, vacation, and military service.

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

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

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

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

Your child, grandchild, great grandchild, etc. (a legally adopted child is considered your child)

Your stepchild

Your brother, sister, half brother, half sister, stepbrother, or stepsister

Your parent, grandparent, or other direct ancestor, but not foster parent

Your stepfather or stepmother

A brother or sister of your father or mother

A son or daughter of your brother or sister

Your father-in-law, mother-in-law, son-in-law, daughter-in-law, brother-in-law, or sister-in-law

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

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

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

However, if a state, one of its political subdivisions, or a tax-exempt child-placing agency makes payments to you as a foster parent, you may not take an exemption for the child.

Cousin. You can claim an exemption for your cousin only if he or she lives with you as a member of your household for the entire year. A cousin is a descendant of a brother or sister of your father or mother and does not qualify under the relationship test.

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

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

Citizenship Test

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

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

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

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

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

Joint Return Test

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

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

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

Example. Your son and his wife each had less than $2,000 of wages and no unearned income. Neither is required to file a tax return. Taxes were taken out of their pay, so they file a joint return to get a refund. You are allowed to take exemptions for your son and daughter-in-law if the other exemption tests are met.

Gross Income Test

Generally, you cannot take an exemption for a dependent if that person had gross income of $2,650 or more for the year. This test does not apply if the person is your child and is either under age 19, or a student under age 24, as discussed later.

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

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

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

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

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

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

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

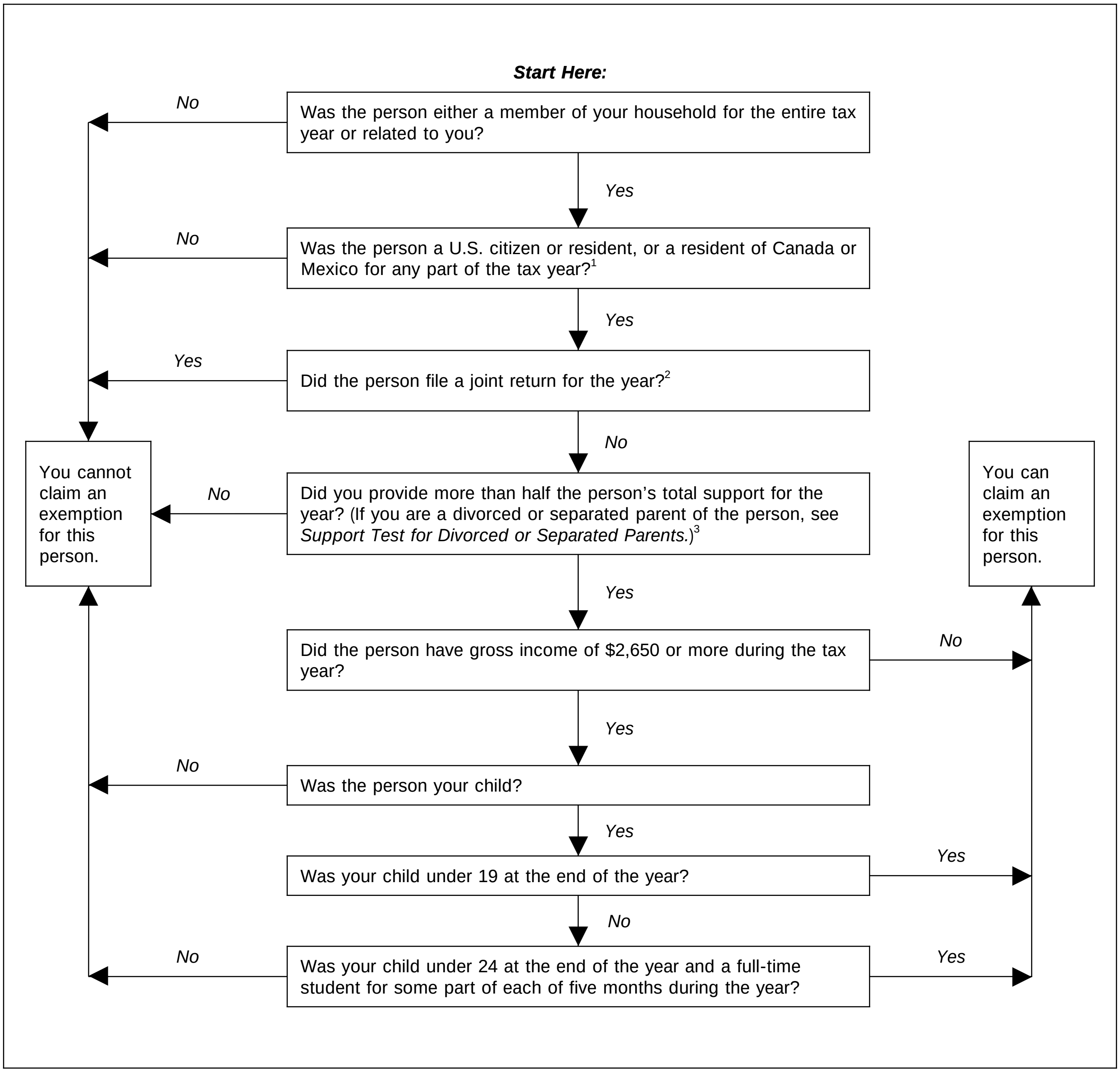
Disabled dependents. For this gross income test, gross income does not include income received by a permanently and totally disabled individual at a sheltered workshop. The availability of medical care must be the main reason the individual is at the workshop. Also, the income must come solely from activities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

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

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

Example. Marie, 18, earned $3,000. Her father provided more than half her support. He can claim an exemption for her

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



[1]If the person was your legally adopted child and lived in your home as a member of your household for the entire tax year, answer "yes" to this question.

[2]If neither the person nor the person's spouse is required to file a return but they file a joint return only to claim a refund of tax withheld, answer "no" to this question.

[3]Answer "yes" to this question if you meet the multiple support requirements under *Multiple Support Agreement.*

because the gross income test does not apply and the other exemption tests were met.

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

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

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

2) A student taking a full-time, on-farm training course given by a school described in (1) above or a state, county, or local government.

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

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

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

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

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

Support Test

You must provide more than half of a person's total support during the calendar year to meet the support test. You figure whether you have provided more than half by comparing the amount you contributed to the person's support with the entire amount of support the person received from all sources. This amount includes the person's own funds used for support. You cannot include in your contribution any part of your child's support that is paid for by the child with the child's own wages, even if you pay the wages. See *Total Support,* later.

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

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

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

Cost determines support. The total cost, not the period of time you provide the support, determines whether you provide more than half of the support.

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

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

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

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

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

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

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

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

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

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

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

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

Total Support

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

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

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

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

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

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

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

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

Example. Your parents live rent free in a house you own. It has a fair rental value of $5,400 a year furnished, which includes a fair rental value of $3,600 for the house and $1,800 for the furniture. This does not include heat and utilities. The house is completely furnished with furniture belonging to your parents. You pay $600 for their utility bills. Utilities are not usually included in rent for houses in the area where your parents live. Therefore, you consider the total fair rental value of the lodging to be $6,000 ($3,600 fair rental value of the unfurnished house, $1,800 allowance for furnishings provided by your parents, and $600 cost of utilities) of which you are considered to provide $4,200 ($3,600 + $600).

Person living in his or her own home. The total fair rental value of a person's home that he or she owns is considered support contributed by that person.

If you help to keep up the home by paying interest on the mortgage, real estate taxes, fire insurance premiums, ordinary repairs, or other items directly related to the home, or give someone cash to pay those expenses, reduce the total fair rental value of the home by those amounts in figuring that person's own contribution.

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

Income of the Person You Supported	
1) Did the person you supported receive any income, such as wages, interest, dividends, pensions, rents, social security, or welfare? (If yes, complete lines 2, 3, 4, and 5. If no, go to line 6.)	☐ Yes ☐ No
2) Total income received	$
3) Amount of income used for support	$
4) Amount of income used for other purposes	$
5) Amount of income saved	$
(The total of lines 3, 4, and 5 should equal line 2)	
Expenses for Entire Household (where the person you supported lived)	
6) Lodging (Complete item a or b)	
a) Rent paid	$
b) If not rented, show fair rental value of home. If the person you supported owned the home, include this amount in line 20.	$
7) Food	$
8) Utilities (heat, light, water, etc. not included in line 6a or 6b)	$
9) Repairs (not included in line 6a or 6b)	$
10) Other. Do not include expenses of maintaining home, such as mortgage interest, real estate taxes, and insurance.	$
11) Total household expenses (Add lines 6 through 10)	$
12) Total number of persons who lived in household	
Expenses for the Person You Supported	
13) Each person's part of household expenses (line 11 divided by line 12)	$
14) Clothing	$
15) Education	$
16) Medical, dental	$
17) Travel, recreation	$
18) Other (specify)	$
19) Total cost of support for the year (Add lines 13 through 18)	$
Did You Provide More Than Half?	
20) Amount the person provided for own support (line 3, plus line 6b if the person you supported owned the home)	$
21) 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 2.	$
22) Amount you provided for the person's support (line 19 minus lines 20 and 21)	$
23) 50% of line 19	$

Is line 22 is more than line 23?
Yes. You meet the support test for the person. If the other exemption tests are met, you may claim an exemption for the person.
No. You do not meet the support test for the person. You cannot claim an exemption for the person unless you can do so under a multiple support agreement. See *Multiple Support Agreement* in this chapter.

Example. You provide $6,000 cash for your father's support during the year. He lives in his own home, which has a fair rental value of $6,600 a year. He uses $800 of the money you give him to pay his real estate taxes. Your father's contribution for his own lodging is $5,800 ($6,600 – $800 for taxes).

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

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

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

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

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

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

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

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

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

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

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

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

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

Do Not Include in Total Support

The following items are not included in total support:

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

Multiple Support Agreement

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

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

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

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

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

Support Test for Divorced or Separated Parents

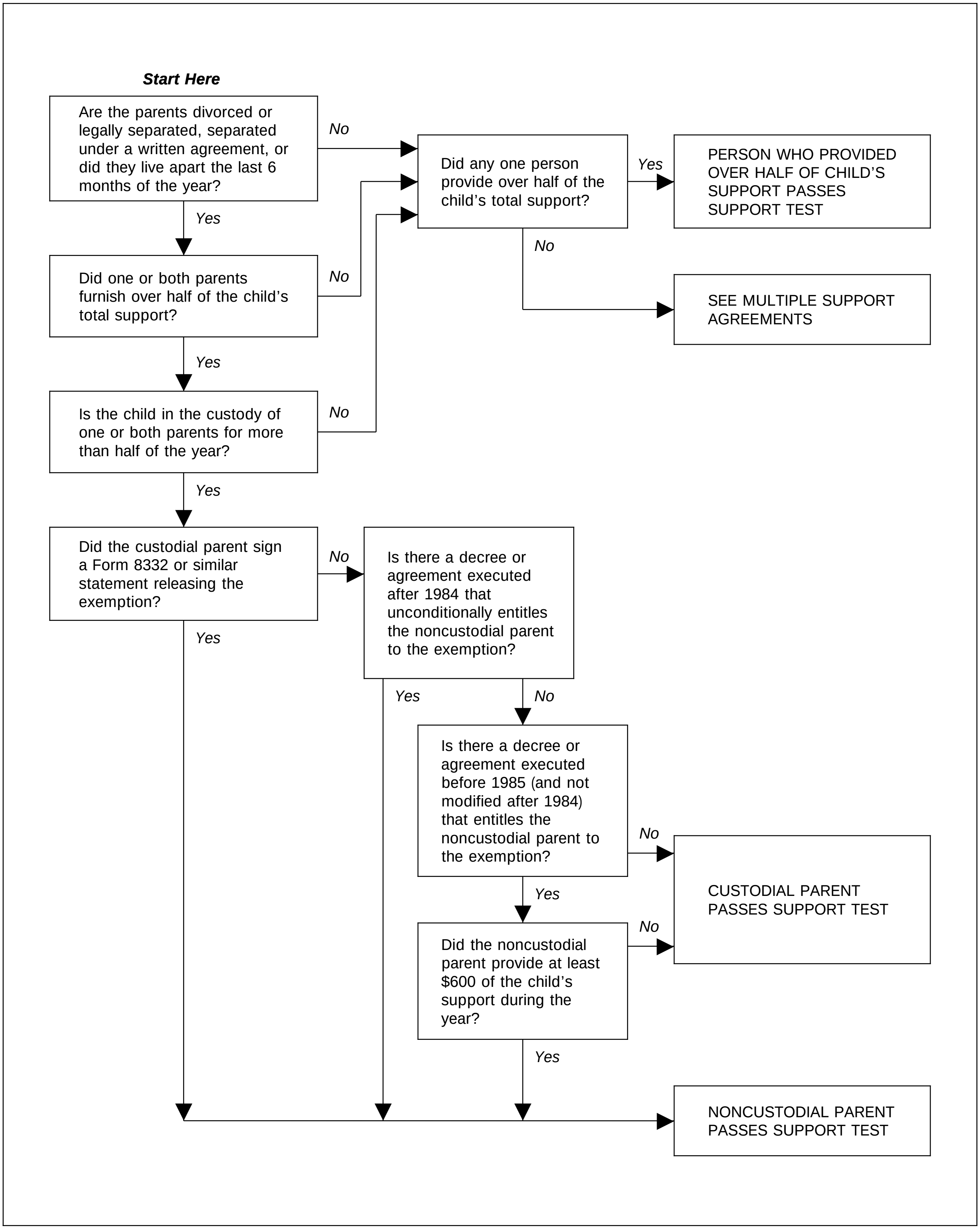
The support test for a child of divorced or separated parents is based on special rules that apply only if:

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

“Child” is defined earlier under *Gross Income Test.*

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

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



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

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

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

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

Example 2. You and your former spouse provided your child's total support for 1997. You had custody of your child under your 1993 divorce decree, but on August 31, 1997, a new custody decree granted custody to your former spouse. Because you had custody for the greater part of the year, you are considered to have provided more than half of your child's support.

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

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

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

Written declaration. The custodial parent should use **Form 8332,** *Release of Claim to Exemption for Child of Divorced or Separated Parents,* or a similar statement, to make the written declaration to release the exemption to the noncustodial parent. The noncustodial parent must attach the form or statement to his or her tax return.

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

Children who didn't live with you. You must attach Form 8332 or a similar statement to your return. If your divorce decree or separation agreement went into effect after 1984 and it unconditionally states that you can claim the child as your dependent, you can attach a copy of the following pages from the decree or agreement instead:

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

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

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

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

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

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

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

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

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

Home jointly owned. If you and your former spouse have the right to use and live in the home, each of you is considered to provide half of your child's lodging. However, if the divorce decree gives only you the right to use and live in the home, you are considered to provide your child's entire lodging. It does not matter if the legal title to the home remains in the names of both parents.

Phaseout of Exemptions

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

Filing Status	AGI Level Which Reduces Exemption Amount
Married filing separately	$90,900
Single	121,200
Head of household	151,500
Married filing jointly	181,800
Qualifying widow(er)	181,800

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

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

Social Security Number for Dependents

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

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

If your child was born and died in 1997 and you do not have an SSN for the child, you may attach a copy of the child's birth certificate instead. If you do, enter “DIED” in column 2 of line 6c of your Form 1040 or Form 1040A.

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

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

Form SS–5 is available at your local SSA office.

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

Taxpayer identification numbers for aliens. If your dependent is a resident or nonresident alien who does not have and is not eligible to get an SSN, the IRS will issue your dependent an individual taxpayer identification number (ITIN). Write the number in column (2) of line 6c of your Form 1040 or Form 1040A. To apply for an ITIN, use **Form W–7,** *Application for IRS Individual Taxpayer Identification Number.*

It usually takes about 30 days to get an ITIN.

Taxpayer identification numbers for adoptees. If you have a child who was placed with you by an authorized adoption agency, you may be able to claim an exemption for the child. However, if you do not know the child's SSN, you must get an adoption taxpayer identification number (ATIN) for the child from the IRS. See Form W–7A, *Application for IRS Adoption Taxpayer Identification Number* for details.

Dependents living in Mexico or Canada. If you claim an exemption for a dependent who lives in Mexico, enter “MX” instead of a number in column (4) of line 6c of your Form 1040 or Form 1040A. If you claim an exemption for a dependent who lives in Canada, enter “CN” instead of a number in column (4) of line 6c of your Form 1040 or Form 1040A.

4.

Decedents

Important Changes

Medical savings accounts (MSAs). Beginning in 1997, certain individuals are eligible to participate in medical savings accounts (MSAs). The treatment of the MSA at the death of the account holder depends on who acquires the interest in the account. For details, see the discussion of MSAs under *How To Report Certain Income,* and *Income in Respect of the Decedent,* later.

Accelerated death benefits. Beginning in 1997, certain payments received under a life insurance contract on the life of a terminally or chronically ill individual before the individual's death (an accelerated death benefit) can be excluded from income. For more information, see *Accelerated Death Benefits,* later.

Consistent treatment of estate and trust items. Beneficiaries must generally treat estate items the same way on their individual returns as they are treated on the estate's return. This rule applies to returns filed after August 5, 1997. For more information, see *How and When to Report,* under *Distributions to Beneficiaries from an Estate,* in Publication 559, *Survivors, Executors, and Administrators.*

65–day rule for estates. For tax years beginning after August 5, 1997, the personal representative can elect to treat distributions paid or credited by the estate within 65 days after the close of the estate's tax year as having been paid or credited on the last day of that tax year. For more information, see *Distributions to Beneficiaries from an Estate* in Publication 559.

Estates and beneficiaries treated as related persons for disallowance of certain items. For tax years beginning after August 5, 1997, an estate and a beneficiary of that estate are treated as related persons. Various tax provisions are affected by this change, including the one that denies a deduction for a loss on the sale of an asset between the parties.

The change does not apply to a sale or exchange made to satisfy a pecuniary bequest.

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

Survivor benefits of public safety officers. Generally, a survivor annuity paid to the spouse, former spouse, or child of a public safety officer killed in the line of duty is excluded from the recipient's gross income. This applies to officers dying after 1996. For more information, see *Gifts, Insurance, and Inheritances* in Publication 559.

Introduction

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

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

This chapter does not discuss the requirements for filing an income tax return of an estate (Form 1041). For information on Form 1041, see *Income Tax Return of an Estate–Form 1041* in Publication 559. This chapter also does not discuss the requirements for filing an estate tax return (Form 706). For information on Form 706, see *Form 706* in Publication 559.

Useful Items

You may want to see:

Publication

- ☐ **559** Survivors, Executors, and Administrators

Form (and Instructions)

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

Personal Representatives

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

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

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

Personal representative. In general, an executor and an administrator perform the same duties and have the same responsibilities. For simplicity, the term personal representative will be used throughout this chapter to refer to these “appointed” representatives and to representatives who are not appointed, but are in charge of a decedent's property.

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

Duties

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

The personal representative must also take the following actions.

1) Notify the IRS (as discussed below) that he or she is acting as the personal representative.
2) File any income tax return and estate tax return that is due. (See *Final Return for the Decedent,* next).
3) Pay any income tax and estate tax that is due.
4) Provide the payers of any interest and dividends the name(s) and identification number(s) of the new owner(s). (See *Interest and Dividend Income (Forms 1099)* later.)

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

Notifying the IRS. You can use **Form 56** to notify the District Director and the Internal Revenue Service Center, as required. See the instructions for Form 56 for more information.

Final Return for the Decedent

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

Filing to get a refund. If none of the filing requirements are met, but the decedent had tax withheld or paid estimated tax, a final return should be filed to get a refund. See *Claiming a refund,* later. A final return should also be filed if the decedent was entitled to a refundable credit such as the earned income credit. See chapters 35 and 36 for additional information on refundable credits.

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

Cash method. If the decedent used the cash method of accounting, which most people use, report only the items of income that the decedent actually or constructively received before death and deduct only the expenses the decedent paid before death. For an exception for certain medical expenses not paid before death, see *Medical costs,* later, under *Deductions.*

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

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

Who must file the return? The personal representative of the decedent is responsible for filing any income tax returns and paying any income tax that is due. This includes the final income tax return of the decedent (for the year of death) and any returns not filed for preceding years.

Example. Roberta Russell died on February 5, 1998, before filing her 1997 tax return. Her personal representative must file her 1997 tax return as well as her final tax return for 1998.

Exception. Under certain circumstances, a surviving spouse may be able to file a joint final return or joint returns for preceding years for which returns have not yet been filed. See *Joint return,* later.

Filing the return. When you file a return for the decedent, either as the personal representative or as the surviving spouse, you should ***write "DECEASED," the decedent's name, and the date of death*** across the top of the tax return. This same information should be included on any Form 1040X, *Amended U.S. Individual Income Tax Return,* that you file for the decedent.

If the decedent and surviving spouse are filing a joint return, you should write the name and address of the decedent and the surviving spouse in the name and address space. If you received a peel-off label with the correct information, you can use it instead.

If a joint return is not being filed, write the decedent's name in the name space and the personal representative's name and address in the remaining space.

Example 1. John Stone died in early 1997. He was survived by his wife Jane. Their final joint return included the required information as shown later in the illustration of the top of Form 1040.

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

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

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

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

Claiming a refund. Generally, a person who is filing a return for a decedent and claiming a refund must file **Form 1310,** *Statement of Person Claiming Refund Due a Deceased Taxpayer,* with the return.

Surviving spouse. If you are a surviving spouse filing a joint return with the decedent, you do not have to file Form 1310.

Appointed personal representative. If you are a court appointed or certified personal representative filing Form 1040, Form 1040A, or Form 1040EZ for the decedent, you also do not have to file Form 1310, but you must attach to the return a copy of the court certificate showing your appointment. If the certificate does not include your address, be sure that your address is shown on the return. See *Filing the return,* earlier.

Example. Joe Brown died on January 14, 1998, before filing his 1997 tax return. On April 3, 1998, you are appointed the personal representative for Joe's estate, and you file his Form 1040 for 1997 showing a refund due. You do not need to attach Form 1310 to claim the refund, but you must attach to his return a copy of the court certificate to show that you are the appointed personal representative of Joe's estate.

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

File the decedent's final income tax return with the Internal Revenue Service Center for the area where you live.

Request for prompt assessment of tax. As the personal representative for the decedent's estate, you must see that any additional taxes that the decedent may owe are paid. The IRS usually has 3 years after the filing of a return to charge any additional tax that is due. Returns filed before the due date are treated as filed on the due date.

You can shorten the time that the IRS has to charge the decedent's estate any additional tax by requesting a prompt assessment of the decedent's income taxes. This request reduces the time the IRS has to charge any additional tax from 3 years from the date the return is filed to 18 months from the date the IRS receives the request. This may permit a quicker settlement of the tax liability of the estate and earlier distribution of the decedent's assets, such as money and property, to the beneficiaries.

You can make the request for any tax year still subject to additional tax charges, even if the return was filed before the decedent's death.

CAUTION *Requesting this prompt assessment will not shorten the time the IRS has to charge any additional tax if it can be charged beyond the 3 years from the date the return was filed or due. For example, additional tax can still be charged because of a substantial omission of income or if a fraudulent return was filed.*

How to request. You can use **Form 4810** for making this request. If Form 4810 is not used, you must clearly indicate that you are requesting a prompt assessment under section 6501(d) of the Internal Revenue Code and specify the year(s) involved. You must file the request separately from any other document. Address your request to the District Director and send it to the IRS office where the decedent's return was filed.

Request for discharge from personal liability for tax. An executor can make a written request for a discharge from personal liability for a decedent's income and gift taxes. The request must be made after the returns for those taxes are filed. For this purpose an executor is an executor or administrator that is appointed, qualified, and acting within the United States.

Within 9 months after receipt of the request, the IRS will notify the executor of the amount of taxes due. If this amount is paid, the executor will be discharged from personal liability for any future deficiencies. If the IRS has not notified the executor, he or she will be discharged from personal liability at the end of the 9-month period.

CAUTION *Even if the executor is discharged, the IRS will still be able to assess tax deficiencies against the executor to the extent that he or she still has any of the decedent's property.*

Form 5495. Form 5495 can be used for making this request. If Form 5495 is not used, you must clearly indicate that the request is for discharge from personal liability under section 6905 of the Internal Revenue Code.

Joint return. Generally, the personal representative and the surviving spouse can file a joint return for the decedent and the surviving spouse. However, the surviving spouse alone can file the joint return if:

1) The decedent did not file a return for that year, and

2) No personal representative is appointed before the due date for filing the return of the surviving spouse.

This also applies to the return for the preceding year if the decedent died after the close of the preceding tax year and before the due date for filing that return. The final joint return must show the decedent's income before death and the surviving spouse's income for the entire year.

If the surviving spouse remarried before the end of the year in which the decedent died, a final joint return with the deceased spouse cannot be filed. The filing status of the deceased spouse is then married filing separately.

Change to joint return. If a separate return was filed by or for the decedent, and the due date for filing that return has expired, that return can be changed to a joint return only by the personal representative on behalf of the decedent. The surviving spouse must also agree to the change. A surviving spouse cannot change a separate return to a joint return if no personal representative has been appointed.

Change to separate return. If the surviving spouse files a joint return with the decedent and a personal representative is later appointed by the court, the personal representative can change the joint return election. This is done by filing a separate return for the decedent within one year from the due date of the return (including any extensions).

DECEASED JOHN S. STONE FEBRUARY 28, 1997

Form **1040** Department of the Treasury—Internal Revenue Service
U.S. Individual Income Tax Return **1997** IRS Use Only—Do not write or staple in this space.

For the year Jan. 1–Dec. 31, 1997, or other tax year beginning , 1997, ending , 19 OMB No. 1545-0074

Label (See instructions on page 10.)
Use the IRS label. Otherwise, please print or type.

LABEL HERE

CAR-RT SORT**CR01
LP 765-00-4321 123-00-4567 S29 30
JOHN S & JANE M STONE
1992 OAK ST 103
SHERIDAN WY 82801

IRS

Your social security number

Spouse's social security number

For help in finding line instructions, see pages 2 and 3 in the booklet.

Presidential Election Campaign (See page 10.)

	Yes	No
Do you want $3 to go to this fund?		
If a joint return, does your spouse want $3 to go to this fund?		

Note: *Checking "Yes" will not change your tax or reduce your refund.*

Filing Status

1 ☐ Single
2 ☐ Married filing joint return (even if only one had income)

65 Estimated tax penalty. Also include on line 64 . . . . . **65**

Sign Here
Keep a copy of this return 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
Jane M. Stone	4/1/98	ENGINEER
Spouse's signature. If a joint return, BOTH must sign. FILING AS SURVIVING SPOUSE	Date	Spouse's occupation

Paid Preparer's Use Only

Preparer's signature	Date	Check if self-employed ☐	Preparer's social security no.
Firm's name (or yours if self-employed) and address			EIN
			ZIP code

Printed on recycled paper

If a separate return is filed for the decedent, the joint return then becomes the separate return of the surviving spouse. The decedent's items are excluded, and the tax liability of the surviving spouse is refigured.

How To Report Certain Income

This section explains how to report certain types of income on the final return. The rules on income discussed in the other chapters of this publication also apply to a decedent's final return. See chapters 6 through 17, if they apply.

Interest and Dividend Income (Forms 1099)

Payers of interest and dividends report amounts on Forms 1099 using the name and identification number of the person to whom the account is payable. After a person's death, the Forms 1099 must reflect the new owner's (the estate's or beneficiary's) name and identification number. As the personal representative, you must furnish this information to the payers.

For example, if an interest-bearing account becomes part of the estate, you must provide the estate's name and employer identification number (EIN) to the payer so that the Form 1099–INT, *Interest Income,* can reflect the correct payee information. If the interest-bearing account is transferred to a surviving joint owner, you must provide the survivor's name and taxpayer identification number (TIN) to the payer.

You should receive Forms 1099 for the decedent that report amounts of interest and dividends earned prior to death. The estate or beneficiary should receive separate Forms 1099 that report the amounts earned after death and that are payable to them.

If you receive Forms 1099 that include both income earned before the date of death (reportable on the decedent's final return) and income earned after the date of death (reportable by the estate or other recipient), then you will need to request new Forms 1099. You should contact the payers to ask them for corrected Forms 1099 that properly identify the recipient of the income (by name and identification number) and the correct amounts.

Capital Loss

A capital loss sustained by a decedent during his or her last tax year can be deducted only on the final return filed for the decedent. The capital loss limits discussed in chapter 17 still apply in this situation. The loss cannot be deducted by the estate or carried over to following years.

Accelerated Death Benefits

If certain requirements are met, accelerated death benefits are excluded from the recipient's income. Accelerated death benefits are amounts received under a life insurance contract before the death of the insured individual. These benefits also include amounts received on the sale or assignment of the contract to a viatical settlement provider. This exclusion applies only if the insured was a terminally or chronically ill individual.

Generally, if the decedent received accelerated death benefits either on his or her own life or on the life of another person, those benefits are not included in the decedent's income. For more information, see the discussion under *Gifts, Insurance, and Inheritances* under *Other Tax Information,* in Publication 559.

Business Income

This section discusses some of the business income which may have to be included on the final return.

Partnership income. If the decedent was a partner, his or her death generally does not close the partnership's tax year. See *Closing of tax year* under *Tax Year* in Publication 541, *Partnerships.*

If the partnership year ends with the death of a partner, see *Deceased partner* under *Distributive Share in Year of Disposition* in Publication 541.

As the personal representative, you must ***include*** on the final return the decedent's share of partnership income for the partnership's tax year that ends within or with the decedent's last tax year (the year ending on the date of death).

Do not include on the final return the decedent's share of partnership income for a partnership's tax year that ends after the date of death. In this case, partnership income earned up to and including the date of death is ***income in respect of the decedent,*** which is discussed later in this chapter. Income earned after the date of death to the end of the partnership's tax year is income to the estate or successor in interest (beneficiary).

Example. The XYZ Partnership and all the partners use a calendar year as their tax year. One of the partners dies on June 10. The decedent's share of the partnership income from January 1 through June 10 is income in respect of a decedent. The share of partnership income after June 10 is income to the estate or beneficiary.

S corporation income. If the decedent was a shareholder in an S corporation, you must include on the final return the decedent's share of S corporation income for the corporation's tax year that ends within or with the decedent's last tax year (the year ending on the date of death). The final return must also include the decedent's pro rata share of the S corporation's income for the period between the end of the corporation's last tax year and the date of death.

The income for the part of the S corporation's tax year after the shareholder's death is income to the estate or other person who has acquired the stock in the S corporation.

Self-employment income. You must include on the final return the self-employment income that the decedent actually or constructively received or accrued, depending on the decedent's accounting method. For self-employment tax purposes only, the decedent's self-employment income will include the decedent's distributive share of a partnership's income or loss through the end of the month in which death occurred. For more information on how to compute the decedent's self-employment income, see Publication 533, *Self-Employment Tax.*

Medical Savings Account (MSA)

The treatment of a medical savings account at the death of the account holder depends on who acquires the interest in the account. If the estate of the holder acquires the interest, the fair market value of the assets in the account on the date of death is included in gross income on the decedent's final return. The estate tax deduction, discussed later, does not apply to this amount.

If a beneficiary acquires the interest, see the discussion under *Income in Respect of the Decedent,* later. For other information on MSAs, see Publication 969, *Medical Savings Accounts (MSAs).*

Deductions, Credits, and Exemptions

Generally, the rules for deductions, credits, and exemptions that apply to individuals also apply to the decedent's final income tax return. On the final return, claim deductible items that were paid before the decedent's death (or accrued, if the decedent reported deductions on an accrual method).

Deductions

All of the deductions that are discussed in this publication also apply to the final return as long as the decedent was eligible for the deduction at the time of death.

You can generally choose to claim itemized deductions or the standard deduction on the final return. See *Standard deduction,* later, for instances when you cannot choose the standard deduction or when the amount of the standard deduction may be limited.

If you have a choice, you should figure the amount of the decedent's itemized deductions before you decide whether to itemize or claim the standard deduction to be sure that you are using the method that gives you the lower tax.

Itemized deductions. If the total of the decedent's itemized deductions is more than the decedent's standard deduction, the federal income tax will generally be less if you claim itemized deductions on the final return. See chapters 23 through 30 for the types of expenses that are allowed as itemized deductions.

Note. The amount you can deduct for most itemized deductions is limited if adjusted gross income is more than $121,200 ($60,600 if married filing separately). See chapter 22 for more information.

Medical costs. If you itemize deductions on the final return, you may be able to deduct medical expenses of the decedent even though they were not paid before the date of death. See *Decedents* in chapter 23 for an explanation of how this election can be made.

CAUTION *Qualified medical expenses paid before death by the decedent are not deductible if paid with a tax-free distribution from a medical savings account.*

Unrecovered investment in pension. If the decedent was receiving a pension or annuity and died without a surviving annuitant, you can take a deduction on the decedent's final return for the amount of the decedent's investment in the pension or annuity contract that remained unrecovered at death. The deduction is a miscellaneous itemized deduction that is not subject to the 2% of adjusted gross income limit. See chapter 30.

Standard deduction. You can generally claim the full amount of the standard deduction on the decedent's final return. However, you cannot use the standard deduction if the surviving spouse files a separate return and itemizes deductions. In that event, you must also itemize deductions on the decedent's final return.

The amount of the standard deduction for a decedent's final return is the same as it would have been had the decedent continued to live. However, if the decedent was not 65 or older at the time of death, the higher standard deduction for age cannot be claimed.

If another taxpayer can claim the decedent as a dependent, the amount you can claim for the decedent's standard deduction may be limited. See chapter 21 for more information on how to determine the amount of the standard deduction.

Credits

Any of the tax credits that are discussed in this publication also apply to the final return if the decedent was eligible for the credits at the time of death. These credits are discussed in chapters 33 through 36 of this publication.

Tax withheld and estimated payments. There may have been income tax withheld from the decedent's pay, pensions, or annuities before death, and the decedent may have paid estimated income tax. To get credit for these tax payments, you must claim them on the decedent's final return. For more information, see *Credit for Withholding and Estimated Tax* in chapter 5.

Exemptions

You can claim the full amount of the personal exemption on the decedent's final return unless the decedent can be claimed as a dependent by another taxpayer. In that case, the decedent's own exemption amount on the final return is zero. See chapter 3 for information on other dependency exemptions that may be allowed on the final return.

Tax Effect on Others

This section contains information about the effect of an individual's death on the income tax liability of the survivors (including the widow or widower and the beneficiaries) and the estate. Any survivor should coordinate the filing of his or her own tax return with the personal representative handling the decedent's estate. The personal representative can coordinate filing status, exemptions, income, and deductions so that the final return and the income tax returns of the survivors and the estate are all filed correctly.

Gifts and inheritances. Property received as a gift, bequest, or inheritance is not included in your income. However, if the property you receive in this manner later produces income, such as interest, dividends, or rentals, then that income is taxable to you. If the gift, bequest, or inheritance you receive is the income from property, that income is taxable to you.

If you inherited the right to receive income in respect of the decedent, see *Income in Respect of the Decedent,* later.

Surviving spouse with dependent child. If there is a dependent child, the surviving spouse may be entitled to use the standard deduction amount and the tax rates that apply to joint returns for the 2 years following the year of the decedent's death. See *Qualifying Widow(er) With Dependent Child* in chapter 2 for information on how to qualify.

Decedent as your dependent. If the decedent qualified as your dependent for the part of the year before death, you can claim the full exemption amount for the dependent on your tax return.

Income in Respect of the Decedent

All gross income that the decedent had a right to receive and that is not properly includible on the decedent's final return is called income in respect of the decedent. Instead of being reported on the final return of the decedent, the income is included, for the tax year when received, in the gross income of:

1) The decedent's estate, if the estate acquires the right to receive the income from the decedent,
2) The person who acquires the right to the income directly from the decedent without going through the estate, or
3) Any person to whom the estate properly distributes the right to receive the income.

Example 1. Thornton Jones owned and operated an orchard, and he used the cash method of accounting. He sold and delivered $2,000 worth of fruit to a customer, but he did not receive payment before his death. When the estate was settled, payment had still not been made, and the estate gave the right to receive the payment to his niece. When she collects the $2,000, she must include it in her income. It is not reported on the final return of the decedent nor on the estate's income tax return.

Example 2. If, in Example 1, Thornton Jones had used the accrual method of accounting, the income from the fruit sale must be included on his final return. Neither his estate nor his niece will report the income when the money is later paid.

Example 3. Mary Smith was entitled to a large salary payment at the time of her death. It was to be paid in five yearly payments. Her estate, after collecting two payments, distributes the right to the remaining payments to you, the beneficiary. None of the payments would be included on the decedent's final return. The estate must include in its gross income, as income in respect of the decedent, the two payments it received. You must include in your gross income each of the three remaining payments as you receive them.

Transferring your right to income. If you transfer your right to receive income in respect of a decedent, you must include in your income the larger of:

1) The amount you receive for the right, or
2) The fair market value of the right at the time of the transfer.

Fair market value (FMV). FMV is the price at which the property would change hands between a buyer and a seller, neither having to buy or sell, and both having reasonable knowledge of all necessary facts.

Giving your right to income as a gift. If you give your right to receive income in respect of a decedent as a gift, you must include in your gross income the fair market value of the right at the time you make the gift.

Type of income. The character, or type, of income that you receive in respect of a decedent is generally the same as it would have been had the decedent continued to live and had received it. For example, if the income would have been a long-term capital gain to the decedent, it will be a long-term capital gain to you.

Interest on certificates of deposit (CDs). Interest on CDs that is not received by the date of death but that is earned between the date of the last interest payment and the date of death is interest income in respect of the decedent. Interest income earned on the account after the decedent's death that becomes payable on CDs after death is not income in respect of a decedent. That interest is ordinary income that belongs to the respective recipients and must be included in their gross income.

Installment payments. If the decedent had sold property using the installment method and you receive the right to collect the payments after the date of death, the payments you collect are income in respect of the decedent. You use the same gross profit percentage that the decedent used to figure the part of each payment that represents profit. Include in your income the same profit the decedent would have included had death not occurred. See Publication 537, *Installment Sales,* for more information on the installment method.

Sale or exchange. If you sell or exchange an installment obligation that you received from a decedent, the rules explained in Publication 537 for figuring the gain or loss on the disposition apply. However, your basis in the obligation is the same as the decedent's basis, adjusted for all installment payments you received before the sale or exchange.

Medical savings account (MSA). The treatment of an MSA at the death of the account holder depends on who acquires the interest in the account. If the decedent's estate acquired the interest, see the earlier discussion under *How to Report Certain Income.*

If the decedent's spouse is the designated beneficiary of the MSA, the MSA becomes that spouse's MSA. It is subject to the rules discussed in Publication 969.

Any other beneficiary (including a spouse that is not the designated beneficiary) must include in gross income the fair market value of the assets in the account on the decedent's date of death. This amount must be reported for the beneficiary's tax year that includes the decedent's date of death. The amount included in gross income is reduced by the qualified medical expenses for the decedent that are paid by the beneficiary within 1 year after the decedent's date of death. An estate tax deduction, discussed later, applies to the amount included in income by a beneficiary, other than the decedent's spouse.

Other income. For examples of other income situations concerning decedents, see *Specific Types of Income in Respect of a Decedent* in Publication 559.

Deductions in Respect of the Decedent

Deductions in respect of the decedent are items, such as business expenses, income-producing expenses, interest, and taxes, for which the decedent was liable but which are not deductible on the decedent's final income tax return. When paid, these expenses can be deducted by:

1) The estate, or
2) If the estate is not liable for the expenses, the person who, because of the decedent's death, acquired the decedent's property subject to that liability.

Federal estate tax deduction. Income that a decedent had a right to receive is included in the decedent's gross estate and is subject to estate tax. This income in respect of a decedent is also taxed when received by the estate or beneficiary. An income tax deduction is allowed to the person (or estate) receiving the income. If you must include in your gross income an amount of income in respect of a decedent, then you can claim a deduction for part of any estate tax paid. The deduction must be claimed in the same tax year that the income is included in your gross income.

You can claim the deduction only as a miscellaneous itemized deduction on Schedule A (Form 1040). This deduction is not subject to the 2% limit on miscellaneous itemized deductions as discussed in chapter 30.

If the income is capital gain income, then in figuring the maximum capital gain tax or any net capital loss limitation, the amount of the gain must be reduced, but not below zero, by the amount of any estate tax deduction attributable to that gain.

For more information, see *Estate Tax Deduction* in Publication 559.

5.

Tax Withholding and Estimated Tax

Important Changes for 1997

You should consider the items in this section when figuring any underpayment penalty for 1997.

Penalty due to new law waived. For estimated tax payments due before January 16, 1998, you will not have to pay a penalty for failure to pay estimated income tax to the extent your underpayment was created or increased by a provision of the Taxpayer Relief Act of 1997.

Excess social security or railroad retirement tax withholding. You will have excess social security or tier 1 railroad retirement tax withholding for 1997 only if your wages from two or more employers were more than $65,400. See *Credit for Excess Social Security Tax or Railroad Retirement Tax Withheld* in chapter 36.

Important Changes for 1998

You should consider the items in this section when you figure your estimated tax or how much income tax you want withheld from your pay for 1998. For more information on these and other tax changes, see Publication 553, *Highlights of 1997 Tax Changes.*

Who must pay estimated tax. For tax years beginning after 1997, you will not be liable for the penalty for failure to pay estimated income tax if the total tax shown on your return minus the amount you paid through withholding (including excess social security and railroad retirement tax withholding) is less than $1,000. This amount has increased from $500.

Dependent child credit. You may be able to take a $400 credit for each of your dependent children under age 17. If you have more than two eligible dependent children, you may be able to take a larger credit.

Credit for higher education expense. You may be able to claim a tax credit of up to $1,500 for each eligible student. The HOPE credit is allowed for the first 2 years of postsecondary education and is based on the qualified higher tuition and related expenses paid during the tax year.

Lifetime learning credit. For expenses paid after June 30, 1998, you may be able to claim a tax credit of up to $1,000 for the total qualified tuition and related expenses paid during the tax year. There is no maximum period for which the lifetime learning credit can be claimed.

Student loan interest deduction. You may be able to deduct up to $1,000 of the interest you pay on a loan for qualified higher education expenses for yourself, your spouse, or your dependents.

IRA deduction restored for some people covered by retirement plans. The phaseout amounts for deducting contributions to an IRA when you are covered under an employer retirement plan have increased for most taxpayers. The amounts are based on your filing status and adjusted gross income. The phaseout amounts for 1998 are:

- $50,000 – 60,000 for married persons filing jointly and qualifying widow(er)s,
- $0 – 10,000 for married persons filing separately, and
- $30,000 – 40,000 for all other filers.

If you are not an active participant in an employer plan but your spouse is, you may be able to deduct a contribution into your IRA account. In this situation, the phaseout amount is $150,000 – 160,000 for married persons filing jointly.

New Roth IRAs. You may be able to contribute up to $2,000 to a Roth IRA. Although the contributions are not deductible, the earnings may be tax free depending on when and why withdrawals are made.

You may be able to transfer amounts from your deductible IRA to your new Roth IRA.

Increased standard deduction for dependents. The standard deduction for dependents for whom an exemption can be claimed by another taxpayer is increased to the lesser of the regular standard deduction amount or the greater of:

1) $700, or
2) The dependent's earned income ***plus $250***.

Increased standard mileage rate for charitable purposes. The standard mileage rate for the cost of operating your car for charitable purposes is increased to 14 cents per mile.

Deduction for donation of appreciated stock to private foundation. The special rule allowing a deduction for the full fair market value of qualified appreciated stock given to certain private foundations will not apply to contributions made after June 30, 1998.

Self-employed health insurance deduction. The part of your self-employed health insurance premiums that you can deduct as an adjustment to income increases to 45% for 1998.

Foreign earned income exclusion. The amount of foreign earned income that you may be able to exclude increases to $72,000 for 1998.

Exemption amount increased. For 1998, the amount you can deduct for each exemption has increased to $2,700.

Phaseout of exemptions. Your deduction for personal exemptions is reduced by 2% for each $2,500 ($1,250 if you are married filing separately), or part of that amount, by which your adjusted gross income is more than an amount based on your filing status. The amounts for 1998 are:

Single	$124,500
Married filing jointly or qualifying widow(er)	186,800
Married filing separately	93,400
Head of household	155,650

Standard deduction. Individuals who do not itemize deductions have an increased standard deduction for 1998. See the *1998 Standard Deduction Tables* in Publication 505, *Tax Withholding and Estimated Tax.*

Reduction of itemized deductions. For 1998, certain itemized deductions are reduced by 3% of the amount of your adjusted gross income that is more than $124,500 ($62,250 if you are married filing separately). For information on the reduction, see *Reduction of itemized deductions* in Publication 505.

Self-employment tax. For 1998, the social security (old age, survivor, and disability insurance) part of the self-employment tax is 12.4% of up to $68,400 of net earnings. The medicare (Hospital insurance) part of the tax is 2.9% of all net earnings.

Employment taxes on household employees. Beginning in 1998, if you are otherwise subject to tax withholding, you must include any expected employment (social security, Medicare, and federal unemployment) taxes for household employees when figuring how much you want withheld from your pay for 1998 or how much you pay in estimated tax.

Medical savings accounts. You may be able to deduct up to $1,462.50 ($3,375 for family coverage) a year for contributions to a medical savings account in 1998, even if you do not itemize your deductions. You must be covered under a high deductible health plan and meet certain other requirements.

Maximum section 179 credit. For 1998, the maximum section 179 deduction increases to $18,500.

Estimated tax safe harbor for higher income taxpayers. For installment payments for tax years beginning in 1998, the estimated tax safe harbor for higher income individuals (other than farmers and fishermen) has been modified. If your adjusted gross income is more than $150,000 ($75,000 if married filing a separate return), you will no longer have to deposit the smaller of 90% of your expected tax for 1998 or 110% of the tax shown on your 1997 return to avoid an estimated tax penalty. The general rule will apply to you. Under the general rule, the amount of estimated tax you must pay to avoid a penalty is the smaller of:

1) 90% of your expected tax for 1998, or
2) 100% of the tax shown on your 1997 return (provided your 1997 return covered all 12 months).

Important Reminders

Unemployment compensation. You can choose to have income tax withheld from any unemployment compensation you get. See *Unemployment Compensation* under *Withholding,* later, for more information.

Federal payments. You can choose to have income tax withheld from certain federal payments you get. These payments include tier 1 railroad retirement benefits. For more information, see *Federal Payments* under *Withholding,* later.

Claiming withholding and estimated tax payments. When you file a federal income tax return, be sure to take credit for all federal income tax and excess social security or railroad retirement taxes withheld from your salary, wages, pensions, etc., and any backup withholding shown on Forms 1099. Also take credit for all estimated tax payments you made for that year. For example, all estimated tax payments made for 1997 should be claimed on the tax return you file for the 1997 tax year. You should file a return and claim these credits even if you do not owe tax. See *Credit for Withholding and Estimated Tax,* later in this chapter.

Introduction

This chapter discusses how to pay your tax as you earn or receive income during the year. In general, the federal income tax is a pay-as-you-go tax. There are two ways to pay as you go:

- ***Withholding.*** If you are an employee, your employer probably withholds income tax from your pay. Tax may also be withheld from certain other income — including pensions, bonuses, commissions, and gambling winnings. In each case, the amount withheld is paid to the Internal Revenue Service (IRS) in your name.
- ***Estimated tax.*** If you do not pay your tax through withholding, or do not pay enough tax that way, you might have to pay estimated tax. People who are in business for themselves generally will have to pay their tax this way. You may have to pay estimated tax if you receive income such as dividends, interest, capital gains, rent, and royalties. Estimated tax is used to pay not only income tax, but self-employment tax and alternative minimum tax as well.

This chapter explains both of these methods. In addition, it explains:

- ***Credit for withholding and estimated tax.*** When you file your 1997 income tax return, take credit for all the income tax withheld from your salary, wages, pensions, etc., and for the estimated tax you paid for 1997.
- ***Underpayment penalty.*** If you did not pay enough tax during the year either through withholding or by making estimated tax payments, you may have to pay a penalty. The IRS usually can figure this penalty for you. See *Underpayment Penalty,* near the end of this chapter.

Useful Items

You may want to see:

Publication

- ☐ **505** Tax Withholding and Estimated Tax
- ☐ **553** Highlights of 1997 Tax Changes
- ☐ **919** Is My Withholding Correct for 1998?

Form (and Instructions)

- ☐ **W–4** Employee's Withholding Allowance Certificate
- ☐ **W–4P** Withholding Certificate for Pension or Annuity Payments
- ☐ **W–4S** Request for Federal Income Tax Withholding From Sick Pay
- ☐ **W–4V** Voluntary Withholding Request
- ☐ **1040–ES** Estimated Tax for Individuals
- ☐ **2210** Underpayment of Estimated Tax by Individuals, Estates, and Trusts

Withholding

This chapter discusses withholding on these types of income:

- Salaries and wages
- Tips
- Taxable fringe benefits
- Sick pay
- Pensions and annuities
- Gambling winnings
- Unemployment compensation
- Certain federal payments.

This chapter explains in detail the rules for withholding tax from each of these types of income. The discussion of salaries and wages includes an explanation of how to complete a Form W–4.

This chapter also covers backup withholding on interest, dividends, and other payments.

Salaries and Wages

Income tax is withheld from the pay of most employees. Your pay includes bonuses, commissions, and vacation allowances, in addition to your regular pay. It also includes reimbursements and other expense allowances paid under a nonaccountable plan. See *Supplemental Wages,* later.

Military retirees. Military retirement pay is treated in the same manner as regular pay for income tax withholding purposes, even though it is treated as a pension or annuity for other tax purposes.

Household workers. If you are a household worker, you can ask your employer to withhold income tax from your pay. Tax is withheld only if you want it withheld and your employer agrees to withhold it. If you do not have enough income tax withheld, you may have to make estimated tax payments, as discussed later under *Estimated Tax.*

Farmworkers. Income tax is generally withheld from your cash wages for work on a farm unless your employer:

1) Pays you cash wages of less than $150 during the year, and
2) Has expenditures for agricultural labor totaling less than $2,500 during the year.

If you receive either cash wages not subject to withholding or noncash wages, you can ask your employer to withhold income tax. If your employer does not agree to withhold tax, or if not enough is withheld, you may have to make estimated tax payments, as discussed later under *Estimated Tax.*

Amount Withheld

The amount of income tax your employer withholds from your regular pay depends on two things:

1) The amount you earn, and
2) The information you give your employer on **Form W–4.**

Form W–4 includes three types of information that your employer will use to figure your withholding:

1) Whether to withhold at the single rate or at the lower married rate,
2) How many withholding allowances you claim (each allowance reduces the amount withheld), and
3) Whether you want an additional amount withheld.

If your income is low enough that you will not have to pay income tax for the year, you may be exempt from withholding. See *Exemption From Withholding,* later.

Note. You must specify a filing status and a number of withholding allowances on Form W–4. You cannot specify only a dollar amount of withholding.

New job. When you start a new job, you must fill out Form W–4 and give it to your employer. Your employer should have copies of the form. If you later need to change the information you gave, you must fill out a new form.

If you work only part of the year (for example, you start working after the beginning of the year), too much tax may be withheld. You may be able to avoid overwithholding if your employer agrees to use the part-year method. See *Part-year method* in chapter 1 of Publication 505 for more information.

Changing your withholding. Events during the year may change your marital status or the exemptions, adjustments, deductions, or credits you expect to claim on your return. When this happens, you may need to give your employer a new Form W–4 to change your withholding status or number of allowances.

You ***must*** give your employer a new Form W–4 within 10 days after:

1) Your divorce, if you have been claiming married status, or

2) Any event that decreases the number of withholding allowances you can claim.

Generally, you can submit a new Form W–4 at any time you wish to change the number of your withholding allowances for any other reason.

Changing your withholding for 1999. If events in 1998 will decrease the number of your withholding allowances for 1999, you must give your employer a new Form W–4 by December 1, 1998. If the event occurs in December 1998, submit a new Form W–4 within 10 days.

Cumulative wage method. If you change the number of your withholding allowances during the year, too much or too little tax may have been withheld for the period before you made the change. You may be able to compensate for this if your employer agrees to use the cumulative wage withholding method for the rest of the year. You must ask in writing that your employer use this method.

To be eligible, you must have been paid for the same kind of payroll period (weekly, biweekly, etc.) since the beginning of the year.

Checking your withholding. After you have given your employer a Form W–4, you can check to see whether the amount of tax withheld from your pay is too little or too much. See *Getting the Right Amount of Tax Withheld,* later. If too much or too little tax is being withheld, you should give your employer a new Form W–4 to change your withholding.

Note. You cannot give your employer a payment to cover withholding for past pay periods. Nor can you give your employer a payment for estimated tax.

Completing Form W–4

The following discussions explain how to complete your Form W–4.

Marital status (line 3). There is a lower withholding rate for married people who can use the tax rates for joint returns. Everyone else must have tax withheld at the higher single rate.

You must claim ***single*** status if either of the following applies.

1) **You are single.** If you are divorced, or separated from your spouse under a court decree of separate maintenance, you are considered single.

2) **You are married, but you are neither a citizen nor a resident of the United States,** or your spouse is neither a citizen nor a resident of the United States. However, if one of you is a citizen or a resident, you can choose to have the other treated as a resident. You can then file a joint return and claim married status on your Form W–4. See *Nonresident Spouse Treated as a Resident* in chapter 1 of Publication 519, *U.S. Tax Guide for Aliens,* for more information.

You can claim ***married*** status if either of the following applies.

1) **You are married and neither you nor your spouse is a nonresident alien.** You are considered married for the whole year even if your spouse died during the year.

2) **You expect to be able to file your return as a qualifying widow or widower.** You usually can use this filing status if your spouse died within the previous 2 years and you provide a home for your dependent child. However, you must file a new Form W–4 showing your filing status as single by December 1 of the last year you are eligible to file as a qualifying widow or widower. See *Qualifying Widow(er) With Dependent Child* in chapter 2.

Some married people find that they do not have enough tax withheld at the married rate. This can happen, for example, when both spouses work. To avoid this, you can choose to have tax withheld at the higher single rate (even if you qualify for the married rate). Also, you can fill out the *Two-Earner/Two-Job Worksheet.*

Withholding allowances (line 5). The more allowances you claim on Form W–4, the less income tax your employer will withhold. You will have the most tax withheld if you claim “0” allowances. The number of allowances you can claim depends on:

1) How many exemptions you can take on your tax return,

2) Whether you have income from more than one job,

3) What deductions, adjustments to income, and credits you expect to have for the year, and

4) Whether you will file as head of household.

If you are married, it also depends on whether your spouse also works and claims any allowances on his or her own Form W–4. If you both work, you should figure your combined allowances on one Form W–4 worksheet. You then should divide the allowances among the Forms W–4 you each file with every employer. See *Two jobs,* later.

Form W–4 worksheets. Form W–4 has worksheets to help you figure how many withholding allowances you can claim. The worksheets are for your own records. Do not give them to your employer.

You do not have to use the worksheets if you use a more accurate method of figuring the number of withholding allowances. See *Alternative method of figuring withholding allowances* under *Completing Form W–4 and Worksheets* in chapter 1 of Publication 505 for more information.

Two jobs. If you have income from two jobs at the same time, complete only one set of Form W–4 worksheets. Then split your allowances between the Forms W–4 for each job. You cannot claim the same allowances with more than one employer at the same time. You can claim all your allowances with one employer and none with the other, or divide them in any other way you wish.

If both you and your spouse are employed and you expect to file a joint return, figure your withholding allowances using your combined income, adjustments, deductions, exemptions, and credits. Use only one set of worksheets. You can divide your total allowances in any way you wish, but you cannot claim an allowance that your spouse also claims.

If you and your spouse expect to file separate returns, figure your allowances separately based on your own individual income, adjustments, deductions, exemptions, and credits.

Personal Allowances Worksheet. Use the *Personal Allowances Worksheet* on page 1 of Form W–4 to figure your withholding allowances for exemptions. Add the special allowance for only one job, the allowance for head of household status, and the allowance for the child and dependent care credit (if they apply) to your total allowances.

Only one job (worksheet line B). You can claim an additional withholding allowance if any of the following apply.

1) You are single, and you have only one job at a time.

2) You are married, you have only one job at a time, and your spouse does not work.

3) Your wages from a second job or your spouse's wages (or the total of both) are $1,000 or less.

Head of household (worksheet line E). You can claim one additional withholding allowance if you expect to file as head of household on your tax return. To find out whether you qualify, see *Head of Household* in chapter 2.

Child and dependent care credit (worksheet line F). You can claim one additional withholding allowance if you expect to have at least $1,500 of qualifying child or dependent care expenses that you plan to claim a credit for on your tax return. For information on this credit, see chapter 33.

Instead of using line F, you can choose to figure allowances for the child and dependent care credit (and other credits you expect to claim on your return) as explained next.

Deductions and Adjustments Worksheet. Fill out this worksheet to adjust the number of your withholding allowances for deductions, adjustments to income, and tax credits. The *Deductions and Adjustments Worksheet* is on page 2 of Form W–4. Chapter 1 of Publication 505 explains this worksheet.

Two-Earner/Two-Job Worksheet. You may need to complete this worksheet if you have two jobs or a working spouse. You should also use this worksheet to figure additional withholding if you expect to owe an amount other than income tax, such as self-employment tax.

For more information about Form W–4 and a filled-in example, see chapter 1 of Publication 505.

Getting the Right Amount of Tax Withheld

In most situations, the tax withheld from your pay will be close to the tax you figure on your return if:

1) You accurately complete all the Form W–4 worksheets that apply to you, and
2) You give your employer a new Form W–4 when changes occur.

But because the worksheets and withholding methods do not account for all possible situations, you may not be getting the right amount withheld. This is most likely to happen in the following situations.

1) You are married and both you and your spouse work.
2) You have more than one job at a time.
3) You have nonwage income, such as interest, dividends, alimony, or self-employment income.
4) You will owe additional amounts with your return, such as self-employment tax.
5) Your withholding is based on obsolete Form W–4 information for a substantial part of the year.
6) Your earnings are more than $150,000 if you are single or $200,000 if you are married.

To make sure you are getting the right amount of tax withheld, get Publication 919. It will help you compare the total tax to be withheld during the year with the tax you can expect to figure on your return. It also will help you determine how much, if any, additional withholding is needed each payday to avoid owing tax when you file your return. If you do not have enough tax withheld, you may have to make estimated tax payments, as explained under *Estimated Tax,* later.

Rules Your Employer Must Follow

The following are some of the withholding rules that can affect how you fill out your Form W–4 and how you handle problems that may arise. For other rules, see *Rules Your Employer Must Follow* in chapter 1 of Publication 505.

New Form W–4. When you start a new job, your employer should give you a Form W–4 to fill out. Your employer will use the information you give on the form to figure your withholding, beginning with your first payday.

If you later fill out a new Form W–4, your employer can put it into effect as soon as it is practical to do so. The deadline for putting it into effect is the start of the first payroll period ending 30 or more days after you turn it in.

No Form W–4. If you do not give your employer a completed Form W–4, your employer must withhold at the highest rate—as if you were single and claimed no allowances.

Repaying withheld tax. If you find you are having too much tax withheld because you did not claim all the withholding allowances you are entitled to, you should give your employer a new Form W–4. Your employer cannot repay you any of the tax withheld under your old Form W–4.

However, if your employer has withheld more than the correct amount of tax for the Form W–4 you have in effect, you do not have to fill out a new Form W–4 to have your withholding lowered to the correct amount. Your employer can repay you the amount that was incorrectly withheld. If you are not repaid, you will receive credit on your tax return for the full amount actually withheld.

Exemption From Withholding

If you claim exemption from withholding, your employer will not withhold federal income tax from your wages. The exemption applies only to income tax, not to social security or Medicare tax.

You can claim exemption from withholding for 1998 only if ***both*** the following situations apply.

1) For 1997 you had a right to a refund of all federal income tax withheld because you had no tax liability.
2) For 1998 you expect a refund of all federal income tax withheld because you expect to have no tax liability.

Use *Figure 5–A* in this chapter to help you decide whether you can claim exemption. Do not use the chart if you are 65 or older or blind or if you will itemize deductions or claim dependents or tax credits on your 1998 return. These situations are discussed later.

Student. If you are a student, you are not automatically exempt. See chapter 1 to see if you must file a return. If you work only part time or only during the summer, you may qualify for exemption from withholding.

Example 1. You are a high school student and expect to earn $2,500 from a summer job. You do not expect to have any other income during 1998, and your parents will be able to claim you as a dependent on their tax return. You worked last summer and had $375 federal income tax withheld from your pay. The entire $375 was refunded when you filed your 1997 return. Using *Figure 5–A,* you find that you ***can*** claim exemption from withholding.

Example 2. The facts are the same as in Example 1, except that you have a savings account and expect to have $20 interest income in 1998. Using *Figure 5–A,* you find that you ***cannot*** claim exemption from withholding because your unearned income will be $1 or more and your total income will be more than $700.

Age 65 or older or blind. If you are 65 or older or blind, use one of the worksheets in chapter 1 of Publication 505, under *Exemption From Withholding,* to help you decide whether you can claim exemption from withholding. Do not use either of those worksheets if you will itemize deductions or claim dependents or tax credits on your 1998 return—see the following discussion instead.

Itemizing deductions or claiming dependents or tax credits. If you had no tax liability for 1997 and you will itemize your deductions or claim dependents or tax credits on your 1998 return, use the 1998 Estimated Tax Worksheet in Form 1040–ES (or see chapter 2 of Publication 505) to figure your 1998 expected tax liability. You can claim exemption from withholding only if your total expected tax liability (line 13c of the worksheet) is zero.

Claiming exemption. To claim exemption, you must give your employer a Form W–4. Write "EXEMPT" on line 7.

Your employer must send the IRS a copy of your Form W–4 if you claim exemption from withholding and your pay is expected to usually be more than $200 a week. If it turns out that you do not qualify for exemption, the IRS will send both you and your employer a written notice.

If you claim exemption, but later your situation changes so that you will have to pay income tax after all, you must file a new Form W–4 within 10 days after the change. If you claim exemption in 1998, but you expect to owe income tax for 1999, you must file a new Form W–4 by December 1, 1998.

An exemption is good for only one year. You must give your employer a new Form W–4 by February 15 each year to continue your exemption.

Supplemental Wages

Supplemental wages include bonuses, commissions, overtime pay, and certain sick pay. Your employer or other payer of supplemental wages may withhold income tax from these wages at a flat rate of at least 28%. The payer can also figure withholding using the same method used for your regular wages.

Also see *Sick Pay,* later.

Expense allowances. Reimbursements or other expense allowances paid by your employer under a nonaccountable plan are treated as supplemental wages.

Reimbursements or other expense allowances paid under an accountable plan that are more than your proven expenses are treated as paid under a nonaccountable plan. However, this does not apply if you return the excess payments within a reasonable period of time.

For more information about accountable and nonaccountable expense allowance plans, see *Reimbursements* in chapter 28.

Penalties

You may have to pay a penalty of $500 if:

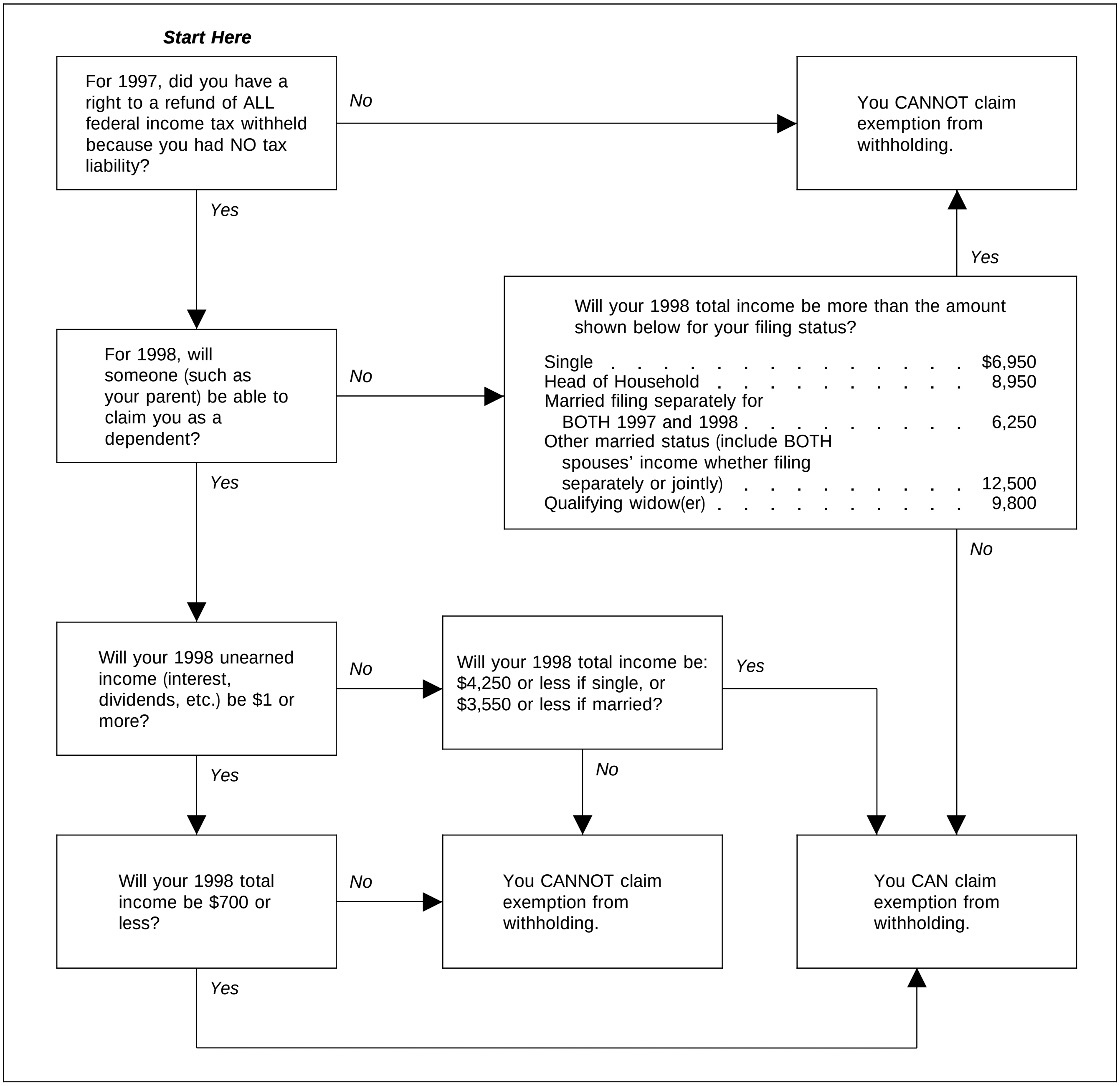
1) You make statements or claim withholding allowances on your Form W–4 that reduce the amount of tax withheld, and
2) You have no reasonable basis for those statements or allowances at the time you prepare your Form W–4.

There is also a criminal penalty for willfully supplying false or fraudulent information on your Form W–4 or for willfully failing to supply information that would increase the amount withheld. The penalty upon conviction can be either a fine of up to $1,000 or imprisonment for up to one year, or both.

These penalties will apply if you deliberately and knowingly falsify your Form W–4 in an attempt to reduce or eliminate the proper withholding of taxes. A simple error

Figure 5-A. **Exemption From Withholding on Form W-4**

NOTE: Do not use this chart if you are 65 or older or blind, or if you will itemize your deductions or claim dependents or tax credits. Instead, see the discussions in this chapter under *Exemption From Withholding.*



— an honest mistake — will not result in one of these penalties. For example, a person who has tried to figure the number of withholding allowances correctly, but claims seven when the proper number is six, will not be charged a W–4 penalty.

Tips

The tips you receive while working on your job are considered part of your pay. You must include your tips on your tax return on the same line as your regular pay. However, tax is not withheld directly from tip income, as it is from your regular pay. Nevertheless, your employer will take into account the tips you report when figuring how much to withhold from your regular pay.

See chapter 7 for information on reporting your tips to your employer. For more information on the withholding rules for tip income, see Publication 531, *Reporting Tip Income.*

How employer figures amount to withhold. The tips you report to your employer are counted as part of your income for the month you report them. Your employer can figure your withholding in either of two ways:

1) By withholding at the regular rate on the sum of your pay plus your reported tips, or

2) By withholding at the regular rate on your pay plus an amount equal to 28% of your reported tips.

Not enough pay to cover taxes. If your regular pay is too low for your employer to withhold all the tax (including social security tax, Medicare tax, or railroad retirement tax) due on your pay plus your tips, you may give your employer money to cover the shortage.

If you do not give your employer money to cover the shortage, your employer will first withhold as much social security tax, Medicare tax, or railroad retirement tax as possible, up to the proper amount, and then withhold income tax up to the full amount of your pay. If not enough tax is withheld, you may have to make estimated tax payments. When you file your return, you also may have to pay any social security tax, Medicare tax, or railroad retirement tax your employer could not withhold.

Allocated tips. Your employer should not withhold income tax, social security tax, Medicare tax, or railroad retirement tax on any allocated tips. Withholding is based only on your pay plus your ***reported tips.*** Your employer should refund to you any incorrectly withheld tax. See *Allocated Tips* in chapter 7 for more information.

Taxable Fringe Benefits

The value of certain noncash fringe benefits you receive from your employer is considered part of your pay. Your employer generally must withhold income tax on these benefits from your regular pay for the period the benefits are paid or considered paid.

For information on taxable fringe benefits, see *Fringe Benefits* under *Employee Compensation* in chapter 6.

Your employer can choose not to withhold income tax on the value of your personal use of a car, truck, or other highway motor vehicle provided by your employer. Your employer must notify you if this choice is made.

For more information on withholding on taxable fringe benefits, see chapter 1 of Publication 505.

Sick Pay

“Sick pay” is a payment to you to replace your regular wages while you are temporarily absent from work due to sickness or personal injury. To qualify as “sick pay,” it must be paid under a plan to which your employer is a party.

If you receive sick pay from your employer or an agent of your employer, income tax must be withheld just as it is from your regular pay.

However, if you receive sick pay from a third party who is not acting as an agent of your employer, income tax will be withheld only if you choose to have it withheld. See *Form W–4S,* later.

If you receive payments under a plan in which your employer does not participate (such as an accident or health plan where you paid all the premiums), the payments are not sick pay and usually are not taxable.

Union agreements. If you receive sick pay under a collective bargaining agreement between your union and your employer, the agreement may determine the amount of income tax withholding. See your union representative or your employer for more information.

Form W–4S. If you choose to have income tax withheld from sick pay paid by a third party, such as an insurance company, you must fill out Form W–4S, *Request for Federal Income Tax Withholding From Sick Pay.* Its instructions contain a worksheet you can use to figure the amount you want withheld. They also explain restrictions that may apply.

Give the completed form to the payer of your sick pay. The payer must withhold according to your directions on the form.

If you do not request withholding on Form W–4S, or if you do not have enough tax withheld, you may have to make estimated tax payments. If you do not pay enough estimated tax or have enough income tax withheld, you may have to pay a penalty. See *Who Must Make Estimated Tax Payments* and *Underpayment Penalty,* later in this chapter.

Pensions and Annuities

Income tax usually will be withheld from your pension or annuity distributions, unless you choose not to have it withheld. This rule applies to distributions from:

1) An individual retirement arrangement (IRA),
2) A life insurance company under an endowment, annuity, or life insurance contract,
3) A pension, annuity, or profit-sharing plan,
4) A stock bonus plan, and
5) Any other plan that defers the time you receive compensation.

The amount withheld depends on whether you receive payments spread out over more than one year (periodic payments), within one year (nonperiodic payments), or as an eligible rollover distribution (ERD). You cannot choose not to have income tax withheld from an ERD.

More information. For more information on taxation of annuities and distributions (including eligible rollover distributions) from qualified retirement plans, see chapter 11. For information on IRAs, see chapter 18. For more information on withholding on pensions and annuities, including a discussion of **Form W–4P,** *Withholding Certificate for Pension or Annuity Payments,* see *Pensions and Annuities* under *Withholding* in chapter 1 of Publication 505.

Gambling Winnings

Income tax is withheld from certain kinds of gambling winnings. The amount withheld is 28% of the proceeds paid (the amount of your winnings minus the amount of your bet).

Gambling winnings of more than $5,000 from the following sources are subject to income tax withholding:

1) Any sweepstakes, wagering pool, or lottery, and
2) Any other wager, if the proceeds are at least 300 times the amount of the bet.

It does not matter whether your winnings are paid in cash, in property, or as an annuity. Winnings not in money are taken into account at their fair market value.

Gambling winnings from bingo, keno, and slot machines are not subject to income tax withholding. If you receive gambling winnings not subject to withholding, you may need to make estimated tax payments. (See *Estimated Tax,* later.)

If you do not pay enough tax through withholding or estimated tax payments, you may be subject to a penalty. (See *Underpayment Penalty,* later.)

Form W–2G. If a payer withholds income tax from your gambling winnings, you should receive a Form W–2G, *Certain Gambling Winnings,* showing the amount you won and the amount withheld.

Reporting your winnings. Report your winnings on line 21 of Form 1040. Report the tax withheld on line 54 of Form 1040. Gambling losses are deductible only to the extent that they offset gambling winnings. You must use Schedule A of Form 1040 to deduct your losses and to deduct state tax withholding.

Unemployment Compensation

You can choose to have income tax withheld from any unemployment compensation you get. To make this choice, you will have to fill out **Form W–4V,** *Voluntary Withholding Request,* (or a similar form provided by the payer) and give it to the payer. The amount withheld will be 15% of each payment.

Unemployment compensation is taxable. So, if you do not have income tax withheld, you may have to make estimated tax payments. See *Estimated Tax,* later.

If you do not pay enough tax either through withholding or estimated tax, you may have to pay a penalty. See *Underpayment Penalty,* later, for information.

Federal Payments

You can choose to have income tax withheld from certain federal payments you receive. These payments are:

1) Tier 1 railroad retirement benefits,
2) Commodity credit loans included in your gross income, and
3) Payments you received under the Agricultural Act of 1949, or title II of the Disaster Assistance Act of 1988, as amended, because:
    a) Your crops were destroyed or damaged by drought, flood, or any other natural disaster, or
    b) You were unable to plant crops because of a natural disaster described in (a).

To make this choice, you will have to fill out **Form W–4V,** *Voluntary Withholding Request,* (or a similar form provided by the payer) and give it to the payer. You can choose to have 7%, 15%, 28%, or 31% of each payment withheld.

The payments in (1) are partly taxable in certain cases. The payments in (2) and (3) are fully taxable. So, if you do not choose to have income tax withheld, you may have to make estimated tax payments. See *Estimated Tax,* later. If you do not pay enough tax either through withholding or estimated tax, you may have to pay a penalty. See *Underpayment Penalty,* later, for information.

More information. For more information about the tax treatment of social security and railroad retirement benefits, see chapter 12. Get Publication 225, *Farmer's Tax Guide,* for information about the tax treatment of commodity credit loans or crop disaster payments.

Backup Withholding

Banks and other businesses that pay you certain kinds of income must file an information return (Form 1099) with the IRS. The information return shows how much you were paid during the year. It also includes your name and taxpayer identification number (TIN). Your TIN generally is either a social security number or an employer identification number.

These payments generally are not subject to withholding. However, “backup” withholding is required in certain situations. And, backup withholding can apply to most kinds of payments that are reported on Form 1099.

Payments made to you are subject to backup withholding at a flat 31% rate in the following situations.

1) You do not give the payer your TIN in the required manner.
2) The IRS notifies the payer that the TIN you gave is incorrect.
3) You are required, but fail, to certify that you are not subject to backup withholding.
4) The IRS notifies the payer to start withholding on interest or dividends because you have underreported interest or dividends on your income tax return. The IRS will do this only after it has mailed you four notices over at least a 120-day period.

See *Backup Withholding* in chapter 1 of Publication 505 for more information.

Penalties. There are civil and criminal penalties for giving false information to avoid backup withholding. The civil penalty is $500. The criminal penalty, upon conviction, is a fine of up to $1,000, or imprisonment of up to one year, or both.

Estimated Tax

Estimated tax is the method used to pay tax on income that is not subject to withholding. This includes income from self-employment, interest, dividends, alimony, rent, gains from the sale of assets, prizes, and awards. You also may have to pay estimated tax if the amount of income tax being withheld from your salary, pension, or other income is not enough. To figure and pay estimated tax, use **Form 1040–ES,** *Estimated Tax for Individuals.*

Estimated tax is used to pay both income tax and self-employment tax, as well as other taxes and amounts reported on your tax return. If you do not pay enough tax through withholding or by making estimated tax payments, you may be charged a penalty. If you do not pay enough by the due date of each payment period (see *When To Pay Estimated Tax,* later), you may be charged a penalty even if you are due a refund when you file your tax return. For information on when the penalty applies, see *Underpayment Penalty,* later.

Who Must Make Estimated Tax Payments

If you had a tax liability for 1997, you may have to pay estimated tax for 1998.

General rule. You must make estimated tax payments for 1998 if you expect to owe at least $1,000 in tax for 1998 after subtracting your withholding and credits, and you expect your withholding and credits to be less than the smaller of:

1) 90% of the tax to be shown on your 1998 tax return, or
2) 100% of the tax shown on your 1997 tax return. Your 1997 tax return must cover all 12 months.

Note. If all your 1998 income will be subject to income tax withholding, you probably do not need to make estimated tax payments.

Exceptions. There are exceptions to the general rule if you are a farmer or fisherman. See *Figure 5–B* and chapter 2 of Publication 505 for more information.

To whom the rules apply. The estimated tax rules apply to:

- U.S. citizens and residents,
- Residents of Puerto Rico, the Virgin Islands, Guam, the Commonwealth of the Northern Mariana Islands, and American Samoa, and
- Nonresident aliens.

Aliens. Resident and nonresident aliens have to make estimated tax payments. Resident aliens should follow the rules in this chapter unless noted otherwise. Nonresident aliens should get **Form 1040–ES(NR),** *U.S. Estimated Tax for Nonresident Alien Individuals.*

Avoiding estimated tax. If, in addition to income not subject to withholding, you also receive salaries or wages, you can avoid having to make estimated tax payments by asking your employer to take more tax out of your earnings. To do this, file a new Form W–4 with your employer.

No tax liability last year. You do not have to pay estimated tax for 1998 if you meet all three of the following conditions:

1) You had no tax liability for your 1997 tax year,
2) You were a U.S. citizen or resident for the whole year, and
3) Your 1997 tax year covered a 12-month period.

You had no tax liability for 1997 if your total tax (defined later under *Required annual payment*) was zero or you did not have to file an income tax return.

Married taxpayers. To figure whether you must make estimated tax payments for 1998, apply the rules discussed here to your 1998 separate estimated income. If you can make joint estimated tax payments, you can apply these rules on a joint basis.

You and your spouse can make joint payments of estimated tax even if you are not living together.

You and your spouse cannot make joint estimated tax payments if you are separated under a decree of divorce or separate maintenance. Also, you cannot make joint estimated tax payments if either spouse is a nonresident alien or if you have different tax years.

Whether you and your spouse make joint estimated tax payments or separate payments will not affect your choice of filing a joint tax return or separate returns for 1998.

1997 separate returns and 1998 joint return. If you plan to file a joint return with your spouse for 1998, but you filed separate returns for 1997, your 1997 tax is the total of the tax shown on your separate returns. You filed a separate return for 1997 if you filed as single, head of household, or married filing separately.

1997 joint return and 1998 separate returns. If you plan to file a separate return for 1998, but you filed a joint return for 1997, your 1997 tax is your share of the tax on the joint return. You file a separate return for 1998 if you file as single, head of household, or married filing separately. To figure your share, first figure the tax both you and your spouse would have paid had you filed separate returns for 1997 using the same filing status as for 1998. Then multiply your joint tax liability by the following fraction:

$$\frac{\text{Your separate tax liability}}{\text{Both spouses' separate tax liabilities}}$$

Example. Joe and Heather filed a joint return for 1997 showing taxable income of $48,000 and a tax of $8,091. Of the $48,000 taxable income, $40,000 was Joe's and the rest was Heather's. For 1998, they plan to file married filing separately. Joe figures his share of the tax on the 1997 joint return as follows:

Tax on $40,000 based on a separate return	$ 8,529
Tax on $8,000 based on a separate return	1,204
Total	$ 9,733
Joe's portion of total ($8,529 ÷ $9,733)	88%
Joe's share of joint return tax ($8,091 × 88%)	$ 7,120

How To Figure Estimated Tax

To figure your estimated tax, you must figure your expected adjusted gross income, taxable income, and taxes and credits for the year.

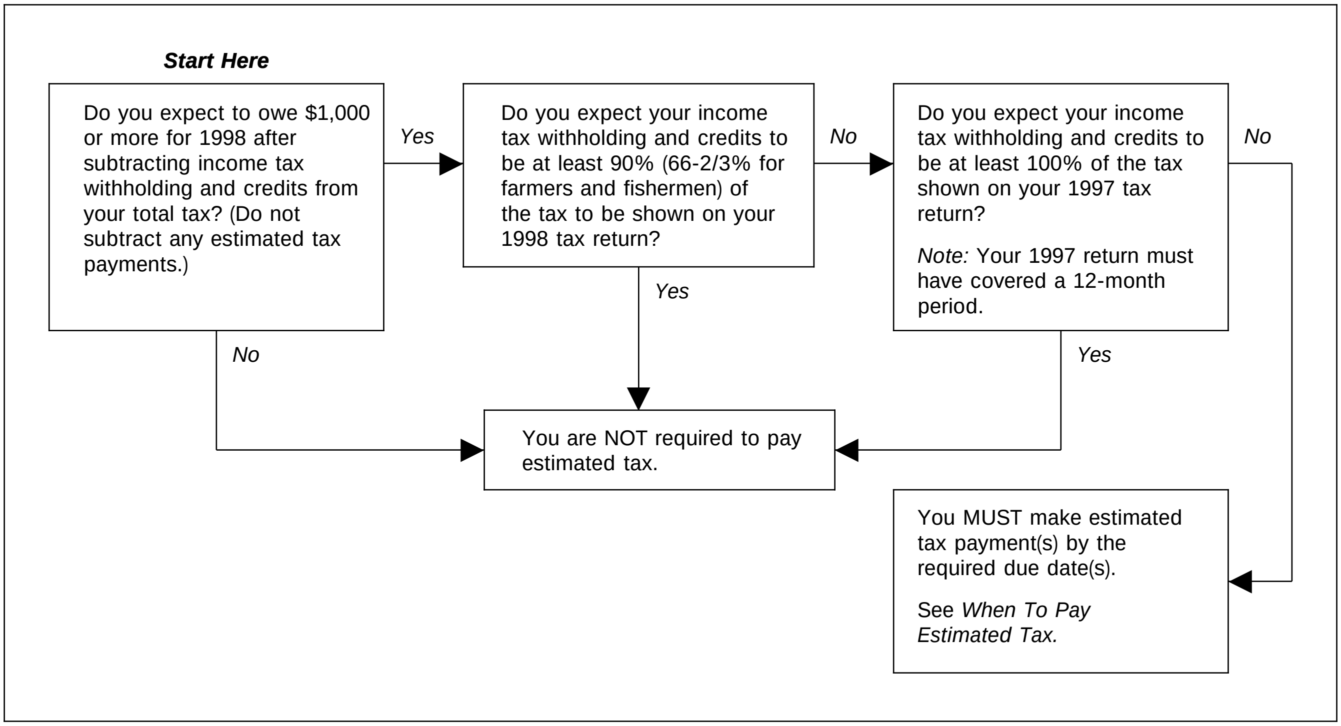
When figuring your 1998 estimated tax, it may be helpful to use your income, deductions, and credits for 1997 as a starting point. Use your 1997 federal tax return as a guide. You will also need Form 1040–ES to figure and pay your estimated tax. You must make adjustments both for changes in your own situation and for recent changes in the tax law. For 1998, there are several important changes in the law. These changes are discussed under *Important Changes for 1998* at the beginning of this chapter.

Form 1040–ES includes a worksheet to help you figure your estimated tax. Keep the worksheet for your records.

For more complete information and examples on how to figure your estimated tax for 1998, see chapter 2 of Publication 505.

Expected adjusted gross income. Your expected adjusted gross income for 1998 is your expected total income minus your expected adjustments to income. Include all the income you expect to receive during the year, even income that is subject to withholding. However, do not include income that is tax exempt. Be sure to subtract all the adjustments to income you expect to take on your 1998 tax return. If you are using your 1997 return as a guide and filed Form 1040, your adjustments for 1997 were on lines 23–30a. If you filed Form 1040A, your

Figure 5-B. **Do You Have To Pay Estimated Tax?**



1997 adjustments were on line 15. When estimating your 1998 adjustments, include any allowable deduction for interest on education loans.

If you expect to receive social security benefits, you can use *Worksheet 2.1* in chapter 2 of Publication 505 to figure your expected taxable benefits.

If you are self-employed, you can use *Worksheet 2.2* in chapter 2 of Publication 505 to figure your deduction for one-half your expected self-employment tax.

Expected taxable income. Reduce your expected adjusted gross income by either your expected itemized deductions or your standard deduction and by a $2,700 deduction for each exemption. For information on the 1998 standard deduction amounts and a possible limit on your itemized deductions, see Publication 505 or the instructions for Form 1040–ES.

Expected taxes and credits. After you have figured your expected taxable income, figure your expected income tax. Use the 1998 Tax Rate Schedules in Publication 505 or in the Form 1040–ES instructions. See chapter 32 for the special tax computation to use for a child under age 14 who has more than $1,300 ($1,400 in 1998) of investment income.

Add your expected additional taxes from Form 8814, *Parents' Election To Report Child's Interest and Dividends,* and Form 4972, *Tax on Lump-Sum Distributions.* Subtract your expected credits. If you are using your 1997 return as a guide and filed Form 1040, your total credits for 1997 were shown on line 45. If you filed Form 1040A, your total credits for 1997 were on line 24d. When estimating your 1998 credits, include any allowable dependent child credit, HOPE credit, and lifetime learning credit. If your credits are more than your taxes, use “–0–” as the result.

Add your expected self-employment tax and other taxes (see chapter 2 of Publication 505). “Other taxes” are the tax shown on line 48 of the 1997 Form 1040, plus the tax on early distributions included on line 50, any advance earned income credit payments on line 51, any household employment taxes on line 52, and any write-in amounts on line 53 (other than recapture of a federal mortgage subsidy and any uncollected social security, Medicare, or railroad retirement tax). If you filed a 1997 Form 1040A, your only “other taxes” were any advance earned income credit payments on line 26, and any household employment taxes on line 27.

Finally, subtract your expected earned income credit and fuel tax credit (from Form 4136). The result is your expected total tax for 1998.

Required annual payment. You figure the total amount you must pay for 1998 through withholding and estimated tax payments on lines 14a through 14c of the 1998 Estimated Tax Worksheet. The result is your required annual payment. It is the ***smaller*** of:

1) 90% of your total expected tax for 1998, or

2) 100% of the total tax shown on your 1997 return. (Your 1997 tax return must cover all 12 months.)

Exceptions. If you are a farmer or fisherman, your required annual payment may be different. See *Required Annual Payment* in chapter 2 of Publication 505.

Total tax for 1997. Your 1997 total tax on Form 1040 is the amount on line 53 reduced by the total of the amounts on lines 49, and 56a, any credit from Form 4136 included on line 59, any recapture of a federal mortgage subsidy and any uncollected social security, Medicare, or railroad retirement tax included on line 53, and any tax from Form 5329 (other than the tax on early distributions) included on line 50. On Form 1040A, it is line 28 reduced by the amount on line 29c. On Form 1040EZ, it is line 10 reduced by line 8.

Total estimated tax payments. Figure the total amount you must pay for 1998 through estimated tax payments on lines 15 and 16 of the 1998 Estimated Tax Worksheet. Subtract your expected withholding from your required annual payment. You usually must pay this difference in four equal installments. (See *When To Pay Estimated Tax* and *How To Figure Each Payment,* later.)

If your total expected tax on line 13c, minus your expected withholding on line 15, is less than $1,000, you do not need to make estimated tax payments.

Withholding. Your expected withholding for 1998 includes the income tax you expect to be withheld from all sources (wages, pensions and annuities, etc.). It also includes excess social security and railroad retirement tax you expect to be withheld from your wages.

For information on excess social security or tier 1 railroad retirement tax withholding for 1998, see Publication 505.

When To Pay Estimated Tax

For estimated tax purposes, the year is divided into four payment periods. Each period has a specific payment due date. If you do not pay enough tax by the due date of each of the payment periods, you may be charged a penalty even if you are due a refund when you file your income tax return. The following chart gives the payment periods and due dates for estimated tax payments.

For the period:	Due date:
Jan. 1* through Mar. 31	April 15
April 1 through May 31	June 15
June 1 through Aug. 31	September 15
Sept. 1 through Dec. 31	January 15 next year**

*If your tax year does not begin on January 1, see *Fiscal year taxpayers,* later.
**See *January payment,* later.

Saturday, Sunday, holiday rule. If the due date for making an estimated tax payment falls on a Saturday, Sunday, or legal holiday, the payment will be on time if you make it on the next day that is not a Saturday, Sunday, or legal holiday.

January payment. If you file your 1998 return by February 1, 1999, and pay the rest of the tax you owe, you do not need to make your estimated tax payment that would be due on January 15, 1999.

Fiscal year taxpayers. If your tax year does not start on January 1, your payment due dates are:

1) The 15th day of the 4th month of your fiscal year,
2) The 15th day of the 6th month of your fiscal year,
3) The 15th day of the 9th month of your fiscal year, and
4) The 15th day of the 1st month after the end of your fiscal year.

You do not have to make the last payment listed above if you file your income tax return by the last day of the first month after the end of your fiscal year and pay all the tax you owe with your return.

When To Start

You do not have to make estimated tax payments until you have income on which you will owe the tax. If you have income subject to estimated tax during the first payment period, you must make your first payment by the due date for the first payment period. You can pay all your estimated tax at that time, or you can pay it in four installments. If you choose to pay in installments, make your first payment by the due date for the first payment period. Make your remaining installment payments by the due dates for the later periods.

No income subject to estimated tax during first period. If you first have income subject to estimated tax during a later payment period, you must make your first payment by the due date for that period. You can pay your entire estimated tax by the due date for that period, or you can pay it in installments by the due date for that period and the due dates for the remaining periods. The following chart shows when to make installment payments:

If you first have income on which you must pay estimated tax:	Make a payment by:	Make later installments by:
Before April 1	April 15	June 15 September 15 January 15 next year*
After March 31 and before June 1	June 15	September 15 January 15 next year*
After May 31 and before Sept. 1	September 15	January 15 next year*
After August 31	January 15 next year*	(None)

*See *January payment,* and *Saturday, Sunday, holiday rule* under *When To Pay Estimated Tax,* earlier.

Change in estimated tax. After making your first estimated tax payment, changes in your income, adjustments, deductions, credits, or exemptions may make it necessary for you to refigure your estimated tax. Pay the unpaid balance of your amended estimated tax by the next payment due date after the change or in installments by that date and the due dates for the remaining payment periods.

How much to pay to avoid penalty. To determine how much you should pay by each payment due date, see *How To Figure Each Payment,* next. If the earlier discussions of *No income subject to estimated tax during first period* or *Change in estimated tax* apply to you, you may need to read the explanation of the *Annualized Income Installment Method,* later, to avoid a penalty.

How To Figure Each Payment

You should pay enough estimated tax by the due date of each payment period to avoid a penalty for that period. If you do not pay enough each payment period, you may be charged a penalty even if you are due a refund when you file your tax return. See *Underpayment Penalty,* later in this chapter.

Regular Installment Method

If you must pay estimated tax beginning with the payment due April 15, 1998, you can figure your required payment for each period by dividing your total estimated tax payments (line 16 of the 1998 Estimated Tax Worksheet) by 4. Use this method only if your required annual payment stays the same throughout the year.

If you do not receive your income evenly throughout the year, your required estimated tax payments may not be the same for each period. See *Annualized Income Installment Method,* later.

Amended estimated tax. If you refigure your estimated tax during the year, or if your first payment is due after April 15, 1998, figure your required payment for each remaining payment period using the following worksheet.

1.	Amended total estimated tax payments	
2.	Multiply line 1 by: ÿ.50 if next payment is due ÿÿÿJune 15, 1998. ÿ.75 if next payment is due ÿÿÿSeptember 15, 1998. ÿ1.00 if next payment is due ÿÿÿJanuary 15, 1999.	
3.	Estimated tax payments for all previous periods	
4.	**Next required payment:** Subtract line 3 from line 2 and enter the result (but not less than zero) here and on your payment-voucher for your next required payment	

If the payment on line 4 is due January 15, 1999, **stop here.** *Otherwise, go on to line 5.*

5.	Add lines 3 and 4	
6.	Subtract line 5 from line 1 and enter the result (but not less than zero)	
7.	**Each following required payment:** If the payment on line 4 is due June 15, 1998, enter one-half of the amount on line 6 here and on the payment-vouchers for your payments due September 15, 1998, and January 15, 1999. If the amount on line 4 is due September 15, 1998, enter the full amount on line 6 here and on the payment-voucher for your payment due January 15, 1999	

Example. Early in 1998, Mayra figures her estimated tax is $1,800. She makes estimated tax payments on April 15 and June 15 of $450 each ($1,800 ÷ 4).

On July 10, she sells investment property at a gain. Her refigured estimated tax is $3,600. Her required estimated tax payment for the third payment period is $1,800, figured as follows.

1.	Amended total estimated tax payments	$3,600
2.	Multiply line 1 by: ÿ.50 if next payment is due ÿÿÿJune 15, 1998. ÿ.75 if next payment is due ÿÿÿSeptember 15, 1998. ÿ1.00 if next payment is due ÿÿÿJanuary 15, 1999.	2,700
3.	Estimated tax payments for all previous periods	900
4.	**Next required payment:** Subtract line 3 from line 2 and enter the result (but not less than zero) here and on your payment-voucher for your next required payment	$1,800

If the payment on line 4 is due January 15, 1999, **stop here.** *Otherwise, go on to line 5.*

5.	Add lines 3 and 4	2,700
6.	Subtract line 5 from line 1 and enter the result (but not less than zero)	900
7.	**Each following required payment:** If the payment on line 4 is due June 15, 1998, enter one-half of the amount on line 6 here and on the payment-vouchers for your payments due September 15, 1998, and January 15, 1999. If the amount on line 4 is due September 15, 1998, enter the full amount on line 6 here and on the payment-voucher for your payment due January 15, 1999	$900

If Mayra's estimated tax does not change again, her required estimated tax payment for the fourth payment period will be $900.

File Form 2210 to avoid penalty. If your estimated tax payment for a previous period is less than one-fourth of your amended estimated tax, you may be charged a penalty for underpayment of estimated tax for that period when you file your tax return. To avoid the penalty, you must show that the total of your withholding and estimated tax payment for the period was at least as much as your annualized income installment. Complete Form 2210 and Schedule AI — *Annualized Income Installment Method,* and attach the form and Schedule AI to your tax return. See *Form 2210,* later, under *Underpayment Penalty,* for more information.

Annualized Income Installment Method

If you do not receive your income evenly throughout the year (for example, your income from a repair shop you operate is much larger in the summer than it is during the rest of the year), your required estimated tax payment for one or more periods may be less than the amount figured using the regular installment method.

To see if you can pay less for any period, complete the *1998 Annualized Estimated Tax Worksheet (Worksheet 2.10)* in chapter 2 of Publication 505.

Note. If you use the annualized income installment method to figure your estimated tax payments, you ***must*** attach to your tax return a completed Form 2210 and Schedule AI (Form 2210). See *Form 2210* under *Underpayment Penalty,* later.

Estimated Tax Payments Not Required

You do not have to make estimated tax payments if your withholding in each payment period is at least one-fourth of your required annual payment or at least your required annualized income installment for that period. You also do not have to make estimated tax payments if you will pay enough through withholding to keep the amount you owe with your 1998 return under $1,000.

How To Pay Estimated Tax

There are two ways to make estimated tax payments:

1) By crediting an overpayment on your 1997 return to your 1998 estimated tax, and
2) By sending in your payment with a payment-voucher from **Form 1040–ES.**

Crediting an Overpayment

When you file your Form 1040 or Form 1040A for 1997 and you have an overpayment of tax, you can apply part or all of it to your estimated tax for 1998. On line 63 of Form 1040, or line 32 of Form 1040A, write the amount you want credited to your estimated tax rather than refunded. The amount you have credited should be taken into account when figuring your estimated tax payments.

You can use all the credited amount toward your first payment, or you can spread it out in any way you choose among any or all of your payments.

If you ask that an overpayment be credited to your estimated tax for the next year, the payment is considered to have been made on the due date of the first estimated tax installment (April 15 for calendar year taxpayers). You cannot have any of that amount refunded to you after that due date until the close of that tax year. You also cannot use that overpayment in any other way after that date.

Using the Payment-Vouchers

Each payment of estimated tax must be accompanied by a payment-voucher from Form 1040–ES. If you made estimated tax payments last year, you should receive a copy of the 1998 Form 1040–ES in the mail. It will have payment-vouchers preprinted with your name, address, and social security number. Using the preprinted vouchers will speed processing, reduce the chance of error, and help save processing costs.

If you did not pay estimated tax last year, you will have to get a copy of Form 1040–ES from the IRS. Do so by calling 1–800–TAX–FORM (1–800–829–3676). After you make your first payment, a Form 1040–ES package with the preprinted vouchers will be mailed to you. Follow the instructions in the package to make sure you use the vouchers correctly.

Use the addressed envelopes that came with your Form 1040–ES package. If you use your own envelope, make sure you mail your payment-vouchers to the address shown in the Form 1040–ES instructions for the place where you live. ***Do not*** use the address shown in the Form 1040 or Form 1040A instructions.

Change of address. You must notify the IRS if you are making estimated tax payments and you changed your address during the year. You must send a clear and concise written statement to the IRS Service Center where you filed your last return and provide all of the following:

1) Your full name (and your spouse's full name),
2) Your signature (and spouse's signature),
3) Your old address (and spouse's old address if different),
4) Your new address, and
5) Your social security number (and spouse's social security number).

You can use Form 8822, *Change of Address,* for this purpose.

You can continue to use your old preprinted payment-vouchers until the IRS sends you new ones. However, ***DO NOT*** correct the address on the old voucher or the address on the envelope.

Credit for Withholding and Estimated Tax

When you file your 1997 income tax return, take credit for all the income tax and excess social security or railroad retirement tax withheld from your salary, wages, pensions, etc. Also, take credit for the estimated tax you paid for 1997. These credits are subtracted from your tax. You should file a return and claim these credits even if you do not owe tax.

If you had two or more employers and were paid wages of more than $65,400 during 1997, too much social security or railroad retirement tax may have been withheld from your wages. See *Credit for Excess Social Security Tax or Railroad Retirement Tax Withheld* in chapter 36.

Withholding

If you had income tax withheld during 1997, you should receive a statement by February 2, 1998, showing your income and the tax withheld. Depending on the source of your income, you will receive:

- Form W–2, *Wage and Tax Statement,*
- Form W–2G, *Certain Gambling Winnings,* or
- A form in the 1099 series.

Forms W–2 and W–2G. You file Form W–2 with your income tax return. File Form W–2G with your return if it shows any federal income tax withheld from your winnings.

You should get at least two copies of each form you receive. Attach Copy B to the front of your federal income tax return. Copy C is for your records. You should also receive copies to file with your state and local returns.

Form W–2

Your employer should give you a Form W–2 for 1997 by February 2, 1998. You should receive a separate Form W–2 from each employer you worked for.

If you stop working before the end of the year, your employer can give you your Form W–2 at any time after you leave your job. However, your employer must give it to you by January 31 of the following year (or the next day that is not a Saturday, Sunday, or holiday if January 31 is a Saturday, Sunday, or holiday). If you ask for the form, your employer must give it to you within 30 days after receiving your written request or within 30 days after your final wage payment, whichever is later.

If you have not received your Form W–2 by February 2, 1998, you should ask your employer for it. If you do not receive it by February 15, call the IRS toll-free telephone number for your area. The number is listed in the Form 1040, Form 1040A, and Form 1040EZ instructions. You will be asked to give your employer's name, address, and telephone number, and, if known, your employer's identification number. You will also be asked for your address, social security number, daytime telephone number, dates of employment, and your best estimate of your total wages and federal income tax withheld.

Form W–2 shows your total pay and other compensation and the income tax, social security tax, and Medicare tax that was withheld during the year. Take credit for the federal income tax withheld on:

- Line 54 if you file Form 1040,
- Line 29a if you file Form 1040A, or
- Line 7 if you file Form 1040EZ.

Form W–2 is also used to report any taxable sick pay you received and any income tax withheld from your sick pay.

Form W–2G

If you had gambling winnings, the payer may have withheld 28% as income tax. If tax was withheld, the payer will give you a Form W–2G showing the amount you won and the amount of tax withheld. Report the amounts you won on line 21 of Form 1040. Take credit for the tax withheld on line 54 of Form 1040. If you had gambling winnings, you must use Form 1040; you cannot use Form 1040A or Form 1040EZ. See *Deductions Not Subject to the 2% Limit* in chapter 30 for information on how to deduct gambling losses.

The 1099 Series

Most forms in the 1099 series are not filed with your return. You should receive these forms by February 2, 1998. Keep these forms for your records. There are several different forms in this series, including:

- Form 1099–B, *Proceeds From Broker and Barter Exchange Transactions,*
- Form 1099–DIV, *Dividends and Distributions,*
- Form 1099–G, *Certain Government Payments,*
- Form 1099–INT, *Interest Income,*
- Form 1099–MISC, *Miscellaneous Income,*
- Form 1099–OID, *Original Issue Discount,*
- Form 1099–R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.,*
- Form SSA–1099, *Social Security Benefit Statement,* and
- Form RRB–1099, *Payments by the Railroad Retirement Board.*

For some types of income reported on forms in the 1099 series, you may not be able to use Form 1040A or Form 1040EZ. See the instructions to these forms for details.

Form 1099–R. Attach Form 1099–R to your return if box 4 shows federal income tax withholding. Include the amount withheld in the total on line 54 of Form 1040 or line 29a of Form 1040A.

Backup withholding. If you were subject to backup withholding on income you received during 1997, include the amount withheld, as shown on your Form 1099, in the total on line 54 of Form 1040, or line 29a of Form 1040A.

Form Not Correct

If you receive a form with incorrect information on it, you should ask the payer for a corrected form. Call the telephone number or write to the address given for the payer on the form. The corrected Form W–2G or Form 1099 you receive will be marked "CORRECTED." A special form, Form W–2c, *Corrected Wage and Tax Statement,* is used to correct a Form W–2.

Form Received After Filing

If you file your return and you later receive a form for income that you did not include on your return, you should report the income and take credit for any income tax withheld by filing Form 1040X, *Amended U.S. Individual Income Tax Return.* See *Amended Returns and Claims for Refund* in chapter 1.

Separate Returns

If you are married but file a separate return, you can take credit only for the tax withheld from your own income. Do not include any amount withheld from your spouse's income. However, different rules may apply if you live in a community property state.

Community property states. Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin are community property states. If you live in a community property state and file a separate return, you and your spouse must each report half of all community income in addition to your own separate income. Each of you takes credit for half of all taxes withheld on the community income. If you were divorced during the year, each of you generally must report half the community income and can take credit for half the withholding on that community income for the period before the divorce.

For more information on these rules, and some exceptions, see Publication 555, *Community Property.*

Fiscal Years

If you file your tax return on the basis of a fiscal year (a 12-month period ending on the last day of any month except December), you must follow special rules, described below, to determine your credit for federal income tax withholding.

During your fiscal year, one calendar year will end and another will begin. You can claim credit on your tax return only for the tax withheld during the calendar year ending in your fiscal year. You cannot claim credit for any of the tax withheld during the calendar year beginning in your fiscal year. You will be able to claim credit for that withholding on your return for next year.

However, if income tax has been withheld from your income under the backup withholding rule, take credit for it on your tax return for the fiscal year in which you received the payment.

For a more detailed discussion of how to take credit for withholding on a fiscal year return, see *Fiscal Years* in chapter 3 of Publication 505.

Estimated Tax

Take credit for all your estimated tax payments for 1997 on line 55 of Form 1040 or line 29b of Form 1040A. Include any overpayment from 1996 that you had credited to your 1997 estimated tax. You must use Form 1040 or Form 1040A if you paid estimated tax. You cannot use Form 1040EZ.

Name changed. If you changed your name, and you made estimated tax payments using your old name, attach a brief statement to the front of your tax return indicating:

1) When you made the payments,
2) The amount of each payment,
3) Which IRS address you sent the payments to,
4) Your name when you made the payments, and
5) Your social security number.

The statement should cover payments you made jointly with your spouse as well as any you made separately.

Separate Returns

If you and your spouse made separate estimated tax payments for 1997 and you file separate returns, you can take credit only for your own payments.

If you made joint estimated tax payments, you must decide how to divide the payments between your returns. One of you can claim all of the estimated tax paid and the other none, or you can divide it in any other way you agree on. If you cannot agree, you must divide the payments in proportion to each spouse's individual tax as shown on your separate returns for 1997.

Divorced Taxpayers

If you made joint estimated tax payments for 1997, and you were divorced during the year, either you or your former spouse can claim all of the joint payments, or you each can claim part of them. If you cannot agree on how to divide the payments, you must divide them in proportion to each spouse's individual tax as shown on your separate returns for 1997.

If you claim any of the joint payments on your tax return, enter your former spouse's social security number (SSN) in the space provided on the front of Form 1040 or Form 1040A. If you divorced and remarried in 1997, enter your present spouse's SSN in that space and write your former spouse's SSN, followed by "DIV," to the left of line 55, Form 1040, or line 29b, Form 1040A.

Underpayment Penalty

If you did not pay enough tax either through withholding or by making estimated tax payments, you will have an underpayment of estimated tax and you may have to pay a penalty. However, you will ***not*** generally have to pay a penalty for 1997 if any of the following situations apply to you.

- The total of your withholding and estimated tax payments was at least as much as your 1996 tax, you are not subject to the special rule limiting use of the prior year's tax, and you paid all required estimated tax payments on time.
- The tax balance on your return (minus household employment taxes) is no more than 10% of your total 1997 tax, and you paid all required estimated tax payments on time.
- Your total 1997 tax (defined later) minus your withholding is less than $500.
- You did not owe tax for 1996.
- All of the tax balance on your return is caused by employment taxes for household workers.

Special rules apply if you are a farmer or fisherman. See *Farmers and Fishermen* in chapter 4 of Publication 505 for more information.

IRS can figure the penalty for you. If you think you owe the penalty but you do not want to figure it yourself when you file your tax return, you may not have to. Generally, the IRS will figure the penalty for you and send you a bill. However, you must complete Form 2210 and file it with your return if you check any of the boxes in Part I of the form. See *Reasons for filing* later in this section.

General Rule

In general, you may owe a penalty for 1997 if the total of your withholding and estimated tax payments did not equal at least the ***smaller*** of:

1) 90% of your 1997 tax, or
2) 100% of your 1996 tax. (Your 1996 tax return must cover a 12-month period.)

Special rules for certain individuals. There are special rules for farmers and fishermen and for certain higher income taxpayers.

Farmers and fishermen. If at least two-thirds of your gross income for 1996 or 1997 is from farming or fishing, substitute 66⅔% for 90% in (1) above.

See *Farmers and Fishermen* in chapter 4 of Publication 505 for more information.

Higher income taxpayers. If less than two-thirds of your gross income for 1996 and 1997 is from farming or fishing and your adjusted gross income (AGI) for 1996 was more than $150,000 ($75,000 if your filing status is married filing a separate return in 1997), substitute 110% for 100% in (2) above.

For 1996, AGI is the amount shown on Form 1040 — line 31; Form 1040A — line 16; and Form 1040EZ — line 4.

Penalty figured for each period. Because the penalty is figured separately for each payment period, you may owe a penalty for an earlier payment period even if you later paid enough to make up the underpayment. If you did not pay enough tax by the due date of each of the payment periods, you may owe a penalty even if you are due a refund when you file your income tax return.

Example. You did not make estimated tax payments during 1997 because you thought you had enough tax withheld from your wages. Early in January 1998, you made an estimate of your total 1997 tax. You then realized that your withholding was $2,000 less than the amount needed to avoid a penalty for underpayment of estimated tax.

On January 10, you made an estimated tax payment of $3,000, the difference between your withholding and your estimate of your total tax. Your final return shows your total tax to be $50 less than your estimate, so you are due a refund.

You do not owe a penalty for your payment due January 15, 1998. However, you may owe a penalty through January 10 for your underpayments for the earlier payment periods.

Minimum required each period. You will owe a penalty for any 1997 payment period for which your estimated tax payment plus your withholding for the period and overpayments for previous periods was less than the ***smaller*** of:

1) 22.5% of your 1997 tax, or
2) 25% of your 1996 tax. (Your 1996 tax return must cover a 12-month period.)

Note. If you are subject to the rule for higher income taxpayers, discussed earlier, substitute 27.5% for 25% in (2) above.

When penalty is charged. If you miss a payment or you paid less than the minimum required in a period, you may be charged an underpayment penalty from the date the amount was due to the date the payment is made.

1996 separate returns and 1997 joint return. If you file a joint return with your spouse for 1997, but you filed separate returns for 1996, your 1996 tax is the total of the tax shown on your separate returns. You filed a separate return in 1996 if you filed as single, head of household, or married filing separately.

1996 joint return and 1997 separate returns. If you file a separate return for 1997, but you filed a joint return with your spouse for 1996, your 1996 tax is your share of the tax on the joint return. You filed a separate return in 1997 if you filed as single, head of household, or married filing separately. To figure your share, first figure the tax both you and your spouse would have paid had you filed separate returns for 1996, using the same filing status as in 1997. Then multiply your joint tax liability by the following fraction:

$$\frac{\text{Your separate tax liability}}{\text{Both spouses' separate tax liabilities}}$$

Example. Lisa and Paul filed a joint return for 1996 showing taxable income of $48,000 and a tax of $8,234. Of the $48,000 taxable income, $40,000 was Lisa's and the rest was Paul's. For 1997, they file married filing separately. Lisa figures her share of the tax on the 1996 joint return as follows:

Tax on $40,000 based on a separate return	$ 8,601
Tax on $8,000 based on a separate return	1,204
Total	$ 9,805
Lisa's portion of total ($8,601 ÷ $9,805)	88%
Lisa's share of 1996 joint return tax ($8,234 × 88%)	$ 7,246

Form 2210. In most cases, you do not need to file Form 2210. The IRS will figure the penalty for you and send you a bill. If you want to figure your penalty, complete Part I, Part II, and either Part III or Part IV of Form 2210. ***Do not*** file Form 2210 unless you must file it, as explained later under *Reasons for filing.* If you use Form 2210, you cannot file Form 1040EZ.

On Form 1040, enter the amount of your penalty on line 65. If you owe tax on line 64, add the penalty to your tax due and show your total payment on line 64. If you are due a refund, subtract the penalty from the overpayment you show on line 61.

On Form 1040A, enter the amount of your penalty on line 34. If you owe tax on line 33, add the penalty to your tax due and show your total payment on line 33. If you are due a refund, subtract the penalty from the overpayment you show on line 30.

Reasons for filing. You may be able to lower or eliminate your penalty if you file Form 2210. You ***must*** file Form 2210 with your return if any of the following applies.

1) You request a waiver. (See *Waiver of Penalty,* later.)
2) You use the annualized income installment method.
3) You use your actual withholding for each payment period for estimated tax purposes.
4) You base any of your required installments on the tax shown on your 1996 return and you filed or are filing a joint return for either 1996 or 1997 but not for both years.

For help in completing Form 2210, including illustrated examples, see chapter 4 of Publication 505.

Annualized income installment method. If you did not receive your income evenly throughout the year (for example, your income from a repair shop you operated was much larger in the summer than it was during the rest of the year), you may be able to lower or eliminate your penalty by figuring your underpayment using the ***annualized income installment method.*** Under this method, your required installment for one or more payment periods may be less than one-fourth of your required annual payment.

To figure your underpayment using this method, complete Schedule AI of Form 2210. Also check the box on line 1b in Part I of Form 2210. You must file the form and Schedule AI with your return. This method is explained in chapter 4 of Publication 505.

Actual withholding method. Instead of using one-fourth of your withholding to figure your payments, you can choose to establish how much was actually withheld by the due dates and use those amounts. You can make this choice separately for the tax withheld from your wages and for all other withholding.

Using your actual withholding may result in a smaller penalty if most of your withholding occurred early in the year.

If you use your actual withholding, you must check the box on line 1c, Part I of the Form 2210. Complete Form 2210 and file it with your return.

Short method for figuring the penalty. You may be able to use the short method in Part III of Form 2210 to figure your penalty for underpayment of estimated tax. If you qualify to use this method, it will result in the same penalty amount as the regular method, but with fewer computations.

You can use the short method ***only*** if you meet one of the following requirements.

1) You made no estimated tax payments for 1997. It does not matter whether you had income tax withholding; or
2) You paid estimated tax on all four due dates in equal installments. You must have paid the same amount on each of the following dates:
    a) April 15, 1997,
    b) June 16, 1997,
    c) September 15, 1997, and
    d) January 15, 1998.

If you do not meet either requirement, figure your penalty using the regular method in Part IV, Form 2210.

Note. If you use the short method in Part III, you cannot use the annualized income installment method or the actual withholding method.

Exceptions

Generally, you do not have to pay an underpayment penalty if either of the following conditions apply:

- Your total tax due is less than $500, or
- You had no tax liability last year.

Less Than $500 Due

You do not owe a penalty if the total tax shown on your return minus the amount you paid through withholding (including excess social security and railroad retirement tax withholding) is less than $500.

Total tax for 1997. For 1997, your total tax on Form 1040 is the amount on line 53 reduced by the total of the following amounts:

1) Any recapture of a federal mortgage subsidy from Form 8828 included on line 53,
2) Any social security or Medicare tax on tips not reported to your employer on line 49,
3) Any tax on an IRA, MSA, or a qualified retirement plan from Form 5329 (other than the tax on early distributions) included on line 50,
4) Any household employment taxes from Schedule H included on line 52,
5) Any uncollected social security, Medicare, or railroad retirement tax included on line 53,
6) Any earned income credit on line 56a, and
7) Any credit for federal tax on fuels from Form 4136 included on line 59.

Your total tax on Form 1040A for 1997 is the amount on line 28 minus the amount on lines 27 and 29c. Your total tax on Form 1040EZ for 1997 is the amount on line 10 minus the amount on line 8.

No Tax Liability Last Year

You do not owe a penalty if you had no tax liability last year and you were a U.S. citizen or resident for the whole year. For this rule to apply, your tax year must have included all 12 months of the year.

You had no tax liability for 1996 if your total tax was zero or you did not need to file an income tax return.

Example. Ray, who is single and age 22, was unemployed for most of 1996. He earned $2,700 in wages before he was laid off, and he received $2,500 in unemployment compensation afterwards. He had no other income. Even though he had gross income of $5,200, he did not have to pay income tax because his gross income was less than the filing requirement for a single person under age 65 ($6,550 for 1996). He filed a return only to have his withheld income tax refunded to him.

In 1997, Ray began regular work as an independent contractor. Ray made no estimated tax payments in 1997. Even though he did owe tax at the end of the year, Ray does not owe the underpayment penalty for 1997 because he had no tax liability in 1996.

Total tax for 1996. For 1996, your total tax on Form 1040 is the amount on line 51 reduced by the total of the following amounts:

1) Any recapture of a federal mortgage subsidy from Form 8828 included on line 51,
2) Any social security or Medicare tax on tips not reported to your employer on line 47,
3) Any tax on an IRA or a qualified retirement plan from Form 5329 (other than the tax on early distributions) included on line 48,
4) Any household employment taxes from Schedule H included on line 50,
5) Any uncollected social security, Medicare, or railroad retirement tax included on line 51,
6) Any earned income credit on line 54, and
7) Any credit for federal tax on fuels from Form 4136 included on line 57.

Your total tax on Form 1040A is the amount on line 28 minus the amount on lines 27 and 29c. Your total tax on Form 1040EZ is the amount on line 10 minus the amount on line 8.

Waiver of Penalty

The IRS can waive the penalty for underpayment if:

1) You did not make a payment because of a casualty, disaster, or other unusual circumstance, and it would be inequitable to impose the penalty, or
2) You retired (after reaching age 62) or became disabled during the tax year a payment was due or during the preceding tax year, and both the following requirements are met:
    a) You had a reasonable cause for not making the payment, and
    b) Your underpayment was not due to willful neglect.

To claim a waiver, follow the procedures explained in the instructions for Form 2210.

Part Two.

Income

The eight chapters in this part discuss many kinds of income. They explain which income is and is not taxed. See Part Three for information on gains and losses you report on Schedule D (Form 1040) and for information on selling your home.

6.

Wages, Salaries, and Other Earnings

Important Changes for 1997

Employer-provided educational assistance. The exclusion from gross income for up to $5,250 of qualified employer-provided educational assistance is extended to apply to courses beginning before June 1, 2000. The exclusion does not apply to expenses for graduate-level courses. For more information, see Publication 508, *Educational Expenses.*

Contributions to plan providing long-term benefits. Beginning January 1, 1997, contributions by your employer to provide coverage for long-term care services through a flexible spending or similar arrangement (such as a cafeteria plan) must be included in your income. This amount will be reported as wages in box 1 of your Form W–2.

Contributions to medical savings accounts. Beginning in 1997, contributions by your employer to your medical savings account are not included in your income. This amount will, however, be reported in box 13, with code R designating that the amounts are excludable from income. This amount must be reported on your tax return. See Form 8853, *Medical Savings Accounts and Long-Term Care Insurance Contracts.*

Adoption expenses. Beginning in 1997, you may be able to exclude from gross income amounts paid or expenses incurred by your employer for qualified adoption expenses in connection with your adoption of an eligible child. See Publication 968, *Tax Benefits for Adoption,* for more information.

Important Reminder

Foreign source income. If you are a U.S. citizen, you must report all income from sources outside the United States (foreign income) unless it is exempt by U.S. law. This is true whether you reside inside or outside the United States and whether or not you receive a Form W–2 or 1099 from the foreign payer. This applies to earned income (such as wages and tips) as well as unearned income (such as interest, dividends, capital gains, pensions, rents and royalties). This rule also applies to resident aliens.

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

Introduction

This chapter discusses wages, salaries, fringe benefits, and other compensation received for services as an employee. The topics include:

- Bonuses and awards,
- Unemployment compensation,
- Disability income, and
- Special rules for certain employees.

The chapter also explains what income is included in the employee's gross income and what is not included.

Useful Items

You may want to see:

Publication

- ☐ **463** Travel, Entertainment, Gift, and Car Expenses
- ☐ **503** Child and Dependent Care Expenses
- ☐ **505** Tax Withholding and Estimated Tax
- ☐ **525** Taxable and Nontaxable Income

Form

- ☐ **W–2** Wage and Tax Statement

Employee Compensation

This section explains many types of employee compensation. The subjects are arranged in alphabetical order followed by *Fringe Benefits, Disability Income,* and *Pension and Annuity Contributions,* which are explained in greater detail.

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

If you repay unearned commissions or other amounts in the same year you receive them, reduce the amount to include in your income by the repayment. However, if you repay the unearned commissions or other amounts in a later tax year, you can deduct the repayment as an itemized deduction on your Schedule A (Form 1040), or you may be able to take a credit for that year. See *Repayments* in chapter 13.

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

Bonuses and awards. Amounts you receive for outstanding work, such as bonuses or awards, are included in your gross income and should be shown on your Form W–2. These include prizes such as vacation trips for meeting sales goals. If the prize or award you receive is goods or services, you must include the fair market value of the goods or services in your income. However, if your employer merely promises to pay you a bonus or award at some future time, it is not taxable until you receive it or it is made available to you.

If you receive an award for length of service or safety achievement, see *Employee achievement awards* under *Income Not Taxed* in chapter 13.

Child-care providers. If you provide child care, either in the child's home or in your home or other place of business, the pay you receive must be included in your income. You are an employee if you are subject to the will and control of your employer as to what you are to do and how you are to do it.

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

If you are an employee, you should receive a Form W–2 if your pay is subject to income tax withholding or would be subject to withholding if one exemption were claimed. Include your pay on line 7 of Form 1040 or Form 1040A, or on line 1 of Form 1040EZ, even if you do not receive a Form W–2.

If you are not an employee, you are probably self-employed and must include the payments you receive on Schedule C (Form 1040), *Profit or Loss From Business.* You may also qualify to use the simpler Schedule C–EZ (Form 1040), *Net Profit From Business.* Information on who may use it is listed in Part I of Schedule C–EZ.

Employer-provided educational assistance. The exclusion from gross income for up to $5,250 of qualified employer-provided educational assistance is extended to apply to courses beginning before June 1, 2000. The exclusion does not apply to graduate-level courses. For more information, see Publication 508, *Educational Expenses.*

Government cost-of-living allowances. Cost-of-living allowances are generally included in your income. However, these allowances are generally not included in your income if you are a federal civilian employee or a federal court employee who is stationed in Alaska, Hawaii, or outside the United States.

Allowances and differentials that increase your basic pay as an incentive for taking a less desirable post of duty are part of your compensation and must be included in your income. For example, your compensation includes Foreign Post, Foreign Service, and Overseas Tropical salary differentials.

For more information, get Publication 516, *U.S. Government Civilian Employees Stationed Abroad.*

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

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

Note received for services. If your employer gives you a secured note as payment for your services, you must include the fair market value (usually the discount value) of the note in your income as wages for the year you receive it. When you later receive payments on the note, the proportionate part of each payment is a recovery of the fair market value that you previously included in your income. Do not include that part in your income again. Include the rest of the payment in your income in the year of payment.

If your employer gives you an unsecured note as payment for your services, payments on the note that are credited toward the principal amount of the note are compensation income when you receive them.

Property received for services. Generally, if you receive property for your services, you must include its fair market value in your gross income in the year you receive the property. However, if you receive stock or other property that has certain restrictions that affect its value, you may not have to include the value of the property in your income in the year you receive it. For details, see *Restricted Property Received for Services* in Publication 525.

Dividends you receive on restricted stock are extra compensation to you. Restricted stock is stock you received from your employer and did not include in your income because it was not substantially vested. Your employer should include these payments on your Form W–2.

Dividends you receive on stock you chose to include in your income in the year transferred or dividends on substantially vested stock are treated the same as any other dividends. Report them on line 9 of Form 1040. For a discussion of dividends, see chapter 9.

For information on how to treat dividends reported on both your Form W–2 and Form 1099–DIV, see *Dividends received on restricted stock* in Publication 525.

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

Accrued leave payment. If you are a federal employee and receive a lump-sum payment for accrued annual leave when you retire or resign, this amount will be included on your Form W–2.

If you resign from one agency and are reemployed by another agency, you may have to repay part of your lump-sum annual leave payment to the second agency. You can reduce gross wages by the amount you repaid in the same tax year in which you received it. You should attach to your tax return a copy of the receipt or statement furnished by the agency to which you make repayment to explain the difference between the wages on the return and the wages on your Forms W–2.

Employer-provided outplacement services. If you choose to accept a reduced amount of severance pay so that you can receive employer-provided outplacement services (such as training in resumé writing and interview techniques), you must include the unreduced amount of the severance pay in income.

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

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

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

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

If you received income because of a disability, see *Disability Income,* later.

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

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

Stock options. If you receive a nonstatutory option to buy stock or other property as payment for your services, you will usually have income when you receive the option or when you exercise (use) the option. However, if your option is a statutory stock option (an incentive stock option or an option granted under an employee stock purchase plan), special rules generally delay the tax until you sell or exchange your shares of stock. Your employer can tell you which kind of option you hold. For details, get Publication 525.

Unemployment compensation. You must include in your income all unemployment compensation you receive. You should receive a Form 1099–G showing the unemployment compensation paid to you. Generally, you enter unemployment compensation on line 19 of Form 1040, line 12 of Form 1040A, or line 3 of Form 1040EZ.

Tax withholding and estimated tax. You can choose to have federal income tax withheld from your unemployment compensation. To make this choice, complete Form W–4V, *Voluntary Withholding Request,* and give it to the paying office. Tax will be withheld at 15% of your payment.

If you do not choose to have tax withheld from your unemployment compensation, you may be liable for estimated tax. For more information on estimated tax, get Publication 505.

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

1) Benefits paid by a state or the District of Columbia from the Federal Unemployment Trust Fund.
2) Unemployment insurance benefits.
3) Railroad unemployment compensation benefits.
4) Disability payments from a government program paid as a ***substitute*** for unemployment compensation. (Amounts received as workers' compensation for injuries or illness are ***not*** unemployment compensation.)
5) Trade readjustment allowances under the Trade Act of 1974.

6) Benefits under the Airline Deregulation Act of 1978.

7) Unemployment assistance under the Disaster Relief Act Amendments of 1974.

Governmental program. If you contribute to a governmental unemployment compensation program and your contributions are not deductible, amounts you receive under the program are not included as unemployment compensation until you recover your contributions.

Supplemental unemployment benefits. Benefits received from a company-financed fund (to which the employees did not contribute) are not unemployment compensation. They are taxable as wages subject to income tax withholding but not subject to social security, Medicare, or federal unemployment taxes. Report these payments on line 7 of Form 1040 or Form 1040A.

You may have to repay some of your supplemental unemployment benefits to qualify for trade readjustment allowances under the Trade Act of 1974. If you repay supplemental unemployment benefits in the same year you receive them, reduce the total benefits by the amount you repay. If you repay the benefits in a later year, you must include the full amount of the benefits received in your income for the year you received them.

Deduct the repayment in the later year as an adjustment to gross income. Include the repayment on line 31 of Form 1040, and put “Sub-pay TRA” and the amount on the dotted line next to line 31. If the amount you repay in a later year is more than $3,000, you may be able to take a credit against your tax for the later year instead of deducting the amount repaid. For more information on this, see the discussion on *Repayments* in chapter 13.

Private unemployment fund. Unemployment benefit payments from a private fund to which you voluntarily contribute are taxable only if the amounts you receive are more than your total payments into the fund. Report the taxable amount on line 21 of Form 1040.

Payments by a union. Benefits paid to you as an unemployed member of a union from regular union dues are included in your gross income on line 21 of Form 1040.

Guaranteed annual wage. Payments you receive from your employer during periods of unemployment, under a union agreement that guarantees you full pay during the year, are taxable as wages.

State employees. Payments can be made by a state to its employees who are not covered by the state's unemployment compensation law. If the payments are similar to benefits under that state law, they are fully taxable. Report these payments on line 21 of Form 1040.

Fraud. Fraudulently obtained unemployment compensation is fully taxable. Report it on line 21 of Form 1040.

Repayment of unemployment compensation benefits. If you repaid in 1997 unemployment compensation benefits you received in 1997, subtract the amount you repaid from the total amount you received and enter the difference on line 19 of Form 1040, line 12 of Form 1040A, or line 3 of Form 1040EZ. Also, enter “Repaid” and the amount you repaid on the dotted line next to line 19, line 12, or line 3. If, in 1997, you repaid unemployment compensation that you included in gross income in an earlier year, you may deduct the amount repaid on Schedule A (Form 1040) if you itemize deductions. For more information, see *Repayments* in chapter 13.

Union benefits and dues. Amounts deducted from your pay for union dues, assessments, contributions, or other payments to a union cannot be excluded from your gross income.

You may be able to deduct some of these payments as a miscellaneous deduction subject to the 2% limit if they are related to your job and if you itemize your deductions on Schedule A (Form 1040). For more information, see *Union Dues and Expenses* in chapter 30.

Strike and lockout benefits. Benefits paid to you by a union as strike or lockout benefits, including both cash and the fair market value of other property, are usually included in your income as compensation. You can exclude these benefits from your income only when the facts show that the union intended them as gifts to you.

Fringe Benefits

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

Generally, your employer determines the amount of your fringe benefits and includes this amount on your Form W–2. Some benefits you may receive are discussed here. More information on fringe benefits can be found in chapter 4 of Publication 535, *Business Expenses.*

Accident or Health Plan

Generally, the value of accident or health plan coverage provided to you by your employer is not included in your gross income.

Contributions to Plan Providing Long-Term Care Benefits

Contributions by your employer to provide coverage for long-term care services are generally not included in income. However, contributions made through a flexible spending or similar arrangement (such as a cafeteria plan) must be included in your income. This amount will be reported as wages in box 1 of your Form W–2.

Contributions you make to the plan are discussed in Publication 502, *Medical Expenses.*

Contributions to Medical Savings Accounts (MSAs)

Contributions by your employer to your medical savings account are not included in your income. This amount will, however, be reported in box 13, with code R designating that the amounts are excludable from income. This amount must be reported on your tax return.

If your employer does not make contributions to your MSA, you can make your own contributions to your MSA. These contributions are discussed in Publication 969, *Medical Savings Accounts (MSAs).* Also see Form 8853, *Medical Savings Accounts and Long-Term Care Insurance Contracts.*

Adoption Expenses

Beginning in 1997 through 2001, you may be able to exclude from gross income amounts paid or expenses incurred by your employer for qualified adoption expenses in connection with your adoption of an eligible child. The amounts must be paid or the expenses must be incurred as part of an adoption assistance program.

See Publication 968, *Tax Benefits for Adoption,* for more information.

Transportation

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

1) Transportation in a commuter highway vehicle (such as a van) between your home and work place,

2) A transit pass, or

3) Qualified parking.

Cash reimbursement by your employer for these expenses under a bona fide reimbursement arrangement is also excludable. However, cash reimbursement for a transit pass is excludable only if a voucher or similar item which can be exchanged only for a transit pass is not readily available for direct distribution to you.

Exclusion limit. The exclusion for commuter highway vehicle transportation and transit pass fringe benefits cannot be more than a total of $65 a month, regardless of the total value of both benefits.

The exclusion for the qualified parking fringe benefit cannot be more than $170 a month, regardless of its value. If the benefits have a value that is more than these limits, the excess must be included in your income.

Commuter highway vehicle. This is a highway vehicle that seats at least six adults (not including the driver). At least 80% of the vehicle's mileage must reasonably be expected to be:

1) For transporting employees between their homes and work place, and

2) On trips during which employees occupy at least half of the vehicle's adult seating capacity (not including the driver).

Transit pass. This is any pass, token, farecard, voucher, or similar item entitling a person to ride mass transit (whether public or private) free or at a reduced rate or to ride in a commuter highway vehicle operated by a person in the business of transporting persons for compensation.

Qualified parking. This is parking provided to an employee at or near the employer's place of business. It also includes parking provided on or near a location from which the employee commutes to work in a commuter highway vehicle or carpool. It does not include parking at or near the employee's home.

Group Life Insurance Premiums

Generally, the cost of up to $50,000 of group-term life insurance coverage that is provided to you by your employer is not included in your income. However, you must include in your income the cost of insurance that is more than the cost of $50,000 of insurance reduced by the amount you pay towards the purchase of the insurance.

The amount included in your income is reported as part of your wages in box 1 of your Form W–2. It is also shown separately in box 13 with code **C.** See *Your payment,* later.

Retired employees. If you are a retired employee, you generally will have to include in your income the cost of providing you with more than $50,000 of insurance coverage. For more information, see *Retired employees* in Publication 525.

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

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

Your payment. If you pay any part of the cost of the insurance, your entire payment reduces, dollar for dollar, the amount your employer would otherwise include in your income. However, you cannot reduce the amount to include in your income by either:

1) Payments for coverage in a different tax year,
2) Payments for coverage through a cafeteria plan, unless the coverage is purchased with after tax employee contributions, or
3) Payments not taxed to you because of the exceptions discussed later.

Permanent benefits. If your group-term life insurance policy includes permanent benefits, such as a paid-up or cash surrender value, you must include in your income, as wages, the cost of the permanent benefits minus the amount you pay for them. Your employer should be able to tell you the amount to include in your income.

Accidental or other death benefits. Accidental or other death benefits from a policy that does not provide general death benefits (travel insurance, for example) are not included as group-term life insurance coverage.

Exceptions. You are not taxed on the cost of group-term life insurance if ***any*** of the following apply.

1) You are disabled and have ended your employment.
2) Your employer is the beneficiary of the policy for the entire period the insurance is in force during the tax year.
3) The only beneficiary is a qualified charitable organization (defined in chapter 26) for the entire period the insurance is in force during the tax year. You are not entitled to a deduction for a charitable contribution for naming a charitable organization as the beneficiary of your policy.

Entire cost taxed. You are taxed on the entire cost of group-term life insurance protection provided by your employer through a qualified employees' trust, such as a pension trust or a qualified annuity plan.

You are also taxed on the entire cost of the group-term life insurance coverage provided by your employer if you are a key employee and your employer's plan discriminates in favor of key employees.

Life insurance agents. Full-time life insurance agents who are considered employees for social security and Medicare tax withholding purposes are treated as employees in applying the provisions relating to group-term life insurance under a policy carried by their employer.

More than $50,000 from one employer. If you have only one employer and you were insured at any time during the tax year for more than $50,000 under a group-term life insurance policy, your taxable income from this source is included as other compensation on the Form W–2 you receive.

More than $50,000 from two or more employers. If two or more employers provide you group-term life insurance coverage totaling more than $50,000, you must figure how much to include in your income. You must include the cost of life insurance provided to you during the tax year, regardless of when your employers paid the premiums.

You figure the cost for each month of coverage by multiplying the number of thousands of dollars of insurance coverage (figured to the nearest tenth), less $50,000 of insurance, by the cost from the following table. You must prorate the cost from the table if less than a full month of coverage is involved.

COST PER $1,000 OF PROTECTION FOR ONE MONTH

Age	Cost
Under 30	$.08
30 through 34	.09
35 through 39	.11
40 through 44	.17
45 through 49	.29
50 through 54	.48
55 through 59	.75
60 through 64	1.17
65 through 69	2.10
70 and older	3.76

Example. You are 51 years old and work for Employers A and B. Both employers provide group-term life insurance coverage for you for the entire year. Your coverage is $35,000 with Employer A and $45,000 with Employer B. You pay premiums of $50 a year under the Employer B group plan. You figure the amount to include in your income as follows:

Employer A coverage (in thousands)	$35
Employer B coverage (in thousands)	+ 45
Total coverage (in thousands)	$80
Minus: Exclusion (in thousands)	− 50
Excess amount (in thousands)	$30
Multiply by cost per $1,000 per month, age 51 (from table)	× .48
Cost of excess insurance for 1 month	$14.40
Multiply by number of full months coverage at this cost	× 12
Cost of excess insurance for tax year	$172.80
Minus: Premiums you paid	–50.00
Cost to include in your income as wages	$122.80

For more information on employer payments for group-term life insurance, see chapter 5 of Publication 535.

How To Report Fringe Benefits

The amount of your taxable fringe benefits is shown on your Form W–2.

Employer-provided car. If your employer provides a car (or other highway motor vehicle) to you, your personal use of the car is usually a taxable noncash fringe benefit.

Your employer must determine the actual value of this fringe benefit to include in your income.

TIP *Certain employer-provided transportation can be excluded from gross income. See the discussion on* Transportation, *earlier.*

Accounting period. You must use the same accounting period your employer uses to report your taxable noncash fringe benefits. Your employer has the option to report taxable fringe benefits by using either of the following rules.

1) ***The general rule.*** Value the benefit for a full calendar year (January 1–December 31), or
2) ***The special accounting period rule.*** Treat the value of benefits provided during the last 2 months of the calendar year (or any shorter period) as paid during the following calendar year. For example, each year your employer includes the value of benefits provided the last 2 months of the prior year and the first 10 months of the current year.

You must use the same accounting period to claim an employee business deduction (for use of a car, for example) that you use to report the benefit. Your employer does not have to use the same accounting period for each fringe benefit, but must use the same period for all employees who receive a particular benefit.

Form W–2. Your employer reports your taxable fringe benefits in box 1 (Wages, tips, other compensation) of Form W–2. The total value of your fringe benefits should also be shown in box 12. The value of your fringe benefits may be added to your other compensation on one Form W–2, or you may receive a separate Form W–2 showing just the value of your fringe benefits in box 1 with a notation in box 12.

Disability Income

Generally, if you retire on disability you must report your pension or annuity as income. There is a tax credit for people who are permanently and totally disabled. For information on this credit and the definition of permanent and total disability, see chapter 34.

Disability pensions. Generally, you must report as income any amount you receive for your disability through an accident or health insurance plan paid for by your employer. If both you and your employer pay for the plan, only the amount you receive for your disability that is due to your employer's payments is reported as income. However, certain payments may not be taxable to you. Your employer should be able to give you specific details about your pension plan and tell you the amount you paid for your disability pension. In addition to disability pensions and annuities, you may be receiving other payments for sickness and injury. See *Other Sickness and Injury Benefits* in chapter 13.

Cost paid by you. If you pay the entire cost of a health or accident insurance plan, do not include any amounts you receive for your disability as income on your tax return. If your plan reimbursed you for medical expenses you deducted in an earlier year, you may have to include some, or all, of the reimbursement in your income. See *Reimbursement in a later year* in chapter 23.

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

Accrued leave payment. If you retire on disability, any lump-sum payment you receive for accrued annual leave is a salary payment. The payment is not a disability payment. You must report it as wages in the tax year you receive it.

Retirement and profit-sharing plans. If you receive payments from a retirement or profit-sharing plan that does not provide for disability retirement, do not report them as disability income. The payments are taxable and should be reported as a pension or annuity. For more information on pensions, see chapter 11.

How to report. If you retired on disability, payments you receive are taxed as wages until you reach minimum retirement age. Minimum retirement age generally is the age at which you can first receive a pension or annuity if you are not disabled. You must report your taxable disability payments as wages on line 7 of Form 1040 or Form 1040A, until you reach minimum retirement age.

Beginning on the day after you reach minimum retirement age, payments you receive are taxable as a pension. Report the payments on lines 16a and 16b of Form 1040, or on lines 11a and 11b of Form 1040A. The rules for reporting pensions are explained in *How To Report* in chapter 11.

Military And Certain Government Disability Pensions

Generally, you must report these disability pensions as income. But certain military and government disability pensions are not taxable.

You may be able to exclude from income amounts you receive as a pension, annuity, or similar allowance for personal injury or sickness resulting from active service in the:

1) Armed Forces of any country,
2) National Oceanic and Atmospheric Administration,
3) Public Health Service, or
4) Foreign Service.

Do not include the disability payments in your income if any of the following apply.

1) You were entitled to receive a disability payment before September 25, 1975.
2) You were a member of a government service or its reserve component, or were under a binding written commitment to become a member, on September 24, 1975.
3) You receive disability payments for a “combat-related injury.”
4) You would be entitled to receive disability compensation from the Department of Veterans Affairs (VA) if you filed an application for it.

Combat-related injury. A combat-related injury is a personal injury or sickness that:

1) Results directly from armed conflict,
2) Takes place while you are engaged in extra-hazardous service,
3) Takes place under conditions simulating war, including training exercises such as maneuvers, or
4) Is caused by an instrumentality of war.

Disability based on years of service. If you receive a disability pension based on years of service, you generally must include it in your income. But if it is the result of active service in one of the organizations listed earlier, do not include in income the part of your pension that you would have received if the pension had been based on a percentage of disability. You must include the rest of your pension in your income.

Terrorist attack. You do not include in your income disability payments you receive for injuries resulting directly from a violent attack that occurs while you are a U.S. government employee performing official duties outside the United States. For your disability payments to be tax exempt, the Secretary of State must determine the attack was a terrorist attack.

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

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

If you receive a lump-sum disability severance payment and are later awarded VA disability benefits, you do not include in your income the portion of the severance payment equal to the VA benefit you would have been entitled to receive in that same year. However, you must include in your income any lump-sum readjustment or other non-disability severance payment you received on release from active duty, even though you are later given a retroactive disability rating by the VA.

Pension and Annuity Contributions

Generally, you cannot exclude from income amounts you pay into a pension plan through payroll deductions.

Contributions to Federal Thrift Savings Plan. If you are a federal employee, you can choose to make contributions from your salary to the Federal Thrift Savings Plan. Your contributions are not included in income for income tax purposes. However, your salary before the contributions are taken out is used for purposes of figuring social security and Medicare taxes and benefits. Payments you later receive from the fund are taxable as a distribution from a qualified pension or annuity plan.

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

For 1997, you cannot set aside more than a total of $9,500 for all elective deferrals. If you set aside more than $9,500, the excess is included in your gross income that year.

The cost of life insurance coverage included in an employer's plan may be income if the proceeds of the policy are payable directly or indirectly to your beneficiary. See *Group Life Insurance Premiums,* earlier, under *Fringe Benefits.*

Amounts actually distributed or made available to you generally are taxable, unless they are eligible for a tax-free rollover. To qualify, they must be rolled over (normally within 60 days after receipt) to another qualified plan or to an individual retirement account or annuity (IRA). If you elect to have an eligible rollover distribution paid directly to you (even if you plan to roll over the distribution), the payer must withhold part of the distribution for income tax. You can avoid withholding if you choose a direct transfer to another qualified retirement plan or individual retirement account or annuity. Your employer may be able to tell you how the amount you received is taxed. For more information on pension plans, see chapter 11, and for IRAs, see chapter 18.

Employer's contributions to nonqualified plan. If your employer pays into a nonqualified plan for you, you generally must include the contributions in your income as wages for the tax year in which the contributions are made. Report this income on line 7 of Form 1040 or Form 1040A, or on line 1 of Form 1040EZ. However, if your interest is subject to a substantial risk of forfeiture (you have a good chance of losing it) at the time of contribution, you do not have to include the value of your interest in your income when you receive it. When your interest is no longer subject to a substantial risk of forfeiture, you must include the value in your income.

Railroad retirement annuities. If you received:

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

these payments are treated as pension or annuity income and are taxable under the rules explained in chapter 11.

Special Rules for Certain Employees

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

Clergy

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

If you are a member of a religious organization and you give your outside earnings to the organization, you still must include the earnings in your income. However, you may be entitled to a charitable contribution deduction for the amount paid to the organization. See chapter 26.

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

Housing allowance. A housing allowance paid to you as part of your salary is not income to the extent you use it, in the year received, to provide a home or to pay utilities for a home with which you are provided. The amount of the housing allowance that you can exclude from your income cannot be more than the reasonable compensation for your services as a minister. The church or organization that employs you must officially designate the payment as a housing allowance before the payment is made. A definite amount must be designated; the amount of the housing allowance cannot be determined at a later date.

If you are employed and paid by a local congregation, a resolution by a national church agency of your denomination does not effectively designate a housing allowance for you. The local congregation must officially designate the part of your salary that is to be a housing allowance. However, a resolution of a national church agency can designate your housing allowance if you are directly employed by the agency. If no part has been officially designated, you must include your total salary in your income.

Expenses of providing a home include rent, house payments, furniture payments, costs for a garage, and utilities. They do not include the cost of food or servants.

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

Interest and taxes on your home. You can deduct on Schedule A (Form 1040) the qualified mortgage interest and real estate taxes you pay on your home even if you use nontaxable housing allowance funds to make the payments. See chapters 24 and 25.

Teachers or administrators. If you are a minister employed as a teacher or administrator by a church school, college, or university, you are performing ministerial services for purposes of the rental exclusion. However, if you perform services as a teacher or administrator on the faculty of a nonchurch college, you cannot exclude from your income a housing allowance or the value of a home that is provided to you.

TIP *If you live in qualified campus housing as an employee of an educational institution or an academic health center, all or part of the value of that housing may be nontaxable. See* Meals and Lodging *in Publication 525.*

If you serve as a “minister of music” or “minister of education,” or serve in an administrative or other function of your religious organization, but are not authorized to perform all of the religious duties of an ordained minister in your church (even though you are commissioned as a “minister of the gospel”), you cannot exclude from your income a housing allowance or the value of a home provided to you.

Theological students. You cannot exclude a housing allowance from your income if you are a theological student serving a required internship as an assistant pastor, unless you are ordained, commissioned, or licensed as a minister.

Traveling evangelists. If you are an ordained minister and are providing evangelistic services, you can exclude amounts received from out-of-town churches that are designated as a housing allowance, provided you actually use them to maintain your permanent home.

Retired members of the clergy. The rental value of a home provided rent free by your church for your past services is not income if you are a retired minister. In addition, a housing allowance paid to you is not income to the extent you spend it for utilities, maintenance, repairs, and similar expenses that are directly related to providing a home. These amounts are also not included in net earnings from self-employment.

The general convention of a national religious denomination can designate a housing allowance for retired ministers that can be excluded from income. This applies if the local congregations authorize the general convention to establish and maintain a unified pension system for all retired clergy members of the denomination for their past services to the local churches.

A surviving spouse of a retired minister cannot exclude a housing allowance from income. If these payments were reported to you on Form 1099–R, include them on lines 16a and 16b of Form 1040, or on lines 11a and 11b of Form 1040A. Otherwise, include them on line 21 of Form 1040.

Pension. A pension or retirement pay for a member of the clergy is usually treated the same as any other pension or annuity. It must be reported on lines 16a and 16b of Form 1040 or on lines 11a and 11b of Form 1040A.

Members of religious orders. If you are a member of a religious order who has taken a vow of poverty, the amounts you earn for services you perform which you renounce and turn over to the order may or may not be included in your income.

Services performed for the order. If you are performing the services as an agent of the order in the exercise of duties required by the order, you do not include in your income the amounts you turn over to the order.

If your order directs you to perform services for another agency of the supervising church or an associated institution, you are considered to be performing the services as an agent of the order. Any wages you earn as an agent of an order that you turn over to the order are not included in your gross income.

Example. You are a member of a church order and have taken a vow of poverty. You renounce any claims to your earnings and turn over to the order any salaries or wages you earn. You are a registered nurse, so your order assigns you to work in a hospital that is an associated institution of the church. However, you remain under the general direction and control of the order. You are considered to be an agent of the order and any wages you earn at the hospital that you turn over to your order are not included in your gross income.

Services performed outside the order. If you are directed to work outside the order, the work will not constitute the exercise of duties required by the order unless the services you perform meet both of the following requirements:

1) The services are the kind that are ordinarily the duties of members of the order, and

2) The services are part of the duties that must be exercised for, or on behalf of, the religious order as its agent.

If the legal relationship of employer and employee exists between you and a third party, the services you perform for the third party will not be considered directed or required of you by the order. Amounts you receive for these services are included in your gross income, even if you have taken a vow of poverty.

Example. Mark Brown is a member of a religious order and has taken a vow of poverty. He renounces all claims to his earnings and turns over his earnings to the order.

Mark is a school teacher. He was instructed by the superiors of the order to get a job with a private tax-exempt school. Mark became an employee of the school, and, at his request, the school made the salary payments directly to the order.

Because Mark is an employee of the school, he is performing services for the school rather than as an agent of the order. The wages Mark earns working for the school are included in his gross income.

Foreign Employer

Special rules apply if you work for a foreign employer.

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

Social security and Medicare taxes. You are exempt from social security and Medicare taxes if you are employed in the United States by an international organization or a foreign government. However, you must pay self-employment tax on your earnings from services performed in the United States, even though you are not self-employed. This rule also applies if you are an employee of a qualifying wholly-owned instrumentality of a foreign government.

Non-U.S. citizen. If you are not a U.S. citizen, or if you are a U.S. citizen but also a citizen of the Philippines, and you work for an international organization, your salary from that source is exempt from tax. If you work for a foreign government in the United States, your salary from that source is exempt from tax if your work is like the work done by an employee of the United States in that foreign country and if the foreign government gives an equal exemption for the salary of the U.S. employee.

Alien status. If you are an alien and you file a waiver under section 247(b) of the Immigration and Nationality Act to keep your immigrant status, different rules may apply. See *Foreign Employer* in Publication 525.

Employment abroad. For information on income earned abroad, get Publication 54, *Tax Guide for U.S. Citizens and Resident Aliens Abroad.*

Military

Payments you receive as a member of a military service generally are taxed as wages except for retirement pay, which is taxed as a pension. Allowances generally are not taxed. For more information on military allowances and benefits, get Publication 3, *Armed Forces' Tax Guide.*

Military retirement pay. If your retirement pay is based on age or length of service, it is taxable and must be included in your gross income as a pension on lines 16a and 16b of Form 1040, or on lines 11a and 11b of Form 1040A. Do not include in your income the amount of reduction in retirement or retainer pay to provide a survivor annuity for your spouse or children under the Retired Serviceman's Family Protection Plan or the Survivor Benefit Plan.

For more information on survivor annuities, see chapter 11.

Disability. If you are retired on disability, see *Military and Certain Government Disability Pensions* under *Disability Income,* earlier.

Veterans

Veterans' benefits generally are not taxable.

Nontaxable Income

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

1) Education, training, or subsistence allowances.

2) Disability compensation and pension payments for disabilities.

3) Grants for homes designed for wheelchair living.

4) Grants for motor vehicles for veterans who lost their sight or the use of their limbs.

5) Veterans' pensions paid either to the veterans or to their families.

6) Veterans' insurance proceeds and dividends paid either to veterans or their beneficiaries, including proceeds of a veteran's endowment policy paid before death.

7) Interest on insurance dividends you leave on deposit with the VA.

Taxable Income

Certain amounts paid by the VA are taxable.

Rehabilitative program payments. VA payments to hospital patients and resident veterans for their services under the VA's therapeutic or rehabilitative programs are included as income other than wages. These payments are reported on line 21 of Form 1040.

Volunteers

The tax treatment of amounts you receive as a volunteer worker for the Peace Corps, ACTION, or similar agency is covered in the following discussions.

Peace Corps

If you are a Peace Corps volunteer or volunteer leader, some allowances you receive are taxable and others are exempt from tax.

Taxable allowances. Any taxable allowances you receive must be included in your income and reported as wages. These include:

1) Cash allowances received during training,

2) Allowances paid to your spouse and minor children while you are training in the United States,

3) The part of living allowances designated by the President, under the Peace Corps Act, as basic compensation,

4) Allowances for personal items such as domestic help, laundry and clothing maintenance, entertainment and recreation, transportation, and other miscellaneous expenses,

5) Leave allowances, and

6) Readjustment allowances or “termination payments.” These are considered received by you when credited to your account.

Example. Gary Carpenter, a Peace Corps volunteer, gets $175 a month during his period of service, to be paid to him in a lump sum at the end of his tour of duty. Although the allowance is not available to him until the end of his service, Gary must include it in his income on a monthly basis as it is credited to his account.

ACTION

ACTION participants perform services in antipoverty programs and Older American volunteer programs. Some amounts these participants receive are taxable and others are exempt from tax.

VISTA. If you are a VISTA volunteer, you must include meal and lodging allowances paid to you in your income as wages.

University Year for Action program. If you receive a stipend as a full-time student for service in the University Year for Action program, you must include the stipend in your income as wages.

Older American programs. Do not include in your income amounts you receive for supportive services or reimbursements for out-of-pocket expenses from the following programs:

- Retired Senior Volunteer Program (RSVP),
- Foster Grandparent Program, and
- Senior Companion Program.

Other Volunteer Programs

If you receive amounts for supportive services or are reimbursed for out-of-pocket expenses under either of the following volunteer programs, you do not include these amounts in your gross income:

- Service Corps of Retired Executives (SCORE), and
- Active Corps of Executives (ACE).

Volunteer tax counseling. You do not include in your income any reimbursements you receive for transportation, meals, and other expenses you have in training for, or actually providing, volunteer federal income tax counseling for the elderly (TCE).

You can deduct as a charitable contribution your unreimbursed out-of-pocket expenses in taking part in the volunteer income tax assistance (VITA) program.

7.

Tip Income

Introduction

This chapter is for employees who receive tips from customers. Waiters, hairdressers, cab drivers, and club performers are some people who get tips. If you are self-employed, see Publication 334, *Tax Guide for Small Business, (For Individuals Who Use Schedule C or C–EZ)* for more information.

Reporting your tip income correctly is not difficult. You must do three things:

1) Keep a daily tip record,
2) Report tips to your employer, and
3) Report all tips you receive on your income tax return.

This chapter will show you how to do these three things, and what to do on your tax return if you have not done the first two. This chapter will also show you how to treat allocated tips.

Useful Items

You may want to see:

Publication

- ☐ **531** Reporting Tip Income
- ☐ **1244** Employee's Daily Record of Tips and Report to Employer

Form (and Instructions)

- ☐ **4137** Social Security and Medicare Tax on Unreported Tip Income

Keeping a Daily Tip Record

Why keep a daily tip record? You must keep a daily tip record so you can:

- Report your tips accurately to your employer,
- Report your tips accurately on your tax return, and
- Prove your tip income if your return is ever questioned.

How to keep a daily tip record. There are two ways to keep a daily tip record. You can either:

1) Write information about your tips in a tip diary, or
2) Keep copies of documents that show your tips, such as restaurant bills and credit card charge slips.

You should keep your daily tip record with your personal records.

If you keep a tip diary, you can use **Form 4070A,** *Employee's Daily Record of Tips*. To get a year's supply of the form, ask the IRS or your employer for **Publication 1244**. Each day, write in the information asked for on the form.

If you do not use Form 4070A, start your records by writing your name, your employer's name, and the name of the business if it is different from your employer's name. Then, each workday, write the date and the following information:

- Cash tips you get directly from customers or other employees,
- Tips from credit card charge customers that your employer pays you,
- The value of any noncash tips you get, such as tickets, passes, or other items of value,
- The amount of tips you paid out to other employees through tip pools or tip splitting, or other arrangements, and the names of the employees to whom you paid the tips.

CAUTION *Do not write in your tip diary the amount of any **service charge** that your employer adds to a customer's bill, and then pays to you and treats as wages. This is part of your wages, not a tip.*

Reporting Tips to Your Employer

Why report tips to your employer? You must report tips to your employer so that:

- Your employer can withhold federal income tax and social security and railroad retirement tax or Medicare taxes.
- Your employer can report the correct amount of your earnings to the Social Security Administration or Railroad Retirement Board (which affects your benefits when you retire or if you become disabled, or your family's benefits if you die), and
- You can avoid the penalty for not reporting tips to your employer (explained later).

What tips to report. Report only cash, check, or credit card tips you get to your employer. If your total tips for any one month from any one job are less than $20, do not report them to your employer. Do not report the value of any noncash tips, such as tickets or passes, to your employer. You do not have to pay social security and Medicare taxes, or railroad retirement tax on these tips.

How to report. You can use **Form 4070,** *Employees' Report of Tips to Employer.* To get a year's supply of the form, ask the IRS or your employer for **Publication 1244**. Write in the information asked for on the form, sign and date the form, and give it to your employer.

If you do not use Form 4070, write the following information in your report:

- Your name, address, and social security number,
- Your employer's name, address, and business name if it is different from the employer's name,
- The month (or the dates of any shorter period) in which you received tips, and
- The total amount of tips you received.

Then, sign and date the report and give it to your employer. You should keep a copy of the report with your personal records.

When to report. Give your report for each month to your employer by the 10th of the next month. If the 10th falls on a Saturday, Sunday, or legal holiday, give your employer the report by the next day that is not a Saturday, Sunday, or legal holiday.

Example 1. You must report your tips received in January 1998 by February 10, 1998.

Example 2. You must report your tips received in April 1998 by May 11, 1998. May 10 is on a Sunday, and the 11th is the next day that is not a Saturday, Sunday, or legal holiday.

Penalty for not reporting tips. If you do not report tips to your employer as required, you may be subject to a penalty equal to 50% of the social security and Medicare taxes or railroad retirement tax you owe. (For information about these taxes, see *Reporting social security and Medicare taxes on tips not reported to your employer* under *Reporting Tips on Your Return*, later.) The penalty amount is in addition to the taxes you owe.

You can avoid this penalty if you can show reasonable cause for not reporting the tips to your employer. To do so, attach a statement to your return explaining why you did not report them.

Giving your employer money for taxes. Your regular pay may not be enough for your employer to withhold all the taxes you owe on your regular pay plus your reported tips. If this happens, you can give your employer money to pay the rest of the taxes, up to the close of the calendar year.

If you do not give your employer enough money, your employer will apply your regular pay and any money you give to the taxes, in the following order:

1) All taxes on your regular pay,
2) Social security and Medicare taxes or railroad retirement tax on your reported tips, and
3) Federal, state, and local income taxes on your reported tips.

Any taxes that remain unpaid may be collected by your employer from your next paycheck. If withholding taxes remain uncollected at the end of the year, you may need to make an estimated tax payment. Use **Form 1040–ES**, *Estimated Tax for Individuals.* See Publication 505, *Tax Withholding and Estimated Tax*, for more information.

CAUTION *You must report on your tax return any social security and Medicare taxes or railroad retirement tax that remained uncollected at the end of 1997. See* Reporting uncollected social security and Medicare taxes on tips *under* Reporting Tips on Your Tax Return*, later. These un-*

collected taxes will be shown in box 13 of your Form W-2 (codes A and B).

Reporting Tips on Your Tax Return

How to report tips. Report your tips with your wages on line 1, Form 1040EZ, or line 7, Form 1040A or Form 1040.

What tips to report. You must report all tips you received in 1997, including both cash tips and noncash tips, on your tax return. Any tips you reported to your employer for 1997 are included in the wages shown in box 1 of your Form W-2. Add to the amount in box 1 only the tips you did not report to your employer.

CAUTION *If you received $20 or more in cash and charge tips in a month and did not report all of those tips to your employer, see* Reporting social security and Medicare taxes on tips not reported to your employer*, later.*

CAUTION *If you did not keep a daily tip record as required and an amount is shown in box 8 of your Form W-2, see* Allocated Tips*, later.*

If you kept a daily tip record and reported tips to your employer as required under the rules explained earlier, add the following tips to the amount in box 1 of your Form W-2:

- Cash and charge tips you received that totaled less than $20 for any month, and
- The value of noncash tips, such as tickets, passes, or other items of value.

Example. John Allen began working at the Diamond Restaurant (his only employer in 1997) on June 30 and received $10,000 in wages during the year. John kept a daily tip record showing that his tips for June were $18 and his tips for the rest of the year totaled $7,000. He was not required to report his June tips to his employer, but he reported all of the rest of his tips to his employer as required.

John's Form W-2 from Diamond Restaurant shows $17,000 ($10,000 wages plus $7,000 reported tips) in box 1. He adds the $18 unreported tips to that amount and reports $17,018 as wages on line 1 of his Form 1040EZ.

Reporting social security and Medicare taxes on tips not reported to your employer. If you received $20 or more in cash and charge tips in a month while working for one employer, you must report the social security and Medicare taxes on the unreported tips as additional tax on your return. To report these taxes, you must file a return even if you would not otherwise have to file. You must use Form 1040. (You cannot file Form 1040EZ or Form 1040A.)

Use **Form 4137,** *Social Security and Medicare Tax on Unreported Tip Income*, to figure these taxes. Enter the amount from line 12 of the form on line 49, Form 1040, and attach the form to your return.

CAUTION **Reporting uncollected social security and Medicare taxes on tips.** *If your employer could not collect all the social security and Medicare taxes or railroad retirement tax you owe on tips reported to your employer, the uncollected taxes will be shown in box 13 of your Form W-2 (codes A and B). You must report these amounts as additional tax on your return. You may have uncollected taxes if your regular pay was not enough for your employer to withhold all the taxes you owe and you did not give your employer enough money to pay the rest of the taxes.*

To report these uncollected taxes, you must file a return even if you would not otherwise have to file. You must use Form 1040. (You cannot file Form 1040EZ or Form 1040A.) Include the taxes in your total tax amount on line 53, and write “UT ”and the total of the uncollected taxes on the dotted line next to line 53.

Allocated Tips

What are allocated tips? These are tips that your employer assigned to you in addition to the tips you reported to your employer for the year. Your employer will have done this only if you worked in a restaurant, cocktail lounge, or similar business that must allocate tips to employees and your reported tips were less than your share of 8% of food and drink sales.

If your employer allocated tips to you, they are shown separately in box 8 of your Form W-2. They are not included in box 1 with your wages and reported tips. If box 8 is blank, this discussion does not apply to you.

How were your allocated tips figured? The tips allocated to you are your share of an amount figured by subtracting the reported tips of all employees from 8% (or an approved lower rate) of food and drink sales (other than carryout sales and sales with a service charge of 10% or more). Your share of that amount was figured using either a method provided by an employer-employee agreement or a method provided by IRS regulations based on employees' sales or hours worked. For information about the exact allocation method used, ask your employer.

Must you report your allocated tips on your return? You must report allocated tips on your return unless either of the following exceptions applies:

1) You kept a daily tip record as required under rules explained earlier, or
2) Your tip record is incomplete, but it shows that your actual tips were more than the tips you reported to your employer plus the allocated tips.

If either exception applies, do not report allocated tips on your return. Report your actual tips. See *What tips to report* under *Reporting Tips on Your Tax Return*, earlier.

How to report allocated tips. If you must report allocated tips on your return, add the amount in box 8 of your Form W-2 to the amount in box 1. Report the total as wages on line 7 of Form 1040. (You cannot file Form 1040EZ or Form 1040A.)

Because social security and Medicare taxes were not withheld from the allocated tips, you must report those taxes as additional tax on your return. Complete **Form 4137,** *Social Security and Medicare Tax on Unreported Tip Income*, and include the allocated tips on line 1 of the form. See *Reporting social security and Medicare taxes on tips not reported to your employer* under *Reporting Tips on Your Return*, earlier.

8.

Interest Income

Important Change for 1998

Education Savings Bond Program. Beginning in 1998, when figuring the amount of interest on qualified U.S. savings bonds that you can exclude from gross income under this program, count any contribution to a qualified state tuition program as a qualified higher educational expense. Do not count any expense you use to claim the Hope credit or the Lifetime learning credit. For more information about this exclusion, see *Education Savings Bond Program* in this chapter. For more information about the Hope credit or the Lifetime learning credit, see Publication 553, *Highlights of 1997 Tax Changes*.

Important Reminder

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

Introduction

This chapter discusses:

- Different types of interest income,
- What interest is taxable and what interest is nontaxable,
- When to report interest income, and
- How to report interest income on your tax return.

In general, any interest that you receive or that is credited to your account and can be withdrawn is taxable income. (It does not have to be entered in your passbook.) Exceptions to this rule are discussed later in this chapter.

RECORDS As an important part of your records, you should keep a list showing sources and amounts of interest received during the year.

You may be able to deduct expenses you have in earning this income on Schedule A (Form 1040) if you itemize your deductions. See chapter 30.

Useful Items

You may want to see:

Publication

- ☐ **537** Installment Sales
- ☐ **550** Investment Income and Expenses
- ☐ **1212** List of Original Issue Discount Instruments

Form (and Instructions)

- ☐ **Schedule B (Form 1040)** Interest and Dividend Income
- ☐ **Schedule 1 (Form 1040A)** Interest and Dividend Income for Form 1040A Filers
- ☐ **3115** Application for Change in Accounting Method
- ☐ **8815** Exclusion of Interest From Series EE U.S. Savings Bonds Issued After 1989
- ☐ **8818** Optional Form To Record Redemption of Series EE U.S. Savings Bonds Issued After 1989

General Information

A few items of general interest are covered here.

Passive activity income and losses. There are tax rules that limit the amount of losses and tax credits from passive activities you can claim. Generally, you can use losses from passive activities only to offset income from passive activities. You generally cannot use passive activity losses to offset your other income, such as your wages or your portfolio income (that is, any gross income from interest, dividends, etc., that is not derived in the ordinary course of a trade or business). For more information about determining and reporting income and losses from passive activities, see Publication 925.

Tax on investment income of a child under age 14. Part of a child's investment income may be taxed at the parent's tax rate. This may happen if the child was under age 14, had more than $1,300 of investment income (such as taxable interest and dividends) and has to file a tax return, and either parent was alive at the end of the year. If these requirements are met, **Form 8615,** *Tax for Children Under Age 14 Who Have Investment Income of More Than $1,300,* must be completed and attached to the child's tax return. If these requirements are not met, Form 8615 is not required and the child's income is taxed at his or her own tax rate.

However, the parent can choose to include the child's interest and dividends on the parent's return if certain requirements are met. Use **Form 8814,** *Parents' Election To Report Child's Interest and Dividends,* for this purpose.

For more information about the tax on investment income of children and the parents' election, see chapter 32.

Beneficiary of an estate or trust. Interest, dividends, or other investment income you receive as a beneficiary of an estate or trust is generally taxable income. You should receive a **Schedule K–1** (Form 1041), *Beneficiary's Share of Income, Deductions, Credits, etc.,* from the fiduciary. Your copy of Schedule K–1 and its instructions will tell you where to report the items on your Form 1040.

Social security number (SSN). You must give your name and SSN to any person required by federal tax law to make a return, statement, or other document that relates to you. This includes payers of interest.

SSN for joint account. If the funds in a joint account belong to one person, list that person's name first on the account and give that person's SSN to the payer. (For information on who owns the funds in a joint account, see *Joint accounts,* later.) If the joint account contains combined funds, give the SSN of the person whose name is listed first on the account.

These rules apply both to joint ownership by a married couple and to joint ownership by other individuals. For example, if you open a joint savings account with your child using funds belonging to the child, list the child's name first on the account and give the child's SSN.

Custodian account for your child. If your child is the actual owner of an account that is recorded in your name as custodian for the child, give the child's SSN to the payer. For example, you must give your child's SSN to the payer of dividends on stock owned by your child, even though the dividends are paid to you as custodian.

Penalty for failure to supply SSN. If you do not give your SSN to the payer of interest, you may have to pay a penalty. See *Failure to supply social security number* under *Penalties* in chapter 1. Backup withholding also may apply.

Backup withholding. Your investment income is generally not subject to regular withholding. However, it may be subject to backup withholding to ensure that income tax is collected on this income.

When you open a new account you must certify under penalties of perjury that your social security number is correct and that you are not subject to backup withholding. Your payer will give you a **Form W–9,** *Request for Taxpayer Identification Number and Certification,* or a similar form, to make this certification. If you fail to make this certification, backup withholding may begin immediately on your new account or investment, and 31% of the interest paid on your account will be withheld. Backup withholding may also be required if the Internal Revenue Service (IRS) has determined that you underreported your interest or dividend income. For more information, see *Backup Withholding* in chapter 5.

Reporting backup withholding. If backup withholding is deducted from your interest income, the payer must give you a Form 1099–INT for the year that indicates the amount withheld. The Form 1099–INT will show any backup withholding as "Federal income tax withheld."

Joint accounts. In a joint account, two or more persons hold property as joint tenants, tenants by the entirety, or tenants in common. That property can include a savings account or bond. Each person may receive a share of any interest from the property. Each person's share is determined by local law.

Income from property given to a child. Property you give as a parent to your child under the Model Gifts of Securities to Minors Act, the Uniform Gifts to Minors Act, or any similar law, is a true gift for federal gift tax purposes.

Income from property transferred under these laws is taxable to the child unless it is used in any way to satisfy a legal obligation of support of that child. The income is taxable to the person having the legal obligation to support the child (the parent or guardian) to the extent that it is used for the child's support.

Savings account with parent as trustee. Interest income derived from a savings account opened for a child who is a minor, but placed in the name and subject to the order of the parents as trustees, is taxable to the child if, under the law of the state in which the child resides, both of the following are true.

1) The savings account legally belongs to the child.

2) The parents are not legally permitted to use any of the funds to support the child.

Form 1099–INT. Interest income is generally reported to you on Form 1099–INT, *Interest Income,* or a similar statement, by banks, savings and loans, and other payers of interest. This form shows you the interest you received during the year. Keep this form for your records. You do not have to attach it to your tax return.

Report on your tax return the total amount of interest income that is shown on any Form 1099–INT that you receive for the tax year. You must also report all of your interest income for which you did not receive a Form 1099–INT.

Nominees. Generally, if someone receives interest as a nominee for you, that person will give you a Form 1099–INT showing the interest received on your behalf.

If you receive a Form 1099–INT that includes amounts belonging to another person, see the discussion on nominee distributions under *How To Report Interest Income* in chapter 1 of Publication 550, or see the Schedule 1 (Form 1040A) or Schedule B (Form 1040) instructions.

Incorrect amount. If you receive a Form 1099–INT that shows an incorrect amount (or other incorrect information), you should ask the issuer for a corrected form. The new Form 1099–INT you receive will be marked "CORRECTED."

Form 1099–OID. Reportable interest income may also be shown on Form 1099–OID, *Original Issue Discount.* For more information about amounts shown on this form, see *Original Issue Discount (OID),* later in this chapter.

Exempt-interest dividends you receive from a regulated investment company (mutual fund) are not included in your taxable income. (However, see *Information reporting requirement,* next.) You will receive a notice from the mutual fund telling you the amount of the tax-exempt interest dividends that you received. Exempt-interest dividends are not shown on Form 1099–DIV or Form 1099–INT.

Information reporting requirement. Although exempt-interest dividends are not taxable, you must show them on your tax return if you are required to file. This is an information reporting requirement and does not convert the exempt-interest dividend to taxable income.

Note: Exempt-interest dividends may be treated as tax-exempt interest on specified private activity bonds, which is a "tax preference item" that may be subject to the alternative minimum tax. See *Alternative Minimum Tax* in chapter 31 for more information. Chapter 1 of Publication 550 contains a discussion on private activity bonds, under *State or Local Government Obligations.*

Interest on VA dividends. Interest on insurance dividends that you leave on deposit with the Department of Veterans Affairs (VA) is not taxable. This includes interest paid on dividends on converted United States Government Life Insurance and on National Service Life Insurance policies.

Taxable Interest

Taxable interest includes interest you receive from bank accounts, loans you make to others, and interest from most other sources. The following are some other sources of taxable interest.

Dividends that are actually interest. Certain distributions commonly called dividends are actually interest. You must report as interest so-called "dividends" on deposits or on share accounts in:

- Cooperative banks,
- Credit unions,
- Domestic building and loan associations,
- Domestic savings and loan associations,
- Federal savings and loan associations, and
- Mutual savings banks.

Money market funds. Generally, amounts you receive from money market funds should be reported as dividends, not as interest.

Money market certificates, savings certificates, and other deferred interest accounts. If you open any of these accounts, and interest is paid at fixed intervals of 1 year or less during the term of the account, you must include this interest in your income when you actually receive it or are entitled to receive it without paying a substantial penalty. The same is true for accounts that mature in 1 year or less and give a single payment of interest at maturity. If interest is deferred for more than 1 year, see *Original Issue Discount (OID),* later.

Interest subject to penalty for early withdrawal. If you deposit money in a deferred interest account that has a term of 1 year or less, and you paid a penalty because you withdrew funds before the end of the term, you must include in income all the interest shown in box 1 of the Form 1099-INT you receive. You can deduct the entire penalty shown in box 2 on line 29 of Form 1040, even if it is more than your interest income.

Money borrowed to invest in money market certificate. The interest you pay on money borrowed from a bank or savings institution to meet the minimum deposit required for a money market certificate from the institution and the interest you earn on the certificate are two separate items. You must report the total interest you earn on the certificate in your income. If you itemize deductions, you can deduct the interest you pay as investment interest, subject to certain limits. These limits are discussed in chapter 3 of Publication 550 under *Limit on Investment Interest.*

Example. You deposit $5,000 with a bank and borrow $5,000 from the bank to make up the $10,000 minimum deposit required to buy a 6–month money market certificate. The certificate earns $575 at maturity in 1997, but you receive only $265, which represents the $575 you earned minus $310 interest charged on your $5,000 loan. The bank gives you a Form 1099–INT for 1997 showing the $575 interest you earned. The bank also gives you a statement showing that you paid $310 interest for 1997. You must include the $575 in your income. If you itemize your deductions on Schedule A (Form 1040), you can deduct $310, subject to the investment interest expense limit.

Gift for opening account. The fair market value of gifts or services you receive for making long-term deposits or for opening an account in a savings institution is interest. Report it in income in the year you receive it.

Example. You open a savings account at your local bank. The account earns $20 interest. You also receive a $10 calculator. If no other interest is credited to your account during the year, the Form 1099–INT you receive would show $30 interest income for the year.

Interest on insurance dividends. Interest on insurance dividends on deposit with an insurance company that can be withdrawn annually is taxable to you in the year it is credited to your account. However, if you can only withdraw it on the anniversary date of the policy (or other specified date), the interest is taxable in the year that date occurs.

Prepaid insurance premiums. Any increase in the value of prepaid insurance premiums, advance premiums, or premium deposit funds is interest if it is applied to the payment of premiums due on insurance policies or made available for you to withdraw.

U.S. obligations. Interest on U.S. obligations, such as U.S. Treasury bills, notes, and bonds, issued by any agency or instrumentality of the United States is taxable for federal income tax purposes, but is exempt from all state and local income taxes.

Treasury bills generally have a 13–week, 26–week, or 52–week maturity period. They are issued at a discount in denominations of $10,000 and additional multiples of $1,000. The difference between the discounted price you pay for the bills and the face value you receive at maturity is interest income. Generally, report this interest income when the bill is paid at maturity.

Treasury notes have maturity periods ranging from 1 to 10 years. Maturity periods for Treasury bonds are longer than 10 years. Both notes and bonds generally pay interest every 6 months. Generally, you report this interest for the year paid. For more information, see *U.S. Treasury Bills, Notes, and Bonds* in Publication 550.

For information on Series EE and Series HH savings bonds, see *U.S. Savings Bonds,* later.

Interest on tax refunds. Interest you receive on tax refunds is taxable income.

Interest on condemnation award. If the condemning authority pays you interest to compensate you for a delay in paying an award, the interest is taxable.

Installment sale payments. Deferred payments you receive under a contract for the sale or exchange of property usually contain interest that is taxable. If little or no interest is provided for in certain contracts with payments due more than one year after the date of sale, each payment due more than 6 months after the date of sale will be treated as containing interest. These unstated interest rules apply to certain payments received on account of a seller-financed sale or exchange of property. See *Unstated Interest* in Publication 537, *Installment Sales.*

Interest on annuity contract. Accumulated interest on an annuity contract you sell before its maturity date is taxable.

Usurious interest. Usurious interest is taxable unless state law automatically changes it to a payment on the principal. Usurious interest is interest charged at an illegal rate.

Individual Retirement Arrangements (IRAs). Interest that you earn on an IRA is tax-deferred. You generally do not include it in your income until you make withdrawals from the IRA. Nor is it included in the amount to be reported as tax-exempt interest. See chapter 18.

Interest income on frozen deposits. Exclude from your gross income interest credited on frozen deposits that you could not withdraw by the end of the year. A frozen deposit is an account from which you are unable to withdraw funds because:

1) The financial institution is bankrupt or insolvent, or

2) The state where the financial institution is located has placed limits on withdrawals because other banks in the state are bankrupt or insolvent.

The amount of interest you must exclude is the interest that was credited on the frozen deposits minus the sum of:

1) The net amount you withdrew from these deposits during the year, and

2) The amount you could have withdrawn as of the end of the year (not reduced by any penalty for premature withdrawals of a time deposit).

If you receive a Form 1099–INT for interest income on deposits that were frozen at the end of 1997, see *Frozen deposits* under *How To Report Interest Income* in chapter 1 of Publication 550, for information about reporting this interest income exclusion on your 1997 tax return.

The interest you exclude must be reported in the later tax year when you can withdraw it from your account.

Example. $100 of interest was credited on your frozen deposit during the year. You withdrew $80 but could not withdraw any more as of the end of the year. Your net amount withdrawn was $80. You must exclude $20. You must include $80 in your income for the year.

Bonds traded flat. If you purchase bonds when interest has been defaulted or when the interest has accrued but has not been paid, that interest is not income and is not taxable as interest if later paid. Such payments are returns of capital which reduce the remaining cost basis. Interest which accrues after the date of purchase, however, is taxable interest income for the year in which received or accrued. See *Bonds Sold Between Interest Dates,* later, for more information.

Interest on below-market loans. A below-market loan is a loan on which no interest is charged or on which interest is charged at a rate below the applicable federal rate. See *Below-Market Loans* in chapter 1 of Publication 550 for more information.

U.S. Savings Bonds

You earn interest on U.S. savings bonds in one of two ways. On some bonds, interest is paid at stated intervals by interest checks or coupons. Other bonds are issued at a discount and pay all interest at redemption or maturity. The interest on the latter is the difference between what you pay for the bond and its redemption or maturity value.

This section provides tax information on different types of U.S. savings bonds. It explains how to report the interest income on these bonds and how to treat transfers of these bonds.

For other information on U.S. savings bonds, write to:

Bureau of the Public Debt
P.O. Box 1328
Parkersburg, WV 26106–1328

Or visit: www.publicdebt.treas.gov

Cash-basis taxpayers. If you use the cash method of accounting, as most individual taxpayers do, you generally report the interest on U.S. savings bonds when you receive it. The cash method of accounting is explained in chapter 1 under *Accounting Methods.*

Accrual-basis taxpayers. If you use an accrual method of accounting, you must report interest on U.S. savings bonds each year as it accrues. You cannot postpone reporting interest until you receive it or the bonds mature. Accrual methods of accounting are explained in chapter 1 under *Accounting Methods.*

Series HH Bonds. These bonds are issued at face value. Interest is paid twice a year by check or by direct deposit to your bank account. If you are a cash-basis taxpayer, you must report interest on these bonds as income in the year you receive it.

Series HH Bonds were first offered in 1980. Before 1980, ***Series H Bonds*** were issued. Series H Bonds are treated the same as Series HH Bonds. If you are a cash-basis taxpayer, you must report the interest when you receive it.

Series EE Bonds. These bonds are issued at a discount. You pay less than the face value for the bonds. The face value is payable to you at maturity. The difference between the purchase price and the redemption value is taxable interest.

Series EE Bonds were first offered in 1980. Before 1980, ***Series E Bonds*** were issued. If you own either Series EE or Series E Bonds and use the cash method of reporting income, you can:

1) Postpone reporting the interest until the earlier of the year you cash or dispose of the bonds or the year in which they finally mature ***(method 1)***, or

2) Choose to report the increase in redemption value as interest each year ***(method 2).***

Change from method 1. If you want to change your method of reporting the interest from method 1 to method 2, you can do so without permission from the IRS. In the year of change you must report all interest accrued to date and not previously reported for all your bonds.

Once you choose to report the interest each year, you must continue to do so for all Series EE or Series E Bonds you own and for any you get later, unless you request permission to change, as explained next.

Change from method 2. To change from method 2 to method 1, you must request permission from the IRS. Permission for the change is automatically granted if you send the IRS a statement that meets all the following requirements.

1) You have typed or printed at the top, "*Change in Method of Accounting Under Section 6.01 of the Appendix of Rev. Proc. 97–37.*"

2) It includes your name and social security number under the label in (1).

3) It identifies the savings bonds for which you are requesting this change.

4) It includes your agreement to:

   a) Report all interest on any bonds acquired during or after the year of change when the interest is realized upon disposition, redemption, or final maturity, whichever is earliest, and

   b) Report all interest on the bonds acquired before the year of change when the interest is realized upon disposition, redemption, or final maturity, whichever is earliest, with the exception of the interest reported in prior tax years.

5) It includes a statement that you agree to all the terms and conditions of Revenue Procedure 97–37.

6) It includes your signature.

You must attach this statement to your tax return for the year of change, which you must file by the due date (including extensions).

By the date you file the original statement, you must also send a copy to this address:

Commissioner of Internal Revenue
Attn: CC:DOM:IT&A
P.O. Box 7604
Benjamin Franklin Station
Washington, DC 20044.

(If you use a private delivery service, send the copy to the Commissioner of Internal Revenue, CC:DOM:IT&A, 1111 Constitution Avenue, NW, Washington, DC 20224.)

Instead of filing this statement, you can request permission to change from method 2 to method 1 by filing **Form 3115,** *Application for Change in Accounting Method.* In that case, follow the instructions for the form.

TIP *If you plan to redeem Series EE bonds in the same year that you will pay for higher educational expenses, you should consider using method 1 above. See* Education Savings Bond Program, *later, for more information.*

Bonds held beyond maturity. If you hold the bonds beyond the original maturity period, and if you have chosen to report the interest each year, you must continue to do so unless you get permission to change your method of reporting. If you have chosen to postpone reporting the interest, do not include the interest in income for the year of original maturity. Report it in the year you redeem or dispose of the bonds or the year in which the extended maturity period ends, whichever is earlier. The original maturity period has been extended on all Series E Bonds.

The extended maturity period of Series E Bonds issued between May 1941 and November 1965 ends 40 years from their issue dates. The Department of the Treasury has announced that no further extension will be given to these bonds. If you have postponed reporting interest on Series E Bonds purchased in 1957, you must report the interest on your 1997 return, unless you trade your Series E Bonds for Series HH Bonds.

Table 8-1. **Who Pays Tax on U.S. Savings Bond Interest**

How Bond Is Purchased	Who Must Pay Tax on Bond Interest
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.	Each of you, in proportion to the amount you and the other co-owner each paid
You and your spouse, who live in a community property state, buy a bond that is community property.	If you file separate returns, each of you generally pays tax on one-half

The maturity period of Series E bonds issued after November 1965 is 30 years. Bonds issued in 1967 stopped accruing interest in 1997. If you have postponed reporting interest on Series E bonds purchased in 1967, you must report the interest on your 1997 return, unless you trade your Series E bonds for Series HH bonds.

Co-owners. If you buy a U.S. savings bond issued in your name and another person's name as co-owners, such as you and your child or you and your spouse, interest on the bond is generally taxable to the co-owner who bought the bond.

One co-owner's funds used. If you used your funds to buy the bond, you must pay the tax on the interest. This is true even if you let the other co-owner redeem the bond and keep all the proceeds. Under these circumstances, since the other co-owner will receive a Form 1099–INT at the time of redemption, the other co-owner must provide you with another Form 1099–INT showing the amount of interest from the bond that is taxable to you. The co-owner who redeemed the bond is a “nominee.” See *Nominee distributions,* under *How To Report Interest Income* in chapter 1 of Publication 550, for more information about how a person who is a nominee reports interest income belonging to another person.

Both co-owners' funds used. If you and the other co-owner each contribute part of the purchase price, interest on the bond is generally taxable to each of you, in proportion to the amount each of you paid.

Community property. If you and your spouse live in a community property state and hold bonds as community property, one-half of the interest is considered received by each of you. If you file separate returns, each of you must report one-half the bond interest. For more information about community property, see Publication 555, *Community Property.*

Table 8–1. These rules are also contained in *Table 8–1.*

Ownership transferred. If you bought Series EE or Series E Bonds ***entirely with your own funds*** and had them reissued in your co-owner's name or beneficiary's name alone, you must include in your gross income for the year of reissue all interest that you earned on these bonds and have not previously reported. But, if the bonds were reissued in your name alone, you do not have to report the interest accrued at that time. This same rule applies when bonds are transferred between spouses incident to divorce.

Purchased jointly. If you and a co-owner each contributed funds to buy Series EE or Series E Bonds ***jointly*** and have the bonds reissued in the co-owner's name alone, you must include in your gross income for the year of reissue your share of all the interest earned on the bonds that you have not previously reported. At the time of reissue, the former co-owner does not have to include in gross income his or her share of the interest earned that was not reported before the transfer. This interest, however, as well as all interest earned after the reissue, is income to the former co-owner.

This income reporting rule also applies when the bonds are reissued in the name of your former co-owner and a new co-owner. But the new co-owner will report only his or her share of the interest earned after the transfer.

If bonds that you and a co-owner bought ***jointly*** are reissued to each of you separately in the same proportion as your contribution to the purchase price, neither you nor your co-owner has to report at that time the interest earned before the bonds were reissued.

Example 1. You and your spouse each spent an equal amount to buy a $1,000 Series EE savings bond. The bond was issued to you as co-owners. You both postpone reporting interest on the bond. You later have the bond reissued as two $500 bonds, one in your name and one in your spouse's name. At that time neither you nor your spouse has to report the interest earned to the date of reissue.

Example 2. You bought a $1,000 Series EE savings bond entirely with your own funds. The bond was issued to you and your spouse as co-owners. You both postpone reporting interest on the bond. You later have the bond reissued as two $500 bonds, one in your name and one in your spouse's name. You must report half the interest earned to the date of reissue.

Transfer to a trust. If you own Series EE or Series E Bonds and transfer them to a trust, giving up all rights of ownership, you must include in your income for that year the interest earned to the date of transfer, if you have not already reported it. However, if you are considered the owner of the trust and if the increase in value both before and after the transfer continues to be taxable to you, you can continue to defer reporting the interest earned each year. You must include the total interest in your income in the year you cash or dispose of the bonds or the year the bonds finally mature, whichever is earlier.

The same rules apply to previously unreported interest on Series EE or Series E Bonds if the transfer to a trust consisted of Series HH or Series H Bonds you got in a trade for the Series EE or Series E Bonds. See *Savings bonds traded,* later.

Decedents. The manner of reporting interest income on Series EE or Series E Bonds, after the death of the owner, depends on the accounting and income reporting method previously used by the decedent.

Decedent who reported interest each year. If the bonds transferred because of death were owned by a person who used an accrual method, or who used the cash method and had chosen to report the interest each year, the interest earned in the year of death up to the date of death must be reported on that person's final return. The person who acquires the bonds includes in income only interest earned after the date of death.

Decedent who postponed reporting interest. If the transferred bonds were owned by a decedent who used the cash method, who had not chosen to report the interest each year, and who bought the bonds entirely with his or her own funds, all interest earned before death must be reported in one of the following ways.

1) The surviving spouse or personal representative (executor, administrator, etc.) who files the final income tax return of the decedent can choose to include on that return all of the interest earned on the bonds before the decedent's death. The person who acquires the bonds then includes in income only interest earned after the date of death.

2) If the choice in (1) is not made, the interest earned up to the date of death is income in respect of a decedent. It should not be included in the decedent's final return. All of the interest earned both before and after the decedent's death is income to the person who acquires the bonds. If that person uses the cash method and does not choose to report the interest each year, he or she can postpone reporting any of it until the year the bonds are cashed or disposed of or the year they finally mature, whichever is earlier. In the year that person reports the interest, he or she can claim a deduction for any federal estate tax paid that was for the part of the interest included in the decedent's estate.

For more information on income in respect of a decedent, see chapter 4.

Savings bonds traded. If you use the cash method and did not choose to report the interest on your Series EE or Series E Bonds as it accrued, you did not realize taxable income when you traded the bonds for Series HH or Series H Bonds, unless you received cash in the trade. Any cash you received is income to the extent of the interest earned on the bonds traded. When your Series HH or Series H Bonds mature, or if you dispose of them before maturity, you report as interest the difference between their redemption value and your cost. Your cost is the sum of the amount you paid for the traded Series EE or Series E Bonds plus any amount you had to pay at the time of the trade.

Example. You trade Series E Bonds with accrued interest of $523 and a redemption value of $2,723 for Series HH Bonds. You get $2,500 in Series HH Bonds and $223 in cash. You must report the $223 as taxable income in the year of the trade to the extent that you did not previously report interest on the Series E Bonds you traded.

$500 minimum value. Series EE or Series E Bonds that you want to trade must have a current redemption value of $500 or more. To figure the current redemption value of the bonds to be traded, you must add the accrued interest to their original purchase price.

Choice to report interest in year of trade. You can choose to treat all of the previously unreported accrued interest on the Series EE or Series E Bonds traded for Series HH Bonds as income in the year of the trade.

Form 1099–INT for U.S. savings bonds interest. When you cash a bond, the bank or other payer that redeems it must give you a Form 1099–INT if the interest part of the payment you receive is $10 or more. Box 3 of your Form 1099–INT should show the interest as the difference between the amount you received and the amount paid for the bond. However, your Form 1099–INT may show more interest than you have to include on your income tax return. For example, this may happen if any of the following are true.

1) You chose to report the increase in the redemption value of the bond each year. The interest shown on your Form 1099–INT will not be reduced by amounts previously included in income.

2) You received the bond from a decedent. The interest shown on your Form 1099–INT will not be reduced by any interest reported by the decedent before death, or on the decedent's final return, or by the estate on the estate's income tax return.

3) Ownership of the bond was transferred. The interest shown on your Form 1099–INT will not be reduced by interest that accrued before the transfer.

4) You were named as a co-owner but did not use your funds to buy the bond. (See *Co-owners,* earlier in this chapter, for more information about the reporting requirements.)

5) You received the bond in a taxable distribution from a retirement or profit-sharing plan. The interest shown on your Form 1099–INT will not be reduced by the interest portion of the amount taxable as a distribution from the plan and not taxable as interest. (This amount is generally shown on Form 1099–R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.,* for the year of distribution.)

You must report your interest income even if you did not get a Form 1099–INT.

For information on including the correct amount of interest on your return for (1), (2), (3), and (4) above, see *How To Report Interest Income,* later. Publication 550 includes examples showing how to report these amounts.

If you received a taxable distribution of bonds from a retirement or profit-sharing plan ((5), above), see *Worksheet for savings bonds distributed from a retirement or profit-sharing plan* under *How To Report Interest Income* in Publication 550 for information on how to report the interest.

TIP *U.S. savings bond interest is exempt from state and local taxes. The Form 1099–INT you receive will indicate the amount that is for U.S. savings bond interest in box 3. Do not include this amount on your state or local income tax return.*

Education Savings Bond Program. You may be able to exclude from income all or part of the interest you receive on the redemption of qualified U.S. savings bonds during the year if you pay qualified higher educational expenses during the same year. This exclusion is known as the *Education Savings Bond Program.*

If you are married, you can qualify for this exclusion only if you file a joint return with your spouse.

Form 8815. Use Form 8815, *Exclusion of Interest From Series EE U.S. Savings Bonds Issued After 1989,* to figure your exclusion. Attach the form to your Form 1040 or Form 1040A.

Qualified U.S. savings bonds. A qualified U.S. savings bond is a Series EE U.S. savings bond ***issued after 1989.*** The bond must be issued either in your name (sole owner) or in your and your spouse's names (co-owners). You must be at least 24 years old before the bond's issue date.

The date a bond is issued may be earlier than the date the bond is purchased because bonds are issued as of the first day of the month in which they are purchased. You can designate any individual (including a child) as a beneficiary of the bond (payable on death).

Verification by IRS. Only Series EE U.S. savings bonds issued after 1989 qualify for this exclusion. If you claim the exclusion, IRS will check it by using bond redemption information from Department of the Treasury records.

Qualified expenses. Qualified higher educational expenses are tuition and fees required for you, your spouse, or your dependent (for whom you can claim an exemption) to attend an eligible educational institution. Qualified expenses do not include expenses for room and board or for courses involving sports, games, or hobbies that are not part of a degree program.

Eligible educational institutions. These institutions include most public and nonprofit universities and colleges and certain vocational schools that are eligible for federal assistance.

Reduction for certain benefits. You must reduce your qualified higher educational expenses by certain benefits the student may have received. These benefits include:

1) Qualified scholarships that are exempt from tax (see chapter 13 for information on qualified scholarships), and

2) Any other nontaxable payments (other than gifts, bequests, or inheritances) received for educational expenses, such as:

   a) Veterans' educational assistance benefits,

   b) Benefits under a qualified state tuition program, or

   c) Certain employer-provided educational assistance benefits.

Amount excludable. If the total proceeds (interest and principal) from the qualified U.S. savings bonds you redeem during the year are not more than your qualified higher educational expenses for the year, you can exclude all of the interest. If the proceeds are more than the expenses, you can exclude only part of the interest.

To determine the excludable amount, multiply the interest part of the proceeds by a fraction. The numerator (top part) of the fraction is the qualified higher educational expenses you paid during the year. The denominator (bottom part) of the fraction is the total proceeds you received during the year.

Example. In April 1997, Mark and Joan, a married couple, cashed a qualified Series EE U.S. savings bond they bought in November 1991. They received proceeds of $6,720, representing principal of $5,000 and interest of $1,720. In 1997, they helped pay for their daughter's college tuition. The qualified higher educational expenses they paid during 1997 totaled $4,000. They can exclude $1,024 ($1,720 × ($4,000 ÷ $6,720)) of interest in 1997. They must pay tax on the remaining $696 ($1,720 − $1,024) interest.

Modified adjusted gross income limit. The interest exclusion is phased out if your modified adjusted gross income (modified AGI) is:

- $50,850 to $65,850 for taxpayers filing single, head of household, and
- $76,250 to $106,250 for married taxpayers filing jointly or qualifying widow(er) with dependent child.

You do not qualify for the interest exclusion if your modified AGI is equal to or more than the upper limit for your filing status.

TIP **Refunds for 1994 and 1995.** *In 1996, the modified AGI amounts at which the exclusion phases out were retroactively increased. If that limit reduced or eliminated your exclusion in 1994 or 1995, you may be entitled to a refund. For details, see the discussion of the Education Savings Bond Program in chapter 1 of Publication 550.*

Modified AGI, for purposes of this exclusion, is adjusted gross income (line 16 of Form 1040A or line 32 of Form 1040) figured before the interest exclusion, and modified by adding back any:

1) Foreign earned income exclusion,

2) Foreign housing exclusion or deduction,

3) Exclusion of income for bona fide residents of American Samoa,

4) Exclusion for income from Puerto Rico, and

5) Exclusion for adoption benefits received under an employer's adoption assistance program.

Use the worksheet in the instructions for line 9, Form 8815, to figure your modified AGI. If you have any of the exclusion or deduction items listed above, add the amount of the exclusion or deduction to the amount on line 5 of the worksheet, and enter the total on Form 8815, line 9, as your modified AGI.

If you have investment interest expense incurred to earn royalty income, see *Education Savings Bond Program* in chapter 1 of Publication 550.

RECORDS **Recordkeeping.** If you claim the interest exclusion, you must keep a written record of the Series EE U.S. savings bonds issued after 1989 that you redeem. Your written record must include the serial number, issue date, face value, and redemption proceeds of each bond. You can use **Form 8818,** *Optional Form To Record Redemption of Series EE U.S. Savings Bonds Issued After 1989,* to keep this information. You should also keep bills, receipts, canceled checks, or other documentation that shows you paid qualified higher educational expenses during the year.

Bonds Sold Between Interest Dates

If you sell a bond between interest payment dates, part of the sales price represents interest accrued to the date of sale. You must report that part of the sales price as interest income for the year of sale.

If you buy a bond between interest payment dates, part of the purchase price represents interest accrued before the date of purchase. When that interest is paid to you, treat it as a return of your capital investment rather than interest income. See *Accrued interest on bonds* under *How To Report Interest Income* in chapter 1 of Publication 550 for information on reporting the payment.

Insurance

Life insurance proceeds paid to you as beneficiary of the insured person are not usually taxable. But if you receive the proceeds in installments, you must usually report a part of each installment payment as interest income.

For more information about insurance proceeds received in installments, see Publication 525.

Annuity. If you buy an annuity with life insurance proceeds, the annuity payments you receive are taxed as pension and annuity income, not as interest income. See Publication 939, *General Rule for Pensions and Annuities,* for information on taxation of pension and annuity income.

Original Issue Discount (OID)

Original issue discount (OID) is a form of interest. You generally report OID as it accrues, whether or not you receive any payments from the bond issuer.

A long-term debt instrument, such as a bond, note, or other evidence of indebtedness, generally has OID when the instrument is issued for a price that is less than its stated redemption price at maturity (principal amount). The amount of OID is the difference between the principal amount and the issue price of the instrument.

All long-term debt instruments that pay no interest before maturity are presumed to be issued at a discount. Zero-coupon bonds are one example of these instruments.

The OID rules do not apply to short-term obligations (those with a fixed maturity date of one year or less from date of issue). See *Discount on Short-Term Obligations* in Publication 550.

De minimis OID. You can disregard the discount and treat it as zero if it is less than one-fourth of 1% (.0025) of the stated redemption price at maturity, multiplied by the number of full years from the date of original issue to maturity. This small discount is known as “de minimis OID.”

Example 1. You bought a 10–year bond, with a stated redemption price at maturity of $1,000, issued at $980 and having OID of $20. One-fourth of 1% of $1,000 (stated redemption price) times 10 (the number of full years from the date of original issue to maturity) equals $25. Because the $20 discount is less than $25, you can disregard reporting the OID.

Example 2. Assume the same facts as in Example 1, except that the bond was issued at $950. The OID is $50. Because the $50 discount is more than the $25 figured in Example 1, you must report the OID.

Debt instrument bought after original issue. If you buy a debt instrument with de minimis OID at a premium, the OID is not includible in income. If you buy a debt instrument with de minimis OID at a discount, the discount is reported under the market discount rules. See *Market Discount Bonds* in chapter 1 of Publication 550.

Exceptions to the OID rules. The OID rules discussed in this chapter for publicly offered, long-term instruments do not apply to the following debt instruments.

1) Tax-exempt obligations. (However, see *Stripped tax-exempt obligations* under *Stripped Bonds and Coupons* in chapter 1 of Publication 550).

2) U.S. savings bonds.

3) Short-term debt instruments (those with a fixed maturity date of not more than one year from the date of issue).

4) Obligations issued by an individual before March 2, 1984.

5) Loans between individuals, if all the following are true.

   a) The lender is not in the business of lending money.

b) The amount of the loan, plus the amount of any outstanding prior loans, is $10,000 or less.

c) Avoiding any federal tax is not one of the principal purposes of the loan.

Form 1099–OID. The issuer of the debt instrument (or your broker, if you held the instrument through a broker) should give you Form 1099–OID, *Original Issue Discount,* or a similar statement, if the total OID for the calendar year is $10 or more. Form 1099–OID will show, in box 1, the amount of OID for the period in 1997 that you held the bond. It also will show, in box 2, the stated interest that you must include in your income. A copy of Form 1099–OID will be sent to the IRS. Do not file your copy with your return. Keep it for your records.

In most cases, you must report the entire amount in boxes 1 and 2 of Form 1099–OID as interest income. But see *Refiguring OID shown on Form 1099–OID,* later in this discussion, for more information.

Nominee. If someone else is the holder of record (the registered owner) of an OID instrument that belongs to you and receives a Form 1099–OID on your behalf, that person must give you a Form 1099–OID.

Refiguring OID shown on Form 1099–OID. You must refigure the OID shown in box 1 of Form 1099–OID if either of the following apply.

1) You bought the debt instrument after its original issue and paid a premium or an acquisition premium.

2) The debt instrument is a stripped bond or a stripped coupon (including certain zero coupon instruments).

For information about figuring the correct amount of OID to include in your income, see *Figuring OID on Long-Term Debt Instruments* in Publication 1212.

Form 1099–OID not received. If you had OID for 1997 but did not receive a Form 1099–OID, see Publication 1212 which lists total OID on certain debt instruments. If your debt instrument is not listed in Publication 1212, consult the issuer for information about the OID that accrued for 1997.

Refiguring periodic interest shown on Form 1099–OID. If you disposed of a corporate debt instrument or acquired it from another holder during 1997, see *Bonds Sold Between Interest Dates,* earlier, for information about the treatment of periodic interest that may be shown in box 2 of Form 1099–OID for that instrument.

Certificates of deposit (CDs). If you buy a CD with a maturity of more than one year, you must include in income each year a part of the total interest due and report it in the same way as other OID.

This also applies to similar deposit arrangements with banks, building and loan associations, etc., including:

- Time deposits,
- Bonus plans,
- Savings certificates,
- Deferred income certificates,
- Bonus savings certificates, and
- Growth savings certificates.

Bearer certificates of deposit. These are not issued in the depositor's name and are transferable from one individual to another.

Banks must provide the IRS and the person redeeming the bearer certificate with a Form 1099–INT.

CDs issued after 1982 generally must be in registered form. For more information about this requirement, see *Bearer obligations* in chapter 4 of Publication 550.

More information. See chapter 1 of Publication 550 for more information about OID and related topics, such as market discount bonds.

State or Local Government Obligations

Generally, interest on obligations used to finance government operations is not taxable if the obligations are issued by a state, the District of Columbia, a possession of the United States, or any of their political subdivisions. This includes interest on certain obligations issued after 1982 by an Indian tribal government treated as a state.

Interest on arbitrage bonds issued by state or local governments after October 9, 1969, and interest on private activity bonds generally is taxable.

For more information on whether such interest is taxable or tax exempt, see *State or Local Government Obligations* in chapter 1 of Publication 550.

Information reporting requirement. If you are required to file a tax return and you received or accrued any tax-exempt interest income, you must show that interest on your return. This is an information reporting requirement and does not convert tax-exempt interest to taxable interest.

When To Report Interest Income

When you report your interest income depends on whether you use the cash method or an accrual method to report income.

Cash method. If you use this method, you generally report your interest income in the year in which you actually or constructively receive it. Most individual taxpayers use this method. However, there are special rules for reporting the discount on certain debt instruments. See *U.S. Savings Bonds,* and *Original Issue Discount,* earlier.

Example. On September 1, 1995, you loaned a friend $2,000 at 12% a year. The note stated that principal and interest would be due on August 31, 1997. In 1997, you received $2,480 ($2,000 principal and $480 interest). If you use the cash method, you must include in income on your 1997 return the $480 interest you received in that year.

Constructive receipt. You constructively receive income when it is credited to your account or made available to you. You do not need to have physical possession of it. For example, you are considered to receive interest, dividends, or other earnings on any deposit or account in a bank, savings and loan, or similar financial institution, or interest on life insurance policy dividends left to accumulate, when they are credited to your account and subject to your withdrawal. This is true even if they are not yet entered in your passbook.

You constructively receive income on the deposit or account even if you must:

1) Make withdrawals in multiples of even amounts,

2) Give a notice to withdraw before making the withdrawal,

3) Withdraw all or part of the account to withdraw the earnings, or

4) Pay a penalty on early withdrawals, unless the interest you are to receive on an early withdrawal or redemption is substantially less than the interest payable at maturity.

Accrual method. If you use an accrual method, you report your interest income when you earn it, whether or not you have received it.

Example. If, in the previous example, you use an accrual method, you must include the interest in your income as you earn it. You would report the interest as follows: 1995, $80; 1996, $240; and 1997, $160.

Coupon bonds. Interest on coupon bonds is taxable in the year the coupon becomes due and payable. It does not matter when you mail the coupon for payment.

How To Report Interest Income

Generally, you report all of your taxable interest income on line 8a, Form 1040; line 8a, Form 1040A; or line 2, Form 1040EZ.

You cannot use Form 1040EZ if any of the following are true.

1) Your interest income is more than $400.

2) You are excluding interest under the Education Savings Bond Program.

3) You received interest as a nominee (that is, in your name but the interest actually belongs to someone else).

4) You received a Form 1099–INT for U.S. savings bond interest that includes amounts you reported before 1997.

Instead, you must complete the schedules for Form 1040A or Form 1040.

Form 1040A. You must complete Part I of Schedule 1 (Form 1040A) if you file Form 1040A and:

1) Your taxable interest income totals more than $400,

2) You are claiming the interest exclusion under the Education Savings Bond Program,

3) You received a Form 1099–INT for tax-exempt interest,

4) You received interest from a seller-financed mortgage and the buyer used the property as a home, or
5) You received, as a nominee, interest that actually belongs to someone else.

List each payer's name and the amount of interest income received from each payer on line 1. If you received a Form 1099–INT or Form 1099–OID from a brokerage firm, list the brokerage firm as the payer.

Form 1040. You must use Form 1040 instead of Form 1040A or Form 1040EZ if:

1) You are reporting OID in an amount more or less than the amount shown on Form 1099–OID,
2) You received or paid accrued interest on securities transferred between interest payment dates,
3) You acquired taxable bonds after 1987 and choose to reduce interest income from the bonds by any amortizable bond premium (see *Bond Premium Amortization* in chapter 3 of Publication 550), or
4) You forfeited interest income because of the early withdrawal of a time deposit.

Schedule B. You must complete Part 1 of Schedule B (Form 1040) if any of the following apply.

1) Your taxable interest income is more than $400.
2) You are claiming the interest exclusion under the Education Savings Bond Program.
3) You received interest from a seller-financed mortgage and the buyer used the property as a home.
4) You received a Form 1099–INT for tax-exempt interest.
5) You received, as a nominee, interest that actually belongs to someone else.
6) You received a Form 1099–INT for interest on a bond that you bought between interest payment dates.
7) Statement (1) or (3) in the preceding list is true.

On line 1, Part I, list each payer's name and the amount received from each.

Form 1099–INT. Your taxable interest income, except for interest from U.S. savings bonds and Treasury obligations, is shown in box 1 of Form 1099–INT. Add this amount to any other taxable interest income you received. You must report all of your taxable interest income even if you do not receive a Form 1099–INT.

If you forfeited interest income because of the early withdrawal of a time deposit, the deductible amount will be shown on Form 1099–INT in box 2 (early withdrawal penalty). If an amount appears in box 2, file Form 1040 and report this amount on line 29 (penalty on early withdrawal of savings).

Box 3 of Form 1099–INT shows the amount of interest income you received from U.S. savings bonds, Treasury bills, Treasury notes, and Treasury bonds. Include the amount shown in box 3 in your total taxable interest income, unless it includes an amount previously included in interest income. If part of the amount shown in box 3 was previously included in interest income, see *U.S. savings bond interest previously reported,* next.

Box 4 of Form 1099–INT (federal income tax withheld) will contain an amount if you were subject to backup withholding. You may have been subject to backup withholding if, for example, you did not furnish your social security number to a payer. Report the amount from box 4 on Form 1040EZ, line 7, on Form 1040A, line 29a, or on Form 1040, line 54 (federal income tax withheld).

U.S. savings bond interest previously reported. If you received a Form 1099–INT for U.S. savings bond interest, the form may show interest you do not have to report. See *Form 1099–INT for U.S. savings bonds interest,* earlier, under *U.S. Savings Bonds.*

On line 1, Part I of Schedule B (Form 1040), or on line 1, Part I of Schedule 1 (Form 1040A), report all the interest shown on your Form 1099–INT. Then make the following adjustment. Several lines above line 2, enter a subtotal of all interest listed on line 1. Below the subtotal write “U.S. Savings Bond Interest Previously Reported,” and enter amounts previously reported or interest accrued before receiving the bond. (To figure the amount to enter for interest reported or being reported as a taxable distribution from a retirement or profit-sharing plan, see *Worksheet for savings bonds distributed from a retirement or profit-sharing plan* under *How To Report Interest Income* in chapter 1 of Publication 550.) Subtract these amounts from the subtotal and enter the result on line 2.

More information. For more information about how to report interest income, see chapter 1 of Publication 550 or the instructions for the form you must file.

9. Dividends and Other Corporate Distributions

Important Changes for 1997

Capital gain distributions. You must report your capital gain distributions on Schedule D (Form 1040) in all cases. This is so that you can benefit from the new maximum capital gains rates. For information on those rates, see chapter 17.

REIT's undistributed capital gains. For tax years beginning after August 5, 1997, a real estate investment trust (REIT) can keep its long-term capital gains and pay the tax on them, in the same way as a mutual fund. Your share of the gains and the tax paid will be reported to you on Form 2439. For more information, see *Undistributed capital gains of mutual funds and REITs,* later, under *Capital Gain Distributions.*

Important Reminder

Foreign-source income. If you are a U.S. citizen with investment income from sources outside the United States (foreign income), you must report all that income on your tax return unless it is exempt by U.S. law. This is true whether you reside inside or outside the United States and whether or not you receive a Form 1099 from the foreign payer.

Introduction

This chapter discusses the tax treatment of:

- Dividend income,
- Capital gain distributions,
- Nontaxable distributions, and
- Other distributions you may receive from a corporation or a mutual fund.

This chapter also explains how to report dividend income on your tax return.

Dividends are distributions of money, stock, or other property paid to you by a corporation. You also may receive dividends through a partnership, an estate, a trust, or an association that is taxed as a corporation. However, some amounts you receive that are called dividends are actually interest income. See *Dividends that are actually interest* under *Taxable Interest* in chapter 8.

Most distributions that you receive are paid in cash (or check). However, you may receive more stock, stock rights, other property, or services. These distributions are also discussed in this chapter.

Useful Items

You may want to see:

Publication

- ☐ **514** Foreign Tax Credit for Individuals
- ☐ **550** Investment Income and Expenses
- ☐ **564** Mutual Fund Distributions

Form (and Instructions)

- ☐ **Schedule B (Form 1040)** Interest and Dividend Income
- ☐ **Schedule 1 (Form 1040A)** Interest and Dividend Income for Form 1040A Filers

General Information

This section discusses general rules on dividend income.

Passive activity income and losses. There are tax rules that limit the amount of losses and tax credits from passive activities you can claim. Generally, you can use losses from passive activities only to offset income from passive activities. You generally cannot use passive activity losses to offset your other income, such as your wages or your portfolio income. ***Portfolio income*** is any gross income from interest, dividends, etc., that is not derived in the ordinary course of a trade or business. For more information about determining and reporting income and losses from passive activities, see Publication 925.

Tax on investment income of a child under age 14. Part of a child's investment income may be taxed at the parent's tax rate. This may happen if the child was under age 14, had more than $1,300 of investment income (such as taxable interest and dividends) and has to file a tax return, and either parent was alive at the end of the year. If these requirements are met, **Form 8615,** *Tax for Children Under Age 14 Who Have Investment Income of More Than $1,300,* must be completed and attached to the child's tax return. If these requirements are not met, Form 8615 is not required and the child's income is taxed at his or her own tax rate.

However, parents can choose to include their child's interest and dividends on their return if certain requirements are met. Use **Form 8814,** *Parents' Election To Report Child's Interest and Dividends,* for this purpose.

For more information about the tax on investment income of children and the parents' election, see chapter 32.

Beneficiary of an estate or trust. Interest, dividends, or other investment income you receive as a beneficiary of an estate or trust is generally taxable income. You should receive a **Schedule K–1** (Form 1041), *Beneficiary's Share of Income, Deductions, Credits, etc.,* from the fiduciary. Your copy of Schedule K–1 and its instructions will tell you where to report the items on your Form 1040.

Social security number (SSN). You must give your name and SSN (or individual taxpayer identification number (ITIN)) to any person required by federal tax law to make a return, statement, or other document that relates to you. This includes payers of dividends.

For more information on SSNs and ITINs, see *Social security number (SSN)* in chapter 8.

Penalty for failure to supply SSN. If you do not give your SSN or ITIN to the payer of dividends, you may have to pay a penalty. See *Failure to supply social security number* under *Penalties* in chapter 1. Backup withholding also may apply.

Backup withholding. Your investment income is generally not subject to regular withholding. However, it may be subject to backup withholding to ensure that income tax is collected on this income.

When you open a new account you must certify under penalties of perjury that your SSN or ITIN is correct and that you are not subject to backup withholding. Your payer will give you a **Form W–9,** *Request for Taxpayer Identification Number and Certification,* or a similar form, to make this certification. If you fail to make this certification, backup withholding may begin immediately on your new account or investment, and 31% of the amount paid on your account or investment will be withheld. Backup withholding may also be required if the Internal Revenue Service (IRS) has determined that you underreported your interest or dividend income. For more information, see *Backup Withholding* in chapter 5.

Stock certificate in two or more names. If two or more persons hold stock as joint tenants, tenants by the entirety, or tenants in common, each person may receive a share of any dividends from the stock. Each person's share is determined by local law.

Form 1099–DIV. Most corporations use Form 1099–DIV, *Dividends and Distributions,* to show you the distributions you received from them during the year. Keep this form with your records. You do not have to attach it to your tax return. Even if you do not receive Form 1099–DIV, you must report all of your taxable dividend income.

Reporting tax withheld. If tax is withheld from your dividend income, the payer must give you a Form 1099–DIV that indicates the amount withheld.

Nominees. If someone receives distributions as a nominee for you, that person will give you a Form 1099–DIV, which will show distributions received on your behalf.

Form 1099–MISC. Certain substitute payments in lieu of dividends or tax-exempt interest that are received by a broker on your behalf must be reported to you on Form 1099–MISC, *Miscellaneous Income,* or a similar statement. See *Reporting substitute payments* under *Short Sales* in chapter 4 of Publication 550 for more information about reporting these payments.

Incorrect amount shown on a Form 1099. If you receive a Form 1099 that shows an incorrect amount (or other incorrect information), you should ask the issuer for a corrected form. The new Form 1099 you receive will be marked "CORRECTED."

Dividends on stock sold. If stock is sold, exchanged, or otherwise disposed of after a dividend is declared, but before it is paid, the owner of record (usually the payee shown on the dividend check) must include the dividend in income.

Dividends received in January. If a regulated investment company (mutual fund) or real estate investment trust (REIT) declares a dividend (including any exempt-interest dividend) in October, November, or December and that dividend is payable to you on a specified date by December 31, you are considered to have received the dividend on December 31 even though the company or trust actually pays the dividend during January of the following calendar year. You report the amount in the year of declaration.

Ordinary Dividends

Ordinary (taxable) dividends are the most common type of distribution from a corporation. They are paid out of the earnings and profits of a corporation and are ordinary income to you. This means they are not capital gains. You can assume that any dividend you receive on common or preferred stock is an ordinary dividend unless the paying corporation tells you otherwise.

Dividends used to buy more stock. The corporation in which you own stock may have a ***dividend reinvestment plan.*** This plan lets you choose to use your dividends to buy (through an agent) more shares of stock in the corporation instead of receiving the dividends in cash. If you are a member of this type of plan and you use your dividends to buy more stock at a price equal to its fair market value, you must report the dividends as income.

If you are a member of a dividend reinvestment plan that lets you buy more stock at a price less than its fair market value, you must report as income the fair market value of the additional stock on the dividend payment date.

You also must report as income any service charge subtracted from your cash dividends before the dividends are used to buy the additional stock. But you may be able to deduct the service charge. See chapter 30 for more information about deducting expenses of producing income.

In some dividend reinvestment plans, you can invest more cash to buy shares of stock at a price less than fair market value. If you choose to do this, you must report as income the difference between the cash you invest and the fair market value of the stock you buy. When figuring this amount, use the fair market value of the stock on the dividend payment date.

Money market funds. Report amounts you receive from money market funds as dividend income. Money market funds are a type of mutual fund and should not be confused with bank money market accounts that pay interest.

Capital Gain Distributions

Capital gain distributions (also called capital gain dividends) are paid to you or credited to your account by ***regulated investment companies*** (commonly called ***mutual funds***) and ***real estate investment trusts.*** They will be shown in box 1c of the Form 1099–DIV you receive from the mutual fund or REIT. Report capital gain distributions as long-term capital gains regardless of how long you owned your shares in the mutual fund or REIT.

If you receive capital gain distributions on mutual fund or REIT stock you hold 6 months or less and sell at a loss, see *Loss on mutual fund or REIT stock held 6 months or less* under *Holding Period* in chapter 15.

Undistributed capital gains of mutual funds and REITs. Some mutual funds keep their long-term capital gains and pay tax on them. You must treat your share of these gains as distributions, even though you did not actually receive them. However, they are not included on Form 1099–DIV. Instead, your share of the fund's undistributed capital gains and tax paid will be reported to you on Form 2439, *Notice to Shareholder of Undistributed Long-Term Capital Gains.*

For tax years beginning after August 5, 1997, a real estate investment trust (REIT) can keep its long-term capital gains and pay the tax on them, in the same way as a mutual fund. Your share of these gains and the tax paid on them will also be reported to you on Form 2439.

Report undistributed capital gains as long-term capital gains on line 11 of Schedule D (Form 1040). You take credit for the tax paid by the mutual fund or REIT by including it on line 59, Form 1040, and checking box a on that line. Attach Copy B of Form 2439 to your return, and keep Copy C for your records.

Basis adjustment. Increase your basis in your mutual fund stock, or your interest in a REIT, by the difference between the gain you report and the credit you claim for the tax paid.

Additional information. For more information on the treatment of distributions from mutual funds, see Publication 564, *Mutual Fund Distributions.*

Nontaxable Distributions

You may receive a return of capital or a tax-free distribution of more shares of stock or stock rights. These distributions are not treated the same as ordinary dividends or capital gain distributions.

Return of Capital

A return of capital is a distribution that is not paid out of the earnings and profits of a corporation. It is a return of your investment in the stock of the company. You should receive a Form 1099–DIV or other statement from the corporation showing you what part of the distribution is a return of capital. If you do not receive such a statement, you report the distribution as an ordinary dividend.

Basis adjustment. A return of capital reduces the basis of your stock. It is not taxed until your basis in the stock is fully recovered. If you buy stock in a corporation in different lots at different times, and you cannot definitely identify the shares subject to the return of capital, reduce the basis of your earliest purchases first.

When the basis of your stock has been reduced to zero, report any additional return of capital that you receive as a capital gain. Whether you report it as a long-term or short-term capital gain depends on how long you have held the stock. See *Holding Period* in chapter 15.

Example. You bought stock in 1986 for $100. In 1988, you received a return of capital of $80. You did not include this amount in your income, but you reduced the basis of your stock to $20. You received a return of capital of $30 in 1997. The first $20 of this amount reduced your basis to zero. You report the other $10 as a long-term capital gain for 1997. You must report as a long-term capital gain any return of capital you receive on this stock in later years.

Liquidating distributions. Liquidating distributions, sometimes called liquidating dividends, are distributions you receive during a partial or complete liquidation of a corporation. These distributions are, at least in part, one form of a return of capital. They may be paid in one or more installments. You will receive a Form 1099–DIV from the corporation showing you the amount of the liquidating distribution.

For more information on liquidating distributions, see chapter 1 of Publication 550.

Distributions of Stock and Stock Rights

Distributions by a corporation of its own stock are commonly known as stock dividends. Stock rights (also known as "stock options") are distributions by a corporation of rights to subscribe to the corporation's stock. Generally, stock dividends and stock rights are not taxable to you, and you do not report them on your return.

Taxable stock dividends and stock rights. Distributions of stock dividends and stock rights are taxable to you if any of the following apply.

1) You or any other shareholder has the choice to receive cash or other property instead of stock or stock rights.
2) The distribution gives cash or other property to some shareholders and an increase in the percentage interest in the corporation's assets or earnings and profits to other shareholders.
3) The distribution is in convertible preferred stock and has the same result as in (2).
4) The distribution gives preferred stock to some common stock shareholders and gives common stock to other common stock shareholders.

5) The distribution is on preferred stock. (The distribution, however, is not taxable if it is an increase in the conversion ratio of convertible preferred stock made solely to take into account a stock dividend, stock split, or similar event that would otherwise result in reducing the conversion right.)

The term “stock” includes rights to acquire stock, and the term “shareholder” includes a holder of rights or of convertible securities.

If you receive taxable stock dividends or stock rights, include their fair market value at the time of the distribution in your income.

Preferred stock redeemable at a premium. If you hold preferred stock having a redemption price higher than its issue price, the difference (the redemption premium) generally is taxable as a constructive distribution of additional stock on the preferred stock. For more information, see chapter 1 of Publication 550.

Basis. Your basis in stock or stock rights received in a taxable distribution is their fair market value when distributed. If you receive stock or stock rights that are not taxable to you, see *Stocks and Bonds* under *Basis of Investment Property* in chapter 4 of Publication 550 for information on how to figure their basis.

Fractional shares. You may not own enough stock in a corporation to receive a full share of stock if the corporation declares a stock dividend. However, with the approval of the shareholders, the corporation may set up a plan in which fractional shares are not issued, but instead are sold, and the cash proceeds are given to the shareholders. Any cash you receive for fractional shares under such a plan is treated as an amount realized on the sale of the fractional shares. You must determine your gain or loss and report it as a capital gain or loss on Schedule D (Form 1040). Your gain or loss is the difference between the cash you receive and the basis of the fractional shares sold.

Example. You own one share of common stock that you bought on January 3, 1990, for $100. The corporation declared a common stock dividend of 5% on June 30, 1997. The fair market value of your stock at the time the stock dividend was declared was $200. You were paid $10 for the fractional-share stock dividend under a plan described in the above paragraph. You figure your gain or loss as follows:

Fair market value of old stock	$200.00
Fair market value of stock dividend (cash received)	10.00
Fair market value of old stock and stock dividend	$210.00
Basis (cost) of old stock after the stock dividend (($200 ÷ $210) × $100)	$95.24
Basis (cost) of stock dividend (($10 ÷ $210) × $100)	4.76
Total	$100.00
Cash received	$10.00
Basis (cost) of stock dividend	4.76
Gain	$5.24

Because you had held the share of stock more than one year at the time the stock dividend was declared, your gain on the stock dividend is a long-term capital gain.

Scrip dividends. A corporation that declares a stock dividend may issue you a scrip certificate that entitles you to a fractional share. The certificate is generally nontaxable when you receive it. If you choose to have the corporation sell the certificate for you and give you the proceeds, your gain or loss is the difference between the proceeds and the portion of your basis in the corporation's stock that is allocated to the certificate.

However, if you receive a scrip certificate that you can choose to redeem for cash instead of stock, the certificate is taxable when you receive it. You must include in income its fair market value on the date you receive it.

Other Distributions

You may receive any of the following distributions during the year.

Exempt-interest dividends. Exempt-interest dividends you receive from a regulated investment company (mutual fund) are not included in your taxable income. (However, see *Information reporting requirement,* next.) You will receive a notice from the mutual fund telling you the amount of the exempt-interest dividends you received. Exempt-interest dividends are not shown on Form 1099–DIV or Form 1099–INT. See *Gains and Losses* in Publication 564 for information about the loss treatment of mutual fund stock on which you received exempt-interest dividends.

Information reporting requirement. Although these dividends are not taxable, you must show them on your tax return if you have to file. This is an information reporting requirement and does not convert exempt-interest dividends to taxable income.

Alternative minimum tax treatment. Exempt-interest dividends may be treated as tax-exempt interest on specified private activity bonds, which is a “tax preference item” that may be subject to the alternative minimum tax. See *Alternative Minimum Tax* in chapter 31 for more information.

Dividends on insurance policies. Insurance policy dividends that the insurer keeps and uses to pay your premiums are not taxable. However, you must report as taxable interest income the interest paid or credited on dividends left with an insurance company. See chapter 8 for treatment of interest income.

If dividends on an insurance contract (other than a modified endowment contract) are distributed to you, they are a partial return of the premiums you paid. Do not include them in your gross income until they are more than the total of all net premiums you paid for the contract. (For information on the treatment of a distribution from a modified endowment contract, see *Distributions before annuity starting date from a nonqualified plan* under *Taxation of Nonperiodic Payments* in Publication 575, *Pension and Annuity Income.*) Report any taxable distributions on insurance policies on line 16b (Form 1040) or line 11b (Form 1040A).

Dividends on veterans' insurance. Dividends you receive on veterans' insurance policies are not taxable. In addition, do not report as taxable income interest on dividends left with the Department of Veterans Affairs. See *Veterans* in chapter 6 for more information about veterans' benefits.

Patronage dividends. Generally, patronage dividends you receive in money from a cooperative organization are included in your income.

Do not include in your income patronage dividends you receive on:

1) Property bought for your personal use, or
2) Capital assets or depreciable property bought for use in your business. But you must reduce the basis (cost) of the items bought. If the dividend is more than the adjusted basis of the assets, you must report the excess as income.

These rules are the same whether the cooperative paying the dividend is a taxable or tax-exempt cooperative.

Alaska Permanent Fund dividends. Do not report these amounts as dividends. Instead, report them on line 21 of Form 1040, line 12 of Form 1040A, or line 3 of Form 1040EZ.

How To Report Dividend Income

Generally, you can use either Form 1040 or Form 1040A to report your dividend income. However, you must use Form 1040 if you receive capital gain distributions or return of capital distributions. You cannot use Form 1040EZ if you receive any dividend income.

Report the total of your taxable dividend income on line 9 of Form 1040 or Form 1040A.

Form 1099–DIV. If you owned stock on which you received $10 or more in gross dividends and other distributions, you should receive a Form 1099–DIV. Even if you do not receive Form 1099–DIV, you must report all of your taxable dividend income.

See Form 1099–DIV for more information on how to report dividend income.

Form 1040A. You must complete Part II of Schedule 1 (Form 1040A) and attach it to your Form 1040A, if:

1) Your gross dividend income (box 1a of Form 1099–DIV) totals more than $400, or
2) You received, as a nominee, dividends that actually belong to someone else.

List on line 5, Part II of Schedule 1, each payer's name and the amount of dividend income received from each payer. If you received a Form 1099–DIV from a brokerage firm, list the brokerage firm as the payer.

Enter on line 6 the total of the amounts listed on line 5. Also enter this total on line 9, Form 1040A.

Form 1040. You must fill in Part II of Schedule B and attach it to your Form 1040, if:

1) Your gross dividends (box 1a of Form 1099–DIV), including capital gain and nontaxable distributions, are more than $400, or

2) You received, as a nominee, dividends that actually belong to someone else.

If your total dividends are more than $400, you must also complete Part III of Schedule B.

You must report all of your dividend income (box 1a of Form 1099–DIV) on line 5, Part II of Schedule B. You must include on this line all the ordinary dividends, capital gain distributions, and return of capital distributions (other than liquidating distributions) you received. List the name of each payer and the amount of distribution you received. If your securities are held by a brokerage firm (in “street name”), list the name of the brokerage firm that is shown on Form 1099–DIV as the payer. If your stock is held by a nominee who is the owner of record, and the nominee credited or paid you dividends on the stock, show the name of the nominee and the dividends you received or for which you were credited.

Enter on line 6 the total of the amounts listed on line 5.

Enter on line 7 any amount shown on line 5 that is a capital gain distribution. Enter on line 8 any amount from line 5 that is a return of capital.

Add the amounts shown on lines 7 and 8, and enter the total on line 9. Subtract the amount on line 9 from the amount on line 6. The difference, if any, is your taxable ordinary dividends. Enter this amount on line 10, Part II of Schedule B, and on line 9, Form 1040.

Expenses related to dividend income. You may deduct expenses related to dividend income only if you itemize your deductions on Schedule A (Form 1040). See chapter 30 for general information about deducting expenses of producing income.

More information. For more information about how to report dividend income, see chapter 1 of Publication 550 or the instructions for the form you must file.

10. Rental Income and Expenses

Introduction

This chapter discusses rental income and expenses on real property. It covers the following topics.

- Rental income.
- Rental expenses.
- Vacation homes and other dwelling units.
- Depreciation.
- Limits on rental losses.
- How to report your rental income and expenses.

If you sell or otherwise dispose of your rental property, see Publication 544, *Sales and Other Dispositions of Assets.*

If you have a loss from damage to, or from theft of, rental property, see Publication 547, *Casualties, Disasters, and Thefts (Business and Nonbusiness).*

If you rent out a condominium or a cooperative apartment, some special rules apply to you even though you receive the same tax treatment as other owners of rental property. See Publication 527 for more information.

Useful Items

You may want to see:

Publication

- ☐ **527** Residential Rental Property
- ☐ **534** Depreciating Property Placed in Service Before 1987
- ☐ **535** Business Expenses
- ☐ **925** Passive Activity and At-Risk Rules
- ☐ **946** How To Depreciate Property

Form (and Instructions)

- ☐ **4562** Depreciation and Amortization
- ☐ **8582** Passive Activity Loss Limitations
- ☐ **Schedule E (Form 1040)** Supplemental Income and Loss

Rental Income

You generally must include in your gross income all amounts you receive as rent.

Rental income is any payment you receive for the use or occupation of property. In addition to amounts you receive as normal rent payments, there are other amounts that may be rental income.

Advance rent. Advance rent is any amount you receive before the period that it covers. Include advance rent in your rental income in the year you receive it regardless of the period covered or the method of accounting you use.

Example. You sign a 10–year lease to rent your property. In the first year, you receive $5,000 for the first year's rent and $5,000 as rent for the last year of the lease. You must include $10,000 in your income in the first year.

Security deposits. Do not include a security deposit in your income when you receive it if you plan to return it to your tenant at the end of the lease. But if you keep part or all of the security deposit during any year because your tenant does not live up to the terms of the lease, include the amount you keep in your income for that year.

If an amount called a security deposit is to be used as a final payment of rent, it is advance rent. Include it in your income when you receive it.

Payment for canceling a lease. If your tenant pays you to cancel a lease, the amount you receive is rent. Include the payment in your income for the year you receive it regardless of your method of accounting.

Expenses paid by tenant. If your tenant pays any of your expenses, the payments are rental income. You must include them in your income. You can deduct the expenses if they are deductible rental expenses. See *Rental Expenses,* later, for more information.

Property or services. If you receive property or services, instead of money, as rent, include the fair market value of the property or services in your rental income.

If the services are provided at an agreed upon or specified price, that price is the fair market value unless there is evidence of a different fair market value.

Rental of property also used as a home. If you rent property that you also use as your home and you rent it for less than 15 days during the tax year, do not include the rent you receive in your gross income. You cannot deduct rental expenses. However, you can deduct the interest, taxes, and casualty and theft losses that are allowed for non-rental property on Schedule A of Form 1040. See *Personal Use of Vacation Home or Dwelling Unit,* later.

Part interest. If you own a part interest in rental property, you must report your part of the rental income from the property.

Rental Expenses

This part discusses repairs and certain other expenses of renting property that you ordinarily can deduct from your gross rental income. It includes information on the expenses you can deduct if you rent part of your property, or if you change your property to rental use. Depreciation, which you can also deduct from your gross rental income, is discussed later.

Part interest. If you own a part interest in rental property, you can deduct your part of the expenses that you paid.

When to deduct. You generally deduct your rental expenses in the year you pay or incur them.

Vacant rental property. If you hold property for rental purposes, you may be able to deduct your ordinary and necessary expenses for managing, conserving, or maintaining the property while the property is vacant. However, you cannot deduct any loss of rental income for the period the property is vacant.

Pre-rental expenses. You can deduct your ordinary and necessary expenses for managing, conserving, or maintaining rental property from the time you make it available for rent.

Expenses for rental property sold. If you sell property you held for rental purposes, you can deduct the ordinary and necessary expenses for managing, conserving, or maintaining the property until it is sold.

Personal use of rental property. If you sometimes use your rental property for personal purposes, you must divide your expenses between rental and personal use. Also, your rental expense deductions may be limited. See *Personal Use of Vacation Home or Dwelling Unit,* later.

Repairs and Improvements

You can deduct the cost of repairs that you make to your rental property. You cannot deduct the cost of improvements. You recover the cost of improvements by taking depreciation (explained later).

Separate the costs of repairs and improvements, and keep accurate records. You will need to know the cost of improvements when you sell or depreciate your property.

Repairs. A repair keeps your property in good operating condition. It does not materially add to the value of your property or substantially prolong its life. Repainting property inside or out, fixing gutters or floors, fixing leaks, plastering, and replacing broken windows are examples of repairs.

If you make repairs as part of an extensive remodeling or restoration of your property, the whole job is an improvement.

Improvements. An improvement adds to the value of your property, prolongs its useful life, or adapts it to new uses. Putting a recreation room in an unfinished basement, paneling a den, adding a bathroom or bedroom, putting decorative grillwork on a balcony, putting up a fence, putting in new plumbing or wiring, putting in new cabinets, putting on a new roof, and paving a driveway are examples of improvements.

If you make an improvement to property, the cost of the improvement must be capitalized. The capitalized cost can generally be depreciated as if the improvement were separate property.

Other Expenses

Other expenses you can deduct from your gross rental income include advertising, janitor and maid service, utilities, fire and liability insurance, taxes, interest, commissions for the collection of rent, ordinary and necessary travel and transportation, and other expenses discussed below.

Rental payments for property. You can deduct the rent you pay for property that you use for rental purposes. If you buy a leasehold for rental purposes, you can deduct an equal part of the cost each year over the term of the lease.

Rental of equipment. You can deduct the rent you pay for equipment that you use for rental purposes. However, in some cases, lease contracts are actually purchase contracts. If so, you cannot deduct these payments. You can recover the cost of purchased equipment through depreciation.

Insurance premiums. You can deduct insurance premiums you pay for rental property. If you pay a premium for more than one year in advance, each year you can deduct the part of the premium payment that will apply to that year. You cannot deduct the total premium in the year you pay it.

Local benefit taxes. Generally, you cannot deduct charges for local benefits that increase the value of your property, such as charges for putting in streets, sidewalks, or water and sewer systems. These charges are capital expenditures that you cannot depreciate. You must add them to the basis of your property. You can deduct local benefit taxes if they are for maintaining, repairing, or paying interest charges for the benefits.

Charges for services. You can deduct charges you pay for services provided for your rental property, such as water, sewer, and trash collection.

Travel expenses. You can deduct the ordinary and necessary costs of traveling away from home if the primary purpose of the trip was to collect rental income or to manage, conserve, or maintain your rental property. You must properly allocate your expenses between rental and nonrental activities. For information on travel expenses, see chapter 28.

To deduct travel expenses, you must keep records that follow the rules in chapter 28.

Local transportation expenses. You can deduct your ordinary and necessary local transportation expenses if you incur them to collect rental income or to manage, conserve, or maintain your rental property.

Generally, if you use your personal car, pickup truck, or light van for rental activities, you can deduct the expenses using one of two methods: actual expenses or the standard mileage rate. The standard mileage rate for 1997 is ***31.5 cents a mile*** for all business miles. For more information, see chapter 28.

To deduct car expenses under either method, you must keep records that follow the rules in chapter 28.

In addition, you must complete Part V of Form 4562 and attach it to your tax return.

Tax return preparation. You can deduct, as a rental expense, the part of tax return preparation fees you paid to prepare Part I of Schedule E (Form 1040). You can also deduct, as a rental expense, any expense you paid to resolve a tax underpayment related to your rental activities. On your 1997 Schedule E, you can deduct fees paid in 1997 to prepare Part I of your 1996 Schedule E.

Renting Part of Property

If you rent part of your property, you must divide certain expenses between the part of the property used for rental purposes and the part of the property used for personal purposes as though you actually had two separate pieces of property.

You can deduct a part of some expenses, such as mortgage interest and property taxes, as a rental expense. You can deduct the other part, subject to certain limitations, only if you itemize your deductions. You can also deduct as a rental expense a part of other expenses that normally are nondeductible personal expenses, such as expenses for electricity or painting the outside of your house. You cannot deduct any part of the cost of a single phone line even if your tenants have unlimited use of it.

You do not have to divide the expenses that belong only to the rental part of your property. If you paint a room that you rent, or if you pay premiums for liability insurance in connection with renting a room in your home, your entire cost is a rental expense. If you install a second phone line strictly for your tenants' use, all of the cost of the second line is deductible as a rental expense. You can deduct depreciation, discussed later, on the part of the property used for rental purposes as well as on the furniture and equipment you use for these purposes.

How to divide expenses. If an expense is for both rental use and personal use, such as mortgage interest or heat for the entire house, you must divide the expense between the rental use and the personal use. You can use any reasonable method for dividing the expense. It may be reasonable to divide the cost of some items (for example, water) based on the number of people using them. However, the two most common methods for dividing an expense are one based on the number of rooms in your home and one based on the square footage of your home.

Property Changed to Rental Use

If you change your home or other property, (or a part of it), to rental use at any time other than at the beginning of your tax year, you must divide yearly expenses, such as depreciation, taxes, and insurance, between rental use and personal use.

You can deduct as rental expenses only the part of the expense that is for the part of the year the property was used or held for rental purposes.

You cannot deduct depreciation or insurance for the part of the year the property was held for personal use. However, you can deduct the interest and tax expenses for the part of the year the property was held for personal use as an itemized deduction on Schedule A (Form 1040).

Example. Your tax year is a calendar year. You moved from your home in May and started renting it out on June 1. You can deduct as rental expenses seven-twelfths of your yearly expenses, such as taxes and insurance.

Starting with June, you can deduct as rental expenses, the amounts you pay for items generally billed monthly, such as utilities.

Not Rented for Profit

If you do not rent your property to make a profit, you can deduct your rental expenses only up to the amount of your rental income. You cannot carry forward any of your rental expenses that are more than your rental income. For more information about the rules for an activity not engaged in for profit, see chapter 1 of Publication 535.

Where to report. Report your not-for-profit rental income on line 21, Form 1040. Deduct your mortgage interest, real estate taxes, and casualty losses on the appropriate lines of Schedule A (Form 1040).

Claim your other expenses, subject to the rules explained in chapter 1 of Publication 535, as miscellaneous itemized deductions on line 22 of Schedule A. You can deduct these expenses only if they, together with certain other miscellaneous itemized deductions, total more than 2% of your adjusted gross income. For more information about miscellaneous deductions, see chapter 30.

Personal Use of Vacation Home or Dwelling Unit

If you have any personal use of a vacation home or other dwelling unit that you rent out, you must divide your expenses between the rental use and the personal use. See *Figuring Days of Personal Use* and *How To Divide Expenses,* later.

If you use the dwelling unit as a home and you rent it for fewer than 15 days during the year, do not include any of the rent in your income and do not deduct any of the rental expenses. If you rent out the dwelling unit for 15 or more days, you must include the rent in your income and, if you have a net loss, you may not be able to deduct all of the rental expenses. See *How To Figure Income and Deductions,* later.

Dwelling unit. The rules in this section apply to vacation homes and other dwelling units. A dwelling unit includes a house, apartment, condominium, mobile home, boat, or similar property. A dwelling unit has basic living accommodations, such as sleeping space, a toilet, and cooking facilities. A dwelling unit does not include property used solely as a hotel, motel, inn, or similar establishment.

Property is used solely as a hotel, motel, inn, or similar establishment if it is regularly available for occupancy by paying customers and is not used by an owner as a home during the year.

Example. You rent out a room in your home that is always available for short-term occupancy by paying customers. You do not use the room yourself, and you only allow paying customers to use the room. The room is used solely as a hotel, motel, inn, or similar establishment and is not a dwelling unit.

Dwelling Unit Used as Home

You use a dwelling unit as a home during the tax year if you use it for personal purposes more than the greater of:

1) 14 days, or
2) 10% of the total days it is rented to others at a fair rental price.

See *Figuring Days of Personal Use,* later.

If a dwelling unit is used for personal purposes on a day it is rented at a fair rental price, do not count that day as a day of rental in applying (2) above. Instead, count it as a day of personal use in applying both (1) and (2) above. This rule does not apply when dividing expenses between rental and personal use.

Fair rental price. A fair rental price for your property generally is an amount that a person who is not related to you would be willing to pay. The rent you charge is not a fair rental price if it is substantially less than the rents charged for other properties that are similar to your property.

Examples. The following examples show how to determine whether you used your rental property as a home.

Example 1. You converted the basement of your home into an apartment with a bedroom, a bathroom, and a small kitchen. You rent the apartment at a fair rental price to college students during the regular school year. You rent to them on a 9–month (273 days) lease.

During the summer, your brothers stay with you for a month (30 days) and live in the apartment rent free.

Your basement apartment is used as a home because you use it for personal purposes for 30 days. That is more than the greater of 14 days or 10% of the total days it is rented (27 days).

Example 2. You rent out the guest bedroom in your home at a fair rental price during the local college's homecoming, commencement, and football weekends (a total of 27 days). Your sister-in-law stays in the room, rent free, for the last three weeks (21 days) in July.

The room is used as a home because you use it for personal use for 21 days. That is more than the greater of 14 days or 10% of the total days it is rented (3 days).

Example 3. You own a cottage at the shore. You rent it out at a fair rental price from June 1 through August 31, a total of 92 days. The tenant who rented the cottage for the month of July was unable to use it from July 4 through July 8. The tenant allowed you to use the cottage for those 5 days. The tenant did not ask for a refund of, or a reduction in, the rent. Your family used the cottage for 3 of those days.

To determine the number of days the cottage was rented at a fair rental price, do not count those 3 days you used it for personal purposes. The cottage was rented at a fair rental price for 89 days (92 – 3).

Figuring Days of Personal Use

A day of personal use of a dwelling unit is any day that it is used by:

1) You or any other person who has an interest in it, unless you rent it to another owner as his or her main home under a shared equity financing agreement (defined later),
2) A member of your family or a member of the family of any other person who has a financial interest in it, unless the family member uses the dwelling unit as his or her main home and pays a fair rental price. Family includes only brothers and sisters, half-brothers and half-sisters, spouses, ancestors (parents, grandparents, etc.) and lineal descendants (children, grandchildren, etc.),
3) Anyone under an arrangement that lets you use some other dwelling unit, or
4) Anyone at less than a fair rental price.

Main home. If the other owner or member of the family in (1) or (2) above has more than one home, his or her main home is the one lived in most of the time.

Shared equity financing agreement. This is an agreement under which two or more persons acquire undivided interests for more than 50 years in an entire dwelling unit, including the land, and one or more of the co-owners is entitled to occupy the unit as his or her main home upon payment of rent to the other co-owner or owners.

Donation of use of property. You use a dwelling unit for personal purposes if:

- You donate the use of the unit to a charitable organization,
- The organization sells the use of the unit at a fund-raising event, and
- The purchaser uses the unit.

Examples

The following examples show how to determine days of personal use.

Example 1. You and your neighbor are co-owners of a condominium at the beach. You rent the unit out to vacationers whenever possible. The unit is not used as a main home by anyone. Your neighbor uses the unit for two weeks every year.

Because your neighbor has an interest in the unit, both of you are considered to have used the unit for personal purposes during those two weeks.

Example 2. You and your neighbors are co-owners of a house under a shared equity financing agreement. Your neighbors live in the house and pay you a fair rental price.

Even though your neighbors have an interest in the house, the days your neighbors live there are not counted as days of personal use by you. This is because your neighbors rent the house as their main home under a shared equity financing agreement.

Example 3. You own a rental property that you rent to your son. Your son has no interest in this dwelling unit. He uses it as his main home. He pays you a fair rental price for the property.

Your son's use of the property is not personal use by you because your son is using it as his main home, he has no interest in the property, and he is paying you a fair rental price.

Example 4. You rent your beach house to Marcia. Marcia rents her house in the mountains to you. You each pay a fair rental price.

You are using your house for personal purposes on the days that Marcia uses it because your house is used by Marcia under an arrangement that allows you to use her house.

Days Not Counted as Personal Use

Some days you spend at the dwelling unit are not counted as days of personal use.

Repairs and maintenance. Any day that you spend working substantially full time repairing and maintaining your property is not counted as a day of personal use. Do not count such a day as a day of personal use even if family members use the property for recreational purposes on the same day.

Use as home before or after renting. When determining if you used your property as a home, the following special rule applies. Do not count as days of personal use the days you used the property as your main home either before or after renting it or offering it for rent in the following circumstances:

1) You rented or tried to rent the property for 12 or more consecutive months, or
2) You rented or tried to rent the property for a period of less than 12 consecutive months and the period ended because you sold or exchanged the property.

This special rule does not apply when dividing expenses between rental and personal use.

How To Divide Expenses

If you use a dwelling unit for both rental and personal purposes, divide your expenses between the rental use and the personal use based on the number of days used for each purpose. Expenses for the rental use of the unit are deductible under the rules explained in *How To Figure Your Rental Income and Deductions,* next. When dividing your expenses follow these rules.

1) Any day that the unit is rented at a fair rental price is a day of rental use even if you used the unit for personal purposes that day. This rule does not apply when determining whether you used the unit as a home.

2) Any day that the unit is held out for rent but not actually rented is not a day of rental use.

Example. You offer your beach cottage for rent from June 1 through August 31 (92 days). Your family uses the cottage during the last 2 weeks in May (14 days). You were unable to find a renter for the first week in August (7 days). The person who rented the cottage for July allowed you to use it over a weekend (2 days) without any reduction in or refund of rent. The cottage was not used at all before May 17 or after August 31.

You figure the part of the cottage expenses to treat as rental expenses as follows:

1) The cottage was used for rental a total of 85 days (92 – 7). The days it was held out for rent but not rented (7 days) are not days of rental use. The July weekend (2 days) you used it is rental use because you received a fair rental price for the weekend.
2) You used the cottage for personal purposes for 14 days (the last 2 weeks in May).
3) The total use of the cottage was 99 days (14 days personal use + 85 days rental use). Your rental expenses are 85/99 (86%) of the cottage expenses.

When determining whether you used the cottage as a home, the July weekend (2 days) you used it is personal use even though you received a fair rental price for the weekend. Therefore, you had 16 days of personal use and 83 days of rental use for this purpose. Because you used the cottage for personal purposes more than 14 days and more than 10% of the days of rental use, you used it as a home. If you have a net loss, you may not be able to deduct all of the rental expenses. See *Property Used as a Home* in the following discussion.

How To Figure Your Income and Deductions

How you figure your rental income and deductions depends on whether the dwelling unit was used as a home and, if used as a home, how many days the property was rented.

Property Not Used as a Home

If you do not use a dwelling unit as a home, report all the rental income and deduct all the rental expenses. See *How To Report Rental Income and Expenses,* later.

Your deductible rental expenses can be more than your gross rental income. However, see *Limits on Rental Losses,* later.

Property Used as a Home

If you use a dwelling unit as a home during the year (see *Dwelling Unit Used as Home,* earlier), how you figure your rental income and deductions depends on how many days the unit was rented.

Rented fewer than 15 days. If you use a dwelling unit as a home and you rent it for fewer than 15 days during the year, you do not include in income any of the rental income. Also, you cannot deduct any expenses as rental expenses.

Rented 15 days or more. If you use a dwelling unit as a home and rent it for 15 days or more during the year, you include all your rental income in your gross income. See *How To Report Rental Income and Expenses,* later. If you had a net profit from the rental property for the year (that is, if your rental income is more than the total of your rental expenses, including depreciation), deduct all of your rental expenses. However, if you had a net loss, you may not be able to deduct all of your rental expenses.

Use *Table 10–1* to figure your deductible expenses.

Depreciation

When you use your property to produce income, such as rents, you can recover (get back) some or all of what you paid for the property through tax deductions. You do this by “depreciating” the property; that is, by deducting some of your cost on your tax return each year.

Several factors determine how much depreciation you can deduct. The main factors are: (1) your basis in the property, (2) the recovery period for the property, and (3) the depreciation method (including convention) used.

You can deduct depreciation only on the part of your property used for rental purposes. Depreciation reduces your basis for figuring gain or loss on a later sale or exchange.

You may have to use **Form 4562,** *Depreciation and Amortization,* to figure and report your depreciation. See *How To Report Rental Income and Expenses,* later.

Claiming the correct amount of depreciation. You should claim the correct amount of depreciation each tax year. If, in an earlier year, you did not claim depreciation that you were entitled to deduct, you must still reduce your basis in the property by the amount of depreciation that you should have deducted. You generally cannot deduct the unclaimed depreciation in the current or any later tax year. However, you may be able to claim the depreciation on an amended return (Form 1040X) for the earlier year. See *Amended Returns and Claims for Refund* in chapter 1 for more information.

Changing your accounting method to deduct unclaimed depreciation. If you claimed less depreciation than allowable in an earlier year, you can change your accounting method to take a deduction in the current year for the unclaimed depreciation. To change your accounting method, you must have the consent of the IRS. In some instances, you can receive automatic consent. For more information, see chapter 1 of Publication 946.

Land. You can never depreciate land. The cost of clearing, grading, planting, and landscaping are usually all part of the cost of land and are not depreciable.

Depreciation Systems

There are three ways to figure depreciation. The depreciation system you use depends on the type of asset and when the asset was placed in service. For property used in rental activities you use:

1) MACRS if placed in service after 1986,
2) ACRS if placed in service after 1980 but before 1987, or
3) Useful lives and either straight line or an accelerated method of depreciation, such as the declining balance method, if placed in service before 1981.

If you placed property in service before 1997, continue to use the same method of figuring depreciation that you used in the past. If you are depreciating property placed in service before 1987, see Publication 534.

Section 179 election. You cannot claim the section 179 deduction for property held to produce rental income (unless renting property is your trade or business). See chapter 2 of Publication 946.

Cannot be more than basis. The total of all your yearly depreciation deductions cannot be more than the cost or other basis of the property. For this purpose, your yearly depreciation deductions include any depreciation that you were allowed to claim, even if you did not claim it.

Cooperative apartments. If you rent your cooperative apartment to others, you may deduct your share of the cooperative housing corporation's depreciation. See *Cooperative apartments* in Publication 527 for information on how to figure your depreciation deduction.

Modified Accelerated Cost Recovery System (MACRS)

In general the modified accelerated cost recovery system (MACRS) applies to all tangible property placed in service during 1997.

MACRS consists of two systems that determine how you depreciate your property. The main system is called the ***General Depreciation System (GDS).*** The second system is called the ***Alternative Depreciation System (ADS).*** GDS is used to figure your depreciation deduction for property used in most rental activities, unless you elect ADS.

To figure your MACRS deduction, you need to know the following information about your property:

1) Its recovery period,
2) Its placed-in-service date, and
3) Its depreciable basis.

Excluded property. You cannot use MACRS for certain personal property placed in service before 1987 (before August 1, 1986, if election made) that is transferred after 1986 (after July 31, 1986, if election made). Generally, if you acquired the property from a related party, or if you or a related party used the property before 1987, you use MACRS to depreciate the property if it had previously been depreciated under

Table 10-1. **Worksheet for Figuring the Limit on Rental Deductions for a Dwelling Unit Used as a Home**

Use this worksheet only if you answer “yes” to all of the following questions.

- Did you use the dwelling unit as a home this year? (See *Dwelling Unit Used as Home.*)
- Did you rent the dwelling unit 15 days or more this year?
- Are the total of your rental expenses and depreciation more than your rental income?

1.	Enter rents received		______
2.a.	Enter the rental portion of deductible home mortgage interest (see instructions)	______	
b.	Enter the rental portion of real estate taxes	______	
c.	Enter the rental portion of deductible casualty and theft losses (see instructions)	______	
d.	Enter direct rental expenses (see instructions)	______	
e.	**Fully deductible rental expenses.** Add lines 2a–2d		______
3.	Subtract line 2e from line 1. If zero or less, enter zero		______
4.a.	Enter the rental portion of expenses directly related to operating or maintaining the dwelling unit (such as repairs, insurance, and utilities)	______	
b.	Enter the rental portion of excess mortgage interest (see instructions)	______	
c.	Add lines 4a and 4b	______	
d.	**Allowable operating expenses.** Enter the smaller of line 3 or line 4c		______
5.	Subtract line 4d from line 3. If zero or less, enter zero		______
6.a.	Enter the rental portion of excess casualty and theft losses (see instructions)	______	
b.	Enter the rental portion of depreciation of the dwelling unit	______	
c.	Add lines 6a and 6b	______	
d.	**Allowable excess casualty and theft losses and depreciation.** Enter the smaller of line 5 or line 6c		______
7.a.	**Operating expenses to be carried over to next year.** Subtract line 4d from line 4c		______
b.	**Excess casualty and theft losses and depreciation to be carried over to next year.** Subtract line 6d from line 6c		______

Enter the amounts on **lines 2e, 4d, and 6d** on the appropriate lines of Schedule E (Form 1040), Part I.

Worksheet Instructions

Follow these instructions for the worksheet above. If you were unable to deduct all your expenses last year, because of the rental income limit, add these unused amounts to your expenses for this year.

Line 2a. Figure the mortgage interest on the dwelling unit that you could deduct on Schedule A (Form 1040) if you had not rented the unit. **Do not** include interest on a loan that did not benefit the dwelling unit. For example, **do not** include interest on a home equity loan used to pay off credit cards or other personal loans, buy a car, or pay college tuition. Include interest on a loan used to buy, build, or improve the dwelling unit, or to refinance such a loan. Enter the rental portion of this interest on line 2a of the worksheet.

Line 2c. Figure the casualty and theft losses related to the dwelling unit that you could deduct on Schedule A (Form 1040) if you had not rented the dwelling unit. To do this, complete Section A of Form 4684, treating the losses as personal losses. On line 17 of Form 4684, enter 10% of your adjusted gross income figured **without** your rental income and expenses from the dwelling unit. Enter the rental portion of the result from line 18 of Form 4684 on line 2c of this worksheet. **Note:** Do **not** file this Form 4684 or use it to figure your personal losses on Schedule A. Instead, figure the personal portion on a separate Form 4684.

Line 2d. Enter the total of your rental expenses that are directly related only to the rental activity. These include interest on loans used for rental activities other than to buy, build, or improve the dwelling unit. Also include rental agency fees, advertising, office supplies, and depreciation on office equipment used in your rental activity.

Line 4b. On line 2a, you entered the rental portion of the mortgage interest you could deduct on Schedule A if you had rented out the dwelling unit. Enter on line 4b of this worksheet the rental portion of the mortgage interest you could not deduct on Schedule A because it is **more than** the limit on home mortgage interest. **Do not** include interest on a loan that did not benefit the dwelling unit (as explained in the line 2a instructions).

Line 6a. To find the rental portion of excess casualty and theft losses, use the Form 4684 you prepared for line 2c of this worksheet.

A.	Enter the amount from line 10 of Form 4684	______
B.	Enter the rental portion of (A)	______
C.	Enter the amount from line 2c of this worksheet	______
D.	Subtract (C) from (B). Enter the result here and on line 6a of this worksheet	______

Allocating the limited deduction. If you cannot deduct all of the amount on line 4c or 6c this year, you can allocate the allowable deduction in any way you wish among the expenses included on line 4c or 6c. Enter the amount you allocate to each expense on the appropriate line of Schedule E, Part I.

ACRS and the MACRS deduction would be less than the deduction under ACRS. Property that does not come under MACRS must be depreciated under ACRS or one of the other methods of depreciation, such as straight line or declining balance. In addition, you may elect to exclude certain property from the application of MACRS. See Publication 534 for more information.

Personal home changed to rental use. You must use MACRS to figure the depreciation on property you used as your home and changed to rental property in 1997.

Recovery Periods Under GDS

Each item of property that can be depreciated is assigned to a property class. The recovery period of a piece of property depends on the class the property is in. The property classes are:

- 3–year property,
- 5–year property,
- 7–year property,
- 10–year property,
- 15–year property,
- 20–year property,
- Nonresidential real property, and
- Residential rental property.

The class to which property is assigned is determined by its class life. The property classes and class life are discussed in Publication 946.

Additions or improvements to property. Treat depreciable additions or improvements you make to any property as separate property items for depreciation purposes. The recovery period for an addition or improvement begins on the later of:

1) The date the addition or improvement is placed in service, or

2) The date the property to which the addition or improvement was made is placed in service.

The class and recovery period of the addition or improvement is the one that would apply to the underlying property if it were placed in service at the same time as the addition or improvement.

Example. You own a residential rental house that you have been renting out since 1980 and are depreciating under ACRS. If you put an addition onto the house, and you place the improvement in service after 1986, you use MACRS for the addition. Under MACRS, the addition would be depreciated as residential rental property.

Placed-In-Service Date

You can begin to depreciate property when you place it in service in your trade or business or for the production of income. Property is considered placed in service in a rental activity when it is ready and available for a specific use in that activity.

Cost Basis

To deduct the proper amount of depreciation each year, you must first determine your basis in the property you intend to depreciate. The basis used for figuring depreciation is your original basis in the property increased by any improvements made to the property. Your original basis is usually your cost. However, if you acquire the property in some other way, such as by inheriting it, getting it as a gift, or building it yourself, you may have to figure your original basis in another way. Other adjustments could also affect your basis. See chapter 14.

Conventions

In the year that you place property in service or in the year that you dispose of property, you are allowed to claim depreciation for only part of the year. The part of the year (or convention) depends on the class of the property.

A half-year convention is used to figure the deduction for property used in rental activities other than residential rental property. However, in certain circumstances, a mid-quarter convention must be used. For residential rental property, use a mid-month convention in all situations.

Half-year convention. The half-year convention treats all property placed in service, or disposed of, during a tax year as placed in service, or disposed of, in the middle of that tax year.

A half year of depreciation is allowable for the first year property is placed in service, regardless of when the property is placed in service during the tax year. For each of the remaining years of the recovery period, you will take a full year of depreciation. If you hold the property for the entire recovery period, a half year of depreciation is allowable for the year in which the recovery period ends. If you dispose of the property before the end of the recovery period, a half year of depreciation is allowable for the year of disposition.

Table 10-2. **MACRS Recovery Periods for Property Used in Rental Activities**

Type of Property	MACRS Recovery Period To Use: General Depreciation System	MACRS Recovery Period To Use: Alternative Depreciation System
Computers and their peripheral equipment	5 years	5 years
Office machinery, such as: Typewriters, Calculators, Copiers	5 years	6 years
Automobiles	5 years	5 years
Light trucks	5 years	5 years
Office furniture and equipment, such as: Desks, Files	7 years	10 years
Appliances, such as: Stoves, Refrigerators	7 years	12 years
Carpets	7 years	12 years
Furniture used in rental property	7 years	12 years
Any property that does not have a class life and that has not been designated by law as being in any other class	7 years	12 years
Fences	15 years	20 years
Roads	15 years	20 years
Shrubbery	15 years	20 years
Residential rental property (buildings or structures) and structural components such as furnaces, water pipes, venting, etc.	27.5 years	40 years
Improvements and additions, such as a new roof	The recovery period of the property to which the addition or improvement is made, determined as if the property were placed in service at the same time as the improvement or addition.	

Mid-quarter convention. Under a mid-quarter convention, all property placed in service, or disposed of, during any quarter of a tax year is treated as placed in service, or disposed of, in the middle of the quarter.

A mid-quarter convention must be used in certain circumstances for property used in rental activities, other than residential rental property. This convention applies if the total basis of such property that is placed in service in the last 3 months of a tax year is more than 40% of the total basis of all such property you place in service during the year.

Do not include in the total basis any property placed in service and disposed of during the same tax year.

Example. During the tax year, John Joyce purchased the following items to use in his rental property:

- A dishwasher for $400, which he placed in service in January,
- Used furniture for $100, which he placed in service in September, and
- A refrigerator for $500, which he placed in service in October.

John uses the calendar year as his tax year. The total basis of all property placed in service in that year is $1,000. The $500 basis of the refrigerator placed in service during the last 3 months of his tax year exceeds $400 (40% × $1,000). John must use the mid-quarter convention for all three items.

Mid-month convention. Under a mid-month convention, residential rental property placed in service, or disposed of, during any month is treated as placed in service, or disposed of, in the middle of that month.

MACRS Depreciation Under GDS

You can figure your MACRS depreciation deduction under GDS in one of two ways. The deduction is substantially the same both ways. (The difference, if any, is slight.) You can either:

1) Use the percentage from the optional MACRS tables, or

2) Actually compute the deduction using the depreciation method and convention that apply over the recovery period of the property.

Publication 946 discusses computing depreciation using the proper method and convention.

Using the Optional Tables

You can use *Table 10–3* to compute annual depreciation under MACRS. The tables show the percentages for the first 6 years. The percentages in Tables A, B, and C make the change from declining balance to straight line in the year that straight line will yield a larger deduction.

If you elect to use the straight line method for 5–, 7– or, 15–year property, or the 150% declining balance method for 5– or 7–year property, use the tables in *Appendix A* of Publication 946.

How to use the tables. The following section explains how to use the optional tables. Figure the depreciation deduction by multiplying your unadjusted basis in the property by the percentage shown in the appropriate table. Your ***unadjusted basis*** is your depreciable basis without reduction for depreciation previously claimed.

Once you begin using an optional table to figure depreciation, you must continue to use it for the entire recovery period unless there is an adjustment to the basis of your property for a reason other than:

1) Depreciation allowed or allowable, or
2) An addition or improvement that is depreciated as a separate item of property.

If there is an adjustment for any other reason (for example, because of a deductible casualty loss), you can no longer use the table. For the year of the adjustment and for the remaining recovery period, figure depreciation using the property's adjusted basis at the end of the year and the appropriate depreciation method, as explained in *MACRS Depreciation Under GDS* in Publication 527.

Tables A, B, and C. The percentages in these tables take into account the half-year and mid-quarter conventions. Use Table 10–3–A for 5–year property, Table 10–3–B for 7–year property, and Table 10–3–C for 15–year property. Use the percentage in the second column (half-year convention) unless you must use the mid-quarter convention (explained earlier). If you must use the mid-quarter convention, use the column that corresponds to the calendar year quarter in which you placed the property in service.

Example 1. You purchased a stove and refrigerator and placed them in service in February. Your basis in the stove is $300, and your basis in the refrigerator is $500. Assume that both are 7–year property. Using the half-year convention column in Table 10–3–B, you find the depreciation percentage for year 1 is 14.29%. For that year, your depreciation deduction is $43 ($300 × .1429) on the stove, and is $71 ($500 × .1429) on the refrigerator.

For the second tax year, you find your depreciation percentage is 24.49%. That year's depreciation deduction will be $73 ($300 × .2449) for the stove and $122 ($500 × .2449) for the refrigerator.

Example 2. Assume the same facts in Example 1, except you buy the refrigerator in October instead of February. You must use the mid-quarter convention to figure depreciation on the stove and refrigerator. The refrigerator was placed in service in the last 3 months of the tax year and its basis ($500) is more than 40% of the total basis of all property placed in service during the year ($800).

Because you placed the stove in service in February, you use the first quarter column of Table 10–3–B and find that the depreciation percentage for year 1 is 25%. For that year, your depreciation deduction on the stove is $75 ($300 × .25).

Because you placed the refrigerator in service in October, you use the fourth quarter column of Table 10–3–B and find that the depreciation percentage for year 1 is 3.57%. Your depreciation deduction on the refrigerator is $18 ($500 × .0357).

Table D. Use this table for residential rental property. Find the row for the month that you placed the property in service. Use the percentages listed for that month to figure your depreciation deduction. The mid-month convention is taken into account in the percentages shown in the table.

Table 10-3. **Optional MACRS TABLES**

Table 10-3-A. 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	13.68
5	11.52	11.01	11.37	11.30	10.94
6	5.76	1.38	4.26	7.06	9.58

Table 10-3-B. MACRS 7-Year property

	Half-year convention	Mid-quarter convention			
Year		**First quarter**	**Second quarter**	**Third quarter**	**Fourth quarter**
1	14.29%	25.00%	17.85%	10.71%	3.57%
2	24.49	21.43	23.47	25.51	27.55
3	17.49	15.31	16.76	18.22	19.68
4	12.49	10.93	11.97	13.02	14.06
5	8.93	8.75	8.87	9.30	10.04
6	8.92	8.74	8.87	8.85	8.73

Table 10-3-C. MACRS 15-Year property

	Half-year convention	Mid-quarter convention			
Year		**First quarter**	**Second quarter**	**Third quarter**	**Fourth quarter**
1	5.00%	8.75%	6.25%	3.75%	1.25%
2	9.50	9.13	9.38	9.63	9.88
3	8.55	8.21	8.44	8.66	8.89
4	7.70	7.39	7.59	7.80	8.00
5	6.93	6.65	6.83	7.02	7.20
6	6.23	5.99	6.15	6.31	6.48

Table 10-3-D. Residential Rental Property (27.5-year)

	Use the row for the month of the taxable year placed in service.					
	Year 1	**Year 2**	**Year 3**	**Year 4**	**Year 5**	**Year 6**
Jan.	3.485%	3.636%	3.636%	3.636%	3.636%	3.636%
Feb.	3.182	3.636	3.636	3.636	3.636	3.636
March	2.879	3.636	3.636	3.636	3.636	3.636
Apr.	2.576	3.636	3.636	3.636	3.636	3.636
May	2.273	3.636	3.636	3.636	3.636	3.636
June	1.970	3.636	3.636	3.636	3.636	3.636
July	1.667	3.636	3.636	3.636	3.636	3.636
Aug.	1.364	3.636	3.636	3.636	3.636	3.636
Sept.	1.061	3.636	3.636	3.636	3.636	3.636
Oct.	0.758	3.636	3.636	3.636	3.636	3.636
Nov.	0.455	3.636	3.636	3.636	3.636	3.636
Dec.	0.152	3.636	3.636	3.636	3.636	3.636

Example. You purchased a single family rental house and placed it in service in February. Your basis in the house is $80,000. Using Table 10–3–D, you find that the percentage for property placed in service in February of year 1 is 3.182%. That year's depreciation deduction is $2,546 ($80,000 × .03182).

MACRS Depreciation Under ADS

If you choose, you can use the ADS method for most property. Under ADS, you use the straight line method of depreciation.

Table 10–2 shows the recovery periods for property used in rental activities that you depreciate under ADS. See *Appendix B* in Publication 946 for other property. If your property is not listed, it is considered to have no class life.

Use the mid-month convention for residential rental property. For all other property, use the half-year or mid-quarter convention.

Election. You choose to use ADS by entering the depreciation on line 16, Part II of Form 4562.

The election of ADS for one item in a class of property generally applies to all property in that class that is placed in service during the tax year of the election. However, the election applies on a property-by-property basis for residential rental property.

Once you choose to use ADS, you cannot change your election.

Other Rules About Depreciable Property

In addition to the rules about what methods you can use, there are other rules you should be aware of with respect to depreciable property.

Gain disposition. If you dispose of depreciable property at a gain, you may have to report, as ordinary income, all or part of the gain. See Publication 544, *Sales and Other Dispositions of Assets.*

Alternative minimum tax. If you use accelerated depreciation, you may have to file **Form 6251,** *Alternative Minimum Tax — Individuals.* Accelerated depreciation includes MACRS and ACRS and any other method that allows you to deduct more depreciation than you could deduct using a straight line method.

Limits on Rental Losses

Rental real estate activities are generally considered passive activities, and the amount of loss you can deduct is limited. Generally, you cannot deduct losses from rental real estate activities unless you have income from other passive activities. See *Passive Activity Limits,* later.

Losses from passive activities are first subject to the ***at-risk rules.*** At-risk rules limit the amount of deductible losses from holding most real property placed in service after 1986.

Exception. If your rental losses are less than $25,000 ($12,500 if married filing separately), the passive activity limits probably do not apply to you. See *Losses From Rental Real Estate Activities,* later.

Property used as a home. If you used the rental property as a home during the year, the passive activity rules do not apply to that home. Instead, you must follow the rules explained earlier under *Personal Use of Vacation Home or Dwelling Unit.*

At-Risk Rules

The at-risk rules place a limit on the amount you can deduct as losses from activities often described as tax shelters. Losses from holding real property (other than mineral property) placed in service before 1987 are not subject to the at-risk rules.

Generally, any loss from an activity subject to the at-risk rules is allowed only to the extent of the total amount you have at risk in the activity at the end of the tax year. You are considered at risk in an activity to the extent of cash and the adjusted basis of other property you contributed to the activity and certain amounts borrowed for use in the activity. See Publication 925 for more information.

Passive Activity Limits

In general, rental activities (except those meeting the exception for real estate professionals, below) are passive activities.

For this purpose, a rental activity is an activity from which you receive income mainly for the use of tangible property, rather than for services.

Passive activity rules. Deductions for losses from passive activities are limited. You generally cannot offset income, other than passive income, with losses from passive activities. Nor can you offset taxes on income, other than passive income, with credits resulting from passive activities. Any excess loss or credit is carried forward to the next tax year.

For a detailed discussion of these rules, see Publication 925.

You may have to complete **Form 8582,** *Passive Activity Loss Limitations,* to figure the amount of any passive activity loss for the current year for all activities and the amount of the passive activity loss allowed on your tax return.

Exception for real estate professionals. Rental activities in which you *materially participate* during the year are not passive activities if for that year you were a real estate professional because you met both of the requirements listed in Publication 527.

Losses From Rental Real Estate Activities

If you ***actively participated*** in a passive rental real estate activity, you may be able to deduct up to $25,000 of loss from the activity from nonpassive income. This special allowance cannot be more than $12,500 if you were married and lived apart from your spouse at all times during the year. It is not available if you were married, file a separate return, and did not live apart from your spouse at all times during the year.

The maximum amount of the special allowance is reduced if your modified adjusted gross income is more than $100,000 ($50,000 if married filing separately).

Active participation. You actively participate in a rental real estate activity if you (and your spouse) owned at least 10% of the rental property and you made management decisions in a significant and bona fide sense. Management decisions include approving new tenants, deciding on rental terms, approving expenditures, and similar decisions.

More information. See Publication 925 for more information on the passive loss limits, including information on the treatment of unused disallowed passive losses and credits and the treatment of gains and losses realized on the disposition of a passive activity.

How To Report Rental Income and Expenses

Report rental income on your return for the year you actually or constructively receive it (if you are a cash-basis taxpayer). You are considered to constructively receive income when it is made available to you, for example, by being credited to your bank account.

For more information about when you constructively receive income, see *Accounting Methods* in chapter 1.

Where to report. Where you report rental income and expenses, including depreciation, depends on whether you provide certain services to your tenant.

If you rent out buildings, rooms, or apartments, and provide only heat and light, trash collection, etc., you normally report your rental income and expenses in Part I of Schedule E (Form 1040), *Supplemental Income and Loss.* However, do not use that schedule to report a not-for-profit activity. See *Not Rented For Profit* under *Rental Expenses,* earlier.

If you provide significant services that are primarily for your tenant's convenience, such as regular cleaning, changing linen, or maid service, you report your rental income and expenses on Schedule C (Form 1040), *Profit or Loss From Business* or Schedule C–EZ, *Net Profit From Business.* Significant services do not include the furnishing of heat and light, cleaning of public areas, trash collection, etc. For information, see Publication 334. You also may have to pay self-employment tax on your rental income. See Publication 533.

Form 1098. If you paid $600 or more of mortgage interest on your rental property, you should receive a Form 1098, *Mortgage Interest Statement,* or a similar statement showing the interest you paid for the year. If you and at least one other person (other than your spouse if you file a joint return) were liable for, and paid interest on the mortgage, and the other person received the Form 1098, report your share of the interest on line 13 of Schedule E. Attach a statement to your return showing the name and address of the other person. In the left margin of Schedule E, next to line 13, write "See attached."

Schedule E

Use Part I of Schedule E (Form 1040) to report your rental income and expenses. List your total income, expenses, and depreciation for each rental property. Be sure to answer the question on line 2.

Show the depreciation you are claiming on line 20 of Schedule E (Form 1040).

You must complete and attach Form 4562 for rental activities only if you are claiming:

- Depreciation on property placed in service during 1997, or
- Depreciation on any property that is listed property (such as a car), regardless of when it was placed in service, or any automobile expenses (actual or the standard mileage rate).

Otherwise, figure your depreciation on your own worksheet. You do not have to attach these computations to your return.

If you have more than three rental or royalty properties, complete and attach as many Schedules E as are needed to list the properties. Complete lines 1 and 2 for each property. However, fill in the "Totals" column on only one Schedule E. The figures in the "Totals" column on that Schedule E should be the combined totals of all Schedules E. If you need to use page 2 of Schedule E, use page 2 of the same Schedule E you used to enter the combined totals in Part I.

Example. On January 1, Eileen Green bought a townhouse and placed it in service as residential rental property. She receives $1,100 a month rental income. Her rental expenses for the year are as follows:

Fire insurance (1–year policy)	$200
Mortgage interest	5,000
Fee paid to real estate company for collecting monthly rent	572
General repairs	175
Real estate taxes imposed and paid	800

Eileen's basis for depreciation of the townhouse is $65,000. She is using MACRS with a 27.5–year recovery period. On April 1, Eileen bought a new dishwasher for the rental property at a cost of $425. She uses the MACRS method with a 7–year recovery period.

Eileen uses the percentage for Jan. in *Table 10–3–D* to figure her depreciation deduction for the townhouse. She uses the percentage under "Half-year convention" in *Table 10–3–B* to figure her depreciation deduction for the dishwasher. She must report the depreciation on Form 4562.

Eileen figures her net rental income or loss for the townhouse as follows:

Total rental income received ($1,100 × 12)		$13,200
Minus Expenses:		
Fire insurance (1-year policy)	$200	
Mortgage interest	5,000	
Rent collection fee	572	
General repairs	175	
Real estate taxes	800	
Total expenses		6,747
Balance		$6,453
Minus Depreciation:		
On townhouse ($65,000 × 3.485%)	$2,265	
On dishwasher ($425 × 14.29%)	61	
Total depreciation		2,326
Net rental income for townhouse		$4,127

11.

Retirement Plans, Pensions, and Annuities

Important Changes for 1997

Minimum required distribution rule modified. Beginning in 1997, the definition of the required beginning date used to figure the minimum required distribution from qualified retirement plans takes into account whether a plan participant has retired. The required beginning date of a participant who is still employed after age $70\frac{1}{2}$ is April 1 of the calendar year that follows the calendar year in which he or she retires. This does not apply to IRAs. For more information, see *Tax for Failure to Make Minimum Distribution,* near the end of the publication.

Repeal of 15% additional tax on excess distributions and excess retirement accumulation. If you receive retirement distributions from a qualified retirement plan after December 31, 1996, you are no longer subject to the additional 15% excise tax on excess distributions. New law also repeals the additional 15% tax on excess retirement accumulations for taxpayers who died after December 31, 1996.

Important Changes for 1998

New recovery table for joint and survivor annuity payments from qualified plans. For annuity starting dates beginning after December 31, 1997, a new method will be used to figure the tax-free portion of an annuity that is payable over the lives of more than one individual. New law requires that the recovery factors (the number of anticipated monthly payments used to recover the tax-free investment in the contract or basis) be determined by ***combining the ages*** of the annuitants. The new rule only applies if the benefits are based on the life of more than one annuitant. For more information, see Publication 575, *Pension and Annuity Income.*

More information on tax law changes. New law also modified several other pension provisions. Get Publication 553, *Highlights of 1997 Tax Changes,* for additional changes that may affect your 1997 and 1998 income tax returns.

Introduction

This chapter discusses the tax treatment of amounts you receive from:

1) Employee pensions and annuities from a qualified plan,
2) Disability retirement, and
3) Purchased annuities.

What is not covered in this chapter. The following topics are not discussed in this chapter:

1) **The General Rule.** This is the method generally used to determine the tax treatment of pension and annuity income from nonqualified plans. If your annuity starting date is after November 18, 1996, and you must use this method, get Publication 939.
2) **Civil Service retirement benefits.** If you are retired from the Federal Government (either regular or disability retirement), get Publication 721, *Tax Guide to U.S. Civil Service Retirement Benefits.* Also, you should get Publication 721 if you are the survivor or beneficiary of a federal employee or retiree who died.
3) **Individual Retirement Arrangements (IRAs).** Information on amounts you receive from an individual retirement arrangement (IRA), as well as general information on IRAs, is in chapter 18.

Useful Items

You may want to see:

Publications

- ☐ **575** Pension and Annuity Income
- ☐ **721** Tax Guide to U.S. Civil Service Retirement Benefits
- ☐ **939** General Rule for Pensions and Annuities

Forms and Instructions

- ☐ **W–4P** Withholding Certificate for Pension or Annuity Payments
- ☐ **1099–R** Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.
- ☐ **4972** Tax on Lump-Sum Distributions
- ☐ **5329** Additional Taxes Attributable to Qualified Retirement Plans (Including IRAs), Annuities, Modified Endowment Contracts, and MSAs

Employee Pensions and Annuities

Generally, if you did not pay any part of the cost of your employee pension or annuity and your employer did not withhold part of the cost of the contract from your pay while you worked, the amounts you receive each year are fully taxable. You must report them on your income tax return.

Partly taxable payments. If you paid part of the cost of your annuity, you are not taxed on the part of the annuity you receive that represents a return of your cost. The rest of the amount you receive is taxable. Your annuity starting date (defined later) determines the method you use to figure the tax-free and the taxable parts of your annuity payments. If you contributed to your pension or annuity and your annuity starting date is:

1) **After November 18, 1996,** and your payments are from a qualified plan, you ***must*** use the Simplified Method. You generally must use the General Rule only for nonqualified plans.
2) **After July 1, 1986, but before November 19, 1996,** you ***can*** use either the General Rule or, if you qualify, the Simplified Method, to figure the taxability of your payments from qualified and nonqualified plans. See *Simplified Method, later.*
3) **Before July 2, 1986,** and you recovered your cost under the Three-Year Rule, you cannot use the General Rule or the Simplified Method because your payments are fully taxable.

Changing the method under prior law. If your annuity starting date is after July 1, 1986 (but before November 19, 1996), you can change the way you figure your pension cost recovery exclusion. You can change from the General Rule to the Simplified Method, or the other way around.

How to change it. Make the change by filing amended returns for all your tax years beginning with the year in which your annuity starting date occurred. You must use the same method for all years. Generally, you can make the change only within 3 years from the due date of your return for the year in which you received your first annuity payment. You can make the change later if the date of the change is within 2 years after you paid the tax for that year.

If your annuity starting date was before July 2, 1986, you cannot choose the Simplified Method at any time.

CAUTION *If your annuity starting date is after November 18, 1996, you cannot change the method. You generally must use the Simplified Method for annuity payments from a qualified plan.*

More than one program. If you receive benefits from more than one program, such as a pension plan and a profit-sharing plan, you must figure the taxable part of each separately. Make separate computations even if the benefits from both are included in the same check. For example, benefits from one of your programs could be fully taxable, while the benefits from your other program could be taxable under the General Rule or the Simplified Method. Your former employer or the plan administrator should be able to tell you if you have more than one program.

Railroad retirement benefits. Part of the railroad retirement benefits you receive is treated like social security benefits, and part is treated like an employee pension. For information about railroad retirement benefits treated as an employee pension, see *Railroad Retirement* in Publication 575.

Credit for the elderly or the disabled. If you receive a pension or annuity, you may be able to take the credit for the elderly or the disabled. See chapter 34.

Withholding and estimated tax. The payer of your pension, profit-sharing, stock bonus, annuity, or deferred compensation plan will withhold income tax on the taxable parts of amounts paid to you. You can choose not to have tax withheld except for amounts paid to you that are eligible rollover distributions. See *Eligible rollover distributions* under *Rollovers,* later. You make this choice by filing Form W–4P.

For payments other than eligible rollover distributions, you can tell the payer how to withhold by filing Form W–4P. If an eligible rollover distribution is paid directly to you, 20% will generally be withheld. There is no withholding on a direct rollover of an eligible rollover distribution. See *Direct rollover option* under *Rollovers,* later. If you choose not to have tax withheld or you do not have enough tax withheld, you may have to pay estimated tax.

For more information, see *Pensions and Annuities* under *Withholding* in chapter 5.

Loans. If you borrow money from an employer's qualified pension or annuity plan, a tax-sheltered annuity program, a government plan, or from a contract purchased under any of these plans, you may have to treat the loan as a distribution. This means that you may have to include in income all or part of the amount borrowed. Even if you do not have to treat the loan as a distribution, you might not be able to deduct the interest on the loan in some situations. For details, see *Loans Treated as Distributions* in Publication 575. For information on the deductibility of interest, see chapter 25.

Elective deferrals. Some retirement plans allow you to choose (elect) to have part of your pay contributed by your employer to a retirement fund, rather than have it paid to you. You do not pay tax on this money until you receive it in a distribution from the fund.

Elective deferrals generally include elective contributions to cash or deferred arrangements (known as ***section 401(k) plans***), section 501(c)(18) plans, salary reduction simplified employee pension (SARSEP) plans, and tax-sheltered annuities provided for employees of tax-exempt organizations and public schools.

For information on the tax treatment of elective deferrals, including their limits, see *Limits on Exclusion for Elective Deferrals* in Publication 575. For information about tax-sheltered annuities, see Publication 571, *Tax-Sheltered Annuity Programs for Employees of Public Schools and Certain Tax-Exempt Organizations.*

H.R. 10 (Keogh) plans. Keogh plans are retirement plans that can only be set up by a sole proprietor or a partnership (but not a partner). They can cover self-employed persons, such as the sole proprietor or partners, as well as regular (common-law) employees.

Distributions from these plans are usually fully taxable. If you have an investment (cost) in the plan, however, your pension or annuity payments from a qualified plan are taxed under the Simplified Method.

Deferred compensation plans of state and local governments and tax-exempt organizations. If you participate in one of these nonqualified plans (known as ***section 457 plans***), you will not be taxed currently on your pay that is deferred under the plan. You or your beneficiary will be taxed on this deferred pay only when it is distributed or otherwise made available to either of you.

Distributions of deferred pay are not eligible for the 5– or 10–year tax option, rollover treatment, or the death benefit exclusion, all discussed later. Distributions are, however, subject to the tax for failure to make minimum distributions, discussed later.

For general information on these deferred compensation plans and their limits, see *Section 457 Deferred Compensation Plans* in Publication 575.

Cost

Before you can figure how much, if any, of your pension or annuity benefits is taxable, you must determine your cost in the plan (your investment). Your total cost in the plan includes everything that you paid. It also includes amounts your employer paid that were taxable at the time paid. Cost does not include any amounts you deducted or excluded from income.

From this total cost paid or considered paid by you, subtract any refunds of premiums, rebates, dividends, unrepaid loans, or other tax-free amounts you received by the later of the annuity starting date or the date on which you received your first payment.

The ***annuity starting date*** is the later of the first day of the first period for which you receive a payment from the plan or the date on which the plan's obligation becomes fixed.

Your employer or the organization that pays you the benefits (plan administrator) should show your cost in Box 5 of your Form 1099–R.

Foreign employment. If you worked in a foreign country and your employer contributed to your retirement plan, a part of those payments may be considered part of your cost. The contributions that apply were made either:

1) Before 1963, or
2) After December 1996 if you perform the services of a foreign missionary.

For details, see *Foreign employment* under *Investment in the Contract (Cost)* in Publication 575.

Simplified Method

The following discussion outlines the rules that apply for using the Simplified Method.

What is the Simplified Method. The Simplified Method is one of the two methods used to figure the tax-free part of each annuity payment using the annuitant's age at his or her annuity starting date. The other method is the General Rule (discussed later).

Who must use the Simplified Method. You must use the Simplified Method if your annuity starting date is after November 18, 1996, **and** you receive pension or annuity payments from a qualified plan or annuity **unless** you were at least 75 years old and entitled to annuity payments from a qualified plan that are guaranteed for 5 years or more.

Who must use the General Rule. You must use the General Rule if you receive pension or annuity payments from:

1) A nonqualified plan (such as a private annuity, a purchased commercial annuity, or a nonqualified employee plan), or
2) A qualified plan if you are 75 or over and your annuity payments from the qualified plan are guaranteed for at least 5 years (regardless of your annuity starting date).

You can use the General Rule for a qualified plan if your annuity starting date is *before* November 19, 1996 (but after July 1, 1986), and you do not qualify to use, or choose not to use, the Simplified Method.

You cannot use the General Rule for a qualified plan if your annuity starting date is after November 18, 1996. Complete information on the General Rule, including the tables you need, is contained in Publication 939.

TIP **If you are 75 or over,** *and your annuity starting date is after November 18, 1996, you must use the General Rule if the payments are guaranteed for at least 5 years. You must use the Simplified Method if the payments are guaranteed for fewer than 5 years.*

Note. If you are not sure whether your retirement plan is a qualified plan (that meets certain Internal Revenue Code requirements), ask your employer or plan administrator.

Guaranteed payments. Your annuity contract provides guaranteed payments if a minimum number of payments or a minimum amount (for example, the amount of your investment) is payable even if you and any survivor annuitant do not live to receive the minimum. If the minimum amount is less than the total amount of the payments you are to receive, barring death, during the first 5 years after payments begin (figured by ignoring any payment increases), you are entitled to fewer than 5 years of guaranteed payments.

If you are the survivor of a deceased retiree, you can use the Simplified Method if the retiree used it.

Amount of exclusion. Your annuity starting date determines the total amount that you can exclude from your taxable income over the years.

If your annuity starting date is after 1986, your exclusion is limited to your cost. If it was after July 1, 1986 (and before January 1, 1987), you can continue to take your monthly exclusion for as long as you receive your annuity.

In both cases, any unrecovered cost at your (or the last annuitant's) death is allowed as a miscellaneous itemized deduction on the final return of the decedent. This deduction is not subject to the 2%-of-adjusted-gross-income limit.

How to use it. Use the following worksheet to figure your taxable annuity for 1997. In completing this worksheet, use your age at the birthday preceding your annuity starting date. Be sure to keep a copy of the completed worksheet; it will help you figure your taxable pension in later years.

Example. Bill Kirkland, age 65, began receiving retirement benefits in January 1997 under a joint and survivor annuity. The benefits are to be paid for the joint lives of Bill and his wife, Kathy. He had contributed $24,700 to a qualified plan and had received no distributions before the annuity starting date. Bill is to receive a retirement benefit of $1,000 a month, and Kathy is to receive a monthly survivor benefit of $500 upon Bill's death.

Bill must use the Simplified Method because his annuity starting date is after November 18, 1996, and the payments are from a qualified plan. He completes the worksheet as follows:

Simplified Method Worksheet

1.	Total pension or annuity payments received this year. Also, add this amount to the total for Form 1040, line 16a, or Form 1040A, line 11a	$12,000
2.	Your cost in the plan (contract) at annuity starting date, as adjusted (if it applies)	24,700
3.	Age at annuity starting date: — Enter: 55 and under 360; 56–60 310; 61–65 260; 66–70 210; 71 and over 160	260
4.	Divide line 2 by line 3	95
	Caution: If your annuity starting date is **before November 19, 1996,** (and you received payments in prior years), skip lines 3 and 4. You do not need to recompute the tax-free monthly amount. Enter your monthly exclusion computed in prior years on line 4.	
5.	Multiply line 4 by the number of months for which this year's payments were made	1,140
6.	Any amounts previously recovered tax free in years after 1986 .	–0–
7.	Subtract line 6 from line 2	24,700
8.	Enter the lesser of line 5 or line 7	1,140
9.	**Taxable pension for year.** Subtract line 8 from line 1. Enter the result, but not less than zero. Also add this amount to the total for Form 1040, line 16b, or Form 1040A, line 11b	$10,860
	NOTE: If your Form 1099–R shows a larger taxable amount, use the amount on line 9 instead.	
10.	Add lines 6 and 8	1,140
11.	Balance of cost to be recovered. Subtract line 10 from line 2	$23,560

Bill's tax-free monthly amount is $95 ($24,700 ÷ 260 as shown on line 4 of the worksheet). If he lives to collect more than 260 payments, he will have to include the full amount of the additional payments in his gross income.

If Bill dies before collecting 260 monthly payments and Kathy begins receiving payments, she will also exclude $95 from each payment until her payments, when added to Bill's, total 260 payments. If she dies before 260 payments are made, a miscellaneous itemized deduction will be allowed for the unrecovered cost on her final income tax return. This deduction is not subject to the 2%-of-adjusted-gross-income limit.

TIP *Had Bill's retirement annuity payments been from a nonqualified plan, he would have used the General Rule. He can only use the Simplified Method Worksheet for plans that are qualified.*

Survivors

If you receive a survivor annuity because of the death of a retiree who had reported the annuity under the **Three-Year Rule,** include the total received in income. (The retiree's cost has already been recovered tax free.)

If the retiree was reporting the annuity payments under the **General Rule,** apply the same exclusion percentage the retiree used to your initial payment called for in the contract. The resulting tax-free amount will then remain fixed. Any increases in the survivor annuity are fully taxable.

If the retiree had used the **Simplified Method,** the monthly tax-free amount remains fixed. Continue to use the same monthly tax-free amount for your survivor payments. See *Simplified Method,* earlier.

In both cases, if the annuity starting date is after 1986, the total exclusion over the years cannot be more than the cost.

If you are the survivor of an employee, or former employee, who died before becoming entitled to any annuity payments, you must figure the taxable and tax-free parts of your annuity payments. You may qualify for the $5,000 death benefit exclusion.

Death benefit exclusion. If you are the beneficiary of a deceased employee (or former employee), who died:

- After August 20, 1996, you are **not eligible** for the $5,000 death benefit exclusion.
- Before August 21, 1996, you may qualify for a death benefit exclusion of up to $5,000. If you are eligible for the exclusion, add it to the cost of the annuity when you figure your cost at the annuity starting date.

Special rules apply if you are the survivor under a joint and survivor annuity. For more information, see Publication 575.

Estate tax. If your annuity was a joint and survivor annuity that was included in the decedent's estate, an estate tax may have been paid on it. You can deduct, as a miscellaneous itemized deduction, the part of the total estate tax that was based on the annuity. This deduction is not subject to the 2%-of-adjusted-gross-income limit. The deceased annuitant must have died after the annuity starting date. This amount cannot be deducted in one year. It must be deducted in equal amounts over your remaining life expectancy.

How To Report

If you file Form 1040, report your total annuity on line 16a and the taxable part on line 16b. If your pension or annuity is fully taxable, enter it on line 16b; do not make an entry on line 16a.

If you file Form 1040A, report your total annuity on line 11a and the taxable part on line 11b. If your pension or annuity is fully taxable, enter it on line 11b; do not make an entry on line 11a.

More than one annuity. If you receive more than one annuity and at least one of them is not fully taxable, enter the total amount received from ***all*** annuities on line 16a, Form 1040, or line 11a, Form 1040A, and enter the taxable part on line 16b, Form 1040, or line 11b, Form 1040A. If all the annuities you receive are fully taxable, enter the total of all of them on line 16b, Form 1040, or line 11b, Form 1040A.

Joint return. If you file a joint return and you and your spouse each receive one or more pensions or annuities, report the total of the pensions and annuities on line 16a, Form 1040, or line 11a, Form 1040A, and report the taxable part on line 16b, Form 1040, or line 11b, Form 1040A.

Lump-Sum Distributions

You may be able to elect optional methods of figuring the tax on lump-sum distributions you receive from a qualified retirement plan (an employer's qualified pension, stock bonus, or profit-sharing plan). A qualified plan is a plan that meets certain requirements of the Internal Revenue Code. For information on a distribution you receive that includes employer securities, see *Distributions of employer securities* under *Lump-Sum Distributions* in Publication 575.

Distributions that qualify. A lump-sum distribution is paid within a single tax year. It is the distribution or payment of a plan participant's ***entire balance*** from all of the employer's qualified plans (i.e., pension, profit-sharing, or stock bonus plans). The participant's entire balance does not include deductible voluntary employee contributions or certain forfeited amounts.

The distribution is paid:

1) Because of the plan participant's death,
2) After the participant reaches age 59½,
3) Because the participant, if an employee, separates from service, or
4) After the participant, if a self-employed individual, becomes totally and permanently disabled.

Tax treatment. You can recover your ***cost*** in the lump sum tax free. Also, you may be entitled to special tax treatment for the remaining part of the distribution.

In general, your ***cost*** consists of:

1) The plan participant's total nondeductible contributions to the plan,
2) The total of the plan participant's taxable costs of any life insurance contract distributed,
3) Any employer contributions that were taxable to the plan participant, and
4) Repayments of loans that were taxable to the plan participant.

You must reduce this cost by amounts previously distributed tax free.

Capital gain treatment. Only a plan participant who was born before 1936 can elect to treat a portion of the taxable part of a lump-sum distribution as a capital gain that is taxable at a 20% (.20) rate. This treatment applies to the portion you receive for the participation in the plan before 1974. You can elect this treatment only once for any plan participant. Use Form 4972, *Tax on Lump-Sum Distributions,* to make this choice.

5- or 10-year tax option. If the plan participant was born before 1936, you can elect to use the 5– or 10–year option to compute the tax on the ordinary income portion of the distribution. (This also includes the capital gain portion of the distribution if you do not elect the capital gain treatment for it.) To qualify, you must elect to use the 5- or 10-year tax option for all lump-sum distributions received in the tax year.

TIP *You may be able to figure the tax on a lump-sum distribution under the 5-year tax option even if the plan participant was born after 1935. You can do this only if the distribution is made on or after the date the participant reached age 59½ and the distribution otherwise qualifies.*

To qualify for the 5- or 10-year option for a distribution you receive for your own participation in the retirement plan, you must have been a participant in the plan for at least 5 full tax years. You can only make one lifetime election to use this option for any plan participant.

If you choose the 5-year tax option, you figure your tax, using Form 4972, as though the distribution were received over 5 years.

However, if you choose the 10-year tax option, you can instead treat the distribution as though it were received over 10 years using special tax rates. Form 4972 shows how to make this computation. The Form 4972 Instructions contain a special tax rate schedule that you must use in making the 10–year tax option computation. Publication 575 illustrates how to complete Form 4972 to figure the separate tax.

Form 1099–R. If you receive a total distribution from a plan, you should receive a Form 1099–R. If the distribution qualifies as a lump-sum distribution, box 3 shows the capital gain, and box 2a minus box 3 is the ordinary income. If you do not get a Form 1099–R, or if you have questions about it, contact your plan administrator.

Rollovers

Generally, a rollover is a tax-free distribution to you of cash or other assets from a qualified retirement plan that you transfer to an ***eligible retirement plan.*** However, see *Direct rollover option,* later.

An eligible retirement plan is an IRA, a qualified employee retirement plan, or a qualified annuity plan. See chapter 18 for information on rollovers from an IRA.

In general, the most you can roll over is the part that would be taxable if you did not roll it over. You cannot roll over your contributions, other than your deductible employee contributions. You do not pay tax on the amount that you roll over. This amount, however, is generally taxable later when it is paid to you or your survivor.

You must complete the rollover by the 60th day following the day on which you receive the distribution. (This 60–day period is extended for the period during which the distribution is in a frozen deposit in a financial institution.) For all rollovers to an IRA, you must irrevocably elect rollover treatment by written notice to the trustee or issuer of the IRA.

Eligible rollover distributions. Generally, you can roll over any part of the taxable portion of most nonperiodic distributions from a qualified retirement plan, unless it is a required minimum distribution.

Direct rollover option. You can choose to have the administrator of your old plan transfer the distribution directly from your old plan to the new plan (if permitted) or IRA. If you decide on a rollover, it is generally to your advantage to choose this direct rollover option. Under this option, the plan administrator would not withhold tax from your distribution.

Withholding tax. If you choose to have the distribution paid to you, it is taxable in the year distributed unless you roll it over to a new plan or IRA within 60 days. The plan administrator must withhold income tax of 20% from the taxable distribution paid to you. (See *Pensions and Annuities* under *Withholding* in chapter 5.) This means that, if you decide to roll over an amount equal to the distribution before withholding, your contribution to the new plan or IRA must include other money (for example, from savings or amounts borrowed) to replace the amount withheld. The administrator should give you a written explanation of your distribution options within a reasonable period of time before making an eligible rollover distribution.

Deductible voluntary employee contributions. If you receive an eligible rollover distribution from your employer's qualified plan of part of the balance of your accumulated deductible voluntary employee contributions, you can roll over tax free any part of this distribution. The rollover can be either to an IRA or to certain other qualified plans.

Rollover by surviving spouse or other beneficiary. You may be entitled to roll over into an IRA part or all of a retirement plan distribution you receive as the surviving spouse of a deceased employee. The rollover rules apply to you as if you were the employee. However, you cannot roll it over to another qualified retirement plan.

A beneficiary other than the employee's surviving spouse cannot roll over a distribution.

Alternate payee under qualified domestic relations order. You may be able to roll over all or any part of a distribution from a qualified employer plan that you receive under a qualified domestic relations order (QDRO). If you receive the distribution as an employee's spouse or former spouse under a QDRO, the rollover rules apply to you (the alternate payee) as if you were the employee. You can rollover the distribution from the plan into an IRA or to another eligible retirement plan. See Publication 575 for more information on benefits received under a QDRO.

Bond purchase plans. The Department of the Treasury stopped issuing U.S. Retirement Plan Bonds after April 30, 1982. They are a special series of interest-bearing bonds that retirement plans could buy.

If you redeem a retirement bond, you can defer the tax on the amount received by rolling it over to an IRA as discussed under *Rollovers* in chapter 18.

For more information on the rules for rolling over distributions, see Publication 575.

Tax on Early Distributions

Distributions you receive from your ***qualified retirement plan or deferred annuity contract*** before you reach age 59½ (and amounts you receive when you cash in retirement bonds before you reach age 59½) are usually subject to an additional tax of 10%. The tax applies to the taxable part of the distribution.

For this purpose, a ***qualified retirement plan*** includes:

1) A qualified employee retirement plan,
2) A qualified annuity plan,
3) A tax-sheltered annuity plan for employees of public schools or tax-exempt organizations, or
4) An IRA, including a SIMPLE IRA.

25% rate on certain early distributions from SIMPLE retirement accounts. Distributions from a SIMPLE retirement account are subject to IRA rules and are includible in income when withdrawn. An early withdrawal is generally subject to a 10% penalty. However, if the distribution is made in 1997 (within the first two years of participation in the SIMPLE plan), the additional tax is 25%. Your Form 1099–R should show distribution code "S" in box 7 if the 25% rate applies.

Exceptions to tax. The early distribution tax does not apply to distributions that are:

1) Made to a beneficiary or to the estate of the plan participant or annuity holder on or after his or her death,
2) Made because you are totally and permanently disabled,
3) Made as part of a series of substantially equal periodic (at least annual) payments over your life expectancy or the joint life expectancy of you and your beneficiary (if from a qualified employee plan, payments must begin after separation from service),
4) Made to you after you separated from service if the separation occurred during or after the calendar year in which you reached age 55,
5) Not more than your deductible medical expense (the medical expense that exceeds 7.5% of your adjusted gross income) whether or not you itemize deductions for the tax year,
6) Paid to alternate payees under qualified domestic relations orders,
7) Made to you if, as of March 1, 1986, you separated from service and began receiving benefits from the qualified plan under a written election that provides a specific schedule of benefit payments,
8) Made to you to correct excess deferrals, excess contributions, or excess aggregate contributions,

9) Allocable to investment in a deferred annuity contract before August 14, 1982,

10) From an annuity contract under a qualified personal injury settlement,

11) Made under an immediate annuity contract, or

12) Made from a deferred annuity contract purchased by your employer upon the termination of a qualified employee retirement plan or qualified annuity that is held by your employer until you separate from the service of the employer.

Only exceptions (1) through (3) apply to distributions from IRAs. Exceptions (4) through (8) apply only to distributions from qualified employee plans. Exceptions (9) through (12) apply only to distributions from deferred annuity contracts not purchased by qualified employer plans.

Reporting tax or exception. If distribution code 1 is shown in box 7 of Form 1099–R, multiply the taxable part of the early distribution by 10% and enter the result on line 50 of Form 1040 and write "No" on the dotted line. You do not have to file Form 5329.

However, if you owe this tax and also owe any other additional tax on a distribution, you must file Form 5329 to report the taxes.

You do not have to file Form 5329 if you qualify for an exception to the 10% tax and distribution code 2, 3, or 4 is shown in box 7 of Form 1099–R. However, you must file Form 5329 if the code is not shown or the code shown is incorrect (e.g., code 1 is shown although you meet an exception).

Tax for Failure to Make Minimum Distribution

To make sure that most of your retirement benefits are paid to you during your lifetime, rather than to your beneficiaries after your death, the payments that you receive from qualified plans and IRAs must begin on your *required beginning date* (defined later). Beginning in 1997, if you are still working after you reach age 70½, the rule on minimum required distributions takes into account whether you have retired unless you are a 5% owner or the distribution is from an IRA.

Beginning in 1997, you must begin to receive distributions from your qualified retirement plan by April 1 of the year that follows the **later of** the:

1) Calendar year in which you reach age 70½, or

2) Calendar year in which you retire.

Before 1997, you were required to begin receiving distributions from your retirement plan by April 1 of the year following the calendar year in which you reached age 70½, regardless of whether or not you had retired. This rule still applies if you are a 5% owner or the distribution is from an IRA.

The new rule applies to qualified employee retirement plans, qualified annuity plans, deferred compensation plans under section 457, and tax-sheltered annuity programs (for benefits accruing after 1986).

Example. You reach age 70½ on the date that is 6 calendar months after the date of your 70th birthday. For example, if you are retired and your 70th birthday was on July 1, 1996, you were age 70½ on January 1, 1997. Your required beginning date is April 1, 1998. If your 70th birthday was on June 30, 1996, you were age 70½ on December 30, 1996, and your required beginning date is April 1, 1997. This applies only if you are not employed after age 70½.

Exception (5% owners). If you are a 5% (or more) owner of the company maintaining the plan, you must still begin to receive distributions by April 1 of the calendar year after the year in which you reach age 70½, regardless of when you retire.

Minimum distributions. These are regular periodic distributions that are large enough to use up the entire interest over your life expectancy or over the joint life expectancies of you and a designated surviving beneficiary (or over a shorter period).

Additional information. For more information on this rule and how to figure the required amount to be distributed, see *Tax on Excess Accumulation* in Publication 575.

Tax on failure to distribute. If you do not receive these required minimum distributions, you, as the payee, are subject to an additional excise tax. The tax equals 50% of the difference between the amount that must be distributed and the amount that was distributed during the tax year. You can get this excise tax excused if you establish that the shortfall in distributions was due to reasonable error and that you are taking reasonable steps to remedy the shortfall.

State insurer delinquency proceedings. You might not receive the minimum distribution because of state insurer delinquency proceedings for an insurance company. If your payments are reduced below the minimum due to these proceedings, you should contact your plan administrator. Under certain conditions, you will not have to pay the excise tax.

Form 5329. You must file a Form 5329 if you owe a tax because you did not receive a minimum required distribution from your qualified retirement plan.

Disability Income

Generally, if you retire on disability, you must report your pension or annuity as income.

If you were 65 or older at the end of the tax year, or if you were under 65, retired on permanent and total disability, and you received taxable disability income, you may be able to claim the credit for the elderly or the disabled. See chapter 34 for more information about the credit.

How to report. You must report all your taxable disability income on line 7, Form 1040, or line 7, Form 1040A, until you reach minimum retirement age.

If you made contributions to your pension or annuity plan, your payments are taxable under the rules discussed earlier, beginning with the day after you reach the ***minimum retirement age.***

Generally, minimum retirement age is the age at which you would have first received a pension or annuity were you not disabled.

For more information on how to report disability pensions, including military and certain government disability pensions, see chapter 6.

Purchased Annuities

If you privately purchased an annuity contract from a commercial organization, such as an insurance company, you must use the General Rule to figure the tax-free part of each annuity payment. For more information, get Publication 939.

Sale of annuity. Gain on the sale of an annuity contract before its maturity date is ordinary income to the extent that the gain is due to interest accumulated on the contract. You do not recognize gain or loss on an exchange of an annuity contract solely for another annuity contract.

See *Transfers of Annuity Contracts* in Publication 575 for more information about exchanges of annuity contracts.

12. Social Security and Equivalent Railroad Retirement Benefits

Introduction

This chapter discusses the taxability of any social security or equivalent tier 1 railroad retirement benefits you may have received. It also explains:

- How to figure whether your benefits are taxable,
- How to use the social security benefits worksheet,
- How to report your taxable benefits on Form 1040 and Form 1040A (with examples), and
- How to treat repayments that are more than the benefits you received during the year.

When the term “benefits” is used in this chapter, it applies to both social security benefits and equivalent tier 1 railroad retirement benefits. Social security benefits include monthly survivor and disability benefits. They do not include supplemental security income (SSI) payments, which are not taxable. Equivalent tier 1 railroad retirement benefits are the part of tier 1 benefits treated as a social security benefit.

If you received these benefits during 1997, you should have received a Form SSA–1099 or Form RRB–1099 (Form SSA–1042S or Form RRB–1042S if you are a nonresident alien) showing the amount.

What is not covered in this chapter. This chapter does not cover the tax rules for the following railroad retirement benefits:

- Non-social security equivalent benefit (NSSEB) portion of tier 1 benefits,
- Tier 2 benefits,
- Vested dual benefits, and
- Supplemental annuity benefits.

For information on these benefits see Publication 575, *Pension and Annuity Income.*

This chapter also does not cover the tax rules for foreign social security or railroad retirement benefits. These are taxable as annuities, unless they are exempt from U.S. tax under a treaty.

Useful Items

You may want to see:

Publication

- ☐ **575** Pension and Annuity Income
- ☐ **590** Individual Retirement Arrangements (IRAs) (Including SEP-IRAs and SIMPLE IRAs)
- ☐ **915** Social Security and Equivalent Railroad Retirement Benefits

Are Any of Your Benefits Taxable?

To find out whether any of your benefits are taxable, compare the ***base amount*** for your filing status with the total of:

1) One-half of your benefits, plus
2) All your other income, including tax-exempt interest.

Do not reduce your income by any exclusions for:

- Interest from Series EE U.S. savings bonds,
- Foreign earned income or foreign housing, or
- Income earned in American Samoa or Puerto Rico by bona fide residents.

Use the worksheet later in this discussion to figure this total income. If the total income is more than your base amount, part of your benefits is taxable.

TIP *If the only income you received during 1997 was your social security or equivalent tier 1 railroad retirement benefits, your benefits generally are not taxable and you probably do not have to file a return. If you have income in addition to your benefits, you may have to file a return even if none of your benefits are taxable.*

If you are married and file a joint return for 1997, you and your spouse must combine your incomes and your benefits to figure whether any of your combined benefits are taxable. Even if your spouse did not receive any benefits, you must add your spouse's income to yours to figure whether any of your benefits are taxable.

Base amount. Your base amount is:

- $25,000 if you are single, head of household, or qualifying widow(er),
- $25,000 if you are married filing separately and ***lived apart*** from your spouse for ***all*** of 1997,
- $32,000 if you are married filing jointly, or
- $–0– if you are married filing separately and ***lived with*** your spouse at any time during 1997.

Worksheet. You can use the following worksheet to figure the amount of income to compare with your base amount.

A. Write in the amount from ***box 5*** of all your Forms SSA–1099 and RRB–1099. Include the full amount of any lump-sum benefit payments received in 1997, for 1997 and earlier years, if you choose to report the full amount for the 1997 tax year. (If you received more than one form, combine the amounts from box 5 and write in the total.) A. ______

Note: *If the amount on line A is zero or less, stop here; none of your benefits are taxable this year.*

B. Enter one-half of the amount on line A .... B. ______

C. Add your taxable pensions, wages, interest, dividends, and other taxable income and write in the total ... C. ______

D. Write in any tax-exempt interest income (such as interest on municipal bonds) plus exclusions from income (such as the Series EE U.S. Savings Bond interest exclusion) .... D. ______

E. Add lines B, C, and D and write in the total .... E. ______

Note. *Compare the amount on line E to your* ***base amount*** *for your filing status. If the amount on line E equals or is less than the base amount for your filing status, none of your benefits are taxable this year. If the amount on line E is more than your* ***base amount,*** *some of your benefits are taxable.*

Example. You and your spouse are filing a joint return for 1997, and you both received social security benefits during the year. In January 1998, you received a Form SSA-1099 showing net benefits of $6,600 in box 5. Your spouse received a Form SSA–1099 showing net benefits of $2,400 in box 5. You also received a taxable pension of $10,000 and interest income of $500. You did not have any tax-exempt interest income. Your benefits are not taxable for 1997 because your income, as figured in the following worksheet, is not more than your base amount ($32,000).

A. Write in the amount from ***box 5*** of all your Forms SSA–1099 and RRB–1099. Include the full amount of any lump-sum benefit payments received in 1997, for 1997 and earlier years, if you choose to report the full amount for the 1997 tax year. (If you received more than one form, combine the amounts from box 5 and write in the total.) A. $ 9,000

Note: *If the amount on line A is zero or less, stop here; none of your benefits are taxable this year.*

B. Enter one-half of the amount on line A .... B. 4,500

C. Add your taxable pensions, wages, interest, dividends, and other taxable income and write in the total ... C. 10,500

D. Write in any tax-exempt interest income (such as interest on municipal bonds) plus any exclusions from income (such as the Series EE U.S. Savings Bond interest exclusion) .... D. –0–

E. Add lines B, C, and D and write in the total .... E. $15,000

Note. *Compare the amount on line E to your* ***base amount*** *for your filing status. If the amount on line E equals or is less than the base amount for your filing status, none of your benefits are taxable this year. If the amount on line E is more than your* ***base amount,*** *some of your benefits are taxable.*

Who is taxed. The person who has the legal right to receive the benefits must determine whether the benefits are taxable. For example, if you and your child receive benefits, but the check for your child is made out in your name, you must use only your part of the benefits to see whether any benefits are taxable to you. The part that belongs to your child must be added to your child's other income to see whether any of those benefits are taxable to the child.

Repayment of benefits. Any repayment of benefits you made during 1997 must be subtracted from the gross benefits you received in 1997. It does not matter whether the repayment was for a benefit you received in 1997 or in an earlier year. If you repaid more than the gross benefits you received in 1997, see *Repayments More Than Gross Benefits,* later. Your gross benefits are shown in box 3 of Form SSA–1099 or RRB–1099. Your repayments are shown in box 4. The amount in box 5 shows your net benefits for 1997 (box 3 minus box 4). Use the amount in box 5 to figure whether any of your benefits are taxable.

How To Report Your Benefits

If part of your benefits is taxable, you must use Form 1040 or Form 1040A. You cannot use Form 1040EZ.

Reporting on Form 1040. Report your net benefits (the amount in box 5 of your Form SSA-1099 or Form RRB-1099) on line 20a and the taxable part on line 20b. If you are married filing separately and you lived apart from your spouse for all of 1997, also enter “D” to the left of line 20a.

Reporting on Form 1040A. Report your net benefits (the amount in box 5 of your Form SSA-1099 or Form RRB-1099) on line 13a and the taxable part on line 13b. If you are married filing separately and you lived apart from your spouse for all of 1997, also enter “D” to the left of line 13a.

Benefits not taxable. If none of your benefits are taxable, do not report any of them on your tax return. But if you are married filing separately and you lived apart from your spouse for all of 1997, make the following entries. On Form 1040, enter “D” to the left of line 20a and “–0–” on line 20b. On Form 1040A, enter “D” to the left of line 13a and “–0–” on line 13b.

How Much Is Taxable?

If part of your benefits is taxable, how much is taxable depends on the total amount of your benefits and other income. Generally, the higher that total amount, the greater the taxable part of your benefits.

Maximum taxable part. The taxable part of your benefits cannot usually be more than 50%. However, up to 85% of your benefits can be taxable, if one of the following situations applies to you.

1) The total of one-half of your benefits and all your other income is more than $34,000 ($44,000 if you are married filing jointly), or

2) You are married filing separately and ***lived with your spouse*** at any time during 1997.

Which worksheet to use. A worksheet to figure your taxable benefits is in the instructions for your tax form. You can use either that worksheet or Worksheet 1 in this chapter (or Publication 915), unless one of the following situations applies to you.

1) You contributed to an individual retirement arrangement (IRA) and your IRA deduction is limited because you or your spouse is covered by a retirement plan at work. In this situation, you ***must*** use the special worksheets in Appendix B of Publication 590 to figure both your IRA deduction and your taxable benefits.

2) Situation (1) does not apply and you take an exclusion for interest from Series EE U.S. savings bonds (Form 8815), for adoption benefits (Form 8839), for foreign earned income or housing (Form 2555 or Form 2555–EZ), or for income earned in American Samoa (Form 4563) or Puerto Rico by bona fide residents. In this situation, you ***must*** use Worksheet 1 in Publication 915 to figure your taxable benefits.

3) You receive a lump-sum payment for an earlier year. In this situation, also complete Worksheet 2 or 3 and Worksheet 4 in Publication 915. See *Lump-Sum Election.*

Lump-Sum Election. You must include the taxable part of a lump-sum (retroactive) payment of benefits received in 1997 in your 1997 income, even if the payment includes benefits for an earlier year.

TIP *This type of lump-sum benefit payment should not be confused with the lump-sum death benefit that both the SSA and RRB pay to many of their beneficiaries. No part of the lump-sum death benefit is subject to tax.*

Generally, you use your 1997 income to figure the taxable part of the total benefits received in 1997. However, you may be able to figure the taxable part of a lump-sum payment for an earlier year separately, using your income for the earlier year. You can elect this method if it lowers your taxable benefits.

Making the election. If you received a lump-sum benefit payment in 1997 that includes benefits for one or more earlier years, follow the instructions in Publication 915 under *Lump-Sum Election* to see whether making the election will lower your taxable benefits. That discussion also explains how to make the election.

Examples

Following are a few examples you can use as a guide to figure the taxable part of your benefits.

Example 1. George White is single and files Form 1040 for 1997. He received the following income in 1997:

Fully taxable pension	$18,600
Wages from part-time job	9,400
Interest income	990
Total	$28,990

George also received social security benefits during 1997. The Form SSA–1099 he received in January 1998 shows $5,980 in box 5. To figure his taxable benefits, George completes the worksheet shown here.

Worksheet 1. Social Security and Equivalent Railroad Retirement Benefits

1. Enter the total amount from **box 5** of **ALL** your **Forms SSA–1099 and RRB–1099**	5,980
Note. *If line 1 is zero or less, stop here; none of your benefits are taxable. Otherwise, go to line 2.*	
2. Enter one-half of line 1	2,990
3. Enter the total of the amounts from: Form 1040: Lines 7, 8a, 8b, 9–14, 15b, 16b, 17–19, and 21. Form 1040A: lines 7, 8a, 8b, 9, 10b, 11b, and 12	28,990
4. Form 1040A filers: Enter the total of any exclusions for Series EE U.S. savings bond interest (Form 8815, line 14) or for adoption benefits (Form 8839, line 22). Form 1040 filers: Enter the total of any exclusions/adjustments for: • Series EE U.S. savings bond interest (Form 8815, line 14), • Adoption benefits (Form 8839, line 22), • Foreign earned income or housing (Form 2555, lines 43 and 48, or Form 2555–EZ, line 18), • Certain income of bona fide residents of American Samoa (Form 4563, line 15) or Puerto Rico	–0–
5. Add lines 2, 3, and 4	31,980
6. Enter the amount from Form 1040, line 31 or from Form 1040A, line 15c	–0–
7. Subtract line 6 from line 5	31,980
8. Enter $25,000 ($32,000 if married filing jointly; $0 if married filing separately and you lived with your spouse at any time during 1997)	25,000
9. Subtract line 8 from line 7. If zero or less, enter –0–	6,980
Note. *If line 9 is zero or less, stop here; none of your benefits are taxable. (Do not enter any amounts on Form 1040, line 20a or 20b or on Form 1040A, line 13a or 13b. But if you are married filing separately and you* **lived apart** *from your spouse for all of 1997, enter “D” to the left of line 20a, Form 1040, or line 13a, Form 1040A. Also enter –0– on Form 1040, line 20b or on Form 1040A, line 13b.) Otherwise, go on to line 10.*	
10. Enter $9,000 ($12,000 if married filing jointly; $0 if married filing separately and you lived with your spouse at any time in 1997)	9,000
11. Subtract line 10 from line 9. If zero or less, enter –0–	–0–
12. Enter the **smaller** of line 9 or line 10	6,980
13. Enter one-half of line 12	3,490
14. Enter the **smaller** of line 2 or line 13	2,990
15. Multiply line 11 by 85% (.85). If line 11 is zero, enter –0–	–0–
16. Add lines 14 and 15	2,990
17. Multiply line 1 by 85% (.85)	5,083
18. Taxable benefits. Enter the smaller of line 16 or line 17	2,990

• Enter the amount from line 1 above on Form 1040, line 20a or on Form 1040A, line 13a. • Enter the amount from line 18 above on Form 1040, line 20b or on Form 1040A, line 13b	

The amount on line 18 of George's worksheet shows that $2,990 of his social security benefits is taxable. On line 20a of his Form 1040, George enters his net benefits of $5,980. On line 20b, he enters his taxable part of $2,990.

Example 2. Ray and Alice Hopkins file a joint return on Form 1040A for 1997. Ray is retired and receives a fully taxable pension of $15,500. Ray also receives social security benefits and his Form SSA–1099 for 1997 shows net benefits of $5,600 in box 5. Alice worked during the year and had wages of $14,000. She made a deductible payment to her IRA account of $1,000. Ray and Alice have two savings accounts with a total of $250 in interest income. They complete Worksheet 1 and find that none of Ray's social security benefits are taxable. They leave lines 13a and 13b of their Form 1040A blank.

Worksheet 1. Social Security and Equivalent Railroad Retirement Benefits

1. Enter the total amount from **box 5** of **ALL** your **Forms SSA–1099 and RRB–1099**	5,600
Note. *If line 1 is zero or less, stop here; none of your benefits are taxable. Otherwise, go to line 2.*	
2. Enter one-half of line 1	2,800
3. Enter the total of the amounts from: Form 1040: Lines 7, 8a, 8b, 9–14, 15b, 16b, 17–19, and 21. Form 1040A: lines 7, 8a, 8b, 9, 10b, 11b, and 12	29,750
4. Form 1040A filers: Enter the total of any exclusion for Series EE U.S. savings bond interest (Form 8815, line 14) or adoption benefits (Form 8839, line 22). Form 1040 filers: Enter the total of any exclusions/adjustments for: • Series EE U.S. savings bond interest (Form 8815, line 14), • Adoption benefits (Form 8839, line 22), • Foreign earned income or housing (Form 2555, lines 43 and 48, or Form 2555–EZ, line 18), and • Certain income of bona fide residents of American Samoa (Form 4563, line 15) or Puerto Rico	–0–
5. Add lines 2, 3, and 4	32,550
6. Enter the amount from Form 1040, line 31 or from Form 1040A, line 15c	1,000
7. Subtract line 6 from line 5	31,550
8. Enter $25,000 ($32,000 if married filing jointly; $0 if married filing separately and you lived with your spouse at any time during 1997)	32,000
9. Subtract line 8 from line 7. If zero or less, enter –0–	–0–
Note. *If line 9 is zero or less, stop here; none of your benefits are taxable. (Do not enter any amounts on Form 1040, line 20a or 20b or on Form 1040A, line 13a or 13b. But if you are married filing separately and you* **lived apart** *from your spouse for all of 1997, enter "D" to the left of line 20a, Form 1040, or line 13a, Form 1040A. Also enter –0– on Form 1040, line 20b or on Form 1040A, line 13b.) Otherwise, go on to line 10.*	
10. Enter $9,000 ($12,000 if married filing jointly; $0 if married filing separately and you lived with your spouse at any time in 1997)	
11. Subtract line 10 from line 9. If zero or less, enter –0–	
12. Enter the **smaller** of line 9 or line 10	
13. Enter one-half of line 12	
14. Enter the **smaller** of line 2 or line 13	
15. Multiply line 11 by 85% (.85). If line 11 is zero, enter –0–	
16. Add lines 14 and 15	
17. Multiply line 1 by 85% (.85)	
18. Taxable benefits. Enter the **smaller** of line 16 or line 17 • Enter the amount from line 1 above on Form 1040, line 20a or on Form 1040A, line 13a. • Enter the amount from line 18 above on Form 1040, line 20b or on Form 1040A, line 13b	

Example 3. Joe and Betty Johnson file a joint return on Form 1040 for 1997. Joe is a retired railroad worker and in 1997 received the social security equivalent portion of tier 1 benefits. Joe's Form RRB–1099 shows $10,000 in box 5. Betty is a retired government worker and receives a fully taxable pension of $38,000. They had $2,300 in interest income plus interest of $200 on a Series EE U.S. savings bond. The savings bond interest qualified for exclusion. They figure their taxable benefits by completing Worksheet 1.

Worksheet 1. Social Security and Equivalent Railroad Retirement Benefits

1. Enter the total amount from **box 5** of **ALL** your **Forms SSA–1099 and RRB–1099**	10,000
Note. *If line 1 is zero or less, stop here; none of your benefits are taxable. Otherwise, go to line 2.*	
2. Enter one-half of line 1	5,000
3. Enter the total of the amounts from: Form 1040: Lines 7, 8a, 8b, 9–14, 15b, 16b, 17–19, and 21. Form 1040A: lines 7, 8a, 8b, 9, 10b, 11b, and 12	40,300
4. Form 1040A filers: Enter the total of any exclusion for Series EE U.S. savings bond interest (Form 8815, line 14) or adoption benefits (Form 8839, line 22). Form 1040 filers: Enter the total of any exclusions/adjustments for: • Series EE U.S. savings bond interest (Form 8815, line 14), • Adoption benefits (Form 8839, line 22), • Foreign earned income or housing (Form 2555, lines 43 and 48, or Form 2555–EZ, line 18), and • Certain income of bona fide residents of American Samoa (Form 4563, line 15) or Puerto Rico	200
5. Add lines 2, 3, and 4	45,500
6. Enter the amount from Form 1040, line 31 or from Form 1040A, line 15c	–0–
7. Subtract line 6 from line 5	45,500
8. Enter $25,000 ($32,000 if married filing jointly; $0 if married filing separately and you lived with your spouse at any time during 1997)	32,000
9. Subtract line 8 from line 7. If zero or less, enter –0–	13,500
Note. *If line 9 is zero or less, stop here; none of your benefits are taxable. (Do not enter any amounts on Form 1040, line 20a or 20b or on Form 1040A, line 13a or 13b. But if you are married filing separately and you* **lived apart** *from your spouse for all of 1997, enter "D" to the left of line 20a, Form 1040, or line 13a, Form 1040A. Also enter –0– on Form 1040, line 20b or on Form 1040A, line 13b.) Otherwise, go on to line 10.*	
10. Enter $9,000 ($12,000 if married filing jointly; $0 if married filing separately and you lived with your spouse at any time in 1997)	12,000
11. Subtract line 10 from line 9. If zero or less, enter –0–	1,500
12. Enter the **smaller** of line 9 or line 10	12,000
13. Enter one-half of line 12	6,000
14. Enter the **smaller** of line 2 or line 13	5,000
15. Multiply line 11 by 85% (.85). If line 11 is zero, enter –0–	1,275
16. Add lines 14 and 15	6,275
17. Multiply line 1 by 85% (.85)	8,500
18. Taxable benefits. Enter the **smaller** of line 16 or line 17 • Enter the amount from line 1 above on Form 1040, line 20a or on Form 1040A, line 13a. • Enter the amount from line 18 above on Form 1040, line 20b or on Form 1040A, line 13b.	6,275

Repayments More Than Gross Benefits

In some situations, your Form SSA–1099 or Form RRB–1099 will show that the total benefits you repaid (box 4) are more than the gross benefits (box 3) you received. If this occurred, your net benefits in box 5 will be a negative figure (a figure in parentheses) and none of your benefits will be taxable. If you receive more than one form, a negative figure in box 5 of one form is used to offset a positive figure in box 5 of another form for that same year.

If you have any questions about this negative figure, contact your local Social Security Administration office or your local U.S. Railroad Retirement Board field office.

Joint return. If you and your spouse file a joint return, and your Forms SSA–1099 or RRB–1099 has a negative figure in box 5, but your spouse's does not, subtract the amount in box 5 of your form from the amount in box 5 of your spouse's form. You do this to get your net benefits when figuring if your combined benefits are taxable.

Example. John and Mary file a joint return for 1997. John received Form SSA–1099 showing $3,000 in box 5. Mary also received Form SSA–1099 and the amount in box 5 was ($500). John and Mary will use $2,500 ($3,000 minus $500) as the amount of their net benefits when figuring if any of their combined benefits are taxable.

Repayment of benefits received in an earlier year. If the sum of the amount shown in box 5 of all of your Forms SSA–1099 and RRB–1099 is a negative figure, you can take an itemized deduction for the part of this negative figure that represents benefits you included in gross income in an earlier year.

If this deduction, ***is $3,000 or less,*** it is subject to the 2%-of-adjusted-gross-income limit that applies to certain miscellaneous itemized deductions. Claim it on line 22, Schedule A (Form 1040).

If this deduction is more than $3,000, you should figure your tax two ways:

1) Figure your tax for 1997 with the itemized deduction. This more-than-$3,000 deduction is ***not*** subject to the 2%-of-adjusted-gross-income limit that applies to certain miscellaneous itemized deductions.

2) Figure your tax for 1997 in the following steps:

   a) Figure the tax without the itemized deduction.

   b) For each year after 1983 for which part of the negative figure represents a repayment of benefits, refigure your taxable benefits as if your total benefits for the year were reduced by that part of the negative figure, then refigure the tax.

   c) Subtract the total of the refigured tax amounts in (b) from the total of your actual tax amounts.

   d) Subtract the result in (c) from the result in (a).

Compare the tax figured in methods (1) and (2). Your tax for 1997 is the smaller of the two amounts. If method (1) results in less tax, take the itemized deduction on line 27, Schedule A (Form 1040). If method (2) results in less tax, claim a credit for the applicable amount on line 59 of Form 1040 and write “I.R.C. 1341” in the margin to the left of line 59. If both methods produce the same tax, deduct the repayment in full on line 27, Schedule A (Form 1040).

13.

Other Income

Important Changes for 1997

Accelerated death benefits. Beginning January 1, 1997, certain payments received under a life insurance contract on the life of a terminally or chronically ill individual before the individual's death (an accelerated death benefit) can be excluded from income. For a chronically ill individual, the payments must be for costs incurred for qualified long-term care services or made on a periodic basis without regard to the costs. The exclusion for payments made on a periodic basis is limited. See *Accelerated Death Benefits.*

Long-term care insurance contracts. Beginning January 1, 1997, qualified long-term care insurance contracts are generally treated as accident and health insurance contracts. Amounts you receive from them (other than policyholder dividends or premium refunds) generally are excludable from income as amounts received for personal injury or sickness. See *Long-term care insurance contracts.*

Deceased public safety officers. Amounts received as a survivor annuity on the life of a public safety officer who was killed in the line of duty after 1996 generally are not taxable. Public safety officers include law enforcement officers, firefighters, rescue squad or ambulance crew. See *Deceased public safety officers.*

Important Reminders

Death benefit exclusion repealed. The exclusion from gross income for the first $5,000 of employer-provided death benefits is repealed for payments received for decedents dying after August 20, 1996. See *Survivor benefits* under *Life Insurance Proceeds.*

Damages received for injuries or sickness. Generally, amounts received before August 21, 1996, as damages for personal injuries or sickness are not taxable. Generally, for amounts received after August 20, 1996, only damages for personal physical injuries or physical sickness are not taxable. See *Court awards and damages,* under *Miscellaneous Taxable Income.*

State tuition programs. Effective for tax years ending after August 20, 1996, distributions from a qualified state tuition program are taxable only to the extent they are more than the amount contributed to the program. See *State tuition programs* under *Miscellaneous Taxable Income.*

Introduction

This chapter discusses many kinds of income and explains whether they are taxable or nontaxable.

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

You must include on your return all income you receive in the form of money, property, and services unless the tax law states that you do not include them. Some items, however, are only partly excluded from income. They are listed and discussed briefly in this chapter.

Useful Items

You may want to see:

Publication

- ☐ **501** Exemptions, Standard Deduction, and Filing Information
- ☐ **520** Scholarships and Fellowships
- ☐ **525** Taxable and Nontaxable Income
- ☐ **544** Sales and Other Dispositions of Assets
- ☐ **550** Investment Income and Expenses

Miscellaneous Taxable Income

This section begins with brief discussions of many income items arranged in alphabetical order. These discussions are followed by discussions of other taxable income items which are discussed in greater detail as follows.

- Bartering.
- Canceled debts.
- Recoveries (including state income tax refunds).
- Rental of personal property.
- Repayments.
- Royalties.

TIP *When you report miscellaneous taxable income on line 21 of Form 1040, write a brief description of the income on the dotted line next to line 21.*

Activity not for profit. You must include on your return income from an activity from which you do not expect to make a profit. An example of this type of activity would be a hobby or a farm you operate mostly for recreation and pleasure. Enter this income on line 21 of Form 1040. Deductions for expenses related to the activity are limited. They cannot total more than the income you report, and can be taken only if you itemize deductions on Schedule A (Form 1040). See *Not-for-Profit Activities* in chapter 1 of Publication 535, *Business Expenses,* for information on whether an activity is considered carried on for a profit.

Alaska Permanent Fund dividend income. If you received a payment from Alaska's mineral income fund (Alaska Permanent Fund dividends), you should report this amount on line 21 of Form 1040. The state of Alaska sends each recipient a document that shows this amount with the check. The amount is also reported to IRS.

TIP *If you otherwise qualify to use Form 1040A or 1040EZ, you can report the Alaska Permanent Fund dividend on line 12 of Form 1040A or line 3 of Form 1040EZ. See your form instructions.*

Alimony. Include in your income on line 11 of Form 1040 any alimony payments you receive. Amounts you receive for child support are not income to you. Alimony and child support payments are discussed in chapter 20.

Allowances and reimbursements. If you receive travel, transportation, or other business expense allowances or reimbursements from your employer, see chapter 28. If you are reimbursed for moving expenses, see chapter 19.

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

1) Interest on any award.
2) Compensation for lost wages or lost profits in most cases.
3) Punitive damages. See *Punitive damages,* later.
4) Amounts received in settlement of pension rights (if you did not contribute to the plan).
5) Damages for:
   a) Patent or copyright infringement,
   b) Breach of contract, or
   c) Interference with business operations.
6) Back pay and damages for emotional distress received to satisfy a claim under Title VII of the Civil Rights Act of 1964.

Do not include in your income compensatory damages for personal physical injury or physical sickness (whether received in a lump sum or installments).

Emotional distress. If emotional distress is due to physical injuries or physical sickness, the damages you receive for medical care due to that emotional distress are not taxable. Emotional distress includes physical symptoms that result from emotional distress, such as headaches, insomnia, and stomach disorders.

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

For more information on punitive damages, get Publication 525, *Taxable and Nontaxable Income.*

Credit card insurance. Generally, if you receive benefits under a credit card disability or unemployment insurance plan, the benefits are taxable to you. These plans make the minimum monthly payment on your credit card account if you cannot make the payment due to injury, illness, disability, or unemployment. Report on line 21 of Form 1040 the amount of benefits you receive during the year that is more than the amount of the premiums you paid during the year.

Estate and trust income. An estate or trust, unlike a partnership, may have to pay federal income tax. If you are a beneficiary of an estate or trust, you are taxed on your share of its income distributed or required to be distributed to you. However, there is never a double tax. Estates and trusts file their returns on Form 1041, *U.S. Income Tax Return for Estates and Trusts,* and your share of the income is reported to you on Schedule K–1 of Form 1041.

Current income required to be distributed. If you are the beneficiary of a trust that must distribute all of its current income, you must report your share of the distributable net income whether or not you have actually received it.

Current income not required to be distributed. If you are the beneficiary of an estate or trust and the fiduciary has the choice of whether to distribute all or part of the current income, you must report:

1) All income that is required to be distributed to you, whether or not it is actually distributed, plus

2) All other amounts actually paid or credited to you,

to the extent of your share of distributable net income.

How to report estate and trust income. Each item of income is treated the same for you as for the estate or trust. For example, if dividend income is distributed to you from a trust, you report the distribution as dividend income on your return. The same rule applies to distributions of tax-exempt interest and capital gains.

The fiduciary of the estate or trust must tell you the type of items making up your share of the estate or trust income and any credits you are allowed on your individual income tax return.

Losses. Losses of estates and trusts generally are not deductible by the beneficiaries.

Grantor trust. Income earned by a grantor trust is taxable to the grantor, not the beneficiary, if the grantor keeps certain control over the trust. This rule applies if the property (or income from the property) put into the trust will or may revert (be returned) to the grantor or the grantor's spouse. The grantor is the one who transferred property to the trust.

Generally, a trust is a grantor trust if the grantor has a reversionary interest valued (at the date of transfer) at more than 5% of the value of the transferred property.

Fees for services. Include all fees for your services in your gross income. Examples of these fees are amounts you receive for services you perform as:

1) A corporate director,

2) An executor or administrator of an estate,

3) A notary public, or

4) An election precinct official.

Corporate director. If you received (or should have received) a Form W–2 showing corporate director fees, report these fees on line 7 of Form 1040 or Form 1040A, or on line 1 of Form 1040EZ.

Otherwise, report these payments on Schedule C (Form 1040) or Schedule C–EZ (Form 1040) as self-employment income.

Executor or administrator of an estate. If these payments total $600 or more for the year, you may receive a Form 1099–MISC. Report these payments on Schedule C (Form 1040) or Schedule C–EZ (Form 1040) as self-employment income. ***Exception:*** If you are not in the trade or business of being an executor (for instance, you are the executor of a friend's or relative's estate), do not include these amounts on Schedule C or Schedule C–EZ. Report them on line 21 of Form 1040.

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

Election precinct official. You should receive a Form W–2 showing payments for services performed as an election official or election worker. Report these payments on line 7 of Form 1040 or Form 1040A, or on line 1 of Form 1040EZ.

Free tour. If you received a free tour from a travel agency for organizing a group of tourists, you must include its value in your income. Report the fair market value of the tour on line 21 of Form 1040, or on Schedule C or Schedule C–EZ (Form 1040). You cannot deduct your expenses in serving as the voluntary leader of the group at the group's request.

Gambling winnings. You must include your gambling winnings in income on line 21 of Form 1040. If you itemize your deductions on Schedule A (Form 1040), you can deduct gambling losses you had during the year, but only up to the amount of your winnings. See Publication 529, *Miscellaneous Deductions,* for information on recordkeeping.

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

TIP *If you win a state lottery prize payable in installments, you must include in your gross income the annual payments and any amount you receive designated as "interest" on the unpaid installments.*

Form W–2G. You may have received a Form W–2G showing the amount of your gambling winnings and any tax taken out of them. Include the amount from box 1 on line 21 of Form 1040. Be sure to include any amount from box 2 on line 54 of Form 1040.

Hobby losses. Losses from a hobby are not deductible from other income. A hobby is an activity from which you do not expect to make a profit. See *Activity not for profit,* earlier.

CAUTION *If you collect stamps, coins, or other items as a hobby for recreation and pleasure, and you sell any of the items, your gain is taxable as a capital gain. (See chapter 17.) However, if you sell items from your collection at a loss, you cannot deduct a net loss.*

Illegal income. Illegal income, such as stolen or embezzled funds, must be included in your gross income on line 21 of Form 1040, or on Schedule C or Schedule C–EZ (Form 1040) if from your self-employment activity.

Indian fishing rights. If you are a member of a qualified Indian tribe that has fishing rights secured by treaty, executive order, or an Act of Congress as of March 17, 1988, do not include in your income amounts you receive from activities related to those fishing rights. The income is not subject to income tax, self-employment tax, or employment taxes.

Jury duty. Jury duty pay you receive must be included in your income on line 21 of Form 1040. If you must give the pay to your employer because your employer continues to pay your salary while you serve on the jury, you can deduct the amount turned over to your employer as an adjustment to your income. Include the amount you repay your employer on line 31 of Form 1040. Write "Jury Pay" and the amount on the dotted line next to line 31.

Kickbacks. You must include in your income on line 21 of Form 1040, or on Schedule C or Schedule C–EZ (Form 1040), kickbacks, side commissions, push money, or similar payments you receive.

Example. You sell cars and help arrange car insurance for buyers. Insurance brokers pay back part of their commissions to you for referring customers to them. You must include the kickbacks in your income.

Prizes and awards. If you win a prize in a lucky number drawing, television or radio quiz program, beauty contest, or other event, you must include it in your income. For example, if you win a $50 prize in a photography contest, you must report this income on line 21 of Form 1040. If you refuse to accept a prize, do not include its value in your income.

Employee cash awards or bonuses. Cash awards or bonuses given to you by your employer for good work or suggestions generally must be included in your income as wages. However, certain employee awards can be excluded from your income. See *Employee achievement awards* under *Income Not Taxed,* later.

Goods or services. Prizes and awards in goods or services must be included in your income at their fair market value.

Pulitzer, Nobel, and other prizes. If you were awarded a Pulitzer, Nobel, or other prize in recognition of past accomplishments (in religious, charitable, scientific, artistic, educational, literary, or civic fields), you do not include this prize in your income if you meet ***all*** of the following requirements.

1) You were selected without any action on your part to enter the contest or proceeding.
2) You are not required to perform substantial future services as a condition to receiving the prize or award.
3) The prize or award is transferred directly to a governmental unit or tax-exempt charitable organization as designated by you.

See Publication 525 for more information about the conditions that apply to the transfer.

State tuition programs. Effective for tax years ending after August 20, 1996, distributions from a qualified state tuition program are taxable only to the extent they are more than the amount contributed to the program. Previously, the tax treatment of these programs was not clearly defined.

Qualified state tuition programs are defined in Publication 525. For more information on a specific program, contact the state or agency that established and maintains it.

Sale of personal items. If you sold an item you owned for personal use, such as a car, refrigerator, furniture, stereo, jewelry, or silverware, your gain is taxable as a capital gain that you report on Schedule D (Form 1040). You cannot deduct a loss.

However, if you sold an item you held for investment, such as gold or silver bullion, coins, or gems, any gain is taxable as a capital gain and any loss is deductible as a capital loss.

Bartering

Bartering is an exchange of property or services. You must include in your income, at the time received, the fair market value of property or services you receive in bartering. If you exchange services with another person and you both have agreed ahead of time as to the value of the services, that value will be accepted as fair market value unless the value can be shown to be otherwise.

Generally, you report this income on Schedule C or Schedule C–EZ (Form 1040). But if the barter involves exchange of something other than services, you may have to use another form or schedule instead.

Example 1. You are a self-employed attorney who performs legal services for a client, a small corporation. The corporation gives you shares of its stock as payment for your services. You must include in income the fair market value of the shares on Schedule C or Schedule C–EZ (Form 1040) in the year that you receive them.

Example 2. You are self-employed and a member of a barter club. The club uses “credit units” as a means of exchange. It adds credit units to your account for goods or services you provide to members, which you can use to purchase goods and services offered by other members of the barter club. The club subtracts credit units from your account when you receive goods or services from other members. You must include in income the value of credit units that are added to your account, even though you may not actually receive goods or services from other members until a later tax year.

Example 3. You own a small apartment building. In return for 6 months' rent-free use of an apartment, an artist gives you a work of art that she created. You must report as rental income on Schedule E (Form 1040) the fair market value of the art work, and the artist must report as income on Schedule C or Schedule C–EZ (Form 1040) the fair rental value of the apartment.

Form 1099–B from barter exchange. If you exchanged property or services through a barter exchange, you should receive Form 1099–B or a similar statement from the barter exchange. You should receive the statement by January 31, 1998, and it should show the value of cash, property, services, credits, or scrip you received from exchanges during the year. The IRS will also receive a copy of Form 1099–B.

Canceled Debts

Generally, if a debt you owe is canceled or forgiven, other than as a gift or bequest, you must include the canceled amount in your gross income. You have no income from the canceled debt if it is intended as a gift to you. A debt includes any indebtedness for which you are liable or which attaches to property you hold.

If you are not self-employed, report the amount on line 21 of Form 1040. If you are self-employed, report the amount on Schedule C or C-EZ (Form 1040) if you are a sole proprietor or on Schedule F (Form 1040) if you are a farmer.

Form 1099–C. If a federal government agency, financial institution, or credit union cancels or forgives a debt you owe of $600 or more, you will receive a Form 1099–C, *Cancellation of Debt.* The amount of the canceled debt is shown in box 2.

Interest included in canceled debt. If any interest is forgiven and included in the amount of canceled debt in box 2, the amount of interest will also be shown in box 3. Whether or not you must include the interest portion of the canceled debt in your gross income depends on whether the interest would be deductible if you paid it.

If the interest would not be deductible (such as interest on a personal loan), include in your income the amount from box 2 of Form 1099–C. If the interest would be deductible (such as on a business loan), include in your income the net amount of the canceled debt (shown in box 2) less the interest amount (shown in box 3).

Mortgage loan. If your financial institution offers a discount for the early payment of your mortgage loan, the amount of the discount is canceled debt. You must include the canceled amount in your gross income.

Stockholder debt. If you are a stockholder in a corporation and the corporation cancels or forgives your debt to it, the canceled debt is dividend income to you.

If you are a stockholder in a corporation and you cancel a debt owed to you by the corporation, you generally do not realize income. This is because the canceled debt is considered as a contribution to the capital of the corporation equal to the amount of debt principal that you canceled.

Exceptions and Exclusions

There are several exceptions and exclusions to the inclusion of canceled debt in income. Some of the more common ones are explained next.

Nonrecourse debt. If you are not personally liable for the debt (nonrecourse debt), different rules apply. You may have a gain or loss if nonrecourse debt is canceled or forgiven in conjunction with the sale or foreclosure of property to which the debt attaches. See Publication 544 for more information.

Student loans. Certain student loans contain a provision that all or part of the debt incurred to attend the qualified educational institution will be canceled if you work for a certain period of time in certain professions for any of a broad class of employers. You do not have income if your student loan is canceled after you agreed to this provision and then performed the services required. To qualify, the loan must have been made by:

1) The government—federal, state, or local, or an instrumentality, agency, or subdivision thereof,
2) A tax-exempt public benefit corporation that has assumed control of a state, county, or municipal hospital, and whose employees are considered public employees under state law, or
3) An educational institution under an agreement with an entity described in (1) or (2) that provided the funds to the institution to make the loan.

Loans canceled after August 5, 1997. If the loan was canceled after August 5, 1997, it will qualify if it was made by an educational institution as part of a program of the institution to encourage students to serve in occupations or areas with unmet needs and under which the services provided are for or under the direction of a governmental unit or a tax-exempt section 501(c)(3) organization.

A loan will also qualify if it was made by an educational institution or a tax-exempt 501(c)(3) organization to refinance any loan that meets the requirements above.

Section 501(c)(3) organizations are defined in Publication 525.

Deductible debt. If a debt that qualified for a tax deduction is canceled, you do not realize income from the canceled debt. However, whether or not you must include the canceled debt in your gross income depends on whether you use the cash or an accrual method of accounting. If you use the cash method, you do not include it in income. If you use an accrual method, you do include it in income. For more information, see chapter 5 of Publication 334, *Tax Guide for Small Business.*

Price reduced after purchase. Generally, if the seller reduces the amount you owe for property you purchased, you do not have income from the reduction. The reduction of the debt is treated as a purchase price adjustment and reduces your basis in the property.

Bankruptcy exclusion. If your debt is canceled in a bankruptcy case under title 11 of the United States Code, do not include the canceled debt in your gross income. However, you must reduce your tax attributes (but not below zero) by the canceled amount that is not included in your income. See Publication 908, *Bankruptcy Tax Guide,* for more information.

Insolvency exclusion. If your debt is canceled when you are insolvent, you do not include the canceled debt (up to a certain limit) in your gross income. However, you must reduce your tax attributes (but not below zero) by the canceled amount that is not included in your income. This exclusion applies only to the amount by which you are insolvent. See Publication 908 for more information.

If the canceled debt occurs because of a title 11 bankruptcy case, the bankruptcy exclusion takes precedence over the insolvency exclusion.

Partnership Income

A partnership is not a taxable entity. The income, gains, losses, credits, and deductions of a partnership are "passed through" to the partners based on each partner's distributive share of these items.

The partnership must file an information return on Form 1065, *U.S. Partnership Return of Income,* and send Schedule K–1 to each partner. In addition, the partnership will send each partner a copy of the *Partner's Instructions for Schedule K–1 (Form 1065)* to help each partner report his or her share of the partnership's income, credits, deductions, and tax preference items.

TIP *Retain Schedule K–1 (Form 1065) for your records. Do not attach it to your Form 1040.*

For more information on partnerships, get Publication 541, *Partnerships.*

S Corporation Income

In general, an S corporation does not pay tax on its income. Instead, the income and expenses of the corporation are "passed through" to the shareholders.

An S corporation must file a return on Form 1120S, *U.S. Income Tax Return for an S Corporation,* and send Schedule K–1 (Form 1120S) to each shareholder. In addition, the S corporation will send each shareholder a copy of the *Shareholder's Instructions for Schedule K–1 (Form 1120S)* to help each shareholder report his or her share of the S corporation's income, credits, and deductions.

TIP *Do not attach Schedule K–1 (Form 1120S) to your Form 1040. Keep it for your records.*

For more information on S corporations and their shareholders, see the instructions for Form 1120S.

Recoveries

A recovery is a return of an amount you deducted or took a credit for in an earlier year. Generally, you must include all or part of the recovered amounts in your income in the year the recovery is received. The most common recoveries are refunds, reimbursements, and rebates of deductions itemized on Schedule A (Form 1040). Nonitemized deduction recoveries include such items as payments you receive on previously deducted bad debts and recoveries of items for which you previously claimed a tax credit.

Federal income tax refund. Refunds of federal income taxes are not included in your income because they are never allowed as a deduction from income.

Form 1099–G. If you received a state or local income tax refund in 1997, you may receive a statement, Form 1099–G, *Certain Government Payments,* from the payer of the refund (or credit or offset) by January 31, 1998. The IRS will also receive a copy of the Form 1099–G.

Interest. Interest on any of the amounts you recover must be reported as interest income in the year received.

Recovery and expense in same year. If the refund or other recovery and the deductible expense occur in the same year, the recovery reduces the deduction and is not reported as income.

Recovery for 2 or more years. If you receive a refund or other recovery that is for amounts you paid in 2 or more separate years, you must allocate, on a pro rata basis, the recovered amount between the years in which it was paid.

This allocation is necessary to determine the amount of recovery from any earlier years and to determine the amount, if any, of your allowable deduction for this item for the current year. For information on how to compute the allocation, see *Recoveries* in Publication 525.

Tax benefit rule. If you recover an amount that you deducted or took a credit for in an earlier year, include the recovery in your income only to the extent the deduction or credit reduced your tax in the earlier year. For more information, get Publication 525.

Itemized Deduction Recoveries

If you recover any amount that you deducted in an earlier year on Schedule A (Form 1040), you must generally include the full amount of the refund or recovery in your income in the year you receive it.

Where to report. Enter your state and local income tax refund on line 10 of Form 1040, and the total of all other recoveries as other income on line 21 of Form 1040. You cannot use Form 1040A or Form 1040EZ.

Example. For 1996, you filed a joint return. Your taxable income was $20,000. Your standard deduction was $6,700, and you had itemized deductions of $7,800. In 1997, you received the following recoveries for amounts deducted on your 1996 return:

Medical expenses	$200
State and local income tax refund	400
Real estate tax rebate	325
Total recoveries	$925

None of the recoveries were more than the deductions taken for 1996.

Because your total recoveries are less than the amount by which your itemized deductions exceeded the standard deduction ($7,800 – 6,700 = $1,100), you must include your total recoveries in your income for 1997. Report the state and local income tax refund of $400 on line 10 of Form 1040 and the balance of your recoveries, $525, on line 21 of Form 1040.

Standard deduction for earlier years. To determine if amounts recovered in 1997 must be included in your income, you must know the standard deduction for your filing status for the year the deduction was claimed. Standard deduction amounts for 1996, 1995, and 1994 are in Publication 525.

Total recoveries not included in income. The total recovery that must be included in your income is limited to the itemized deduction amount that reduced your tax for the earlier year. (See *Tax benefit rule,* earlier.)

You are generally allowed to claim the standard deduction if you do not itemize your deductions. Only your itemized deductions that are more than your standard deduction are subject to the recovery rule (unless you are required to itemize your deductions). If your total deductions on the earlier year return were not more than your income for that year, include in your income this year the smaller of:

1) Your recoveries, or
2) The amount by which your itemized deductions exceeded the standard deduction.

Example. You filed a joint return for 1996 with taxable income of $25,000. Your itemized deductions were $8,500. The standard deduction that you could have claimed was $6,700. In 1997 you recover $2,400 of your 1996 itemized deductions. None of the recoveries were more than the actual deductions for 1996. Include $1,800 of the recoveries in your 1997 income. This is the smaller of your recoveries ($2,400) or the amount by which your itemized deductions were more than the standard deduction ($8,500 − 6,700 = $1,800).

Recovery limited to deduction. You do not include in your income any amount of your recovery that is more than the amount you deducted in the earlier year. The amount you include in your income is limited to the smaller of:

1) The amount deducted on Schedule A (Form 1040), or
2) The amount recovered.

Example. During 1996 you paid $1,700 for medical expenses. From this amount you subtracted $1,500, which was 7.5% of your adjusted gross income. Your actual medical expense deduction was $200. In 1997, you received a $500 reimbursement from your medical insurance for your 1996 expenses. The only amount of the $500 reimbursement that must be included in your income in 1997 is $200—the amount actually deducted.

Other recoveries. See *Recoveries* in Publication 525 if:

1) You have recoveries of items other than itemized deductions, or
2) You received a recovery for an item for which you claimed a tax credit (other than investment credit or foreign tax credit) in a prior year.

Rental of Personal Property

If you rent out personal property, such as equipment or vehicles, how you report your income and expenses is generally determined by:

1) Whether or not the rental activity is a business, and
2) Whether or not the rental activity is conducted for profit.

Generally, if your primary purpose is income or profit and you are involved in the rental activity with continuity and regularity, your rental activity is a business. See Publication 535 for details on deducting expenses for both business and not-for-profit activities.

Reporting business income and expenses. If you are in the business of renting personal property, report your income and expenses on Schedule C or C-EZ. The form instructions have information on how to complete them.

Reporting nonbusiness income. If you are not in the business of renting personal property, report your rental income on line 21 of Form 1040. List the type and amount of the income on the dotted line to the left of the amount you report on line 21.

Reporting nonbusiness expenses. If you rent personal property for a profit, report your rental expenses on line 31 of Form 1040. Enter the amount and "PPR" on the dotted line to the left and include the amount of your deductible expenses in the total amount you enter on line 31.

If you do not rent personal property for a profit, your deductions are limited and you cannot report a loss to offset other income. You report these rental expenses on Schedule A (Form 1040).

Repayments

If you had to repay an amount that you had included in your income in an earlier year because at that time you thought you had an unrestricted right to it, you can deduct the amount repaid from your income in the year in which you repay it.

Type of deduction. The type of deduction you are allowed in the year of repayment depends on the type of income you included in the earlier year. For instance, if you repay an amount that you previously reported as a capital gain, deduct the repayment as a capital loss.

Repayment $3,000 or less. If the amount you repaid was $3,000 or less, deduct it from your income in the year you repaid it. If you reported it as wages, unemployment compensation, or other ordinary income, enter it on line 22 of Schedule A (Form 1040). If you reported it as a capital gain, deduct it on Schedule D (Form 1040).

Repayment over $3,000. If the amount you repaid was more than $3,000, you can take a deduction for the amount repaid or you can take a credit against your tax. Follow the steps below and compare the results. Use the method that results in less tax.

1) Figure your tax for 1997 claiming a deduction for the repaid amount.
2) Figure your tax for 1997 ***without*** deducting the repaid amount. Then:
    a) Refigure your tax from the earlier year without including in income the amount you repaid in 1997.
    b) Subtract the tax in (a) from the tax shown on your return for the earlier year.
    c) Then subtract the answer in (b) from the tax for 1997 figured without the deduction.

How you treat the repayment on your 1997 return depends on which answer above results in less tax.

If the answer in Step (1) is less tax, deduct the amount repaid on the same form or schedule on which you previously reported it. For example, if you reported it as self-employment income, deduct it on Schedule C or Schedule C–EZ (Form 1040), or if you reported it as wages, deduct it on line 27 of Schedule A (Form 1040).

If the answer in Step (2) is less tax, claim a credit on line 59 of Form 1040, and write "I.R.C. 1341" next to line 59.

An example of this computation can be found in Publication 525.

Repaid social security benefits. If you repaid social security benefits, see *Repayments* in chapter 12.

Royalties

Royalties from copyrights, patents, and oil, gas, and mineral properties are taxable as ordinary income.

You generally report royalties on Part I of Schedule E (Form 1040). However, if you hold an operating oil, gas, or mineral interest or are in business as a self-employed writer, inventor, artist, etc., report your gross income and expenses on Schedule C or Schedule C–EZ (Form 1040).

Copyrights and patents. Royalties from copyrights on literary, musical, or artistic works, and similar property, or from patents on inventions, are amounts paid to you for the right to use your work over a specified period of time. Royalties are generally based on the number of units sold, such as the number of books, tickets to a performance, or machines sold.

Oil, gas, and minerals. Royalty income from oil, gas, and mineral properties is the amount you receive when natural resources are extracted from your property. The royalties are based on units, such as barrels, tons, etc., and are paid to you by a person or company who leases the property from you.

Depletion. If you are the owner of an economic interest in mineral deposits or oil and gas wells, you can recover your investment through the depletion allowance. For information on this subject, see chapter 13 of Publication 535.

Coal and iron ore. Under certain circumstances, you can treat amounts you receive from the disposal of coal and iron ore as payments from the sale of a capital asset, rather than as royalty income. For information about gain or loss from the sale of coal and iron ore, get Publication 544, *Sales and Other Dispositions.*

Interest in the property sold. If you sell your complete interest in the oil, gas, or mineral rights, the amount you receive is considered payment for the sale of your property, not royalty income. Under certain circumstances, the sale is subject to capital gain or loss treatment on Schedule D (Form 1040).

Part of future production sold. If you own mineral property but sell part of the future production, you generally treat the money you receive from the buyer at the time of the sale as a loan from the buyer. Do not include it in your income or take depletion based on it.

When production begins, you include all the proceeds in your income, deduct all the production expenses, and deduct depletion from that amount to arrive at your taxable income from the property.

Retained interest. If you retain a royalty, an overriding royalty, or a net profit interest in a mineral property for the life of the property, you have made a lease or a sublease, and any cash you receive for the assignment is ordinary income subject to a depletion allowance.

Income Not Taxed

You generally should not report the following items on your return. However, some of the items are only partly excluded from your income. A discussion of other totally and partly excluded items follows this list.

Accident and health insurance proceeds

"Black lung" benefits

Casualty insurance and other reimbursements (chapter 27)

Child support payments (chapter 20)

Compensatory damages awarded for physical injury or sickness

Federal Employees' Compensation Act payments

Government cost-of-living allowances for civilian employees stationed outside the continental U.S. (or in Alaska) (chapter 6)

Housing allowance for members of the clergy (chapter 6)

Interest on state or local government obligations (chapter 8)

Meals and lodging provided by employer

Military allowances

Moving expense reimbursements (chapter 19)

Scholarship and fellowship grants

Supplemental security income (SSI)

Veterans' benefits (chapter 6)

Welfare benefits

Workers' compensation

Campaign contributions. These contributions are not income to a candidate unless they are diverted to his or her personal use. To be exempt from tax, the contributions must be spent for campaign purposes or kept in a fund for use in future campaigns. However, interest earned on bank deposits, dividends received on contributed securities, and net gains on sales of contributed securities are taxable and must be reported on Form 1120–POL, *U.S. Income Tax Return for Certain Political Organizations.* Excess campaign funds transferred to an office account must be included in the officeholder's income on line 21 of Form 1040, in the year transferred.

Cash rebates. A cash rebate you receive from a dealer or manufacturer of an item you buy is not income.

Example. You buy a new car for $9,000 cash and receive a $400 rebate check from the manufacturer. The $400 is not income to you. Your cost is $8,600. This is your basis on which you figure gain or loss if you sell the car, and depreciation if you use it for business.

Employee achievement awards. Exclude from your income employee achievement awards you receive only if your employer can deduct them. To be deducted by your employer and excluded by you, the awards must meet all the following requirements:

1) Be given for length of service or safety achievement.
2) Be tangible personal property other than cash, gift certificates, or equivalent items.
3) Be given under conditions and circumstances that do not create a significant likelihood of the payment of disguised compensation.
4) Be given as part of a meaningful presentation.
5) Be no more than the specified dollar limits.

Dollar limits. There are limits to the total awards you can exclude in one year. Awards from nonqualified plans are limited to $400, and total awards from both qualified and nonqualified plans are limited to $1,600. The cost to your employer is the determining factor for these limits. Amounts over the limits cannot be deducted by your employer and must be included in your income.

Qualified plan award. A qualified plan award is one you are awarded as part of an established written plan by your employer that does not discriminate in favor of highly compensated employees. An award will not be considered a qualified plan award if the average cost of all employee achievement awards given by your employer during the tax year is more than $400. In determining average cost, awards of nominal value are not taken into account.

Example. Ben Green received three employee achievement awards during the year: a nonqualified plan award of a watch valued at $250, and two qualified plan awards of a stereo valued at $1,000 and a set of golf clubs valued at $500. Assuming that the requirements for qualified plan awards are otherwise satisfied, each award by itself would be excluded from his income. However, since the $1,750 total value of the awards is more than $1,600, Ben must include $150 ($1,750 – $1,600) in his income.

Energy conservation subsidies. You can exclude from gross income any subsidy provided, either directly or indirectly, by public utilities for the purchase or installation of an energy conservation measure for a dwelling unit.

Energy conservation measure. This includes installations or modifications that are primarily designed to reduce consumption of electricity or natural gas, or improve the management of energy demand.

Dwelling unit. This includes a house, apartment, condominium, mobile home, boat, or similar property. If a building or structure contains both dwelling and other units, any subsidy must be properly allocated.

Foster-care providers. Payments you receive from a state, political subdivision, or tax-exempt child-placement agency for providing foster care to qualified individuals in your home generally are not included in your income. You must include in your income payments received for the care of more than 5 individuals age 19 or older and certain difficulty-of-care payments.

A qualified foster individual is a person who:

1) Is living in a foster family home, and
2) Was placed there by:
   a) An agency of a state or one of its political subdivisions, or
   b) If the individual is under age 19, a tax-exempt child placement agency licensed by a state or one of its political subdivisions.

Difficulty-of-care payments. These are additional payments that are designated by the payor as compensation for providing the additional care which is required for physically, mentally, or emotionally handicapped qualified foster individuals. To be difficulty-of-care payments, a state must determine that the additional compensation is needed and the care for which the payments are made must be provided in your home.

You must include in your income difficulty-of-care payments received for more than:

1) 10 qualified foster individuals under age 19, and
2) 5 qualified foster individuals age 19 or older.

Maintaining space in home. If you are paid by a placement agency to maintain space in your home for foster-care individuals, or if you receive payments that you must include in your income, you are in business as a foster-care provider and you are self-employed. You must include these payments in income.

Get Publication 587, *Business Use of Your Home,* to help you determine the amount you can deduct for the use of your home. For more information on foster care, get Publication 501.

Gifts and inheritances. Generally, property you receive as a gift, bequest, or inheritance is not included in your income. However, if property you receive this way later produces income such as interest, dividends, or rentals, that income is taxable to you. If property is given to a trust and the income from it is paid, credited, or distributed to you, that also is income to you. If the gift, bequest, or inheritance is the income from the property, that income is taxable to you.

Items given to you as an incentive to enter into a business transaction are not gifts. For example, items such as small appliances or dinnerware given to you by a bank as an incentive to make a deposit are interest income to you and must be reported at their fair market value.

Inherited pension or IRA. If you inherited a pension or an individual retirement arrangement (IRA), you may have to include part of the inherited amount in your income. See chapter 11 if you inherited a pension. See chapter 18 if you inherited an IRA.

Interest on frozen deposits. Generally, you can exclude from your income the amount of interest earned on a frozen deposit. See *Interest income on frozen deposits* in chapter 8.

Interest on qualified savings bonds. You may be able to exclude from your income all or part of the interest from qualified U.S. savings bonds you redeem if you pay qualified higher educational expenses in the same year. For more information on this exclusion, see *Education Savings Bond Program* under *U.S. Savings Bonds* in chapter 8.

Living expenses paid by insurance. Do not include in your income amounts you receive under an insurance policy for additional living expenses you and your family had because you lost the use of your home due to a fire, storm, or other casualty. The amount you exclude from income is limited to your extra living expenses that are more than the normal expenses you would have had. Extra living expenses, for this purpose, include only those to keep you and your family at the same standard of living you had before the loss.

Sale of home. You may be able to exclude from income all or part of any gain from the sale or exchange of your principal residence. See chapter 16.

Transporting schoolchildren. Do not include in your income a school board mileage allowance for taking children to and from school if you are not in the business of taking children to school. You cannot deduct expenses for providing this transportation.

Utility rebates. If you are a customer of an electric utility company and you participate in the utility's energy conservation program, you may receive on your monthly electric bill either:

1) A reduction in the purchase price of electricity furnished to you (rate reduction), or

2) A nonrefundable credit against the purchase price of the electricity.

The amount of the rate reduction or nonrefundable credit is not included in your income.

Life Insurance Proceeds

Life insurance proceeds paid to you because of the death of the insured person are not taxable unless the policy was turned over to you for a price. This is true even if the proceeds were paid under an accident or health insurance policy or an endowment contract.

Proceeds not received in installments. If death benefits are paid to you in a lump sum or other than at regular intervals, include in your gross income only the benefits that are more than the amount payable to you at the time of the insured person's death. If the benefit payable at death is not specified, you include in your income the benefit payments that are more than the present value of the payments at the time of death.

Proceeds received in installments. If you receive life insurance proceeds in installments, you can exclude part of each installment from your income.

To determine the excluded part, divide the amount held by the insurance company (generally the total lump sum payable at the death of the insured person) by the number of installments to be paid. Include anything over this excluded part in your income as interest.

Surviving spouse. If your spouse died before October 23, 1986, and insurance proceeds are payable to you because of the death of your spouse, and you receive them in installments, you can exclude up to $1,000 a year of the interest included in the installments.

More information. For more information, see *Life Insurance Proceeds* in Publication 525.

Surrender of policy for cash. If you surrender a life insurance policy for cash, you must include in income any proceeds that are more than the cost of the life insurance policy. In general, your cost (or investment in the contract) is the total premiums that you paid for the life insurance policy, less any refunded premiums, rebates, dividends or unrepaid loans that were not included in your income. This is explained more fully in Publication 575.

Reporting. You should receive a Form 1099–R. Report these amounts on lines 16a and 16b of Form 1040, or lines 11a and 11b of Form 1040A.

Endowment proceeds. Endowment proceeds paid in a lump sum to you at maturity are taxable only if the proceeds are more than the cost of the policy. To determine your cost, see *Endowment proceeds* in Publication 525.

Survivor benefits. Generally, payments made by or for an employer because of an employee's death must be included in income. However, if the decedent died before August 21, 1996, the first $5,000 paid to beneficiaries can be excluded from the income of the beneficiaries. The payments need not be made as the result of a contract. The amount excluded for any deceased employee cannot be more than $5,000 regardless of the number of employers or the number of beneficiaries.

See Publication 525 for more information on this exclusion.

Deceased public safety officers. If you are a survivor of a public safety officer who died in the line of duty, you may be able to exclude from income certain amounts you receive.

Bureau of Justice assistance payments. If you are a surviving dependent of a public safety officer (law enforcement officer or firefighter) who died in the line of duty, do not include in your income the death benefit paid to you by the Bureau of Justice Assistance.

Governmental plan annuity. If you are a surviving child (or former spouse) of a public safety officer who was killed in the line of duty after 1996, you generally do not have to include in income the survivor benefit paid to you. Public safety officers include law enforcement officers, firefighters, rescue squad or ambulance crew. See Publication 525 for more information.

Accelerated Death Benefits

Beginning in 1997, certain payments received under a life insurance contract on the life of a terminally or chronically ill individual before the individual's death (an accelerated death benefit) can be excluded from income. See the exception later. For a chronically ill individual, the payments must be for costs incurred for qualified long-term care services or made on a periodic basis without regard to the costs.

In addition, if any portion of a death benefit under a life insurance contract on the life of a terminally or chronically ill individual is sold or assigned to a viatical settlement provider, the amount received is also excluded from income. Generally, a viatical settlement provider is one who regularly engages in the business of buying or taking assignment of life insurance contracts on the lives of insured individuals who are terminally or chronically ill.

Terminally or chronically ill defined. A terminally ill person is one who has been certified by a physician as having an illness or physical condition that can reasonably be expected to result in death within 24 months from the date of the certification. A chronically ill person is one who is not terminally ill but has been certified by a licensed health care practitioner as meeting one of the following conditions:

1) Is unable to perform (without substantial help) at least two activities of daily living for a period of 90 days or more because of a loss of functional capacity,

2) Has a level of disability similar to the disability in (1) above, or

3) Requires substantial supervision to protect himself or herself from threats to health and safety due to severe cognitive impairment.

Exception. The exclusion does not apply to any amount paid to a person other than the insured if that other person has an insurable interest in the life of the insured:

- Because the insured is a director, officer, or employee of the other person, or
- Because the insured has a financial interest in the business of the other person.

Limit on exclusion. The amount of accelerated death benefits you may exclude may be limited if:

1) They are paid on account of chronic illness, and

2) They are received as periodic payments.

There is no limit on amounts paid on account of terminal illness.

For 1997, the most you can exclude is $175 per day ($63,875 a year). See Form 8839, *Medical Savings Accounts and Long-Term Care Insurance Contracts,* for more information.

Long-Term Care Insurance Contracts

Beginning January 1, 1997, qualified long-term care insurance contracts are generally treated as accident and health insurance contracts. Amounts you receive from them (other than policyholder dividends or premium refunds) generally are excludable from income as amounts received for personal injury or sickness.

A long-term care insurance contract is any insurance contract that only provides coverage of qualified long-term care services. The contract:

1) Must be guaranteed renewable.

2) Must not provide for a cash surrender value or other money that can be paid, assigned, pledged, or borrowed.

3) Must provide that refunds, other than refunds on the death of the insured or complete surrender or cancellation of the contract, and dividends under the contract may be used only to reduce future premiums or increase future benefits.

4) Generally must not pay or reimburse expenses incurred for services or items that would be reimbursed under Medicare, except where Medicare is a secondary payer or the contract makes per diem or other periodic payments without regard to expenses.

Qualified long-term care services. Qualified long-term care services are:

1) Necessary diagnostic, preventive, therapeutic, curing, treating, mitigating, and rehabilitative services, and

2) Maintenance or personal care services required by a chronically ill individual as prescribed by a licensed health care practitioner.

Chronically ill individual. A chronically ill individual is one who has been certified as one of the following:

1) An individual who, for at least 90 days, is unable to perform at least two activities of daily living without substantial assistance due to loss of functional capacity. Activities of daily living are eating, toileting, transferring, bathing, dressing, and continence.
2) An individual who requires substantial supervision to be protected from threats to health and safety due to severe cognitive impairment.

The certification must have been made by a licensed health care practitioner within the previous 12 months.

Limit on exclusion. You can generally exclude from gross income up to $175 a day ($63,875 a year) for 1997. The $175 is indexed for inflation after 1997.

Medical Savings Accounts (MSAs)

Do not include in income amounts you withdraw from your MSA if you use the money to pay for qualified medical expenses for you, your spouse, or your dependents. Generally, qualified medical expenses are those you can deduct on Schedule A (Form 1040), *Itemized Deductions.* You must have paid these expenses yourself. For more information about qualified medical expenses, see Publication 502, *Medical and Dental Expenses.*.

CAUTION *You cannot buy health insurance with distributions from your MSA unless you are receiving unemployment benefits, buying continuation coverage required by Federal law, or buying long-term care insurance.*

Taxable distributions and penalty. If you use the money from your MSA for any purpose besides qualified medical expenses, it will be taxable income that you must report on your tax return. In addition to the tax, you will be charged a 15 percent penalty for an early distribution. The penalty will not be charged if you are disabled or age 65.

Welfare and Other Public Assistance Benefits

Do not include in your income the benefit payments from a public welfare fund, such as payments due to blindness. Payments from a state fund for the victims of crime should not be included in the victims' incomes if they are in the nature of welfare payments. Do not deduct medical expenses that are reimbursed by such a fund. You must include in your income any welfare benefits obtained fraudulently.

Alaska residents. Payments the state of Alaska makes to its citizens who meet certain age and residency tests that are not based on need are not welfare benefits. Include them in gross income on line 21 of Form 1040.

Persons with disabilities. If you have a disability, you must include in income compensation you receive for services you perform unless the compensation is otherwise excluded. However, you do not include in income the value of goods, services, and cash that you receive, not in return for your services, but for your training and rehabilitation. Excludable amounts include payments for transportation and attendant care, such as interpreter services for the deaf, reader services for the blind, and services to help mentally retarded persons do their work.

Disaster relief grants. Grants made under the Disaster Relief Act of 1974 to help victims of natural disasters are not included in income. Do not deduct casualty losses or medical expenses that are specifically reimbursed by these disaster relief grants. Disaster unemployment assistance payments under the Act are unemployment benefits that are taxable. See *Unemployment compensation* in chapter 6.

Mortgage assistance payments. Payments made under section 235 of the National Housing Act for mortgage assistance are not included in the homeowner's gross income.

Interest paid for the homeowner under the mortgage assistance program cannot be deducted.

Payments to reduce cost of winter energy. Payments made by a state to qualified people to reduce their cost of winter energy use are not taxable.

Other Sickness and Injury Benefits

In addition to welfare or insurance benefits, you may receive other payments for sickness or injury. *Table 13–1* gives a general overview of some of these payments.

Table 13-1. **Are Your Sickness and Injury Benefits Taxable?**

This table is intended as a general overview. Additional rules may apply depending on your situation. For more information about your benefits, see ***Other Sickness and Injury Benefits.***

Type of Benefit	General Rule
Workers' Compensation	Not taxable if paid under a workers' compensation act or a statute in the nature of a workers' compensation act and paid due to a work related sickness or injury. However, payments received after returning to work are taxable.
Federal Employees' Compensation Act (FECA)	Not taxable if paid because of personal injury or sickness. However, payments received as "continuation of pay" for up to 45 days while a claim is being decided and pay received for sick leave while a claim is being processed are taxable.
Compensatory Damages	Not taxable if received for injury or sickness.
Accident or Health Insurance Benefits	Not taxable if you paid the insurance premiums.
Disability Benefits	Not taxable if received for loss of income or earning capacity due to an injury covered by a "no-fault" automobile policy.
Compensation for Permanent Loss or Loss of Use of a Part or Function of Your Body, or for Permanent Disfigurement	Not taxable if paid due to the injury. The payments must be figured without regard to any period of absence from work.
Reimbursements for Medical Care	Not taxable—but the reimbursement may reduce your medical expense deduction.

Workers' compensation. Amounts you receive as workers' compensation for an occupational sickness or injury are fully exempt from tax if they are paid under a workers' compensation act or a statute in the nature of a workers' compensation act. The exemption also applies to your survivor(s). The exemption from tax, however, does not apply to retirement benefits you receive based on your age, length of service, or prior contributions to the plan, even if you retired because of occupational sickness or injury.

Note. If part of your workers' compensation reduces your social security or equivalent railroad retirement benefits received, that part is considered social security (or equivalent railroad retirement) benefits and may be taxable. For more information, see Publication 915, *Social Security and Equivalent Railroad Retirement Benefits.*

Return to work. If you return to work after qualifying for workers' compensation, payments you continue to receive while assigned to light duties are taxable. Report these payments as wages on line 7 of Form 1040 or Form 1040A, or on line 1 of Form 1040EZ.

Federal Employees' Compensation Act (FECA). Payments received under this Act for personal injury or sickness, including payments to beneficiaries in case of death, are not taxable. However, you are taxed on amounts you receive under this Act as "continuation of pay" for up to 45 days while a claim is being decided. Report this income on line 7 of Form 1040 or Form 1040A, or on line 1 of Form 1040EZ. Also, pay for sick leave while a claim is being processed is taxable and must be included in your income as wages.

You can deduct the amount you spend to "buy back" sick leave for an earlier year to be eligible for nontaxable FECA benefits for that period. It is a miscellaneous deduction subject to the 2% limit on Schedule A (Form 1040). If you buy back sick leave in the same year you use it, the amount reduces your taxable sick leave pay. Do not deduct it separately.

Other compensation. Many other amounts you receive as compensation for injury or illness are not taxable. These include:

- ***Compensatory damages*** you receive for physical injury or physical illness, whether paid in a lump sum or in periodic payments,
- ***Benefits you receive under an accident or health insurance policy*** on which either you paid the premiums or your employer paid the premiums but you had to include them in your gross income,
- ***Disability benefits*** you receive for loss of income or earning capacity as a result of injuries under a "no-fault" car insurance policy, and
- ***Compensation you receive for permanent loss or loss of use*** of a part or function of your body, or for your permanent disfigurement. This compensation must be based only on the injury and not on the period of your absence from work. These benefits are exempt from tax even though your employer pays for the accident and health plan that provides these benefits.

Reimbursement for medical care. A reimbursement for medical care is generally not taxable. However, this reimbursement may reduce your medical expense deduction. For more information, see chapter 23.

Scholarship and Fellowship Grants

If you receive a scholarship or fellowship grant, you may be able to exclude from income all or part of the amounts you receive.

Qualified scholarships. A candidate for a degree can exclude amounts received as a qualified scholarship. A qualified scholarship is any amount you receive that is for:

1) Tuition and fees to enroll at or attend an educational organization, or
2) Fees, books, supplies, and equipment required for courses at the educational institution.

Amounts used for room and board ***do not*** qualify.

Payments for services. Payments you receive for services required as a condition of receiving a scholarship or fellowship grant must be included in income, even if the services are required of all candidates for the degree. This includes amounts received for teaching and research. Include these payments on line 7 of Form 1040 or Form 1040A, or on line 1 of Form 1040EZ. For more information on scholarships and fellowship grants, get Publication 520.

VA payments. Allowances paid by the Department of Veterans Affairs are not included in your gross income. These allowances are not considered scholarship or fellowship grants.

Prizes. Scholarship prizes won in a contest are not scholarships or fellowships if you do not have to use the prizes for educational purposes. You must include these amounts in your gross income on line 21 of Form 1040, whether or not you use the amounts for educational purposes.

Qualified tuition reductions. These reductions are excluded from your income. A qualified tuition reduction is the amount of reduction in tuition for education (below the graduate level) furnished to an employee of an educational institution (or certain other persons) provided certain requirements are met. However, graduate students who engage in teaching or research activities for the educational institution may qualify for this exclusion. For more information, get Publication 520.

Part Three.

Gains and Losses

The four chapters in this part discuss investment gains and losses, including how to figure your basis in property. A gain from selling or trading stocks, bonds, or other investment property may be taxed or it may be tax free, at least in part. A loss may or may not be deductible. These chapters also discuss gains from selling property you personally use — including the special rules for selling your home. Nonbusiness casualty and theft losses are discussed in chapter 27 in Part Five.

14.

Basis of Property

Introduction

This chapter discusses how to figure your basis in property and covers the following topics.

- Cost basis of property you buy.
- Adjustments to basis after you get property.
- Property you get because of a casualty or condemnation.
- Property you get in exchange for your services.
- Business or investment property you get in an exchange or trade-in.
- Property you get as a gift.
- Property transferred to you because of a divorce.
- Property you inherit.
- Stocks, bonds, and mutual funds in which you invest.

Basis is a way of measuring your investment in property for tax purposes. Use the basis of property to figure the deductions for depreciation, amortization, depletion, and casualty losses. Also use it to figure gain or loss on the sale or other disposition of property. You must keep accurate records of all items that affect the basis of property so you can make these computations.

Useful Items

You may want to see:

Publication

- ☐ **463** Travel, Entertainment, Gift, and Car Expenses
- ☐ **525** Taxable and Nontaxable Income
- ☐ **537** Installment Sales
- ☐ **550** Investment Income and Expenses
- ☐ **551** Basis of Assets
- ☐ **564** Mutual Fund Distributions

Cost Basis

The basis of property you buy is usually its cost. The cost is the amount you pay in cash, debt obligations or in other property. Your cost also includes, for example, amounts you pay for:

- Sales tax charged on the purchase,
- Freight charges to obtain the property,
- Installation and testing charges,
- Excise taxes,
- Legal and accounting fees (when they must be capitalized),
- Revenue stamps,
- Recording fees,
- Real estate taxes (if assumed for the seller), and
- Commissions.

In addition, the cost basis of real estate and business assets will include other items.

Loans with low or no interest. If you buy property on any time-payment plan that charges little or no interest, the basis of your property is your stated purchase price minus the amount considered to be unstated interest. You generally have unstated interest if your interest rate is less than the federal rate that applies.

For more information, see *Unstated Interest* in Publication 537.

Real Property

If you buy real property, certain fees and other expenses you pay are part of your basis in the property. Real property is land and generally anything built on, growing on, or attached to land. For example, a building is considered real property.

Assumption of a mortgage. If you buy property and assume (or buy subject to) an existing mortgage on the property, your basis includes the amount you pay for the property plus the unpaid mortgage.

Settlement costs. You can include in the basis of property you buy the settlement fees and closing costs that you pay in buying it. You cannot include the fees and costs that are for getting a loan on the property. (A fee is for buying property if you would have had to pay it even if you bought the property for cash.)

Some of the settlement fees or closing costs that you can include in the basis of your property are:

- Abstract fees (sometimes called abstract of title fees),
- Charges for installing utility services,
- Legal fees (including title search and preparing the sales contract and deed),
- Recording fees,
- Surveys,
- Transfer taxes,
- Owner's title insurance, and
- Any amounts the seller owes that you agree to pay, such as back taxes or interest, recording or mortgage fees, charges for improvements or repairs, and sales commissions.

You must reasonably allocate these fees or costs between land and improvements, such as buildings, to figure the basis for depreciation of the improvements. Allocate the fees according to the fair market values of the land and improvements at the time of purchase. ***Fair market value (FMV)*** is the price at which the property would change hands between a buyer and a seller, neither having to buy or sell, and both having reasonable knowledge of all necessary facts. Sales of similar property on or about the same date may be helpful in figuring the FMV of the property.

Settlement costs ***do not include*** amounts placed in escrow for the future payment of items such as taxes and insurance.

Some settlement fees and closing costs you ***cannot*** include in the basis of the property are:

1) Fire insurance premiums,
2) Rent for occupancy of the property before closing,
3) Charges for utilities or other services relating to occupancy of the property before closing,
4) Fees for refinancing a mortgage, and
5) Charges connected with getting a loan, such as:
   a) Points (discount points, loan origination fees),
   b) Mortgage insurance premiums,
   c) Loan assumption fees,
   d) Cost of a credit report, and
   e) Fees for an appraisal required by a lender.

Real estate taxes. If you buy real property and agree to pay taxes the seller owed on it, treat the taxes you pay as part of your basis. You cannot deduct them as taxes paid.

If you reimburse the seller for taxes the seller paid for you, you can usually deduct that amount. Do not include that amount in the basis of the property.

Points. If you pay points to get a loan (including a mortgage, second mortgage, line of credit, or a home equity loan), you generally must capitalize them. You can amortize them ratably over the term of the loan. Do not add the cost to the basis of the related property.

Points on home mortgage. Special rules may apply to amounts you and the seller pay as points when you get a mortgage to buy your main home. If these amounts meet certain requirements, you can deduct them in full as points for the year in which they are paid. If you deduct seller-paid points, reduce your basis by that amount. For more information, see *Points* in chapter 25.

Adjusted Basis

Before figuring any gain or loss on a sale, exchange, or other disposition of property, or figuring allowable depreciation, depletion, or amortization, you must usually make certain adjustments (increases and decreases) to the basis of the property. The result of these adjustments to the basis is the adjusted basis.

Increases to Basis

Increase the basis of any property by all items properly added to a capital account. This includes the cost of any improvements having a useful life of more than 1 year and amounts spent after a casualty to restore the damaged property. Other items added to the basis of property include the cost of extending utility service lines to the property and legal fees, such as the cost of defending and perfecting title.

Improvements. Add the cost of improvements that increase the value of property, lengthen its life, or adapt it to a different use to your basis in the property. For example, improvements include putting a recreation room in your unfinished basement, adding another bathroom or bedroom, putting up a fence, putting in new plumbing or wiring, installing a new roof, or paving your driveway.

Assessments for local improvements. Add assessments for improvements, such as streets and sidewalks, that increase the value of the property assessed to the basis of the property. Do not deduct them as taxes. However, you can deduct as taxes assessments you pay for maintenance or repair or meeting interest charges on the improvements.

Example. Your city changes the street in front of your store into an enclosed pedestrian mall and assesses you and other affected property owners for the cost of the conversion. The city adds the assessment to your property's basis. In this example, the assessment is a depreciable asset.

Table 14-1. **Examples of Adjustments to Basis**

Increases to Basis	**Decreases to Basis**
Capital improvements: Putting an addition on your home Replacing an entire roof Paving your driveway Installing central air conditioning Rewiring your home	Exclusion from income of subsidies for energy conservation measures Casualty or theft loss deductions and insurance reimbursements Credit for qualified electric vehicles
Assessments for local improvements: Water connections Sidewalks Roads	Gain from the sale of your old home on which tax was postponed Section 179 deduction
Casualty Losses: Restoring damaged property	Deduction for clean-fuel vehicles and clean-fuel vehicle refueling property
Legal fees: Cost of defending and perfecting a title	Depreciation
Zone costs	Nontaxable corporate distributions

Decreases to Basis

Some items that reduce the basis of your property are:

- The section 179 deduction (an elected deduction in lieu of depreciation deductions),
- The deduction for clean-fuel vehicles and clean-fuel vehicle refueling property,
- Nontaxable corporate distributions,
- Deductions previously allowed or allowable for amortization, depreciation, and depletion,
- Exclusion from income of subsidies for energy conservation measures (see *Energy conservation subsidies* in chapter 13),
- Credit for qualified electric vehicles,
- Gain from the sale of your old home on which tax was postponed,
- Casualty and theft losses and insurance reimbursements,
- Certain canceled debt excluded from income,
- Rebates received from the manufacturer or seller,
- Easements, and
- Gas-guzzler tax.

Some of these decreases to basis are discussed next.

Casualties and thefts. If you have a casualty or theft loss, decrease the basis of your property by any insurance proceeds or other amount you get. Also decrease it by any deductible loss not covered by insurance. However, increase your basis for your costs after a casualty to restore the damaged property. For more information, see chapter 27.

Easements. The amount you get for granting an easement usually is considered to be from the sale of an interest in your real property. It reduces the basis of the affected part of the property. If the amount received is more than the basis of the part of the property affected by the easement, reduce your basis to zero and treat the excess as a recognized gain.

If the recognized gain is on a capital asset, see chapter 17 for more information about how to report it. If the recognized gain is on property used in a trade or business, get Publication 544, *Sales and Other Dispositions of Assets,* for more information about how to report this gain.

Depreciation and section 179 deduction. Decrease the basis of your business property by any section 179 deduction you take and the depreciation you deducted, or could have deducted, on your tax returns under the method of depreciation you selected.

For more information, get Publication 946.

Credit for qualified electric vehicles. If you claim the credit for qualified electric vehicles, you must reduce the basis of the property on which you claimed the credit. For more information about this credit, see chapter 15 in Publication 535, *Business Expenses.*

Deduction for clean-fuel vehicle and clean-fuel vehicle refueling property. If you take the deduction for either clean-fuel vehicles or clean-fuel vehicle refueling property, or both, decrease the basis of the property by the deduction. For more information about these deductions, see chapter 15 in Publication 535.

Tax-free subsidies for energy conservation measures. A subsidy from a public utility company for the purchase or installation of any energy conservation measure may be tax free. Reduce the basis of the property on which you got the subsidy by the tax-free amount. For more information about this subsidy, see chapter 13.

Adjusted Basis Example

You owned a duplex used as rental property that cost you $40,000. The $40,000 cost was allocated $35,000 for the building and $5,000 for the land. You added an improvement to the duplex that cost $10,000. In February last year the duplex was damaged by fire. Up to that time you had been allowed depreciation of $23,000. You sold some salvaged material for $1,300 and collected $19,700 from your insurance company. You deducted a casualty loss of $1,000 on your income tax return for last year. You spent $19,000 of the insurance proceeds for restoration of the duplex, which was completed this year. Figure the adjusted basis of the duplex after the restoration as follows:

Original cost of duplex		$35,000
Addition to duplex		10,000
Total cost of duplex		$45,000
Minus: Depreciation		23,000
Adjusted basis before casualty		$22,000
Minus: Casualty loss	$1,000	
Insurance proceeds	19,700	
Salvage proceeds	1,300	22,000
Adjusted basis after casualty		$–0–
Add: Cost of restoring duplex		19,000
Adjusted basis after restoration		$19,000

Your basis in the land is its original cost of $5,000.

Other Basis

There are many times when you cannot use cost as a basis. In these cases, the fair market value or the adjusted basis of certain property may be used. Fair market value is discussed next. Adjusted basis is discussed earlier.

Property received for services. If you get property for your services, the property's FMV is taxable. The taxable amount becomes your basis. If the services were performed for a price agreed on beforehand, the price will be accepted as the FMV of the property if there is no evidence to the contrary.

Restricted property. If you get property, such as stock, for your services and the property is subject to certain restrictions, your basis in the property is its FMV when it becomes substantially vested, unless you make an election. Property becomes substantially vested when it is not subject to a substantial risk of forfeiture. For more information, see *Restricted Property Received for Services* in Publication 525.

Bargain purchases. A bargain purchase is a purchase of an item for less than its FMV. If, as compensation for services, someone you work for lets you buy goods or other property at less than FMV, include the difference between the purchase price and the property's FMV in your income. Your basis in the property is its FMV, that is, your purchase price plus the amount you include in your income.

If the difference between your purchase price and the FMV is a qualified employee discount, do not include the difference in income. However, your basis in the property is still its FMV. See *Qualified Employee Discount* in chapter 4 of Publication 535.

Taxable exchanges. A taxable exchange is one in which the gain is taxable or the loss is deductible. If you get property in exchange for other property in a taxable exchange, the basis of the property you get is usually its FMV at the time of the exchange.

Involuntary Exchanges

If you get property as a result of an involuntary exchange, such as a casualty, theft, or condemnation, you may figure the basis of the replacement property you get using the basis of the property exchanged.

Similar or related property. If you get property that is similar or related in service or use to the property exchanged, the new property's basis is the same as the old property's basis on the date of the exchange. However, make the following adjustments:

Decrease the basis by—

- Any loss recognized on the exchange, and
- Any money received that was not spent on similar property.

Increase the basis by—

- Any gain recognized on the exchange, and
- Any cost of getting replacement property.

Not similar or related property. If you get money or property that is not similar or related in service or use to the old property and you buy new property that is similar or related in service or use to the old property, the basis of the new property is the cost of the new property decreased by the gain not recognized on the exchange.

Example. The state condemned your property. The adjusted basis of the property was $26,000, and the state paid you $31,000 for it. You realized a gain of $5,000 ($31,000 – $26,000). You bought new property that is similar in use to the old property for $29,000. You recognize a gain of $2,000 ($31,000 – $29,000), the unspent part of the payment from the state. Your gain not recognized is $3,000, the difference between the $5,000 realized gain and the $2,000 recognized gain. You figure the basis of the new property as follows:

Cost of new property	$29,000
Minus: Gain not recognized	3,000
Basis of new property	$26,000

Allocating the basis. If you buy more than one piece of replacement property, allocate your basis among the properties based on their respective costs.

Nontaxable Exchanges

A nontaxable exchange is an exchange in which you are not taxed on any gain and you cannot deduct any loss. If you get property in a nontaxable exchange, its basis is usually the same as the basis of the property you exchanged. See *Nontaxable Trades* in chapter 15.

Example. You trade in an old truck, which has an adjusted basis of $1,700, for a new one costing $6,800. The dealer allows you $2,000 on the old truck, and you pay $4,800. This is a nontaxable exchange, and the basis of the new truck is $6,500, that is, the adjusted basis of the old one, $1,700, increased by the additional cost, $4,800. If you instead sell your old truck to a third party for $2,000 and then buy the new one from the dealer, you have a taxable gain on the sale. The basis of the new truck is the price you pay the dealer for it.

Partially nontaxable exchange. A partially nontaxable exchange is an exchange in which you get unlike property or money and like property.

The basis of property you get is usually the same as the basis of the property exchanged ***decreased*** by any money you get and any loss recognized on the exchange; and then ***increased*** by any additional costs incurred and any gain recognized on the exchange.

Allocate the basis among the properties, other than money, you got in the exchange. In making this allocation, the basis of the unlike property is its fair market value on the date of exchange. The rest is the basis of the like property.

Property Received as a Gift

To figure the basis of property you get as a gift, you must know its adjusted basis to the donor just before it was given to you. You also must know its FMV at the time it was given to you and any gift tax paid on it.

FMV less than donor's adjusted basis. If the FMV of the property was less than the donor's adjusted basis, your basis for figuring gain on its sale or other disposition is the donor's adjusted basis plus or minus any required adjustment to basis while you held the property. Your basis for figuring loss on its sale or other disposition is its FMV when you got the gift plus or minus any required adjustment to basis while you held the property. See *Adjusted Basis,* earlier.

Example. You got an acre of land as a gift. At the time of the gift, the land had an FMV of $8,000. The donor's adjusted basis was $10,000. After you got the property, no events occur that would increase or decrease your basis in it. If you later sell the property for $12,000, you will have a $2,000 gain. You must use the donor's adjusted basis ($10,000) at the time of the gift as your basis to report a gain. If you sell the property for $7,000, you have a $1,000 loss because you must use the FMV ($8,000) at the time of the gift to report a loss.

If the sales price were between $8,000 and $10,000, you have neither a gain nor a loss.

Business property. If you hold the gift as business property, your basis for figuring any depreciation, depletion, or amortization deduction is the same as the donor's adjusted basis plus or minus any required adjustments to basis while you hold the property.

FMV equal to or greater than donor's adjusted basis. If the FMV of the property were equal to or greater than the donor's adjusted basis, your basis for figuring gain or loss on its sale or other disposition is the same as the donor's adjusted basis at the time you got the gift. Increase your basis by all or part of the gift tax paid, depending on the date of the gift.

Also, for figuring gain or loss from a sale or other disposition or figuring depreciation, depletion, or amortization deductions on business property, you must increase or decrease your basis (the donor's adjusted basis) for any required adjustments to basis while you held the property. See *Adjusted Basis,* earlier.

Gift received before 1977. If you got a gift before 1977, increase your basis in the gift by the gift tax paid on it. However, do not increase your basis above the FMV of the gift when it was given to you.

Gift received after 1976. If you got a gift after 1976, increase your basis in the gift by the part of the gift tax paid that is due to the net increase in value of the gift. Figure the increase by multiplying the gift tax paid on the gift by a fraction. The numerator (top part) of the fraction is the net increase in value of the gift and the denominator (bottom part) is the value of the gift. The net increase in value of the gift is the FMV of the gift minus the donor's adjusted basis.

Example. Last year you got a gift of property from your mother that had an FMV of $50,000. Her adjusted basis was $20,000. She paid a gift tax of $9,000 on the property. For figuring depreciation, depletion, amortization, and gain or loss, your basis is $25,400, figured as follows:

Fair market value	$50,000
Minus: Adjusted basis	20,000
Net increase in value	$30,000
Gift tax paid	$9,000
Multiplied by ($30,000 ÷ $50,000)	.60
Gift tax due to net increase in value	$5,400
Plus: Adjusted basis of property to your mother	20,000
Your basis in the property	$25,400

Property Transferred From a Spouse

The basis of property transferred to you or transferred in trust for your benefit by your spouse is the same as your spouse's adjusted basis. The same rule applies to a transfer by your former spouse if the transfer is incident to divorce. However, adjust your basis for any gain recognized by your spouse on a property transferred in trust. This rule applies only to a property transfer in trust in which the liabilities assumed plus the liabilities to which the property is subject are more than the adjusted basis of the property transferred.

If the property transferred is a Series E or EE United States savings bond, your spouse must include in income the interest accrued to the date of transfer. Your spouse's basis in the bond immediately after the transfer is equal to his or her adjusted basis plus the interest income includible in his or her income.

Your spouse must give you records needed to determine the adjusted basis and holding period of the property as of the date of the transfer. For more information about the transfer of property between spouses, see chapter 15.

Inherited Property

Your basis in property you inherit is usually its fair market value (FMV) at the date of the decedent's death. If a federal estate tax return has to be filed, your basis in property you inherit can be its FMV at the alternate valuation date if the estate qualifies and elects to use alternate valuation. If a federal estate tax return does not have to be filed, your basis in the property is its appraised value at the date of death for state inheritance or transmission taxes.

Your basis in inherited property may also be figured under the special farm or closely held business real property valuation method, if chosen for estate tax purposes.

For more information about the basis of inherited property, see *Inherited Property* in Publication 551.

Property Changed to Business or Rental Use

When you hold property for personal use and change it to business use or use it to produce rent, you must figure the basis for depreciation. An example of this would be renting out your former main home.

Basis for depreciation. The basis for depreciation equals the lesser of:

1) The FMV (defined earlier under *Other Basis*) of the property on the date of the change, or

2) Your adjusted basis (defined earlier under *Adjusted Basis)* on the date of the change.

Example. Several years ago, you paid $160,000 to have your house built on a lot that cost you $20,000. Before changing the property to rental use last year, you paid $20,000 for permanent improvements to the house and claimed a $2,000 casualty loss deduction to the house. Because land is not depreciable, you can include only the cost of the house when figuring the basis for depreciation.

Your adjusted basis in the house when you changed its use was $178,000 ($160,000 + $20,000 − $2,000).

On the date of the change in use, your property had a FMV of $180,000, of which $15,000 was for the land and $165,000 was for the house. The basis for depreciation on the house is the FMV on the date of the change ($165,000) because it is less than your adjusted basis ($178,000).

Sale of property. If you later sell or dispose of the property, the basis of the property to be used will depend on whether you are figuring gain or loss.

Gain. The basis for gain is your adjusted basis (not your basis for depreciation) when you sell the property.

Example. Assume the same facts as in the previous example except that, after being allowed depreciation deductions of $37,500, you sell the property. Your basis for figuring gain in this case would be $160,500 ($178,000 + $20,000 (land) − $37,500).

Loss. Figure the basis for loss starting with the smaller of your adjusted basis or the FMV of the property at the time of the change.

Example. Assume the same facts as in the previous example. Your basis for figuring gain in this case would be the FMV ($180,000) because it is less than the adjusted basis ($198,000) on the date of the exchange. That amount ($180,000) is reduced by the depreciation deduction to arrive at a basis of $142,500 ($180,000 − $37,500).

Stocks and Bonds

The basis of stocks or bonds you own generally is the purchase price plus the costs of purchase, such as commissions and recording or transfer fees. If you got stocks or bonds other than by purchase, your basis is usually determined by FMV or the donor's adjusted basis, as discussed earlier.

You must adjust the basis of stocks for certain events that occur after purchase. For example, if you get additional stock from nontaxable stock dividends or stock splits, reduce the basis of your original stock. Also reduce your basis when you get nontaxable distributions because these are a return of capital.

Example. In 1995 you bought 100 shares of XYZ stock for $1,000 or $10 a share. In 1996 you bought 100 shares of XYZ stock for $1,600 or $16 a share. In 1997 XYZ declared a 2-for-1 stock split. You now have 200 shares of stock with a basis of $5 a share and 200 shares with a basis of $8 a share.

Other basis. There are other ways to figure the basis of stocks or bonds depending on how you acquired them. For detailed information, get Publication 550.

Identifying shares. If you buy and sell securities at different times in varying quantities and you cannot definitely identify the securities you sell, figure the basis of those sold under the first-in first-out method—that is, the first securities you acquired are the first sold. For more information about identifying securities you sell, see *Stocks and Bonds* in chapter 4 of Publication 550.

Mutual fund shares. You can choose to use the average basis of shares you own in a regulated investment company (mutual fund) if you acquired the shares at various times and prices. For more information about figuring the basis of mutual fund shares, see Publication 564.

Premiums on bonds. If you buy a taxable bond at a premium and choose to amortize the premium paid, reduce the basis of the bond by the amount of the amortized premium deducted each year. See *Bond Premium Amortization* in chapter 3 of Publication 550 for more information. Although you cannot take a deduction for the premium on tax-exempt bonds, each year you must amortize the premium and reduce your basis in the bonds by the amortized amount.

Original issue discount (OID) on debt instruments. You must increase your basis in an OID debt instrument by the amount of OID that you included in income for that instrument. See *Original Issue Discount* in chapter 8.

Tax-exempt bonds. OID on tax-exempt bonds is not taxable. However, there are special rules for figuring basis on tax-exempt OID bonds issued after September 3, 1982, and acquired after March 1, 1984. See chapter 4 of Publication 550.

15.

Sale of Property

Important Change for 1998

Qualified small business stock. Beginning in 1998, you may have to pay tax on only one-half of your gain from the sale or exchange of qualified small business stock. This applies only to stock originally issued after August 10, 1993, and held by you for more than 5 years. For more information, see *Sales of Small Business Stock* in chapter 4 of Publication 550.

Important Reminder

Foreign-source income. If you are a U.S. citizen with investment income from sources outside the United States (foreign income), you must report all that income on your tax return unless it is exempt by U.S. law. This is true whether you reside inside or outside the United States and whether or not you receive a Form 1099 from the foreign payer.

Introduction

This chapter discusses the tax consequences of selling or trading investment property. It explains:

- What is a sale or trade,
- When you have a nontaxable trade,
- What to do with a related party transaction,
- Whether the property you sell is a capital asset or a noncapital asset,
- Whether you have a capital or ordinary gain or loss from the sale of property,
- How to determine your holding period, and
- When you can make a tax-free rollover of a gain from selling certain securities.

Sales not discussed in this publication. Certain sales or trades of property are discussed in other IRS publications. They include, for example, installment sales, covered in Publication 537, *Installment Sales,* and transfers of property at death, covered in Publication 559, *Survivors, Executors, and Administrators.*

Publication 544, *Sales and Other Dispositions of Assets,* provides information about various types of transactions involving business property.

Publication 550, *Investment Income and Expenses (Including Capital Gains and Losses),* provides more detailed discussion about sales and trades of investment property. Publication 550 includes information about the rules covering nonbusiness bad debts, straddles, section 1256 contracts, puts and calls, commodity futures, short sales, and wash sales. It also discusses investment-related expenses.

Publication 925, *Passive Activity and At-Risk Rules,* discusses the rules that limit losses and credits from passive activities as well as the rules that apply to the disposition of an interest in a passive activity.

If you sell your home, different tax rules apply. These rules are discussed in chapter 16.

Useful Items

You may want to see:

Publication

- ☐ **504** Divorced or Separated Individuals
- ☐ **550** Investment Income and Expenses
- ☐ **564** Mutual Fund Distributions

Form (and Instructions)

- ☐ **Schedule D (Form 1040)** Capital Gains and Losses
- ☐ **8824** Like-Kind Exchanges

Sales and Trades

Sales and trades (or exchanges) of assets generally result in taxable gains or deductible losses, although some trades of property are nontaxable.

Form 1099–B. If you sold property such as stocks, bonds, or certain commodities through a broker during the year, you should receive, for each sale, a Form 1099–B, *Proceeds From Broker and Barter Exchange Transactions,* or an equivalent statement from the broker. You should receive the statement by January 31 of the next year. It will show the gross proceeds from the sale. The Internal Revenue Service (IRS) will also get a copy of Form 1099–B from the broker.

If you receive a Form 1099–B or equivalent statement, you must complete Schedule D of Form 1040.

What is a Sale or Trade?

A sale is generally a transfer of property for money or a mortgage, note, or other promise to pay money. A trade is a transfer of property for other property or services and may be taxed in the same way as a sale.

Sale and purchase. Ordinarily, a transaction is not a trade when you voluntarily sell property for cash and immediately buy similar property to replace it. The sale and purchase are two separate transactions. But see *Like-kind exchanges* under *Nontaxable Trades,* later.

Redemption of stock. A redemption of stock is treated as a sale or trade and is subject to the capital gain or loss provisions unless the redemption is a dividend or other distribution on stock.

Dividend vs. sale or trade. Whether a redemption is treated as a sale, trade, dividend, or other distribution depends on the circumstances in each case. Both direct and indirect ownership of stock will be considered. The redemption is treated as a sale or trade of stock if:

1) The redemption is not essentially equivalent to a dividend (see chapter 9),
2) There is a substantially disproportionate redemption of stock,
3) There is a complete redemption of all the stock of the corporation owned by the shareholder, or
4) The redemption is a distribution in partial liquidation of a corporation.

Redemption or retirement of bonds. A redemption or retirement of bonds or notes at their maturity is treated as a sale or trade. You must report the transaction on Schedule D (Form 1040) whether or not you realize gain or loss.

However, if the issuer has merely extended the maturity date of its notes, during which period some of the noteholders have agreed not to redeem their notes until all the other notes are retired or their retirement is provided for, neither a trade nor a closed or completed transaction has occurred. Under these circumstances, you do not figure gain or loss.

Surrender of stock. A surrender of stock by a dominant shareholder who retains control of the corporation is treated as a contribution to capital rather than as an immediate loss deductible from taxable income. The surrendering shareholder must reallocate his or her basis in the surrendered shares to the shares he or she retains.

How To Figure a Gain or Loss

You figure gain or loss on a sale or trade of property by comparing the amount you realize with the adjusted basis of the property.

Gain. If the amount you realize from a sale or trade is more than the adjusted basis of the property you transfer, the difference is a gain.

Loss. If the adjusted basis of the property you transfer is more than the amount you realize, the difference is a loss.

Adjusted basis. The adjusted basis of property is your original cost or other original basis properly adjusted (increased or decreased) for certain items. See chapter 14 for more information about determining the adjusted basis of property.

Amount realized. The amount you realize from a sale or trade of property is everything you receive for the property. This includes the money you receive plus the fair market value of any property or services you receive.

If you finance the buyer's purchase of your property and the debt instrument does not provide for adequate stated interest, the unstated interest will reduce the amount realized. For more information, see Publication 537.

Fair market value. Fair market value is the price at which the property would change hands between a buyer and a seller, neither being forced to buy or sell and both having reasonable knowledge of all the relevant facts.

The fair market value of notes or other debt instruments you receive as a part of the sale price is usually the best amount you can get from selling them to, or discounting them with, a bank or other buyer of debt instruments.

Example. You trade A Company stock with an adjusted basis of $7,000 for B Company stock with a fair market value of $10,000, which is your amount realized. Your gain is $3,000 ($10,000 – $7,000). If you also receive a note for $6,000 that has a discount value of $4,000, your gain is $7,000 ($10,000 + $4,000 – $7,000).

Debt paid off. A debt against the property, or against you, that is paid off as a part of the transaction, or that is assumed by the buyer, must be included in the amount realized. This is true even if neither you nor the buyer is personally liable for the debt. For example, if you sell or trade property that is subject to a nonrecourse loan, the amount you realize includes the full amount of the note assumed by the buyer even if the amount of the note is more than the fair market value of the property.

Example. You sell stock that you had pledged as security for a bank loan of $8,000. Your basis in the stock is $6,000. The buyer pays off your bank loan and pays you $20,000 in cash. The amount realized is $28,000 ($20,000 + $8,000). Your gain is $22,000 ($28,000 – $6,000).

Payment of cash. If you trade property for other property and in addition pay cash, the amount you realize is the fair market value of the property you receive. Determine your gain or loss by subtracting the cash you pay plus the adjusted basis of the property you traded in from the amount you realize. If the result is a positive number, it is a gain. If the result is a negative number, it is a loss.

No gain or loss. You may have to use a basis for figuring gain that is different from the basis used for figuring loss. In this case, you may have neither a gain nor a loss. See *Other Basis* in chapter 14. In these situations, if you use the basis for figuring a gain and the result is a loss, and then use the basis for figuring a loss and the result is a gain, you will have neither a gain nor a loss.

Example. You receive a gift of investment property having an adjusted basis of $10,000 at the time of the gift. The fair market value at the time of the gift is $9,000. You later sell the property for $9,500. You have neither gain nor loss. Your basis for figuring gain is $10,000, and $10,000 minus $9,500 results in a $500 loss. Your basis for figuring loss is $9,000, and $9,500 minus $9,000 results in a $500 gain.

Nontaxable Trades

Certain trades or exchanges are nontaxable. This means that any gain from the exchange is not taxed, and any loss cannot be deducted. In other words, even though you may realize a gain or loss on the exchange, it will not be recognized for tax purposes. The property you get generally has the same basis as the adjusted basis of the property you gave up.

For additional information on nontaxable trades, see chapter 1 of Publication 544.

Like-kind exchanges. If you trade business or investment property for other business or investment property of a like kind, you must postpone tax on the gain or postpone deducting the loss until you sell or dispose of the property you receive. To be nontaxable, a trade must meet all six of the following conditions.

1) The property must be business or investment property. You must hold both the property you trade and the property you receive for business or investment purposes. Neither property may be property used for personal purposes, such as your home or family car.

2) The property must not be property held primarily for sale. The property you trade and the property you receive must not be property you sell to customers, such as merchandise. It must be property held for productive use in your trade or business or property held for investment.

3) There must be an exchange of like property. The exchange of real estate for real estate and the exchange of personal property for similar personal property are exchanges of like property. The trade of an apartment house for a store building, or a panel truck for a pickup truck, is a like-kind exchange. The exchange of a piece of machinery for a store building is not a like-kind exchange. Real property located in the United States and real property located outside the United States are not like property. In the case of transfers after June 8, 1997, personal property used predominantly within the United States and personal property used predominantly outside the United States are not like property.

4) The property must not be stocks, bonds, notes, choses in action, certificates of trust or beneficial interests, or other securities or evidences of indebtedness or interest, including partnership interests. However, you can have a nontaxable exchange of corporate stocks under a different rule, as discussed later under *Corporate stocks.*

5) The property to be received must be identified by the day that is 45 days after the date of transfer of the property given up in the exchange.

6) The property to be received must be received by the earlier of:

   a) The 180th day after the date on which you transfer the property given up in the trade, or

   b) The due date, including extensions, for your tax return for the year in which the transfer of the property given up occurs.

If you trade property with a related party in a like-kind exchange, a special rule may apply. See *Related Party Transactions,* later in this chapter. Also, see chapter 1 of Publication 544 for more information on exchanges of business property and special rules for exchanges using qualified intermediaries or involving multiple properties.

Partially nontaxable exchange. If you receive cash or unlike property in addition to like property, and conditions (1) – (6) are met, you have a partially nontaxable trade. You are taxed on any gain you realize, but only to the extent of the cash and the fair market value of the unlike property you receive. You cannot deduct a loss.

Like property and unlike property transferred. If you give up unlike property in addition to the like property, you must recognize gain or loss on the unlike property you give up. The gain or loss is the difference between the adjusted basis of the unlike property and its fair market value. See chapter 1 of Publication 544 for more information about partially nontaxable exchanges.

Like property and money transferred. If conditions (1) – (6) are met, you have a nontaxable trade even if you pay money in addition to transferring property in exchange for like property.

Basis of property received. To figure the basis of the property received, see *Nontaxable Exchanges* in chapter 14.

How to report. You must report the exchange of like property on **Form 8824,** *Like-Kind Exchanges.* If you figure a recognized gain or loss on Form 8824, report it on Schedule D of Form 1040 or on Form 4797, *Sales of Business Property,* whichever applies.

For information on using Form 4797, see chapter 5 of Publication 544.

Corporate stocks. The following trades of corporate stocks generally do not result in a taxable gain or a deductible loss.

Stock for stock of the same corporation. You can exchange common stock for common stock or preferred stock for preferred stock in the same corporation without having a recognized gain or loss. This is true for a trade between two stockholders as well as a trade between a stockholder and the corporation.

Corporate reorganizations. In some instances, you can trade common stock for preferred stock, preferred stock for common stock, or stock in one corporation for stock in another corporation without having a recognized gain or loss. These trades must be part of mergers, recapitalizations, transfers to controlled corporations, bankruptcies, corporate divisions, corporate acquisitions, or other corporate reorganizations.

Convertible stocks and bonds. You generally will not have a recognized gain or loss if you convert bonds into stock or preferred stock into common stock of the same corporation according to a conversion privilege in the terms of the bond or the preferred stock certificate.

Property for stock of a controlled corporation. If you transfer property to a corporation solely in exchange for stock in that corporation, and immediately after the trade you are in control of the corporation, you ordinarily will not recognize a gain or loss. This rule applies both to individuals and to groups who transfer property to a corporation. It does not apply if the corporation is an investment company.

However, if you had a gain from the disposition of depreciable property from this transaction, you may be taxed on part of the gain. See Publication 544 for more information.

For this purpose, to be in control of a corporation, you or your group of investors must own, immediately after the exchange, at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the outstanding shares of each class of nonvoting stock of the corporation.

If this provision applies to you, you must attach to your return a complete statement of all facts pertinent to the exchange.

Additional information. For more information on trades of stock, see *Nontaxable Trades* in Publication 550.

Insurance policies and annuities. You will not have a recognized gain or loss if you trade:

1) A life insurance contract for another life insurance contract or for an endowment or annuity contract,
2) An endowment contract for an annuity contract or for another endowment contract that provides for regular payments beginning at a date not later than the beginning date under the old contract, or
3) An annuity contract for another annuity contract.

The insured or annuitant must stay the same as under the original contract. Exchanges of contracts not included in this list, such as an annuity contract for an endowment contract, or an annuity or endowment contract for a life insurance contract, are taxable.

U.S. Treasury notes or bonds. You can trade certain issues of U.S. Treasury obligations for other issues, designated by the Secretary of the Treasury, with no gain or loss recognized on the trade. See *U.S. Treasury Notes or Bonds* under *Nontaxable Trades* in Publication 550 for information about the tax treatment of income from these investments.

For other information on Treasury notes or bonds, write to:
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Bureau of the Public Debt
U.S. Department of the Treasury
Capitol Area Servicing Center
1300 C Street, S.W.
Washington, D.C. 20239–0001

Or, on the Internet, visit:
www.publicdebt.treas.gov

Transfers Between Spouses

Generally, no gain or loss is recognized on a transfer of property from an individual to (or in trust for the benefit of) a spouse, or if incident to a divorce, a former spouse. This nonrecognition rule does not apply if the recipient spouse or former spouse is a nonresident alien. The rule also does not apply to a transfer in trust to the extent the adjusted basis of the property is less than the amount of the liabilities assumed plus any liabilities on the property.

Any transfer of property to a spouse or former spouse on which gain or loss is not recognized is treated by the recipient as a gift and is not considered a sale or exchange. The recipient's basis in the property will be the same as the adjusted basis of the giver immediately before the transfer. This carryover basis rule applies whether the adjusted basis of the transferred property is less than, equal to, or greater than either its fair market value at the time of transfer or any consideration paid by the recipient. This rule applies for purposes of determining loss as well as gain. Any gain recognized on a transfer in trust increases the basis.

A transfer of property is incident to a divorce if the transfer occurs within one year after the date on which the marriage ends, or if the transfer is related to the ending of the marriage.

For more information, see Publication 504.

Related Party Transactions

Special rules apply to the sale or trade of property between related parties.

Gain on sale or trade of depreciable property. The capital gain provisions do not apply and your gain is ordinary income, if both of the following are true.

1) You have a recognized gain on the sale or trade of property, including a leasehold or a patent application, that is depreciable property in the hands of the party who receives it.
2) The transaction is between you and a controlled entity, or you and a trust in which you or your spouse is a beneficiary.

See chapter 2 in Publication 544 for more information.

Like-kind exchanges. Generally, if you trade business or investment property for other business or investment property of a like kind, no gain or loss is recognized. See *Like-kind exchanges* earlier under *Nontaxable Trades.*

This rule also applies to trades of property between related parties, defined next under *Losses on sales or trades of property.* However, if either you or the related party disposes of the like property within 2 years after the trade, you both must report any gain or loss not recognized on the original trade on your return filed for the year in which the later disposition occurs.

Losses on sales or trades of property. You cannot deduct a loss on the sale or trade of property, other than a distribution in complete liquidation of a corporation, if the transaction is directly or indirectly between you and the following related parties.

1) Members of your family. This includes only your brothers and sisters, half-brothers and half-sisters, spouse, ancestors (parents, grandparents, etc.), and lineal descendants (children, grandchildren, etc.).
2) A partnership in which you directly or indirectly own more than 50% of the capital interest or the profits interest.
3) A corporation in which you directly or indirectly own more than 50% in value of the outstanding stock (see *Constructive ownership of stock,* later).
4) A tax-exempt charitable or educational organization that is directly or indirectly controlled, in any manner or by any method, by you or by a member of your family, whether or not this control is legally enforceable.

In addition, a loss on the sale or trade of property is not deductible if the transaction is directly or indirectly between the following related parties.

1) A grantor and fiduciary, or the fiduciary and beneficiary, of any trust.
2) Fiduciaries of two different trusts, or the fiduciary and beneficiary of two different trusts, if the same person is the grantor of both trusts.
3) A trust fiduciary and a corporation of which more than 50% in value of the outstanding stock is directly or indirectly owned by or for the trust, or by or for the grantor of the trust.
4) A corporation and a partnership if the same persons own more than 50% in value of the outstanding stock of the corporation and more than 50% of the capital interest, or the profits interest, in the partnership.
5) Two S corporations if the same persons own more than 50% in value of the outstanding stock of each corporation.
6) Two corporations, one of which is an S corporation, if the same persons own more than 50% in value of the outstanding stock of each corporation.
7) An executor and a beneficiary of an estate (except in the case of a sale or trade to satisfy a pecuniary bequest), for tax years beginning after August 5, 1997.
8) Two corporations that are members of the same controlled group. (Under certain conditions, however, these losses are not disallowed but must be deferred.)
9) Two partnerships if the same persons own, directly or indirectly, more than 50% of the capital interests or the profits interests in both partnerships.

Multiple property sales or trades. If you sell or trade to a related party a number of blocks of stock or pieces of property in a lump sum, you must figure the gain or loss separately for each block of stock or piece of property. The gain on each item may be taxable. However, you cannot deduct the loss on any item. Also, you cannot reduce gains from the sales of any of these items by losses on the sales of any of the other items.

Indirect transactions. These include sales through a stock exchange. You cannot deduct your loss on the sale of stock through your broker if, under a prearranged plan, a related party buys the same stock you had owned.

Constructive ownership of stock. In determining whether a person directly or indirectly owns any of the outstanding stock of a corporation, the following rules apply.

Rule 1. Stock directly or indirectly owned by or for a corporation, partnership, estate, or trust is considered owned proportionately by or for its shareholders, partners, or beneficiaries.

Rule 2. An individual is considered to own the stock that is directly or indirectly owned by or for his or her family. Family includes only brothers and sisters, half-brothers and half-sisters, spouse, ancestors, and lineal descendants.

Rule 3. An individual owning, other than by applying rule 2, any stock in a corporation is considered to own the stock that is directly or indirectly owned by or for his or her partner.

Rule 4. When applying rule 1, 2, or 3, stock constructively owned by a person under rule 1 is treated as actually owned by that person. But stock constructively owned by an individual under rule 2 or rule 3 is not treated as owned by that individual for again applying either rule 2 or rule 3 to make another person the constructive owner of the stock.

Property received from a related party. If you sell or trade at a gain property that you acquired from a related party, you recognize the gain only to the extent it is more than the loss previously disallowed to the related party. This rule applies only if you are the original transferee and you acquired the property by purchase or exchange. This rule does not apply if the related party's loss was disallowed because of the wash sale rules, described in Publication 550 under *Wash Sales.*

Example 1. Your brother sells you stock for $7,600. His cost basis is $10,000. Your brother cannot deduct the loss of $2,400. Later, you sell the same stock to an unrelated party for $10,500, realizing a gain of $2,900. Your reportable gain is $500 — the $2,900 gain minus the $2,400 loss not allowed to your brother.

Example 2. If, in *Example 1,* you sold the stock for $6,900 instead of $10,500, your recognized loss is only $700 (your $7,600 basis minus $6,900). You cannot deduct the loss that was not allowed to your brother.

Capital or Ordinary Gain or Loss

This section discusses the tax treatment of different types of investment transactions. For information about the tax treatment of gains and losses on the sale or exchange of property used in a trade or business, see Publication 544.

If you have a taxable gain or a deductible loss from a transaction, it may be either a capital gain or loss or an ordinary gain or loss, depending on the circumstances. Generally, a sale or trade of a capital asset (defined later) results in a capital gain or loss. A sale or trade of a noncapital asset generally results in ordinary gain or loss. Depending on the circumstances, a gain or loss on a sale or trade of property used in a trade or business may be treated as either capital or ordinary, as explained in Publication 544. In some situations, part of your gain or loss may be a capital gain or loss and part may be an ordinary gain or loss.

Character of gain or loss. It is important for you to properly distinguish or classify your gains and losses as either ordinary or capital gains or losses. You need to classify your capital gains and losses as either short-term or long-term. If you have long-term gains and losses, you must identify your 28% rate gains and losses.

The correct classification and identification helps you figure the limit on capital losses and your proper tax on capital gains.

For information about determining whether your capital gain or loss was short-term or long-term and whether your long-term gain or loss is a 28% rate gain or loss, see the discussion under *Holding Period,* later in this chapter.

Capital Assets and Noncapital Assets

For the most part, everything you own and use for personal purposes, pleasure, or investment is a ***capital asset.*** Some examples are:

- Stocks or bonds held in your personal account,
- A house owned and used by you and your family,
- Household furnishings,
- A car used for pleasure or commuting,
- Coin or stamp collections,
- Gems and jewelry, and
- Gold, silver, or any other metal.

The following items are ***noncapital assets.***

1) ***Property held mainly for sale to customers*** or property that will physically become a part of the merchandise that is for sale to customers.
2) ***Depreciable property*** used in your trade or business, even if fully depreciated.
3) ***Real property*** used in your trade or business.
4) ***A copyright, a literary, musical, or artistic composition, a letter or memorandum,*** or similar property:
   a) Created by your personal efforts,
   b) Prepared or produced for you as a letter, memorandum, or similar property, or
   c) Acquired under circumstances (for example, by gift) entitling you to the basis of the person who created the property or for whom it was prepared or produced.
5) ***Accounts or notes receivable*** acquired in the ordinary course of a trade or business, or for services rendered as an employee, or from the sale of any of the properties described in (1).
6) ***U.S. Government publications*** that you received from the government free or for less than the normal sales price, or that you acquired under circumstances entitling you to the basis of someone who received the publications free or for less than the normal sales price.

Property Held for Personal Use

Property held for personal use is a capital asset. Gain from a sale or exchange of that property is a capital gain. Loss from the sale or exchange of that property is not deductible. You can deduct a loss relating to personal use property only if it results from a casualty, such as a fire or hurricane, or a theft, as discussed in chapter 27.

Investment Property

Investment property is a capital asset. Any gain or loss you have from its sale or exchange is generally a capital gain or loss.

Gold, silver, stamps, coins, gems, etc. These are capital assets except when they are held for sale by a dealer. Any gain or loss you have from their sale or trade generally is a capital gain or loss.

Stocks, stock rights, and bonds. All of these (including stock received as a dividend) are capital assets except when held for sale by a securities dealer. However, if you own small business stock, see *Losses on Small Business Stock* and *Losses on Small Business Investment Company Stock* in Publication 550.

Worthless securities. Stocks, stock rights, and bonds (other than those held for sale by a securities dealer) that became worthless during the tax year are treated as though they were sold on the last day of the tax year. To determine whether your capital loss is long-term or short-term and whether it is a 28% rate loss, you are considered to have held the securities until the last day of the year in which they became worthless. See *Holding Period,* later.

If you are a cash-basis taxpayer and make payments on a negotiable promissory note that you issued for stock that became worthless, you can deduct these payments as losses in the years you actually make the payments. Do not deduct them in the year the stock became worthless.

How to report loss. Report worthless securities on line 1 or line 8 of Schedule D (Form 1040), whichever applies. In columns (c) and (d), write “Worthless.” Enter the amount of your loss in parentheses in column (f) and, if it is a 28% rate loss, in column (g).

Filing a claim for refund. If you do not claim a loss for a worthless security on your original return for the year it becomes worthless, you can file a claim for a credit or refund due to the loss. Use Form 1040X, *Amended U.S. Individual Income Tax Return,* to amend your return for the year the security became worthless. You must file it within 7 years from the date your original return for that year had to be filed, or 2 years from the date you paid the tax, whichever is later. For more information about filing a claim, see *Amended Returns and Claims for Refund* in chapter 1.

Discounted debt instruments. Treat your gain or loss on the sale, redemption, or retirement of a bond or other debt instrument originally issued at a discount or bought at a discount as capital gain or loss, except as explained in the following discussions.

Short-term government obligations. Treat gains on short-term federal, state, or local government obligations (other than tax-exempt obligations) as ordinary income up to the ratable share of the acquisition discount. This treatment applies to obligations that have a fixed maturity date not more than one year from the date of issue. ***Acquisition discount*** is the stated redemption price at maturity minus your basis in the obligation.

However, do not treat these gains as income to the extent you previously included the discount in income. This amount increases your basis in the obligation. See *Discount on Short-Term Obligations* in chapter 1 of Publication 550 for more information.

Short-term nongovernment obligations. Treat gains on short-term nongovernment obligations as ordinary income up to the ratable share of original issue discount (OID). This treatment applies to obligations that have a fixed maturity date of not more than one year from the date of issue.

However, to the extent you previously included the discount in income, you do not have to include it in income again. This amount increases your basis. See *Discount on Short-Term Obligations* in Publication 550 for more information.

Tax-exempt state and local government bonds. If these bonds were originally issued at a discount before September 4, 1982, or you acquired them before March 2, 1984, treat your part of the OID as tax-exempt interest. To figure your gain or loss on the sale or exchange of these bonds, reduce the amount realized by your part of the OID.

If the bonds were issued after September 3, 1982, and acquired after March 1, 1984, increase the adjusted basis by your part of the OID to figure gain or loss. For more information on the basis of these bonds, see *Discounted tax-exempt obligations* under *Stocks and Bonds,* in Publication 550.

If you redeem tax-exempt bonds issued before June 9, 1980, before maturity, treat the entire OID on the bonds as tax exempt interest. If the bonds were issued after June 8, 1980, treat only your part of the OID as tax-exempt interest.

Any gain from market discount is usually taxable on disposition or redemption of tax-exempt bonds. If you bought the bonds before May 1, 1993, the gain from market discount is capital gain. If you bought the bonds after April 30, 1993, the gain from market discount is ordinary income.

You figure the market discount by subtracting the price you paid for the bond from the sum of the original issue price of the bond and the amount of accumulated OID from the date of issue that represented interest to any earlier holders. For more information, see *Market Discount Bonds* in chapter 1 of Publication 550.

A loss on the sale or other disposition of a tax-exempt state or local government bond is deductible as a capital loss.

Long-term debt instruments issued after 1954 and before May 28, 1969 (or before July 2, 1982, if a government instrument). If you sell, exchange, or redeem for a gain one of these debt instruments, the part of your gain that is not more than your ratable share of the original issue discount (OID) at the time of the sale or redemption is ordinary income. The rest of the gain is capital gain. If, however, there was an intention to call the debt instrument before maturity, all of your gain that is not more than the entire OID is treated as ordinary income at the time of the sale. This treatment of taxable gain also applies to corporate instruments issued after May 27, 1969, under a written commitment that was binding on that date and thereafter.

See *Original Issue Discount (OID)* in chapter 8 for information on OID.

Long-term corporate debt instruments issued after May 27, 1969, and government instruments issued after July 1, 1982. If you hold one of these debt instruments, you must include a part of the OID in your gross income each year that you own the instrument. Your basis in the instrument is increased by the amount of OID that you have included in your gross income. See *Original Issue Discount (OID)* in chapter 8 for information about the OID that you must report on your tax return.

If you sell or exchange the debt instrument before maturity, your gain on the sale is a capital gain. However, if at the time the instrument was originally issued there was an intention to call it before its maturity, your gain on the sale of the instrument generally is ordinary income to the extent of the entire OID reduced by any amounts of OID previously includible in your income. In this case, the rest of the gain is a capital gain.

Market discount bonds. If the debt instrument has market discount and you did not choose to include the discount in income as it accrued, you generally must report gain as ordinary interest income up to the instrument's accrued market discount. See *Market Discount Bonds* in chapter 1 of Publication 550.

Retirement of debt instrument. Any amount that you receive on the retirement of a debt instrument is treated in the same way as if you had sold or exchanged that instrument.

More information. See *Capital or Ordinary Gain or Loss* in Publication 550 for more information about the tax treatment of the sale or redemption of discounted debt instruments.

Notes of individuals. If you hold an obligation of an individual that was issued with OID after March 1, 1984, you generally must include the OID in your income currently, and your gain or loss on its sale or retirement is generally capital gain or loss. An exception to this treatment applies if the obligation is a loan between individuals and all of the following requirements are met.

1) The lender is not in the business of lending money.
2) The amount of the loan, plus the amount of any outstanding prior loans, is $10,000 or less.
3) Avoiding federal tax is not one of the principal purposes of the loan.

If the exception applies, or the obligation was issued before March 2, 1984, you do not include the OID in your income currently. When you sell or redeem the obligation, the part of your gain that is not more than your ratable share of the OID at that time is ordinary income. The balance of the gain, if any, is capital gain. Any loss on the sale or redemption is capital loss.

Loss on deposits in an insolvent or bankrupt financial institution. If you can reasonably estimate your loss on a deposit because of the bankruptcy or insolvency of a qualified financial institution, you can choose to treat the amount as either a casualty loss or an ordinary loss in the current year. Either way, you claim the loss as an itemized deduction. Otherwise, you can wait until the year of final determination of the actual loss and treat the amount as a nonbusiness bad debt (discussed later under *Nonbusiness Bad Debts*) in that year.

If you claim a casualty loss, attach **Form 4684,** *Casualties and Thefts,* to your return. Each loss must be reduced by $100. Your total casualty losses for the year are reduced by 10% of your adjusted gross income.

If you claim an ordinary loss, report it as a miscellaneous itemized deduction on line 22 of Schedule A (Form 1040). The maximum amount you can claim is $20,000 ($10,000 if you are married filing separately) reduced by any expected state insurance proceeds. Your loss is subject to the 2% of adjusted gross income limit. You cannot choose to claim an ordinary loss if any of the deposit is federally insured.

You cannot choose either of these methods if:

1) You own at least 1% of the financial institution,
2) You are an officer of the institution, or
3) You are related to such an owner or officer.

If the actual loss that is finally determined is more than the amount deducted as an estimated loss, you can claim the excess loss as a bad debt. If the actual loss is less than the amount deducted as an estimated loss, you must include in income (in the final determination year) the excess loss claimed.

Sale of annuity. The part of any gain on the sale of an annuity contract before its maturity date that is based on interest accumulated on the contract is ordinary income.

Nonbusiness Bad Debts

If someone owes you money that you cannot collect, you have a bad debt. You may be able to deduct the amount owed to you when you figure your tax for the year the debt becomes worthless. A debt must be genuine for you to deduct a loss. A debt is genuine if it arises from a debtor-creditor relationship based on a valid and enforceable obligation to repay a fixed or determinable sum of money.

Bad debts that you did not get in the course of operating your trade or business are nonbusiness bad debts. To be deductible, nonbusiness bad debts must be totally worthless. You cannot deduct a partially worthless nonbusiness debt.

Basis in bad debt required. To deduct a bad debt, you must have a basis in it — that is, you must have already included the amount in your income or loaned out your cash. For example, you cannot claim a bad debt deduction for court-ordered child support not paid to you by your former spouse. If you are a cash-basis taxpayer (most individuals are), you cannot take a bad debt deduction for expected income such as unpaid salaries, wages, rents, fees, interest, and dividends unless you have previously included the amount in your income.

How to report bad debts. Deduct nonbusiness bad debts as short-term capital losses on Schedule D (Form 1040). There are limits on how much of your capital losses may be deducted. For a discussion of these limits, see chapter 17.

In Part I, line 1 of Schedule D, enter the name of the debtor and “statement attached,” in column (a). Enter the amount of the bad debt in parentheses in column (f). Use a separate line for each bad debt.

For each bad debt, attach a statement to your return that contains:

1) A description of the debt, including the amount, and the date it became due,
2) The name of the debtor, and any business or family relationship between you and the debtor,
3) The efforts you made to collect the debt, and
4) Why you decided the debt was worthless. For example, you could show that the borrower has declared bankruptcy, or that legal action to collect would probably not result in payment of any part of the debt.

Filing a claim for refund. If you do not deduct a bad debt on your original return for the year it becomes worthless, you can file a claim for a credit or refund due to the bad debt. Use Form 1040X, *Amended U.S. Individual Income Tax Return.* You must file it within 7 years from the date your original return for that year had to be filed, or 2 years from the date you paid the tax, whichever is later. For more information about filing a claim, see *Amended Returns and Claims for Refund* in chapter 1.

Additional information. For more information, see *Nonbusiness Bad Debts* in Publication 550.

For information on business bad debts, see chapter 14 of Publication 535.

Losses on Small Business Stock

You can deduct as an ordinary loss, rather than as a capital loss, your loss on the sale, trade, or worthlessness of certain stock you own in a small business corporation or a small business investment company. Gain on this stock is capital gain and is reported on Schedule D (Form 1040) if the stock is a capital asset in your hands. See *Losses on Small Business Stock* and *Losses on Small Business Investment Company Stock* in Publication 550.

Holding Period

If you sold or traded investment property, you must determine your holding period for the property. Your holding period determines whether any capital gain or loss is a short-term or long-term capital gain or loss. If it is a long-term capital gain or loss, your holding period can also determine whether it is a 28% rate gain or loss.

Long term or short term. If you hold investment property ***more than one year,*** any capital gain or loss is a ***long-term*** capital gain or loss. If you hold the property ***one year or less,*** any capital gain or loss is a ***short-term*** capital gain or loss.

To determine how long you held the investment property, begin counting on the date after the day you acquired the property. The same date of each following month is the beginning of a new month regardless of the number of days in the preceding month. The day you disposed of the property is part of your holding period.

Example. If you buy investment property on February 5, 1996, you start counting on February 6. The 6th of each following month is the beginning of a new month. If you sell the property on February 5, 1997, your holding period is not more than one year and you will have a short-term capital gain or loss. If you sell it on February 6, 1997, your holding period is more than one year and you will have a long-term capital gain or loss.

28% rate gain or loss. Your 28% rate gains and losses determine the amount of a net capital gain that is taxed at a maximum rate of 28%. (See *Using the Maximum Capital Gains Rates,* in chapter 17.) These are your long-term capital gains and losses from:

1) Sales or trades (or installment payments received):
   a) Before May 7, 1997, or
   b) After July 28, 1997, for assets that you held more than 1 year but not more than 18 months, or
2) Sales or trades of collectibles (works of art, rugs, antiques, metals, gems, stamps, coins, and alcoholic beverages):
   a) Held more than 18 months, or
   b) Held more than 1 year, in the case of sales or trades after May 6, 1997, but before July 29, 1997.

Securities traded on established market. For securities traded on an established securities market, your holding period begins the day after the trading date you bought the securities, and ends on the trading date you sold them. Ignore the settlement date(s) for tax purposes.

Example. You are a cash-basis, calendar-year taxpayer. You sold stock at a gain on December 27, 1997. According to the rules of the stock exchange, the sale was closed by delivery of the stock 3 trading days after the sale, on January 2, 1998. You received payment of the sales price on that same day. Report your gain on your 1997 return, even though you received the payment in 1998. The gain is long term or short term depending on whether you held the stock more than one year. Your holding period ended on December 27. If you had sold the stock at a loss, you would also report it on your 1997 return.

Nontaxable trades. If you acquire investment property in a trade for other investment property and your basis for the new property is determined, in whole or in part, by your basis in the old property, your holding period for the new property begins on the day following the date you acquired the old property. Chapter 14 discusses basis.

Property received as a gift. If you receive a gift of property and your basis is determined by the donor's basis, your holding period is considered to have started on the same day the donor's holding period started. See *Property Received as a Gift* in chapter 14.

If your basis is determined by the fair market value of the property, your holding period starts on the day after the date of the gift.

Inherited property. If you inherit investment property and your basis for it is:

1) Determined by its fair market value at the date of the decedent's death,
2) Determined by its fair market value at the alternate valuation date, or
3) The decedent's adjusted basis (for appreciated property),

your capital gain or loss on any later disposition of that property is treated as a long-term capital gain or loss from property held more than 18 months. This is true even if you dispose of it within one year after the decedent's death. See *Inherited Property* in chapter 14.

Real property bought. To figure how long you have held real property bought under an unconditional contract, begin counting on the earlier of the day after you received title to it or the day after you took possession of it and assumed the burdens and privileges of ownership. However, taking delivery or possession of real property under an option agreement is not enough to start the holding period. The holding period cannot start until there is an actual contract of sale. The holding period of the seller cannot end before that time.

Loss on mutual fund or REIT stock held 6 months or less. If you hold stock in a mutual fund or real estate investment trust (REIT) for 6 months or less and then sell it at a loss, special rules may apply. See chapter 4 of Publication 550.

Automatic investment service and dividend reinvestment plans. If you take part in a plan to buy stock through a bank or other agent, the date the bank or other agent buys the stock is your purchase date for figuring the holding period of that stock. In determining your holding period for shares bought by the bank or agent, full shares are considered bought first and any partial shares are considered bought last. If a full share or a partial share was bought over a period of more than one purchase date, your holding period for that share is a split holding period. A part of the share is considered to have been bought on each date that stock was bought by the bank or other agent with the proceeds of available funds.

Nontaxable stock dividend. The holding period for new stock you received as a nontaxable stock dividend begins on the same day as the holding period of the old stock. This rule also applies to stock acquired in a "spin-off," which is a distribution of stock or securities in a controlled corporation.

Nontaxable stock rights. Your holding period for nontaxable stock rights begins on the same day as the holding period of the underlying stock. The holding period for stock acquired through the exercise of stock rights begins on the date the right was exercised.

Rollover of Gain

This section discusses the tax-free rollover of certain gains from the sale of publicly traded securities. If you buy certain replacement property and make the choice described in this section, you postpone part or all of your gain. You postpone the gain by adjusting the basis of the replacement property as described in *Basis of replacement property,* later. This postpones your gain until the year you dispose of the replacement property.

You qualify to make this choice if you meet all the following tests.

1) You sell publicly traded securities at a gain. Publicly traded securities are securities traded on an established securities market.

2) Your gain from the sale is a capital gain.

3) During the 60-day period beginning on the date of the sale, you buy replacement property. This replacement property must be either common stock or a partnership interest in a specialized small business investment company (SSBIC). This is any partnership or corporation licensed by the Small Business Administration under section 301(d) of the Small Business Investment Act of 1958, as in effect on May 13, 1993.

Amount of gain postponed. If you make the choice described in this section, you must recognize gain only up to the following amount:

1) The amount realized on the sale, minus

2) The cost of any common stock or partnership interest in an SSBIC that you bought during the 60-day period beginning on the date of sale (and did not previously take into account on an earlier sale of publicly traded securities).

If this amount is less than the amount of your gain, you can postpone the rest of your gain, subject to the limit described next. If this amount is more than the amount of your gain, you must recognize the full amount of your gain.

Limit on gain postponed. The amount of gain you can postpone each year is limited to the smaller of:

1) $50,000 ($25,000 if you are married and file a separate return), or

2) $500,000 ($250,000 if you are married and file a separate return), minus the amount of gain you postponed for all earlier years.

Basis of replacement property. You must subtract the amount of postponed gain from the basis of your replacement property.

How to report gain. If you choose to postpone gain, see the Schedule D (Form 1040) instructions for details on how to report it.

16. Selling Your Home

Important Changes for 1997

Exclusion for sales after May 6, 1997. If you sell your main home after May 6, 1997, you may be able to exclude any gain from income up to a limit of $250,000 ($500,000 on a joint return in most cases). See *Sales After May 6, 1997,* for details.

New maximum tax rates on net capital gain. The maximum tax rate on a net capital gain has been reduced for some sales and exchanges after May 6, 1997. See chapter 17 for details.

Important Reminders

Change of address. If you change your mailing address, be sure to notify the IRS using Form 8822, *Change of Address.* Mail it to the Internal Revenue Service Center for your old address (addresses for the Service Centers are on the back of the form).

Combat zone service. The replacement period for postponing tax on any gain from the sale of your home is suspended if you served in a combat zone. See *Replacement Period* under *Sales Before May 7, 1997,* for more information.

Home sold with undeducted points. If you have not deducted all the points you paid to secure a mortgage on your old home, you may be able to deduct the remaining points in the year of the sale. See *Mortgage ending early* under *Points* in chapter 25.

Introduction

This chapter explains the tax rules that apply when you sell your main home. Generally, your main home is the one in which you live most of the time.

Gain. If you have a gain from the sale of your main home, follow the rules that apply to your date of sale.

Sales before May 7, 1997. The rules that apply to gains from these sales are explained later under *Sales Before May 7, 1997.* References in this chapter to sales before May 7, 1997, also include certain sales after May 6, 1997, for which you made the choice described in *Choosing To Use Rules for Sales Before May 7, 1997,* later.

Sales after May 6, 1997. The rules that apply to gains from these sales are explained later under *Sales After May 6, 1997.* In most cases, if your gain from a sale after May 6, 1997, is not more than $250,000 ($500,000 on most joint returns), you will not have to pay tax on any of the gain.

Date of sale. If you received a Form 1099–S, *Proceeds From Real Estate Transactions,* the date of sale should be shown in box 1. If you did not receive this form, the date of sale is the earlier of (a) the date title transferred or (b) the date the economic burdens and benefits of ownership shifted to the buyer. In most cases, these dates are the same.

Loss. You cannot deduct a loss from the sale of your main home.

How to report the sale. You must report the sale of your main home using Form 2119. This is true whether you sell the home at a gain or a loss.

Useful Items

You may want to see:

Publication

- ☐ **523** Selling Your Home
- ☐ **530** Tax Information for First-Time Homeowners

Form (and Instructions)

- ☐ **Schedule D (Form 1040)** Capital Gains and Losses
- ☐ **1040X** Amended U.S. Individual Income Tax Return
- ☐ **2119** Sale of Your Home
- ☐ **8822** Change of Address
- ☐ **8828** Recapture of Federal Mortgage Subsidy

Main Home

This explanation of the term "main home" applies regardless of the date of sale.

Usually, the home you live in most of the time is your main home and can be a:

- House,
- Houseboat,
- Mobile home,
- Cooperative apartment, or
- Condominium.

To postpone gain under the rules for sales before May 7, 1997, the home you sold and the one you buy to replace it must both qualify as your main home.

To exclude gain under the rules for sales after May 6, 1997, you generally must have owned and used the property as your main home for at least 2 years during the 5-year period ending on the date of sale.

Land. You may sell the land on which your main home is located, but not the house itself. In this case, you cannot postpone or exclude any gain you have from the sale of the land.

Example. On March 3, 1997, you sell the land on which your main home is located. Within the replacement period, you buy another piece of land and move your house to it. This sale is not considered a sale of your main home, and you cannot postpone tax on any gain on the sale.

More than one home. If you have more than one home, only the sale of your main home qualifies for postponing or excluding gain. If you have two homes and live in both of them, your main home is the one you live in most of the time.

Example 1. You own and live in a house in town. You also own a beach house, which you use in the summer months. The town house is your main home; the beach house is not.

Example 2. You own a house, but you live in another house that you rent. The rented home is your main home.

Property used partly as your home. If you use only part of the property as your main home, the rules discussed in this chapter apply only to the gain or loss on the sale of that part of the property. For details, see *Property used partly as your home and partly for business or rental* under *Postponing Gain,* later.

How To Figure Gain or Loss On the Sale

Figure gain or loss on the sale of your main home in Part I of Form 2119. To figure the gain or loss, you must know the selling price, the amount realized, and the adjusted basis.

Selling price. The selling price (line 4 of Form 2119) is the total amount you receive for your home. It includes money, all notes, mortgages, or other debts assumed by the buyer as part of the sale, and the fair market value of any other property or any services you receive.

Payment by employer. You may have to sell your home because of a job transfer. If your employer pays you for a loss on the sale or for your selling expenses, do ***not*** include the payment as part of the selling price. Include it in your gross income as wages on line 7 of Form 1040. Your employer will include it with the rest of your wages in box 1 of your Form W-2.

Option to buy. If you grant an option to buy your home and the option is exercised, add the amount you receive for the option to the selling price of your home. If the option is not exercised, you must report the amount as ordinary income in the year the option expires. Report this amount on line 21 of Form 1040.

Form 1099–S. If you received Form 1099–S, box 2 should show the total amount you received for your home.

However, box 2 will not include the fair market value of any property other than cash or notes, or any services, you received or will receive. Instead, box 4 will be checked.

Sales after May 6, 1997. If you can exclude the entire gain from a sale after May 6, 1997, the person responsible for closing the sale generally will not have to report it on Form 1099–S.

Selling expenses. Selling expenses (line 5 of Form 2119) include:

- Commissions,
- Advertising fees,
- Legal fees, and
- Loan charges paid by the seller, such as loan placement fees or "points."

Amount realized. The amount realized (line 6 of Form 2119) is the selling price minus selling expenses.

Amount of gain or loss. When you know the amount realized and the home's adjusted basis (line 7 of Form 2119), you can figure your gain or loss (line 8 of Form 2119). If the amount realized is more than the adjusted basis, the difference is a gain. If the amount realized is less than the adjusted basis, the difference is a loss.

To figure your home's adjusted basis, see *Basis,* later.

Gain on Sale

You will generally be subject to tax on all of a gain unless:

- You ***postpone*** or ***exclude*** all or part of the gain under the rules for sales before May 7, 1997, described later, or
- You ***exclude*** all or part of the gain under the rules for sales after May 6, 1997, also described later.

Loss on Sale

You ***cannot*** deduct a loss on the sale of your home. It is a personal loss. However, you must report the sale on Form 2119. The loss has no effect on the basis of any new home.

Special Situations

The paragraphs that follow explain how to determine your gain or loss if:

- You sell a jointly owned home,
- You trade one home for another one, or
- Your home is foreclosed on, repossessed, or abandoned.

Transfers of a home to your spouse are also covered here.

Jointly owned home. If you and your spouse sell your jointly owned home and file a joint return, you figure and report your gain or loss as one taxpayer.

Separate returns. If you file separate returns, each of you must figure and report your own gain or loss according to your ownership interest in the home. Your ownership interest is determined by state law.

Joint owners not married. If you and a joint owner other than your spouse sell your jointly owned home, each of you must figure and report your own gain or loss according to your ownership interest in the home. Each of you applies the rules discussed in this chapter on an individual basis.

Trading homes. If you trade your old home for another home, treat the trade as a sale and a purchase.

Example. You owned and lived in a home that had an adjusted basis of $41,000. A real estate dealer accepted your old home as a trade-in and allowed you $50,000 toward a new house priced at $80,000. You are considered to have sold your old home for $50,000 and to have had a gain of $9,000 ($50,000 – $41,000).

If the dealer had allowed you $27,000 and assumed your unpaid mortgage of $23,000 on your old home, your sales price would still be $50,000 (the $27,000 trade-in allowed plus the $23,000 mortgage assumed).

Foreclosure or repossession. If your home was foreclosed on or repossessed, you have a sale that you must report on Form 2119. If the sale resulted in a taxable gain, also report it on Schedule D (Form 1040).

Form 1099–A and Form 1099–C. Generally, you will receive Form 1099–A, *Acquisition or Abandonment of Secured Property,* from your lender. This form will have the information you need to determine the amount of your gain or loss and whether you have any ordinary income from cancellation of debt. If your debt is canceled, you may receive Form 1099–C, *Cancellation of Debt,* instead of Form 1099–A.

For more information, get Publication 523.

Abandonment. If you abandon your home and it secures a debt that is canceled, you may have ordinary income. If the home is foreclosed on or repossessed, you may also have a gain or loss. See *Foreclosure or repossession,* above. Get Publication 523 for more information.

Transfer to spouse. If you transfer your home to your spouse, or to your former spouse incident to your divorce, you generally have no gain or loss. This is true even if you receive cash or other consideration for the home. Therefore, the rules in this chapter do not apply. You do not have to file Form 2119.

Exception. If your spouse or former spouse is a nonresident alien, the rules in this chapter apply and you must file Form 2119.

More information. If you need more information, see *Transfer to spouse* in Publication 523 and *Property Settlements* in Publication 504, *Divorced or Separated Individuals.*

Basis

You will need to know your basis in your home as a starting point for determining any gain or loss when you sell it.

Your basis in your home is determined by how you got the home. Your basis is its cost if you bought it or built it. If you got it in some other way, its basis is either its fair market value when you received it or the adjusted basis of the person you received it from.

While you owned your home, you may have made adjustments (increases or decreases) to the basis. This adjusted basis is used to figure gain or loss on the sale of your home.

You can find more information on basis and adjusted basis in chapter 14 of this publication and in Publication 523.

Settlement fees or closing costs. If you buy your home, you may have to pay settlement fees or closing costs in addition to the contract price of the property. You can include in your basis the settlement fees and closing costs that are for buying the home. You cannot include in your basis the fees and costs that are for getting a mortgage loan. A fee is for buying the home if you would have had to pay it even if you paid cash for the home.

Chapter 14 lists some of the settlement fees and closing costs that you can include in the basis of property, including your home. It also lists some settlement costs that cannot be included in basis.

In addition to the items listed in chapter 14, you ***cannot*** include in basis:

1) Any fee or cost that you deducted as a moving expense (allowed for certain fees and costs before 1994), and
2) VA funding fees.

See *Settlement fees or closing costs* under *How To Figure Cost of New Home,* later, for information about the fees and costs (real estate taxes and mortgage interest, including points) that you may be able to deduct.

Adjusted Basis

Adjusted basis is your basis ***increased*** or ***decreased*** by certain amounts.

Increases to basis. These include any:

1) Improvements,
2) Additions,
3) Special assessments for local improvements, and
4) Amounts you spent after a casualty to restore damaged property.

Decreases to basis. These include any:

1) Gain you postponed from the sale of a previous home before May 7, 1997,
2) Insurance payments for casualty losses,
3) Deductible casualty losses not covered by insurance,
4) Payments you received for granting an easement or right-of-way,
5) Depreciation allowed or allowable if you used your home for business or rental purposes,
6) Residential energy credit (generally allowed from 1977 through 1987) claimed for the cost of energy improvements that you added to the basis of your home,
7) Adoption credit you claimed for improvements that you added to the basis of your home,
8) Nontaxable payments from an adoption assistance program of your employer that you used for improvements you added to the basis of your home,
9) First-time homebuyers credit (allowed to certain first-time buyers of a home

in the District of Columbia) claimed for 1997, and

10) Energy conservation subsidy excluded from your gross income because you received it (directly or indirectly) from a public utility after 1992 to buy or install any energy conservation measure. An energy conservation measure is an installation or modification that is primarily designed either to reduce consumption of electricity or natural gas or to improve the management of energy demand for a home.

Improvements. These add to the value of your home, prolong its useful life, or adapt it to new uses. You add the cost of improvements to the basis of your property.

Examples. Putting a recreation room in your unfinished basement, adding another bathroom or bedroom, putting up a fence, putting in new plumbing or wiring, putting on a new roof, or paving your driveway are improvements.

Repairs. These maintain your home in good condition but do not add to its value or prolong its life. You do not add their cost to the basis of your property.

Examples. Repainting your house inside or outside, fixing your gutters or floors, repairing leaks or plastering, and replacing broken window panes are examples of repairs.

Recordkeeping. You should keep records to prove your home's adjusted basis. Ordinarily, you must keep records for 3 years after the due date for filing your return for the tax year in which you sold your home. But if the basis of your old home affects the basis of your new one, such as when you sold your old home before May 7, 1997, and postponed tax on any gain, you should keep those records as long as they are needed for tax purposes.

The records you should keep include:

- Proof of the home's purchase price and purchase expenses,
- Receipts and other records for all improvements, additions, and other items that affect the home's adjusted basis,
- Any Form 2119 that you filed to postpone gain from the sale of a previous home before May 7, 1997, and
- Any worksheets you used to prepare Form 2119, such as the *Adjusted Basis of Home Sold Worksheet* or the *Capital Improvements Worksheet* from the Form 2119 instructions.

Sales Before May 7, 1997

The rules in this section apply to you if:

1) You sold your home before May 7, 1997, or

2) You sold your home after May 6, 1997, but make the choice explained under *Choosing To Use Rules for Sales Before May 7, 1997*, later.

Gain. If you have a gain from the sale, you must include it in your income, except for any part you postpone or exclude. *Table 16–1* gives an overview of postponing and excluding gain.

Loss. If you have a loss from the sale, you cannot deduct it.

How to report the sale. You must report the sale of your main home using **Form 2119.** This is true whether you sell the home at a gain or a loss and whether or not you buy another main home.

Postponing Gain

Generally, you ***must*** postpone tax on the gain on the sale of your main home if both of the following are true.

1) You buy and live in a new main home within the replacement period.

2) The new main home costs at least as much as the adjusted sales price of the old home.

However, if you are age 55 or older and meet certain qualifications, no tax applies to any gain you choose to exclude. See *Exclusion of Gain,* later.

This section explains the time allowed for replacing your main home and how to determine the taxable gain, if any.

Tax postponed, not forgiven. The tax on the gain is postponed, not forgiven. You subtract any gain that is not taxed in the year you sell your old home from the cost of your new home. This gives you a lower basis in the new home.

Example. You sold your home in January 1997 for $90,000 and had a $5,000 gain. Within the time allowed for replacement, you bought another home for $103,000 and moved into it. The $5,000 gain will not be taxed in 1997, but you must subtract it from the $103,000. This makes the basis of your new home $98,000. If you later sell the new home for $110,000, your gain will be $12,000 ($110,000 – $98,000).

Source of funds to buy home. You do not have to use the same funds received from the sale of your old home to buy or build your new home. For example, you can use less cash than you received by increasing the amount of your mortgage loan and still postpone the tax on your gain.

Table 16-1. **Overview of Postponing and Excluding Gain From Sales Before May 7, 1997**

To . . .	You must . . .	How You Benefit	How To Find Out More
1. Postpone gain	Buy (or build) and live in a new home within the replacement period.	You may not have to pay tax on all (or part) of your gain in 1997. (But you have to reduce the basis of your new home by the amount of the postponed gain. This will increase any gain on the later sale of that new home.)	See *Postponing Gain* in this chapter.
2. Exclude gain	• Be age 55 or older on the date of sale, • Meet ownership and use tests, *and* • Choose to take the exclusion.	You exclude up to $125,000 ($62,500 if married filing separately) of your gain. (You can exclude gain under the rules for sales before May 7, 1997, only once in your lifetime after July 26, 1978. But you may be able to exclude gain on a sale after May 6, 1997, under the rules for those sales, as described in this chapter.)	See *Exclusion of Gain* in this chapter.
Any part of your gain that you do not postpone or exclude is taxable. You must include that part in your income.			

Replacement Period

Your replacement period is the time period during which you must replace your old home to postpone any of the gain from its sale. It starts ***2 years before*** and ends ***2 years after*** the date of sale.

Example. You sold your old home on April 27, 1997. You have until April 27, 1999, to buy and move into a new home that you use as your main home.

Occupancy test. You must physically live in the new home as your main home within the replacement period. If you move furniture or other personal belongings into the new home but do not actually live in it, you have not met the occupancy test.

No added time is allowed. To postpone gain on the sale of your home, you must replace the old home and occupy the new home within the specified period. You are not allowed any additional time, even if conditions beyond your control keep you from doing it (unless you qualify for a suspension of the replacement period, as explained later). For example, destruction of the new home while it was being built would not extend the replacement period. Also, if you bought or began building your new home within the specified period but for any reason were unable to live in it within 2 years, the replacement period is not extended.

If you do not replace the home in time and you had postponed gain in the year of sale, you must file an amended return for the year of sale. You must include in your income the entire gain on the sale of your old home.

Suspension of replacement period. The replacement period may be suspended for:

- People living outside the United States, and
- Members of the Armed Forces.

Table 16–2 illustrates the replacement period for most people and for those who qualify for the suspension. The table uses the example of a home sold on April 30, 1997.

People outside the United States. The replacement period after the sale of your old home is suspended while you have your tax home (the place where you live and work) outside the United States. This suspension applies only if your stay abroad begins before the end of the 2-year replacement period. The replacement period, plus the period of suspension, is limited to ***4 years*** after the date of sale of your old home.

For more information, see *People Outside the United States* in chapter 3 of Publication 523. For a discussion of tax home, see chapter 28 of this publication.

Combat zone service. The running of the replacement period (including the suspension if you live and work outside the United States) is suspended for any period you served in a combat zone (defined later under *Members of the Armed Forces*) in support of the Armed Forces, plus 180 days. This suspension applies even though you were not a member of the Armed Forces. It applies to Red Cross personnel, accredited correspondents, and civilians under the direction of the Armed Forces in support of those forces.

The rules for suspending the running of the replacement period are the same as the suspension rules explained next under *Members of the Armed Forces*.

Members of the Armed Forces. The replacement period after the sale of your old home is suspended while you serve on extended active duty in the Armed Forces. You are on extended active duty if you are serving under a call or order for more than 90 days or for an indefinite period. The suspension applies only if your service begins before the end of the 2-year replacement period. The replacement period, plus any period of suspension, is limited to ***4 years*** after the date you sold your old home. For more information, see *Members of the Armed Forces* in chapter 3 of Publication 523.

Overseas assignment. The suspension of the replacement period after the sale of your old home is extended for up to an additional 4 years while you are:

- Stationed outside the United States, or
- Required to live in on-base quarters following your return from a tour of duty outside the United States. In this case, you must be stationed at a remote site where the Secretary of Defense has determined that adequate off-base housing is not available.

The suspension can continue for up to 1 year after the last day you are stationed outside the United States or the last day you are required to live in government quarters on base. However, the replacement period, plus any period of suspension, is limited to ***8 years*** after the date of sale of your old home.

If you qualify for the time suspension for members of the Armed Forces and have already filed an income tax return reporting gain from the sale of a home that can be further postponed, you can file Form 1040X to claim a refund. See *Amended return,* later.

Combat zone service. The running of the replacement period (including any suspension) is suspended for any period you served in a combat zone.

Combat zone. The term "combat zone" means:

1) The Persian Gulf Area combat zone (effective August 2, 1990), and
2) The qualified hazardous duty area of Bosnia and Herzegovina, Croatia, and Macedonia, which is treated as a combat zone effective November 21, 1995.

Service outside combat zone. If you performed military service in an area outside the combat zone that was in direct support of military operations in the combat zone ***and*** you received special pay for duty subject to hostile fire or imminent danger, you are treated as if you served in the combat zone.

Also, you are treated as if you served in a combat zone if you performed services as part of Operation Joint Endeavor or Operation Joint Guard, were outside the United States, and were deployed away from your permanent duty station.

When suspension ends. This suspension ends 180 days after the later of:

1) The last day you were in the combat zone (or, if earlier, the last day the area qualified as a combat zone), or
2) The last day of any continuous hospitalization (limited to 5 years if hospitalized in the United States) for an injury sustained while serving in the combat zone.

More information. For more information on suspension of the replacement period, see *Combat zone service* in chapter 3 of Publication 523. For more information on other tax benefits available to those who served in a combat zone, get Publication 3, *Armed Forces' Tax Guide.*

Amended return. If you sell your old home and do not plan to replace it, you must include the gain in income for the year of sale. If you later change your mind, buy or build and live in another home within the replacement period, and meet the requirements to postpone gain, you will have to file an amended return (Form 1040X) for the year of sale to claim a refund. For information on the time allowed for filing an amended return, see chapter 1.

Extended replacement period. If you have an extended replacement period because you have your tax home outside the United States or are a member of the Armed Forces, the replacement period may go beyond the last date you can file an amended return claiming a refund for the year of sale. If there is a possibility you may change your mind and buy (or build) and live in another home during the extended replacement period, get Publication 523 to find out how to file a "protective claim" for refund of the tax you paid on the gain.

Old Home

You figure gain or loss on the sale of your old home in Part I of Form 2119.

You use Part III of Form 2119 to figure the taxable gain and the postponed gain.

How to figure taxable and postponed gain. Compare the ***adjusted sales price*** of your old home with the cost of your new home, as shown in the table below.

IF the cost of your new home is. . .	THEN you. . .
Equal to or more than the adjusted sales price of your old home	Postpone your entire gain. None of it is taxed in the year of sale.
Less than the adjusted sales price of your old home	Are taxed on the smaller of: • The entire gain (minus any exclusion), or • The difference between the adjusted sales price of the old home and the cost of the new home. You postpone any gain that is not taxed.

Adjusted sales price. This is the amount realized from the sale of your old home minus:

- Any exclusion you claim (line 14 of Form 2119), and
- Any fixing-up expenses you had (line 16 of Form 2119).

If the amount realized (minus any exclusion) is not more than the cost of your new home, you postpone your entire gain. You do not need to figure your fixing-up expenses.

Fixing-up expenses. Fixing-up expenses are decorating and repair costs that you paid to sell your old home. For example, the costs of painting the home, planting flowers, and replacing broken windows are fixing-up expenses. Fixing-up expenses must meet all the following conditions. The expenses:

1) Must be for work done during the 90-day period ending on the day you sign the contract of sale with the buyer,
2) Must be paid no later than 30 days after the date of sale,
3) Cannot be deductible in arriving at your taxable income,
4) Must not be used in figuring the amount realized, and
5) Must not be capital expenditures or improvements.

Note. You subtract fixing-up expenses from the amount realized ***only*** in figuring the part of the gain that you postpone. You ***cannot*** use them in figuring the actual gain on the sale of the old home.

Example. Your old home had a basis of $55,000. You signed a contract to sell it on December 17, 1996. On January 7, 1997, you sold it for $71,400. Selling expenses were $5,000. During the 90-day period ending December 17, the date you signed the sales contract, you had the following work done. You paid for the work within 30 days after the date of sale.

Fixing-up expenses:	
Inside and outside painting	$800
Improvements:	
New venetian blinds and new water heater	$900

Within the replacement period, you bought and lived in a new home that cost $64,600. You figured the amount of gain on which tax is postponed, the amount of gain on which tax is not postponed, and the basis of your new home, as follows:

Gain On Sale		
a) Selling price of old home	$71,400	
b) Minus: Selling expenses	5,000	
c) Amount realized on sale		$66,400
d) Basis of old home	$55,000	
e) Plus: Improvements (blinds and heater)	900	
f) Adjusted basis of old home		55,900
g) Gain on sale [(c) minus (f)]		$10,500
Gain Taxed in Year of Sale		
h) Amount realized on sale	$66,400	
i) Minus: Fixing-up expenses (painting)	800	
j) Adjusted sales price		$65,600
k) Minus: Cost of new home		64,600
l) Excess of adjusted sales price over cost of new home		$1,000
m) Gain taxed in year of sale [lesser of (g) or (l)]		$1,000
Gain Postponed		
n) Gain on sale [line (g)]	$10,500	
o) Minus: Gain taxed [line (m)]	1,000	
p) Gain postponed		$9,500
Adjusted Basis of New Home		
q) Cost of new home [line (k)]	$64,600	
r) Minus: Gain postponed [line (p)]	9,500	
s) Adjusted basis of new home		$55,100

Property used partly as your home and partly for business or rental. You may use part of your property as your home and part of it for business or to produce income. Examples are:

- A working farm on which your house is located,
- An apartment building in which you live in one unit and rent out the others, or
- A store building with an upstairs apartment in which you live.

If you sell the entire property, you postpone only the tax on the part used as your home. This includes the land and outbuildings, such as a garage for the home, but not those used for the business or the production of income. For more information, see *Property used partly as your home and partly for business or rental* in chapter 3 of Publication 523.

Business use of your home. If, in the year of sale, you are entitled to deduct expenses for the business use of your home, you cannot postpone the gain on the part of the home used for business. For information on how to figure the business part, see *Figuring the Deduction* in Publication 587, *Business Use of Your Home.*

If, in the year of sale, you are ***not*** entitled to deduct expenses for the business use of your home, you may be able to postpone all your gain, even if you were entitled to deduct expenses for the business use of your home in earlier years.

Home changed to rental property. You cannot postpone tax on the gain on rental property, even if you once used it as your home. The rules explained in this chapter generally will not apply to its sale. Gains are taxable and losses are deductible as explained in Publication 544, *Sales and Other Dispositions of Assets.* The basis of the property is determined as explained under *Property Changed to Business or Rental Use* in chapter 14.

Temporary rental of home before sale. You have not changed your home to rental property if you temporarily rented out your old home before selling it, or your new home before living in it, as a matter of convenience or for another nonbusiness purpose. You postpone the tax on the gain from the sale if you meet the requirements explained earlier. For information on how to treat the rental income you receive, see chapter 10.

Failed attempt to rent home. If you place your home with a real estate agent for rent or sale and it is ***not*** rented, it is not considered business property or property held for the production of income. The rules explained in this chapter apply to the sale of the home.

Condemned property. If your home is condemned for public use and you have a gain, you can postpone the tax on the gain in one of two ways. You can postpone the tax under the rules explained in this chapter or under those discussed under *Involuntary Conversions* in chapter 1 of Publication 544.

Gain on casualty. The tax on a gain from a fire, storm, or other casualty cannot be postponed under the rules explained in this chapter, but may be postponed under the rules explained in Publication 547, *Casualties, Disasters, and Thefts (Business and Nonbusiness).*

New Home

Your new home must be your main home. See *Main Home,* earlier.

You must include in income any gain from the sale of your old home if you replace it with property that is not your main home.

Table 16-2. **An Illustration of the Time Allowed for Replacement**

This illustrates the time period during which you can replace your main home and postpone tax on the gain from a home sold on ***April 30, 1997.*** It does not apply if you served in a combat zone (defined under *Members of the Armed Forces*).

FOR . . .	**THE replacement period begins . . .**	**AND the replacement period ends . . .**
Most people	2 years before sale (April 30, 1995)	2 years after the sale (April 30, 1999)
Certain people living and working outside the United States	2 years before sale (April 30, 1995)	4 years after the sale (April 30, 2001)
Members of the Armed Forces on extended active duty	2 years before sale (April 30, 1995)	4 years after the sale (April 30, 2001)
Members of the Armed Forces stationed outside the United States	2 years before sale (April 30, 1995)	8 years after the sale (April 30, 2005)

For details, including the special rules that apply to combat zone service, see the discussions of *People outside the United States* and *Members of the Armed Forces.*

New home outside the United States. A new home outside the United States qualifies as a new home for purposes of postponing gain. You must buy or build and live in the new home as your main home within the time allowed for replacement.

Retirement home. You have not purchased a new home if you invest in a retirement home project that gives you living quarters and personal care, but does not give you any legal interest in the property. Therefore, you must include in income any gain on the sale of your home. However, if you are 55 or older, see *Exclusion of Gain,* later in this chapter.

Title to new home not held by you or spouse. You have not purchased a new home if you invest in a home in which neither you nor your spouse holds any legal interest (for example, a house to which someone else, such as your child, holds the title).

More than one new home bought in 2-year period. If you buy (or build) and live in more than one main home during the replacement period, only the last one can be treated as your new main home to determine whether you must postpone the gain from the sale of the old home.

For an exception to this rule, see *Work-related move* under *New home sold in 2-year period* in chapter 3 of Publication 523.

New home sold in 2-year period. If you postponed the gain on the sale of your old home, then sell your new home within 2 years after the sale of your old home, you cannot postpone the gain on the sale of the new home. Any gain on the sale of that new home is taxable; any loss is not deductible. For details and an exception for work-related moves, see Publication 523.

Holding period. If you postponed tax on any part of the gain from the sale of your old home, you will be considered to have owned your new home for the combined period you owned both the old and the new homes. This may affect how any taxable gain when you sell the new home is reported on Schedule D (Form 1040). See chapter 15 for more information on holding periods.

How To Figure Cost of New Home

You need to know the cost of your new home to figure the gain taxed and the gain on which tax is postponed on the sale of your old home. The cost of your new home includes costs incurred within the replacement period (beginning 2 years before and ending 2 years after the date of sale) for the following items:

1) Buying or building the home,
2) Rebuilding the home, and
3) Capital improvements or additions.

You cannot consider any costs incurred before or after the replacement period. However, if you live outside the United States or you are a member of the Armed Forces, you can include any costs incurred during the suspension period (discussed under *Replacement Period,* earlier).

Debts on new home. The cost of a new home includes the debts it is subject to when you buy it (purchase-money mortgage or deed of trust) and the face amount of notes or other liabilities you give for it.

Temporary housing. If a builder gives you temporary housing while your new home is being finished, you must reduce the contract price to arrive at the cost of the new home. To figure the amount of the reduction, multiply the contract price by a fraction. The numerator is the value of the temporary housing and the denominator is the sum of the value of the temporary housing plus the value of the home.

Seller-paid points. In figuring the cost of your new home, you must subtract any points paid by the seller from its purchase price.

Settlement fees or closing costs. The cost of your new home includes the settlement fees and closing costs that you can include in your basis. See *Settlement fees or closing costs* under *Basis,* earlier.

Deductible costs. If you itemize your deductions in the year you buy the house, you can deduct some of the costs you paid at closing, such as real estate taxes, mortgage interest, and “points” that are deductible as interest. You may also be able to deduct points paid by the seller at closing. For more information, see chapters 24 and 25.

Real estate taxes. If you agree to pay taxes the seller owed on your new home (that is, taxes up to the date of sale), the taxes you pay are treated as part of the cost. You cannot deduct them as taxes paid. If the seller paid taxes for you (that is, taxes beginning with the date of sale), you can still deduct the taxes. If you do not reimburse the seller for your part of the taxes, you must reduce the purchase price of your new home by the amount of those taxes. For more information, see *Settlement or closing costs* under *Basis* in Publication 530.

Inheritance or gift. If you receive any part of your new home as a gift or an inheritance, you cannot include the value of that part in the cost of the new home when figuring the gain taxed in the year of sale and the gain on which tax is postponed. However, you include the basis of that part in your adjusted basis to determine any gain when you sell the new home. For an example, see Publication 523.

Certain Sales by Married Persons

Special rules apply if any of the following situations apply to you.

1) You or your spouse owned the old home separately, but the two of you own the new home jointly.
2) You and your spouse owned the old home jointly, but either you or your spouse owns the new home separately.
3) Your spouse dies after you sell your old home and before you buy and live in a new home.
4) You and your spouse had two separate gains from the sales of homes that had been your separate main homes before your marriage, and you jointly buy one new home.
5) You and your spouse have agreed to live apart, and you each buy and live in separate new homes.

For more information about any of these situations, see the discussion *Certain Sales by Married Persons* in Publication 523.

How and When To Report

Report the details of the sale as explained in this section. Report the sale even if:

- You have a loss,
- You are postponing the tax on the entire gain, or
- You have not bought or moved into a new home.

Reporting the sale on Form 2119. Use Form 2119, *Sale of Your Home,* to report the sale of your old home and any purchase of a new one within the replacement period. File Form 2119 with your tax return for the year you sold your old home. If you file your return before buying a new home, you may also have to file a second Form 2119 when you do buy your new home. See Publication 523 for examples of filled-in Forms 2119.

RECORDS Keep a copy of Form 2119 with your tax records for the year. Form 2119 is also a supporting document that shows how your new home's basis is decreased by the amount of any postponed gain on the sale of your old home. Therefore, you should also keep a copy of Form 2119 with your records for the basis of your new home.

Reporting a loss. You must report the sale of your main home even if you have a loss on the sale. Complete Part I of Form 2119 for the year in which the sale occurred. You cannot deduct the loss from your income.

If you report a loss on the sale, you do not have to file a second Form 2119 if you later purchase a new home. The loss on the sale has no effect on the basis of your new home.

Reporting exclusion of gain. If you qualify for the one-time exclusion of gain from selling your home, use Form 2119 to claim the exclusion. See *Exclusion of Gain,* later.

Reporting a taxable gain. If you report taxable gain on the sale of your main home, you will also have to file a Schedule D (Form 1040), *Capital Gains and Losses,* with your return.

Maximum tax rate on capital gains. Your net capital gain from sales before May 7, 1997, is taxed at a maximum tax rate of 28%. See chapter 17 for details.

New home purchased before return filed. If you buy and live in a new home before you file a return for the year of sale of your old home, complete Form 2119 and attach it to your return.

Reporting a gain. If the new home costs less than the adjusted sales price of the old home, the gain is taxed up to the amount of the difference. Report the taxable gain on Schedule D (Form 1040) for the year of sale.

If your new home costs as much as or more than the adjusted sales price of your old home, you postpone the tax on the entire gain. You do not need to report the sale on Schedule D (Form 1040).

New home not yet purchased. If you plan to replace your home but have not done so by the time your return for the year of sale is due, you must still report the sale. Complete Form 2119, Part I only, and attach it to your return for the year of sale.

No plan to buy new home. If you do not plan to replace your home within the replacement period, you must complete Form 2119 and attach it to your return for the year of sale. If you have a gain on the sale, you will also need to complete Schedule D (Form 1040) and attach it to your return.

New home purchased after return filed. If you postponed gain from the sale of your old home and you buy and live in a new home after you file your return but within the replacement period, you should notify the IRS. File a second Form 2119 giving the date you first lived in the new home and its cost.

If you paid tax on the gain from the sale of your old home, but replaced it within the replacement period, see *New home purchased after tax paid on gain,* later.

New home costs at least as much as adjusted sales price. If you postponed gain from the sale of your old home, and your new home costs at least as much as the adjusted sales price of your old home, file a second Form 2119 by itself. Your address, signature, and the date are required on this Form 2119. If you filed a joint return for the year of sale, both you and your spouse must sign the Form 2119. File it with the Internal Revenue Service Center where you will file your next tax return.

New home costs less. If you postponed gain from the sale of your old home, and your new home costs less than the adjusted sales price of the old home, you must file an amended return (Form 1040X) for the year of the sale. Attach a second completed Form 2119 and Schedule D (Form 1040) showing the gain you must report. You will have to pay interest on any additional tax due on the amended return. The interest is generally figured from the due date of the return for the year of sale.

New home purchased after tax paid on gain. If you paid tax on the gain from the sale of your old home, and you buy or build and live in a new home within the replacement period, you must file an amended return (Form 1040X) for the year of sale of your old home. Complete a new Form 2119, and include it with your amended return. Report on Schedule D (Form 1040) any gain on which you cannot postpone the tax, and claim a refund of the rest of the tax.

No new home within replacement period. If you postponed gain on the sale of your old home because you planned to replace it but you do not replace it within the replacement period, you must file a second Form 2119. Attach it to an amended return (Form 1040X) for the year of the sale. Include a Schedule D (Form 1040) to report your gain.

Divorce after sale. If you are divorced after filing a joint return on which you postponed tax on the gain on the sale of your home, but you do not buy or build a new home (and your former spouse does), you must file an amended joint return to report the tax on your share of the gain. If your former spouse refuses to sign the amended joint return, attach a letter explaining why your former spouse's signature is missing.

Installment sale. Some sales are made under arrangements that provide for part or all of the selling price to be paid in a later year. These sales are called “installment sales.” If you finance the buyer's purchase of your home yourself, instead of having the buyer get a loan or mortgage from a bank, you may have an installment sale. If the sale qualifies, you can report the part of the gain you cannot postpone on the installment basis.

Seller-financed mortgage. If you sell your home and hold a note, mortgage, or other financial agreement, the payments you receive generally consist of both interest and principal. You must report the interest you receive as part of each payment separately as interest income. If the buyer of your home uses the property as a main or second home, you must also report the name, address, and social security number of the buyer on line 1 of either Schedule B (Form 1040) or Schedule 1 (Form 1040A). The buyer must give you his or her social security number, and you must give the buyer your social security number. Failure to meet these requirements may result in a $50 penalty for each failure.

More information. For more information, see Publication 537, *Installment Sales.*

Statute of limitations. The 3-year limit for assessing tax on the gain from the sale of your home begins when you give the IRS information that shows that:

1) You replaced your old home, and how much the new home cost,

2) You do not plan to buy and occupy a new home within the replacement period, ***or***

3) You did not buy and occupy a new home within the replacement period.

This information may be on the Form 2119 attached to your tax return for the year of the sale, or on a second Form 2119 filed later. File the second Form 2119 with the Service Center where you will file your next tax return. If needed, send an amended return for the year of the sale to include in income the gain that you cannot postpone.

Exclusion of Gain

This section discusses excluding from gross income all or part of the gain from the sale of your main home if you meet certain age, ownership, and use tests at the time of the sale. This is a one-time exclusion of gain for sales after July 26, 1978, and before May 7, 1997. However, for sales after May 6, 1997, you may qualify for the exclusion described later under *Sales After May 6, 1997*.

If you meet the requirements discussed in this section and you make the choice to exclude gain on the sale of your main home, the excluded gain is not taxed.

If you change your mind after you file the return for the year of sale, you may be able to make or revoke the choice later. You would have to file an amended return for the year of sale within certain time limits. See *How To Make and Revoke a Choice To Exclude Gain* in chapter 3 of Publication 523.

Age, Ownership, and Use Tests for Sales Before May 7, 1997

You can choose to exclude from income $125,000 of gain on the sale of your main home ($62,500 if you are married on the date of sale and file a separate return) if you meet ***all*** the following tests.

1) You were age ***55 or older*** on the date of the sale.

2) During the ***5-year period*** ending on the date of the sale, you:

   a) ***Owned*** your main home for at least ***3 years,*** and

   b) ***Lived in*** your main home for at least ***3 years.***

3) Neither you nor your spouse have ever excluded gain on the sale of a home after July 26, 1978.

For more information and examples, see *Exclusion of Gain* in chapter 3 of Publication 523.

Sales After May 6, 1997

If you sell your main home after May 6, 1997, you may qualify to exclude all or part of any gain from your income. This means that, if you qualify, you will not have to pay tax on the gain up to the limit described under *Amount of Exclusion,* next. To qualify, you must meet the ownership and use tests described later.

You can choose not to take the exclusion. In that case, you will have to pay tax on your entire gain, unless you make the choice described in *Choosing To Use Rules for Sales Before May 7, 1997,* later.

Amount of Exclusion

You can exclude the entire gain on the sale of your main home up to:

1) $250,000, or

2) $500,000 if all of the following are true.

   a) You are married and file a joint return for the year.

   b) Either you or your spouse meets the ownership test.

   c) Both you and your spouse meet the use test.

   d) Neither you nor your spouse is excluding gain from the sale of another home after May 6, 1997.

Ownership and Use Tests for Sales After May 6, 1997

You can claim the exclusion if, during the 5-year period ending on the date of the sale, you have:

1) ***Owned*** the home for at least ***2 years*** (the ownership test), ***and***
2) ***Lived in*** the home as your main home for at least ***2 years*** (the use test).

Exception. If you owned and used the property as your main home for less than 2 years, you may be able to claim a reduced exclusion. See *Reduced Exclusion,* later.

Period of ownership and use. The required 2 years of ownership and use (during the 5-year period ending on the date of the sale) do not have to be continuous. You meet the tests if you can show that you owned and lived in the property as your main home for either 24 full months or 730 days (365 × 2) during the 5-year period. Short temporary absences for vacations or other seasonal absences, even if you rent out the property during the absences, are counted as periods of use. See *Ownership and use tests met at different times,* later.

Example 1 – met use test but not ownership test. From 1990 through August 1997 Amanda lived with her parents in a house that her parents owned. On September 2, 1997, she bought this house from her parents. She continued to live there until December 15, 1997, when she sold it at a gain. Although Amanda ***lived in*** the property as her main home for more than 2 years, she did not ***own*** it for the required 2 years. She cannot exclude any part of her gain on the sale, unless she sold the property due to a change in health or place of employment, as explained under *Reduced Exclusion,* later.

Example 2 – period of absence. Professor Paul Beard bought and moved into a house on January 4, 1995. He lived in it as his main home continuously until October 1, 1996, when he went abroad for a 1-year sabbatical leave. During part of the period of leave, the house was unoccupied, and during the rest of the period, he rented it out. On October 1, 1997, he sold the house. Because his leave was not a short temporary absence, he cannot include the period of leave to meet the 2-year use test. However, even though he did not live in the house for the required 2-year period, he does qualify for a reduced exclusion because he owned the home on August 5, 1997, and sold it before August 5, 1999. See *Reduced Exclusion,* later.

Ownership and use tests met at different times. You can meet the ownership and use tests during different 2-year periods. However, you must meet both tests during the 5-year period ending on the date of the sale.

Example. In 1990, Helen Jones was 50 years old and lived in a rented apartment. The apartment building was later changed to a condominium and she bought her apartment on December 1, 1993. In 1995, Helen became ill and on April 14 of that year she moved to her daughter's home. On July 10, 1997, while still living in her daughter's home, she sold her apartment.

Helen can exclude gain on the sale of her apartment because she met the ownership and use tests. Her 5-year period is from July 11, 1992, to July 10, 1997, the date she sold the apartment. She owned her apartment from December 1, 1993, to July 10, 1997 (over 2 years). She lived in the apartment from July 11, 1992 (the beginning of the 5-year period), to April 14, 1995 (over 2 years).

Cooperative apartment. If you sold stock in a cooperative housing corporation, the ownership and use tests are that, during the 5-year period ending on the date of sale, you must have:

1) Owned the stock for at least 2 years, and
2) Used the house or apartment that the stock entitles you to occupy as your main home for at least 2 years.

Exception for individuals with a disability. There is an exception to the 2-out-of-5-year use test if you become physically or mentally unable to care for yourself at any time during the 5-year period.

You qualify for this exception to the use test if, during the 5-year period before the sale of your home:

1) You become physically or mentally unable to care for yourself, and
2) You owned and lived in your home as your main home for a total of at least 1 year.

Under this exception, you are considered to live in your home during any time that you live in a facility (including a nursing home) that is licensed by a state or political subdivision to care for persons in your condition.

If you meet this exception to the use test, you still have to meet the 2-out-of-5-year ownership test to claim the exclusion.

Gain postponed on sale of previous home. For the ownership and use tests, you may be able to add the time you owned and lived in a previous home to the time you lived in the home on which you wish to exclude gain. You can do this if you postponed all or part of the gain on the sale of the previous home (as described under *Postponing Gain,* earlier) because of buying the home on which you wish to exclude gain.

In addition, if buying the previous home enabled you to postpone all or part of the gain on the sale of a home you owned earlier, you can also include the time you owned and lived in that earlier home.

Previous home destroyed or condemned. For the ownership and use tests, you add the time you owned and lived in a previous home that was destroyed or condemned to the time you owned and lived in the home on which you wish to exclude gain. This rule applies if any part of the basis of the home you sold depended on the basis of the destroyed or condemned home. Otherwise, you must have owned and lived in the ***same*** home for 2 of the 5 years before the sale to qualify for the exclusion.

Married Persons

If you and your spouse file a joint return for the year of sale, you can exclude gain if either spouse meets the ownership and use tests. (But see *Amount of Exclusion,* earlier.)

Example 1 – one spouse meets use test. Emily sells her home in June 1997. She marries Jamie later in the year. She meets the ownership and use tests, but Jamie does not. She can exclude up to $250,000 of gain on a separate or joint return for 1997.

Example 2 – each spouse sells a home. The facts are the same as in *Example 1* except that Jamie also sells a home. He meets the ownership and use tests on his home. Emily and Jamie can each exclude up to $250,000 of gain.

Death of spouse before sale. If your spouse died before the date of sale, you are considered to have owned and used the property as your main home during any period of time when your spouse owned and used it as a main home.

Home transferred from spouse. If your home was transferred to you by your spouse (or former spouse if the transfer was incident to divorce), you are considered to have owned it during any period of time when your spouse owned it.

Use of home after divorce. You are considered to have used property as your main home during any period when:

1) You owned it, and
2) Your spouse or former spouse is allowed to use it under a divorce or separation instrument.

Choosing To Use Rules for Sales Before May 7, 1997

You can choose to use the rules under *Sales Before May 7, 1997,* rather than the rules in this discussion, if any of the following statements are true:

1) You sold your home before August 6, 1997,
2) You sold your home after August 5, 1997, under a contract that was binding on that date, or
3) You sold your home after August 5, 1997, and you bought a new home on or before that date, or under a binding contract that was in effect on that date, that would enable you to postpone gain on the sale under the rules described under *Postponing Gain,* earlier.

More Than One Home Sold During 2-Year Period

You cannot exclude gain on the sale of your home if, during the 2-year period ending on the date of the sale, you sold another home at a gain and exclude all or part of that gain. If you cannot exclude the gain, you must include it in your income.

However, you can claim a reduced exclusion if you sold the home due to a change in health or place of employment. See *Reduced Exclusion,* next.

Sales before May 7, 1997. When counting the number of sales during a 2-year period, do not count sales before May 7, 1997.

Reduced Exclusion

The maximum amount of gain you can exclude will be reduced if:

1) You owned a home on August 5, 1997, sold it before August 5, 1999, and did not meet the ownership and use tests, or

2) Due to a change in health or place of employment, you either:

   a) Did not meet the ownership and use tests, or

   b) Are excluding gain on the sale of another home after May 6, 1997.

See Publication 523 for a worksheet to figure your reduced exclusion.

Special Situations

This section explains certain special situations that may affect your exclusion.

Business use of your home. You cannot exclude the part of your gain that is equal to any depreciation allowed or allowable for the business use of your home after May 6, 1997.

For more information, see Publication 523.

Expatriates. You cannot claim the exclusion if section 877(a)(1) of the Internal Revenue Code applies to you. That section applies to U.S. citizens who have renounced their citizenship (and long-term residents who have ended their residency) if one of their principal purposes was to avoid U.S. taxes.

In addition, you cannot make the choice described under *Choosing To Use Rules for Sales Before May 7, 1997,* even if statements (2) or (3) in that discussion are true. (You can make that choice if statement (1) is true.)

Home destroyed or condemned. If your home is destroyed or condemned after May 6, 1997, any gain (for example, because of insurance proceeds you received) qualifies for the exclusion.

Any part of the gain that cannot be excluded (because it is more than the limit) may be postponed under the rules explained in:

- Publication 547, *Casualties, Disasters, and Thefts (Business and Nonbusiness),* in the case of a home that was destroyed, or
- Chapter 1 of Publication 544, *Sales and Other Dispositions of Assets,* in the case of a home that was condemned.

Sale of remainder interest. Subject to the other rules in this chapter, you can choose to exclude gain from the sale of a remainder interest in your home. If you make this choice, you cannot choose to exclude gain from your sale of any other interest in the home that you sell separately.

Exception for sales to related persons. You cannot exclude gain from the sale of a remainder interest in your home to a related party. Related parties include your brothers and sisters, half-brothers and half-sisters, spouse, ancestors (parents, grandparents, etc.), and lineal descendants (children, grandchildren, etc.). Related parties also include certain corporations, partnerships, trusts, and exempt organizations, as explained under *Related Party Transactions* in chapter 15.

How To Report

Use Form 2119 to report the sale of your main home.

Reporting a loss. You must report the sale even if you have a loss. Complete Part I of Form 2119 for the year in which the sale occurred. You cannot deduct the loss from your income.

Reporting exclusion of gain. If you qualify for the exclusion of gain from selling your home, use Part IV of Form 2119 to claim it.

Reporting a taxable gain. If you report taxable gain on the sale of your main home, you will also have to file a Schedule D (Form 1040) with your return.

Maximum tax rate on capital gains. Your net capital gain from sales after May 6, 1997, is taxed at a maximum tax rate of 10%, 20%, 25%, or 28%, depending on your situation. See chapter 17.

Installment sale. If you finance the buyer's purchase of your home yourself, instead of having the buyer get a loan or mortgage from a bank, you may have an installment sale. If the sale qualifies, you can report any part of the gain you cannot exclude on the installment basis. For information on reporting income from this type of sale, see *Installment sale* under *Sales Before May 7, 1997,* earlier.

Recapture of Federal Subsidy

If you financed your home under a federally subsidized program (loans from tax-exempt qualified mortgage bonds or loans with mortgage credit certificates), you may have to recapture all or part of the benefit you received from that program when you sell or otherwise dispose of your home. You recapture the benefit by increasing your federal income tax for the year of the sale. The postponement and exclusion of gain provisions discussed earlier in this chapter do not apply to this recapture tax.

The recapture tax is figured on **Form 8828.** If your mortgage loan is subject to the recapture rules, you must file Form 8828 even if you do not owe a recapture tax.

Loans subject to recapture rules. The recapture of the subsidy applies to loans provided after 1990 that:

1) Came from the proceeds of qualified mortgage bonds issued after August 15, 1986, or

2) Were based on mortgage credit certificates.

The recapture also applies to assumptions of these loans.

If your mortgage loan is subject to this recapture rule, you should have received a notice containing information that you need to figure the recapture tax.

When the recapture applies. The recapture of the federal mortgage subsidy applies only if you meet ***both*** of the following conditions.

1) You sell or otherwise dispose of your home:

   a) At a gain, and

   b) During the first 9 years after the date you closed your mortgage loan.

2) Your income for the year of disposition is more than that year's adjusted qualifying income for your family size for that year (related to the income requirements a person must meet to qualify for the federally subsidized program).

When recapture does not apply. The recapture does ***not*** apply if any of the following situations apply to you:

- The mortgage was secured solely as a qualified home improvement loan of not more than $15,000,
- The home is disposed of as a result of your death,
- You dispose of the home more than 9 years after the date you closed your mortgage loan,
- You transfer the home to your spouse, or to your former spouse incident to a divorce, where no gain is included in your income,
- You dispose of the home at a loss,
- Your home is destroyed by a casualty, and you repair it or replace it on its original site within 2 years after the destruction, or
- You refinance your mortgage loan (unless you later meet all of the conditions listed previously under *When the recapture applies).*

17.

Reporting Gains and Losses

Important Changes for 1997

New maximum tax rates on net capital gain. The maximum tax rate on a net capital gain has been reduced for some sales and exchanges after May 6, 1997. The maximum rate may be 10%, 20%, 25%, or 28%, depending on the situation. See *Using the Maximum Capital Gains Rates,* later, for more information.

Capital gain distributions. You must report your capital gain distributions on Schedule D (Form 1040) in all cases. This is so that you can benefit from the new maximum capital gains rates.

Introduction

This chapter discusses how to report capital gains and losses from sales, exchanges, and other dispositions of investment property on Schedule D of Form 1040. The discussion includes:

- How to report short-term gains and losses,
- How to report long-term gains and losses,
- How to figure capital loss carryovers,
- How to figure your tax using the maximum tax rates on a net capital gain, and
- An illustrated example of how to complete Schedule D.

If you sell or otherwise dispose of property used in a trade or business or for the production of income, see Publication 544, *Sales and Other Dispositions of Assets,* before completing Schedule D.

Useful Items

You may want to see:

Publication

- ☐ **537** Installment Sales
- ☐ **544** Sales and Other Dispositions of Assets
- ☐ **550** Investment Income and Expenses

Form (and Instructions)

- ☐ **Schedule D (Form 1040)** Capital Gains and Losses
- ☐ **4797** Sales of Business Property
- ☐ **6252** Installment Sale Income
- ☐ **8582** Passive Activity Loss Limitations

Schedule D

Report capital gains and losses on Schedule D (Form 1040). Enter your sales and trades of stocks, bonds, etc., and real estate (if not required to be reported on another form) on line 1 of Part I or line 8 of Part II, as appropriate. Include all these transactions even if you did not receive a Form 1099–B or Form 1099–S (or substitute statement).

Installment sales. If you will receive any of the proceeds from the sale of your investment property after the year of sale, you may have an installment sale. Generally, you report gain from an installment sale using the installment method. Under this method, you report part of the gain each year that you receive a payment. For information, see Form 6252 and Publication 537, *Installment Sales.*

Stock or securities. You cannot use the installment method to report gain from the sale of stock or securities traded on an established securities market. You must report the entire gain for the year of sale (the year in which the trade date occurs).

Passive activity gains and losses. If you have gains or losses from a passive activity, you may also have to report them on **Form 8582.** In some cases, the loss may be limited under the passive activity rules. Refer to Form 8582 and its separate instructions for more information about reporting capital gains and losses from a passive activity.

Form 1099–B transactions. If you sold property, such as stocks, bonds, or certain commodities, through a broker, you should receive Form 1099–B, *Proceeds From Broker and Barter Exchange Transactions,* or an equivalent statement from the broker. Use the Form 1099–B or equivalent statement to complete Schedule D.

Report the gross proceeds shown in box 2 of Form 1099–B as the ***gross sales price*** in column (d) of either line 1 or line 8 of Schedule D, whichever applies. However, if the broker advises you, in box 2 of Form 1099–B, that gross proceeds (gross sales price) less commissions and option premiums were reported to the IRS, enter that ***net sales price*** in column (d) of either line 1 or line 8 of Schedule D, whichever applies. If the net amount is entered in column (d), do not include the commissions and option premiums in column (e).

Form 1099–S transactions. If you sold or exchanged reportable real estate, you should receive from the real estate reporting person a Form 1099–S, *Proceeds From Real Estate Transactions,* showing the gross proceeds from the sale.

“Reportable real estate” is defined as any present or future ownership interest in any of the following:

1) Improved or unimproved land, including air space,

2) Inherently permanent structures, including any residential, commercial, or industrial building,

3) A condominium unit and its accessory fixtures and common elements, including land, and

4) Stock in a cooperative housing corporation (as defined in section 216 of the Internal Revenue Code).

A “real estate reporting person” could include the buyer's attorney, your attorney, the title or escrow company, a mortgage lender, your broker, the buyer's broker, or the person acquiring the biggest interest in the property.

Your Form 1099–S will show the gross proceeds from the sale or exchange in box 2. Follow the instructions for Schedule D to report these transactions and include them on line 1 or 8 as appropriate.

Reconciling Forms 1099 with Schedule D. Add the following amounts reported to you for 1997 on Forms 1099–S and 1099–B (or on substitute statements):

1) Proceeds from transactions involving stocks, bonds, and other securities, and

2) Gross proceeds from real estate transactions not reported on another form or schedule.

If this total is more than the total of lines 3 and 10 of Schedule D, attach a statement to your return explaining the difference.

Sale of property bought at various times. If you sell a block of stock or other property that you bought at various times, report the short-term gain or loss from the sale on one line in Part I of Schedule D and the long-term gain or loss on one line in Part II. Write “Various” in column (b) for the “Date acquired.” See the *Comprehensive Example* later in this chapter.

Sale expenses. Add to your cost or other basis any expense of sale such as brokers' fees, commissions, state and local transfer taxes, and option premiums. Enter this adjusted amount in column (e) of either Part I or Part II of Schedule D, whichever applies, unless you reported the net sales price amount in column (d).

For more information about adjustments to basis, see chapter 14.

Property held for personal use. Property held for personal use is a capital asset. Gain from a sale or exchange of that property is a capital gain. Loss from the sale or exchange of that property is not deductible. You can deduct a loss relating to personal use property only if it results from a casualty.

Short-term gains and losses. A capital gain or loss on the sale or trade of property held one year or less is a short-term capital gain or loss. Report it in Part I of Schedule D. If the amount you report in column (f) is a loss, show it in parentheses.

You combine your share of short-term capital gains or losses from partnerships, S corporations, and fiduciaries, and any short-term capital loss carryover, with your other short-term capital gains and losses to figure your net short-term capital gain or loss on line 7 of Schedule D.

Long-term gains and losses. A capital gain or loss on the sale or trade of property held more than one year is a long-term capital gain or loss. Report it in Part II of Schedule D. Report the amount of each gain or loss for the entire year in column (f). If you have a loss, show it in parentheses.

You also report the following in Part II of Schedule D:

1) Undistributed long-term capital gains from a regulated investment company (mutual fund) or real estate investment trust (REIT),
2) Your share of long-term capital gains or losses from partnerships, S corporations, and fiduciaries,
3) All capital gain distributions from mutual funds and REITs, and
4) Long-term capital loss carryovers.

The result from combining these items with your other long-term capital gains and losses is your net long-term capital gain or loss (line 16 of Schedule D).

28% rate gain or loss. Enter in column (g) the amount, if any, from column (f) that is a 28% rate gain or loss (defined under *Holding Period* in chapter 15). Enter any loss in parentheses.

Total net gain or loss. To figure your total net gain or loss, combine your net short-term capital gain or loss (line 7) with your net long-term capital gain or loss (line 16). Enter the result on line 17, Part III of Schedule D. If your losses are more than your gains, see *Capital Losses,* next. If both lines 16 and 17 are gains and line 38 of Form 1040 is more than zero, see *Using the Maximum Capital Gains Rates,* later.

Capital Losses

If your capital losses are more than your capital gains, you can claim a capital loss deduction. Report the deduction on line 13 of Form 1040, enclosed in parentheses.

Limit on deduction. Your allowable capital loss deduction for any tax year, figured on Schedule D, is limited to the smaller of:

1) $3,000 ($1,500 if you are married and file a separate return), or
2) Your total net loss as shown on line 17 of Schedule D.

You can use your total net loss to reduce your income dollar for dollar, up to the $3,000 limit.

Capital loss carryover. If you have a total net loss on line 17 of Schedule D that is more than the yearly limit on capital loss deductions, you can carry over the unused part to the next year and treat it as if you had incurred it in that next year. If part of the loss is still unused, you can carry it over to later years until it is completely used up.

When you figure the amount of any capital loss carryover to the next year, you must take the current year's allowable deduction into account, whether or not you claim it.

When you carry over a loss, it remains long term or short term. A long-term capital loss you carry over to the next tax year will reduce that year's long-term capital gains before it reduces that year's short-term capital gains.

Figuring your carryover. The amount of your capital loss carryover is the amount of your total net loss that is more than the lesser of:

1) Your allowable capital loss deduction for the year, or
2) Your taxable income increased by your allowable capital loss deduction for the year and your deduction for personal exemptions.

If your deductions are more than your gross income for the tax year, use your negative taxable income in computing the amount in item (2).

Complete the *Capital Loss Carryover Worksheet* in the Schedule D (Form 1040) instructions to determine the part of your capital loss for 1997 that you can carry over to 1998.

Example. Bob and Gloria sold securities in 1997. The sales resulted in a capital loss of $7,000. They had no other capital transactions. Their taxable income was $26,000. On their joint 1997 return, they can deduct $3,000. The unused part of the loss, $4,000 ($7,000 – $3,000), can be carried over to 1998.

If their capital loss had been $2,000, their capital loss deduction would have been $2,000. They would have no carryover to 1998.

Use short-term losses first. When you figure your capital loss carryover, use your short-term capital losses first, even if you incurred them after a long-term capital loss. If you have not reached the limit on the capital loss deduction after using short-term losses, use the long-term losses until you reach the limit.

A decedent's capital loss. A capital loss sustained by a decedent during his or her last tax year can only be deducted on the final income tax return filed for the decedent. The capital loss limits discussed earlier still apply in this situation. The decedent's estate cannot deduct any of the loss or carry it over to following years.

Joint and separate returns. If you and your spouse once filed separate returns and are now filing a joint return, combine your separate capital loss carryovers. However, if you and your spouse once filed a joint return and are now filing separate returns, any capital loss carryover from the joint return can be deducted only on the return of the person who actually had the loss.

Using the Maximum Capital Gains Rates

The 31%, 36%, and 39.6% income tax rates for individuals do not apply to a net capital gain. In some cases, the 15% and 28% rates do not apply either. Instead, your net capital gain is taxed at a lower maximum rate.

The term "net capital gain" means the amount by which your net long-term capital gain for the year is more than your net short-term capital loss.

Figuring your tax. You will need to use Part IV of Schedule D (Form 1040) to figure your tax using the maximum capital gains rates if both of the following are true.

1) You have a net capital gain. You have a net capital gain if both lines 16 and 17 of Schedule D (Form 1040) are gains. (Line 16 is your net long-term capital gain or loss. Line 17 is your net long-term capital gain or loss combined with any net short-term capital gain or loss.)
2) Your taxable income on Form 1040, line 38, is more than zero.

The maximum rate may be 10%, 20%, 25%, or 28%, or a combination of those rates, as shown in the following table.

The Maximum Rate is . . .	For . . .
28%	• Gain on a sale before May 7, 1997, of property held more than 1 year • Gain on a sale after July 28, 1997, of property held more than 1 year but not more than 18 months • A collectibles gain
25%	• Unrecaptured section 1250 gain on a sale after May 6, 1997, and before July 29, 1997, of property held more than 1 year • Unrecaptured section 1250 gain on a sale after July 28, 1997, of property held more than 18 months
20%	• Gain on a sale after May 6, 1997, and before July 29, 1997, of property held more than 1 year (unless 28%, 25%, or 10% rate applies) • Gain on a sale after July 28, 1997, of property held more than 18 months (unless 28%, 25%, or 10% rate applies)
10%	• Gain on a sale that would qualify for the 20% maximum rate except that, if there were no maximum capital gains rates, the gain would be taxed at the 15% regular tax rate

The term "sale" includes a trade, involuntary conversion, and installment payment received.

See the *Comprehensive Example,* later, for an example of how to figure your tax using the maximum capital gains rates.

Collectibles gain. This is gain from the sale of a work of art, rug, antique, metal, gem, stamp, coin, or alcoholic beverage:

- Held more than 18 months, or
- Held more than 1 year, in the case of sales after May 6, 1997, but before July 29, 1997.

Unrecaptured section 1250 gain. Generally, this is the part of any capital gain from selling section 1250 property (real property) that is due to depreciation. For more information about section 1250 property, see Publication 544.

Investment interest deducted. If you claim a deduction for investment interest, you may have to reduce the amount of your net capital gain that is eligible for the maximum tax rates. Reduce it by the amount of the net capital gain you choose to include in investment income when figuring the limit on your investment interest deduction. For

Table 17-1. **What Is Your Maximum Capital Gains Rate for 1997?**

IF the sale* took place . . .	**AND the capital asset was held . . .**	**AND your gain . . .**	**THEN your maximum capital gains rate is . . .**
Before May 7, 1997	More than 1 year	Is from selling any type of capital asset	28%
After May 6, 1997, but **before** July 29, 1997	More than 1 year	1) Is a collectibles gain	28%
		2) Is an unrecaptured section 1250 gain	25%
		3) Is not a gain that (1), (2), or (4) applies to	20%
		4) Would be taxed, if there were no maximum capital gains rates, at the 15% regular tax rate — and (1) and (2) don't apply	10%
After July 28, 1997	More than 1 year but not more than 18 months	Is from selling any type of capital asset	28%
After July 28, 1997	More than 18 months	1) Is a collectibles gain	28%
		2) Is an unrecaptured section 1250 gain	25%
		3) Is not a gain that (1), (2), or (4) applies to	20%
		4) Would be taxed, if there were no maximum capital gains rates, at the 15% regular tax rate — and (1) and (2) don't apply	10%

* The term "sale" includes a trade, involuntary conversion, and installment payment received.

more information, see *Limit on Investment Interest* in chapter 3 of Publication 550.

Table 17–1. You may find *Table 17–1* helpful in finding your maximum capital gains rate for 1997.

Changes for years after 1997. Beginning in the year 2001, the 10% maximum capital gains rate will be lowered to 8% for "qualified 5-year gain" (generally, long-term capital gain from the sale of property held for more than 5 years).

Beginning in the year 2006, the 20% maximum capital gains rate will be lowered to 18% for qualified 5-year gain from property with a holding period that begins after 2000. See Publication 553, *Highlights of 1997 Tax Changes,* for more information.

Comprehensive Example

Emily Jones is single and, in addition to wages from her job, she has income from some stocks and other securities. For the 1997 tax year, she had the following capital gains and losses, which she reports on Schedule D. All the Forms 1099 she received showed net sales prices. Her filled-in Schedule D is shown in this chapter.

Capital gains and losses — Schedule D. Emily sold stock in two different companies that she held for less than a year. In June, she sold 100 shares of Trucking Co. stock that she had purchased in May. She had an adjusted basis of $650 in the stock and sold it for $900, for a gain of $250. In July, she sold 25 shares of Computer Co. stock that she bought in March. She had an adjusted basis in the stock of $2,500 and she sold it for $2,000, for a loss of $500. She reports these short-term transactions on line 1 in Part I of Schedule D.

Emily had three other stock sales that she reports as long-term transactions on line 8 in Part II of Schedule D. In February, she sold 60 shares of Car Co. for $2,100. She had inherited the Car Co. stock from her father. Its fair market value at the time of his death was $2,500, which became her basis. Her loss on the sale is $400. Because she had inherited the stock, her loss is a long-term loss, regardless of how long she and her father actually held the stock. Because she sold the stock before May 7, it is a 28% rate loss, so she enters it in both column (f) and column (g) of line 8.

On June 27, she sold 500 shares of Furniture Co. stock for $10,000. She bought 100 of those shares in 1987, for $1,000. She bought 100 more shares in 1989 for $2,200, and an additional 300 shares in 1991 for $1,500. Her total basis in the stock is $4,700. She has a $5,300 ($10,000 – $4,700) gain on this sale, which she enters in column (f) of line 8.

In September, she sold 20 shares of Toy Co. for $2,600. Her basis is $1,100, so she has a $1,500 gain. Because she sold the stock after July 28 and did not hold it more than 18 months, her gain is a 28% rate gain. She enters it in both column (f) and column (g) of line 8.

She received a Form 1099–B (not shown) from her broker for each of these transactions.

Capital loss carryover from 1996. Emily has a capital loss carryover to 1997 of $800, of which $300 is short-term capital loss, and $500 is long-term capital loss. She enters these amounts on lines 6 and 14 of Schedule D.

She kept the completed *Capital Loss Carryover Worksheet* in her 1996 Schedule D instructions (not shown), so she could properly report her loss carryover for the 1997 tax year without refiguring it.

Tax computation using maximum capital gains rates. Because Emily has gains on both lines 16 and 17 of Schedule D and has taxable income, she uses Part IV of Schedule D to figure her tax. She had already filled out her Form 1040 through line 38 and enters the amount from that line, $30,000, on line 19 of Schedule D. After filling out the rest of Part IV, she finds that her tax is $4,779. This is less than the tax she would have found using the Tax Table, $5,203.

Reconciliation of Forms 1099–B. Emily makes sure that the total of the amounts reported in column (d) of lines 3 and 10 of Schedule D is not less than the total of the amounts shown on the Forms 1099–B she received from her broker. For 1997, the total of each is $17,600.

SCHEDULE D (Form 1040)

Department of the Treasury
Internal Revenue Service

Capital Gains and Losses

▶ Attach to Form 1040. ▶ See Instructions for Schedule D (Form 1040).

▶ Use Schedule D-1 for more space to list transactions for lines 1 and 8.

OMB No. 1545-0074

1997

Attachment Sequence No. 12

Name(s) shown on Form 1040: Emily Jones

Your social security number: 111 00 1111

Part I Short-Term Capital Gains and Losses—Assets Held One Year or Less

(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-3)	(e) Cost or other basis (see page D-4)	(f) GAIN or (LOSS) FOR ENTIRE YEAR. Subtract (e) from (d)
1 100 sh Trucking Co.	5-12-97	6-12-97	900	650	250
25 sh Computer Co.	3-14-97	7-30-97	2,000	2,500	(500)

Line	Description	(d)	(f)
2	Enter your short-term totals, if any, from Schedule D-1, line 2		
3	**Total short-term sales price amounts.** Add column (d) of lines 1 and 2 . . .	2,900	
4	Short-term gain from Forms 2119 and 6252, and short-term gain or (loss) from Forms 4684, 6781, and 8824		
5	Net short-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1		
6	Short-term capital loss carryover. Enter the amount, if any, from line 9 of your 1996 Capital Loss Carryover Worksheet		(300)
7	**Net short-term capital gain or (loss).** Combine lines 1 through 6 in column (f) . . . . ▶		(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-3)	(e) Cost or other basis (see page D-4)	(f) GAIN or (LOSS) FOR ENTIRE YEAR. Subtract (e) from (d)	(g) 28% RATE GAIN or (LOSS) *(see instr. below)
8 60 sh Car Co.	Inherited	2-3-97	2,100	2,500	(400)	(400)
500 sh Furniture Co.	Various	6-27-97	10,000	4,700	5,300	
20 sh Toy Co.	6-28-96	9-15-97	2,600	1,100	1,500	1,500

Line	Description	(d)	(f)	(g)
9	Enter your long-term totals, if any, from Schedule D-1, line 9			
10	**Total long-term sales price amounts.** Add column (d) of lines 8 and 9 . . .	14,700		
11	Gain from Form 4797, Part I; long-term gain from Forms 2119, 2439, and 6252; and long-term gain or (loss) from Forms 4684, 6781, and 8824 . .			
12	Net long-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1			
13	Capital gain distributions			
14	Long-term capital loss carryover. Enter in both columns (f) and (g) the amount, if any, from line 14 of your 1996 Capital Loss Carryover Worksheet . . .		(500)	(500)
15	Combine lines 8 through 14 in column (g)			600
16	**Net long-term capital gain or (loss).** Combine lines 8 through 14 in column (f) . . . . ▶		5,900	

***28% Rate Gain or Loss** includes all gains and losses in Part II, column (f) from sales, exchanges, or conversions (including installment payments received) **either:**
- **Before** May 7, 1997, **or**
- **After** July 28, 1997, for assets held more than 1 year but **not** more than 18 months.

It also includes **ALL** "collectibles gains and losses" (as defined on page D-4).

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 11338H **Schedule D (Form 1040) 1997**

Part III Summary of Parts I and II

Line	Description		Amount
17	Combine lines 7 and 16. If a loss, go to line 18. If a gain, enter the gain on Form 1040, line 13 **Next:** Complete Form 1040 through line 38. Then, go to **Part IV** to figure your tax if: • Both lines 16 and 17 are gains, **and** • Form 1040, line 38, is more than zero.	17	5,350
18	If line 17 is a loss, enter here and as a (loss) on Form 1040, line 13, the **smaller** of these losses: • The loss on line 17; **or** • ($3,000) or, if married filing separately, ($1,500) **Next:** Complete Form 1040 through line 36. Then, complete the **Capital Loss Carryover Worksheet** on page D-4 if: • The loss on line 17 exceeds the loss on line 18, **or** • Form 1040, line 36, is a loss.	18	( )

Part IV Tax Computation Using Maximum Capital Gains Rates

Line	Description	Inner amount		Amount
19	Enter your taxable income from Form 1040, line 38		19	30,000
20	Enter the **smaller** of line 16 or line 17	5,350		
21	If you are filing Form 4952, enter the amount from Form 4952, line 4e			
22	Subtract line 21 from line 20. If zero or less, enter -0-	5,350		
23	Combine lines 7 and 15. If zero or less, enter -0-	50		
24	Enter the **smaller** of line 15 or line 23, but not less than zero	50		
25	Enter your unrecaptured section 1250 gain, if any (see page D-4)			
26	Add lines 24 and 25	50		
27	Subtract line 26 from line 22. If zero or less, enter -0-		27	5,300
28	Subtract line 27 from line 19. If zero or less, enter -0-		28	24,700
29	Enter the **smaller** of line 19 or $41,200 ($24,650 if single; $20,600 if married filing separately; $33,050 if head of household)		29	24,650
30	Enter the **smaller** of line 28 or line 29		30	24,650
31	Subtract line 22 from line 19. If zero or less, enter -0-		31	24,650
32	Enter the **larger** of line 30 or line 31		32	24,650
33	Figure the tax on the amount on line 32. Use the Tax Table or Tax Rate Schedules, whichever applies ▶		33	3,705
34	Enter the amount from line 29		34	24,650
35	Enter the amount from line 28		35	24,700
36	Subtract line 35 from line 34. If zero or less, enter -0-		36	-0-
37	Multiply line 36 by 10% (.10) ▶		37	
38	Enter the **smaller** of line 19 or line 27		38	5,300
39	Enter the amount from line 36		39	-0-
40	Subtract line 39 from line 38. If zero or less, enter -0-		40	5,300
41	Multiply line 40 by 20% (.20) ▶		41	1,060
42	Enter the **smaller** of line 22 or line 25		42	
43	Add lines 22 and 32	30,000		
44	Enter the amount from line 19	30,000		
45	Subtract line 44 from line 43. If zero or less, enter -0-		45	-0-
46	Subtract line 45 from line 42. If zero or less, enter -0-		46	-0-
47	Multiply line 46 by 25% (.25) ▶		47	
48	Enter the amount from line 19		48	30,000
49	Add lines 32, 36, 40, and 46		49	29,950
50	Subtract line 49 from line 48		50	50
51	Multiply line 50 by 28% (.28) ▶		51	14
52	Add lines 33, 37, 41, 47, and 51		52	4,779
53	Figure the tax on the amount on line 19. Use the Tax Table or Tax Rate Schedules, whichever applies		53	5,203
54	**Tax.** Enter the **smaller** of line 52 or line 53 here and on Form 1040, line 39 ▶		54	4,779

Part Four.

Adjustments to Income

The three chapters in this part discuss three deductions that are used to figure adjusted gross income. They are deductions for:

- *Payments to an individual retirement arrangement (IRA) — chapter 18,*
- *Moving expenses you pay — chapter 19, and*
- *Alimony you pay — chapter 20.*

Other adjustments to income are discussed in other parts of this publication or in other publications. They are deductions for:

- *Contributions to a medical savings account — chapter 23,*
- *Self-employment tax — chapter 24,*
- *Self-employed health insurance — chapter 23,*
- *Payments to a Keogh retirement plan or self-employed SEP or SIMPLE plan — Publication 560, Retirement Plans for Small Business, and*
- *Penalty on early withdrawal of savings — chapter 8.*

You can also write in certain deductions in figuring adjusted gross income on Form 1040. They are discussed in other parts of this publication or in other publications and instructions. These write-in deductions include the following:

- *Amortization of the costs of reforestation — chapter 12 of Publication 535, Business Expenses,*
- *Contributions to Internal Revenue Code section 501(c)(18) pension plans — instructions for Form 1040, line 31,*
- *Expenses from the rental of personal property — chapter 13,*
- *Expenses of fee-basis officials or certain performing artists — chapter 28,*
- *Certain required repayments of supplemental unemployment benefits (sub-pay) — chapter 6,*
- *Foreign housing deduction — chapter 4 of Publication 54, Tax Guide for U.S. Citizens and Resident Aliens Abroad,*
- *Jury duty pay given to your employer — chapter 13, and*
- *Part of the cost of qualified clean-fuel vehicle property — chapter 15 of Publication 535, Business Expenses.*

18.

Individual Retirement Arrangements (IRAs)

Important Changes for 1997

Contributions to spousal IRAs. Beginning in 1997, in the case of a married couple filing a joint return, up to $2,000 can be contributed to each spouse's IRA, even if one spouse has little or no compensation. This means that the total combined contributions that can be made to both IRAs can be as much as $4,000 for the year. Previously, if one spouse had no compensation or elected to be treated as having no compensation, the total combined contributions to both IRAs could not be more than $2,250. See *Spousal IRA limit,* under *Contribution Limits,* later.

Deduction for contributions to spousal IRA. Beginning in 1997, in the case of a married couple with unequal compensation who file a joint return, the limit on the deductible contributions to the IRA of the spouse with less compensation is the smaller of:

1) $2,000, or

2) The total compensation of both spouses, reduced by any deduction allowed for contributions to IRAs of the spouse with more compensation.

The deduction for contributions to both spouses' IRAs may be further limited if either spouse is covered by an employer retirement plan. See *Deduction Limits,* later.

Tax on prohibited transactions. The tax on the amount of a prohibited transaction that takes place after August 5, 1997, has increased from 10% to 15%. See *Prohibited Transactions,* later.

No additional tax on early withdrawals for certain medical expenses. Beginning in 1997, the 10% additional tax on premature distributions (early withdrawals) from an IRA will not apply to distributions up to the amount you pay for unreimbursed medical expenses that are more than 7½% of your adjusted gross income.

Also beginning in 1997, the 10% tax may not apply to distributions up to the amount you paid for medical insurance for yourself, your spouse, and your dependents. See *Premature Distributions (Early Withdrawals),* later.

Tax on excess distributions repealed. For IRA distributions made after 1996, the 15% tax on excess distributions has been repealed.

Salary reduction arrangements for SEPs repealed. Beginning in 1997, an employer cannot start a simplified employee pension (SEP) that includes a salary reduction arrangement. Only SEPs that allowed employees to choose elective deferrals as of December 31, 1996, can include salary reduction arrangements. SEPs are discussed later.

Savings incentive match plans for employees (SIMPLE). Beginning in 1997, certain employers can set up SIMPLE retirement plans.

A SIMPLE plan can be set up either as an IRA or as part of a qualified cash or deferred arrangement (401(k) plan). For more information on this new plan, get Publication 590 or Publication 560, *Retirement Plans for Small Business.* SIMPLE IRAs are discussed later, under *Savings Incentive Match Plan for Employees (SIMPLE).*

Matching contributions for self-employed individual clarified. Matching contributions to a SIMPLE IRA on behalf of a self-employed individual are not treated as elective employer contributions. Consequently, these matching contributions are not counted when figuring whether the $6,000 limit on salary reductions that an employee can elect to have the employer contribute has been reached.

Important Changes for 1998

The following changes will not affect your 1997 tax return. They are effective beginning in 1998. For more information on these and other changes to the tax law, get Publication 553, *Highlights of 1997 Tax Changes.*

Deduction — spouse covered by employer plan. Beginning in 1998, even if your spouse is covered by an employer retirement plan, you may be able to deduct your contributions to an IRA if you are not covered by an employer plan. The deduction is limited to $2,000 and it must be reduced if your adjusted gross income on a joint return is more than $150,000 but less than $160,000. Your deduction is eliminated if your income on a joint return is $160,000 or more.

CAUTION *As this publication was being prepared for print, Congress was considering legislation that would clarify its intent regarding the IRA deduction of a spouse who is not covered by an employer plan. See Publication 553.*

Deduction — modified AGI limit increased. For 1998, if you are covered by a retirement plan at work, your IRA deduction will not be reduced (phased out) unless your modified adjusted gross income (AGI) is between:

- $50,000 (a $10,000 increase) and $60,000 for a married couple (or a qualifying widow(er)) filing a joint return,
- $30,000 (a $5,000 increase) and $40,000 for a single individual (or head of household), or
- $–0– (no increase) and $10,000 for a married individual filing a separate return.

CAUTION *As this publication was being prepared for print, Congress was considering legislation that would clarify its intent relating to the phase-out ranges for married individuals who are not covered by a retirement plan at work. See Publication 553.*

No additional tax on early withdrawals for higher education expenses. Beginning in 1998, you can take distributions from your IRA to pay qualified higher education expenses without having to pay the 10% additional tax on early withdrawals.

To qualify for this higher education expenses exception, a distribution must be used to pay qualified higher education expenses for:

1) You,
2) Your spouse,
3) Your or your spouse's children, or
4) Your or your spouse's grandchildren.

Qualified higher education expenses means tuition, fees, books, supplies and equipment required for the enrollment or attendance of any of the individuals listed earlier at an eligible education institution. In addition, if the individual is at least a half-time student, room and board are qualified higher education expenses.

CAUTION *As this publication was being prepared for print, Congress was considering legislation that would modify the rules relating to rollovers to IRAs to prevent avoidance of the additional tax on premature distributions. Under the rules, certain hardship distributions from employer-sponsored retirement plans would not be treated as eligible rollover distributions. See Publication 553.*

No additional tax on early withdrawals for first home. Beginning in 1998, you can take qualified first-time homebuyer distributions totalling $10,000 from your IRA without having to pay the 10% additional tax on early withdrawals.

To qualify under this first-time homebuyer exception, a distribution must be used to buy, build, or rebuild a first home that is the principal residence of:

1) Yourself,
2) Your spouse,
3) Your child, or your spouse's child,
4) Your grandchild, or your spouse's grandchild,
5) Your parent or other ancestor, or
6) Your spouse's parent or other ancestor.

CAUTION *As this publication was being prepared for print, Congress was considering legislation that would modify the rules relating to rollovers to IRAs and the rules relating to this exception to prevent avoidance of the additional tax on premature distributions. Under the rules, certain hardship distributions from employer-sponsored retirement plans would not be treated as eligible rollover distributions. See Publication 553.*

Coins and bullion. Beginning in 1998, your IRA can invest in certain platinum coins and certain gold, silver, palladium, and platinum bullion.

Education individual retirement account (Education IRA). Beginning in 1998, you may be able to make nondeductible contributions of up to $500 annually to an education IRA for a child until he or she reaches age 18. Earnings in the IRA accumulate free of income tax.

Distributions from an education IRA during a year are tax-free, unless distributions from the education IRA are more than qualified higher education expenses during that year.

CAUTION *As this publication was being prepared for print, Congress was considering legislation that would increase the maximum annual contributions to an education IRA. The legislation would also allow tax-free distributions for elementary and secondary school expenses. See Publication 553.*

Roth IRA. Beginning in 1998, you may be able to establish and contribute to a new nondeductible tax-free individual retirement account called the Roth IRA. Unlike an ordinary IRA, you cannot claim a deduction for contributions. But, if you satisfy the requirements, all earnings are tax-free and neither your nondeductible contributions nor any earnings on them are taxable when you withdraw them.

You may be able to roll over amounts from an ordinary IRA into a Roth IRA, but, any amount from the ordinary IRA that would be taxable if distributed must be included in your gross income.

CAUTION *As this publication was being prepared for print, Congress was considering legislation that would clarify its intent relating to the $2,000 contribution* *limit for contributions to all IRAs. The clarification takes into account the phase-out rules that limit deductions to ordinary IRAs and limit contributions to Roth IRAs. The legislation would also clarify tax treatment of rollovers to Roth IRAs. See Publication 553.*

Important Reminders

Interest earned. Although interest earned from your IRA(s) is generally not taxed in the year earned, it is ***not tax-exempt*** interest. ***Do not*** report this interest on your tax return as tax-exempt interest.

Penalty for failure to file Form 8606. If you make nondeductible IRA contributions and you do not file Form 8606, *Nondeductible IRAs (Contributions, Distributions, and Basis),* with your tax return, you may have to pay a $50 penalty.

Introduction

An individual retirement arrangement (IRA) is a personal savings plan that offers you tax advantages to set aside money for your retirement. Two advantages are that you may be able to deduct your contributions to your IRA in whole or in part, depending on your circumstances, and, generally, amounts in your IRA, including earnings and gains, are not taxed until they are distributed.

This chapter discusses:

- Who can set up an IRA,
- When and how an IRA can be set up,
- How much you can contribute and deduct,
- How retirement plan assets can be transferred,
- When IRA assets can be withdrawn,
- What acts result in penalties,
- Simplified Employee Pensions (SEPs), and
- Savings Incentive Match Plans for Employees (SIMPLE)

Useful Items

You may want to see:

Publication

☐ **590** Individual Retirement Arrangements (IRAs) (Including SEP-IRAs and Simple IRAs)

Form (and Instructions)

☐ **5329** Additional Taxes Attributable to Qualified Retirement Plans (Including IRAs), Annuities, Modified Endowment Contracts, and MSAs

☐ **8606** Nondeductible IRAs (Contributions, Distributions, and Basis)

Who Can Set Up an IRA?

You can set up and make contributions to an IRA if you (or if you file a joint return, your spouse) received taxable compensation during the year and you were not age 70½ by the end of the year.

Compensation. Compensation includes wages, salaries, commissions, tips, professional fees, bonuses, and other amounts you receive for providing personal services. The IRS treats as compensation any amount properly shown in box 1 (Wages, tips, other compensation) of Form W-2, provided that amount is reduced by any amount properly shown in box 11 (Nonqualified plans). Compensation also includes taxable alimony and separate maintenance payments.

Self-employment income. If you are self-employed (a sole proprietor or a partner), compensation is your net earnings from your trade or business (provided your personal services are a material income-producing factor) reduced by your deduction for contributions on your behalf to retirement plans and the deduction allowed for one-half of your self-employment taxes.

Compensation also includes earnings from self-employment that are not subject to self-employment tax because of your religious beliefs. See Publication 533, *Self-Employment Tax,* for more information.

Compensation does ***not*** include any of the following items:

- Earnings and profits from property, such as rental income, interest income, and dividend income,
- Pension or annuity income,
- Deferred compensation received (compensation payments postponed from a past year),
- Foreign earned income and housing cost amounts that you exclude from income, or
- Any other amounts that you exclude from income.

When and How Can an IRA Be Set Up?

You can set up an IRA at any time. However, the time for making contributions for any year is limited. See *When To Contribute,* later.

You can set up different kinds of IRAs with a variety of organizations. You can set up an IRA at a bank or other financial institution or with a mutual fund or life insurance company. You can also set up an IRA through your stockbroker. Any IRA must meet Internal Revenue Code requirements.

Kinds of IRAs. Your IRA can be an individual retirement account or annuity. It can be either a part of a simplified employee pension (SEP) or a part of an employer or employee association trust account. Beginning in 1997, an IRA can be part of a savings incentive match plan for employees (SIMPLE). These IRAs are also called simple retirement accounts.

Inherited IRAs. If you inherit an IRA, that IRA becomes subject to special rules. For example, if you are a surviving spouse, you can elect to treat an IRA inherited from your spouse as your own. For more information, see the discussions of inherited IRAs under *Contribution Limits* and *Rollovers,* later.

How Much Can I Contribute and Deduct?

Contributions to an IRA must be in the form of money (cash, check, or money order). You cannot contribute property.

Contribution Limits

The most that you can contribute for any year to your IRA is the smaller of the following amounts:

1) Your compensation (defined earlier) that you must include in income for the year, or
2) $2,000.

This is the most you can contribute regardless of whether your contributions are to one or more IRAs or whether all or part of your contributions are nondeductible. (See *Nondeductible Contributions,* later.)

Example 1. Betty, who is single, earns $24,000 in 1997. Her IRA contributions for 1997 are limited to $2,000.

Example 2. John, a college student working part time, earns $1,500 in 1997. His IRA contributions for 1997 are limited to $1,500, the amount of his compensation.

Spousal IRA limit. Beginning in 1997, if you file a joint return and your taxable compensation is less than that of your spouse, you can contribute for the year to your IRA, the smaller of the following amounts:

1) $2,000, or
2) The sum of:
   a) Your taxable compensation for the year, and
   b) The taxable compensation of your spouse for the year, reduced by the amount of his or her IRA deduction for the year.

This means that the total combined contributions that can be made to your IRA and your spouse's IRA can be as much as $4,000 for the year.

Spouse over age 70½. Your spouse cannot make contributions to his or her IRA for the year in which he or she reaches age 70½ or any later year. However, for any year your spouse has compensation, you can continue to make contributions of up to $2,000 to your spousal IRA. You can contribute to your IRA until the year you reach age 70½.

Contributions not required. You do not have to contribute to your IRA for every tax year, even if you can.

If you and your spouse each contribute to an IRA, the contribution limit for each of you is figured separately.

Community property laws – effect on separate computations. Generally when figuring the maximum contribution, each spouse figures his or her limit separately, using his or her own compensation. This is the rule even in states with community property laws.

TIP *If one spouse has less compensation than the other and files a joint return with the other spouse, the spouse with less compensation can include, to a limited extent, the compensation of the other spouse when figuring the limit.*

Inherited IRAs. If you inherit an IRA from your spouse, you can choose to treat it as your own by making contributions to that IRA.

If, however, you inherit an IRA and you are not the decedent's spouse, you cannot contribute to that IRA, because you cannot treat it as your own.

When To Contribute

You can make contributions to your IRA for a year at any time during the year or by the due date for filing your return for that year, ***not*** including extensions. For most people, this means that contributions for 1997 must be made by April 15, 1998.

Designating year for which contribution is made. If you contribute an amount to your IRA between January 1, 1998, and April 15, 1998, tell the sponsor (the trustee or issuer) to which year (1997 or 1998) the contribution applies. If you do not tell the sponsor, the sponsor can assume, for reporting to IRS, that the contribution is for 1998, the year the sponsor received it.

Filing before making your contribution. You can file your return claiming an IRA contribution before you actually make the contribution. You must, however, make the contribution by the due date of your return, ***not*** including extensions.

Deductible Contributions

Generally, you can take a deduction for the contributions that you are allowed to make to your IRA. However, if you or your spouse were covered by an employer retirement plan at any time during 1997 and you made contributions, your allowable IRA deduction may be less than your contributions. Your allowable deduction may be reduced or eliminated, depending on your filing status and the amount of your income, as discussed later under *Deduction Limits.*

Who Is Covered by an Employer Plan?

The Form W-2, *Wage and Tax Statement,* you receive from your employer has a box used to indicate whether you were covered for the year. The "Pension Plan" box should have a mark in it if you were covered.

You are also covered by a plan if you are self-employed and participate in a qualified retirement plan (such as a Keogh plan), a simplified employee pension (SEP) plan, or a SIMPLE plan.

If you are not certain whether you were covered by your employer's retirement plan, you should ask your employer.

Employer plans. An employer retirement plan is one that an employer sets up for the benefit of the employees. For purposes of the IRA deduction rules, an employer retirement plan is any of the following:

- A qualified pension, profit-sharing, stock bonus, money purchase pension, etc., plan (including Keogh plans),
- A 401(k) plan (generally a profit-sharing or stock bonus plan to which contributions can be made under an arrangement allowing you to choose to take your income in cash or have your employer pay it into the plan),
- A union plan (a qualified stock bonus, pension, or profit-sharing plan created by a collective bargaining agreement between employee representatives and one or more employers),
- A qualified annuity plan,
- A plan established for employees by a federal, state, or local government, or any of their political subdivisions, agencies, or instrumentalities (other than an eligible state deferred compensation plan (section 457(b) plan)),
- A tax-sheltered annuity plan for employees of public schools and certain tax-exempt organizations (403(b) plan),
- A simplified employee pension (SEP) plan,
- A 501(c)(18) trust (a certain type of tax-exempt trust created before June 25, 1959, that is funded only by employee contributions) if you made deductible contributions during the year, or
- A SIMPLE plan.

A ***qualified plan*** is one that meets the requirements of the Internal Revenue Code.

Effects of marital status. Generally, for 1997, you were considered covered by an employer retirement plan if your spouse was covered by one. To determine whether you were considered covered for the year because of your spouse, you had to wait until the last day of the year. This is because your filing status (whether you are considered married or single) for the year depends on your marital status on the last day of the tax year.

TIP *Beginning in 1998, even if your spouse is covered by an employer-sponsored retirement plan, you can deduct your contributions to an IRA if you are not covered by an employer plan. The deduction is limited to $2,000 and it must be reduced if your adjusted gross income on a joint return is more than $150,000, but less than $160,000. Your deduction is eliminated if your income on a joint return is $160,000 or more.*

Spouse died during year. If your spouse died during the year, and you file a joint return as the surviving spouse, coverage by an employer retirement plan for the year is determined as if your spouse were still alive at the end of the year.

Married filing a joint return. Both you and your spouse are considered covered by a plan for the entire year if either of you is covered by a plan for any part of the year and you file a joint return.

Married filing a separate return. If you are not covered by an employer retirement plan, but your spouse is, you are not considered covered if you and your spouse file separate returns and you did not live together at any time during the year.

Effect of amounts. Even if your employer sets aside only a very small amount for you under a retirement plan, you are considered covered by a plan for the year.

Nonvested employees. If, for a plan year, an amount is allocated to your plan account in a defined contribution plan, or you accrue a benefit in a defined benefit plan, but you have ***no vested interest*** (legal right) in such account or accrual, you are still an active participant in (covered by) such plan.

Judges. Federal judges are considered covered by an employer retirement plan.

When Are You Not Covered?

You are not covered by an employer plan if neither you nor your spouse is covered for any part of the year. You are also not covered for this purpose in the following situations.

Married filing a separate return. If you are married filing a separate return and you are not covered but your spouse is covered by an employer retirement plan, you are not considered covered by a plan. This rule applies only if you and your spouse did not live together at any time during the year.

Social security or railroad retirement. Coverage under social security or railroad retirement (Tier I and Tier II) does not count as coverage under an employer retirement plan.

Benefits from a previous employer's plan. If you receive retirement benefits from a previous employer's plan and you are not covered (or considered covered because of your spouse) under your current employer's plan, you are not considered covered.

Reservists. If the only reason you participate in a plan is because you are a member of a reserve unit of the armed forces, you may not be considered covered by the plan. You are not considered covered by the plan if both of the following conditions are met.

1) The plan you participate in is established for its employees by:
   a) The United States,
   b) A state or political subdivision of a state, or
   c) An instrumentality of either (a) or (b) above.
2) You did not serve more than 90 days on active duty during the year (not counting duty for training).

Table 18-1. **Can You Take An IRA Deduction?**

This chart sums up whether you can take a full deduction, a partial deduction, or no deduction as discussed in this chapter.

If Your Modified AGI[1] is:		**If You Are Covered by a Retirement Plan at Work and Your Filing Status is:**			**If You Are Not Covered by a Retirement Plan at Work and Your Filing Status is:**			
		• **Single** • **Head of Household**	• **Married Filing Jointly** (even if your spouse is not covered by a plan at work) • **Qualifying Widow(er)**	**Married Filing Separately**[2]	**Married Filing Jointly** (and Your spouse is covered by a plan at work)	• **Single** • **Head of Household**	• **Married Filing Jointly** or **Separately** (and your spouse is not covered by a plan at work) • **Qualifying Widow(er)**	**Married Filing Separately** (even if your spouse is covered by a plan at work)[3]
At Least	But Less Than	You Can Take	You Can Take	You Can Take	You Can Take	You Can Take	You Can Take	You Can Take
$0.01	$10,000.00	Full deduction	Full deduction	Partial deduction	Full deduction	Full Deduction	Full Deduction	Full Deduction
$10,000.00	$25,000.01	Full deduction	Full deduction	No deduction	Full deduction			
$25,000.01	$35,000.00	Partial deduction	Full deduction	No deduction	Full deduction			
$35,000.00	$40,000.01	No deduction	Full deduction	No deduction	Full deduction			
$40,000.01	$50,000.00	No deduction	Partial deduction	No deduction	Partial deduction			
$50,000.00 or over		No deduction	No deduction	No deduction	No deduction			

[1]**Modified AGI** (adjusted gross income) is: (1) for Form 1040A—the amount on line 14 increased by any excluded series EE bond interest shown on Form 8815, *Exclusion of Interest from Series EE U.S. Savings Bonds Issued after 1989,* and certain tax-exempt income amounts (See *Modified adjusted gross income,* later.), or (2) for Form 1040—the amount on line 32, figured without taking into account any IRA deduction, any foreign earned income exclusion and foreign housing exclusion (deduction), any series EE bond interest exclusion from Form 8815, and certain tax-exempt income amounts (See *Modified adjusted gross income,* later.).

[2]If you did not live with your spouse at any time during the year, your filing status is considered, for this purpose, as Single (therefore your IRA deduction is determined under the "Single" column).

[3]You are entitled to the full deduction only if you did not live with your spouse at any time during the year. If you did live with your spouse during the year, you are, for this purpose, treated as though you are covered by a retirement plan at work (therefore, your IRA deduction is determined under the "Married Filing Separately" column in the "If You Are Covered by a Retirement Plan..." section of the chart).

Volunteer firefighters. If the only reason you participate in a plan is because you are a volunteer firefighter, you may not be considered covered by the plan. You are not considered covered by the plan if both of the following conditions are met.

1) The plan you participate in is established for its employees by:

   a) The United States,

   b) A state or political subdivision of a state, or

   c) An instrumentality of either (a) or (b) above.

2) Your accrued retirement benefits at the beginning of the year will not provide more than $1,800 per year at retirement.

Social Security Recipients

If you received social security benefits, received taxable compensation, contributed to your IRA, and were covered (or considered covered) by an employer retirement plan, complete the worksheets in Appendix B of Publication 590. Use those worksheets to figure your IRA deduction and the taxable portion, if any, of your social security benefits.

Deduction Limits

As discussed under *Deductible Contributions,* earlier, the deduction you can take for contributions made to your IRA depends on whether you or your spouse was covered for any part of the year by an employer retirement plan. But your deduction is also affected by how much income you had and your filing status, as discussed below under *Adjusted Gross Income Limit.*

Full deduction. If neither you nor your spouse was covered for any part of the year by an employer retirement plan, you can take a deduction for your total contributions to one or more IRAs of up to $2,000, or 100% of your compensation, whichever is less. This limit is reduced by any contributions to a 501(c)(18) plan (generally, a plan created before June 25, 1959, funded entirely by employee contributions).

Spousal IRA. Beginning in 1997, in the case of a married couple with unequal compensation who file a joint return, the limit on the deductible contributions to the IRA of the spouse with less compensation is the smaller of:

1) $2,000, or

2) The total compensation of both spouses, reduced by any deduction allowed for contributions to IRAs of the spouse with more compensation.

This limit is reduced by any contributions to a 501(c)(18) plan (generally, a plan created before June 25, 1959, funded entirely by employee contributions).

Reduced or no deduction. For 1997, if either you or your spouse was covered by an employer retirement plan, your deduction may be reduced or eliminated, depending on your income and your filing status. The deduction begins to decrease ***(phase out)*** when your income rises above a certain amount, and is eliminated altogether when it reaches a higher amount. The amounts vary depending on your filing status.

Adjusted Gross Income Limit

The effect of income on your deduction, as just described, is sometimes called the adjusted gross income limit (AGI limit). To compute your reduced IRA deduction, you must first determine your "modified adjusted gross income" and your filing status.

Modified adjusted gross income. Your modified adjusted gross income (modified AGI) is:

1) If you file ***Form 1040*** — the amount on the page 1 "adjusted gross income" line, but modified (changed) by figuring it without taking any:

   a) IRA deduction,

   b) Foreign earned income exclusion,

   c) Foreign housing exclusion or deduction,

   d) Exclusion of Series EE bond interest shown on Form 8815, *Exclusion of Interest From Series EE U.S. Savings Bonds Issued After 1989, or*

e) Exclusion of employer-paid adoption expenses shown on Form 8839, *Qualified Adoption Expenses.*

2) If you file ***Form 1040A*** — the amount on the page 1 “adjusted gross income” line, but modified by figuring it without any IRA deduction, or any exclusion of series EE bond interest shown on Form 8815, or any exclusion of employer-paid adoption expenses shown on Form 8839.

CAUTION *Do not assume modified AGI is the same as your compensation. You will find that your modified AGI may include income in addition to your taxable compensation (discussed earlier), such as interest, dividends, and taxable IRA distributions.*

Filing status. Your filing status depends primarily on your marital status. For this purpose, you need to know if your filing status is single or head of household, married filing jointly or qualifying widow(er), or married filing separately. If you need more information on filing status, see chapter 2.

Married filing separately exception. If you did not live with your spouse at any time during the year and you file a separate return, your filing status is considered, for this purpose, as single.

Deduction phaseout. Your IRA deduction is reduced or eliminated depending on your filing status and modified AGI as follows:

If your ***filing status*** is:	Your deduction is reduced if your ***modified AGI*** is within the ***phaseout range*** of:	Your deduction is eliminated if your ***modified AGI*** is:
Single, or Head of household	$25,000.01 to $35,000	$35,000 or more
Married—joint return, or Qualifying widow(er)	$40,000.01 to $50,000	$50,000 or more
Married—separate return	$0.01 to $10,000	$10,000 or more

Also, see Table 18–1 earlier.

TIP *For 1998, if you are covered by a retirement plan at work, your IRA deduction will not be reduced (phased out) unless your modified adjusted gross income (AGI) is between:*

- *$30,000 (a $5,000 increase) and $40,000 for a single individual (or head of household),*
- *$50,000 (a $10,000 increase) and $60,000 for a married couple (or a qualifying widow(er)) filing a joint return, or*
- *$–0– (no increase) and $10,000 for a married individual filing a separate return.*

How To Figure Your Reduced IRA Deduction

You can figure your reduced IRA deduction ***for either*** Form 1040 or Form 1040A by using the worksheets in Chapter 3 of Publication 590. Also, the instructions for these tax forms include similar worksheets.

Note. If you were married and both you and your spouse worked and you both contributed to IRAs, use separate worksheets to figure your deductions.

If you were divorced or legally separated (and did not remarry) before the end of the year, you cannot deduct any contributions you made to your spouse's IRA. You can deduct only the contributions you made to your own IRA, and your deductions are subject to the adjusted gross income limit rules for single individuals.

Reporting Deductible Contributions

You do not have to itemize deductions to claim your deduction for IRA contributions. If you file ***Form 1040,*** deduct your IRA contributions for 1997 on line 23 and, if you file a joint return, also deduct your spouse's IRA contributions on line 23.

If you file ***Form 1040A,*** deduct your contributions on line 15 and, if you file a joint return, also deduct contributions to your spouse's IRA on line 15.

Form 1040EZ does not provide for IRA deductions.

Form 5498. You should receive by June 1, 1998, Form 5498, *Individual Retirement Arrangement Information,* or similar statement, from plan sponsors, showing all the contributions made to your IRA for 1997.

Trustee's fees. Trustee's administrative fees that are billed separately and paid by you in connection with your IRA are deductible. They are deductible (if they are ordinary and necessary) as a miscellaneous deduction on Schedule A (Form 1040). The deduction is subject to the 2% of adjusted gross income limit (see chapter 30).

Broker's commissions. Broker's commissions that you paid in connection with your IRA are subject to the IRA contribution limit. They are not deductible as a miscellaneous deduction on Schedule A (Form 1040).

Nondeductible Contributions

Although your deduction for IRA contributions may be reduced or eliminated because of the adjusted gross income limit (See *Deductible Contributions,* earlier.), you can still make contributions of up to $2,000 or 100% of compensation, whichever is less. For a spousal IRA, see *Spousal IRA limit,* earlier. Often, the difference between your total permitted contributions and your total deductible contributions, if any, is your nondeductible contribution.

Example. Sonny Jones is single. In 1997, he is covered by a retirement plan at work. His salary is $52,312. His modified AGI is $55,000. Sonny makes a $2,000 IRA contribution for that year. Because he is covered by a retirement plan and his modified AGI is over $35,000, he cannot deduct his $2,000 IRA contribution. However, he can choose to either:

1) Designate this contribution as a nondeductible contribution by reporting it on his tax return, as explained later under *Reporting Nondeductible Contributions,* or
2) Withdraw the contribution as explained later under *Tax-Free Withdrawal of Contributions.*

As long as your contributions are within the contribution limits, none of the earnings on those contributions (deductible or nondeductible) or gains will be taxed until they are distributed. See *When Can I Withdraw or Use Assets From an IRA?* later.

Cost basis. You will have a cost basis in your IRA if you make nondeductible contributions. Your basis is the sum of the nondeductible amounts you have contributed to your IRA less any distributions of those amounts. When you withdraw (or receive distributions of) those amounts as discussed later under *Distributions Fully or Partly Taxable,* you can do so tax free.

Reporting Nondeductible Contributions

You must report nondeductible contributions to the IRS, but you do not have to designate a contribution as nondeductible until you file your tax return. When you file, you can even designate otherwise deductible contributions as nondeductible.

Designating nondeductible contributions. To designate contributions as nondeductible, you must file Form 8606, *Nondeductible IRAs (Contributions, Distributions, and Basis).* You must file Form 8606 to report nondeductible contributions even if you do not have to file a tax return for the year.

Form 8606. You must file Form 8606 if either of the following applies.

- You made nondeductible contributions to your IRA for 1997, or
- You received IRA distributions in 1997 and you have ever made nondeductible contributions to any of your IRAs.

Contribution and distribution in the same year. If you receive a distribution from an IRA in the same year that you make an IRA contribution that may be partly nondeductible, use the worksheet in chapter 5 of Publication 590 to figure the taxable portion of the distribution. Then you can figure the amount of nondeductible contributions to report on Form 8606.

Failure to report nondeductible contributions. If you do not report nondeductible contributions, all of your IRA contributions will be treated as deductible. When you make withdrawals from your IRA, they will be taxed unless you can show, with satisfactory evidence, that nondeductible contributions were made.

Penalty for overstatement. If you overstate nondeductible contributions on your Form 8606, you must pay a penalty of $100 for each overstatement, unless it was due to reasonable cause.

Penalty for failure to file Form 8606. You will have to pay a $50 penalty if you do not file a required Form 8606, unless you can prove that the failure was due to reasonable cause.

Tax-Free Withdrawal of Contributions

If you made IRA contributions for 1997, you can withdraw them tax free by the due date of your return. If you have an extension of time to file your return, you can withdraw them tax free by the extended due date. You can do this if both the following apply.

- You did not take a deduction for the contributions you withdraw.
- You also withdraw any interest or other income earned on the contributions. You must include in income any earnings on the contributions you withdraw. Include the earnings in income for the year in which you made the withdrawn contributions.

IRA trustees must include these amounts in box 1 and, if applicable, in box 2a of Form 1099-R. You must report these amounts on line 15a, Form 1040. If there is an amount in box 2a of Form 1099-R, include it on line 15b of Form 1040.

Premature withdrawal tax. The 10% additional tax on withdrawals made before you reach age 59½ does not apply to these withdrawals of your contributions. However, your early withdrawal of interest or other income must be reported on Form 5329 and may be subject to this tax.

Excess contributions tax. If any part of these contributions is an excess contribution for 1996, it is subject to a 6% excise tax, unless you withdrew it from your IRA by April 15, 1997 (plus extensions). An excess contribution for 1997 must be withdrawn by April 15, 1998, to avoid the excise tax. See *Excess Contributions* under *What Acts Result in Penalties?,* later.

Can Retirement Plan Assets Be Transferred?

IRA rules permit you to transfer, tax free, assets (money or property) from other retirement plans (including IRAs) to an IRA. The rules permit the following kinds of transfers:

- Transfers from one trustee to another,
- Rollovers, and
- Transfers incident to a divorce.

Transfer From One IRA Trustee to Another

A transfer of funds in your IRA from one trustee directly to another, either at your request or at the trustee's request, is not a rollover. Because there is no distribution to you, the transfer is tax free. Because it is not a rollover, it is not affected by the one-year waiting period that is required between rollovers, discussed next. For information about direct transfers to IRAs from retirement programs other than IRAs, see Publication 590.

Rollovers

Generally, a rollover is a tax free distribution to you of cash or other assets from one retirement plan that you contribute (roll over) to another retirement plan. The amount you roll over tax free, however, is generally taxable later when the new plan pays that amount to you or your beneficiary.

Kinds of rollovers to an IRA. There are two kinds of rollover contributions to an IRA. In one, you put amounts you receive from one IRA into another. In the other, you put amounts from an employer's qualified (meets certain requirements) retirement plan for its employees, such as a qualified pension plan, into an IRA.

Treatment of rollovers. You cannot deduct a rollover contribution but you must report the rollover distribution on your tax return as discussed later under *Reporting Your Rollover.*

Time limit for making a rollover contribution. You must make the rollover contribution by the 60th day after the day you receive the distribution from your IRA or your employer's plan.

Extension of rollover period. If the amount distributed to you from an IRA or a qualified employer retirement plan becomes a frozen deposit in a financial institution during the 60-day period allowed for a rollover, a special rule extends the rollover period. For more information, get Publication 590.

Rollover From One IRA Into Another

You can withdraw, tax free, all or part of the assets from one IRA if you reinvest them within 60 days in another IRA.

Waiting period between rollovers. You can take (receive) a distribution from a particular IRA and make a rollover contribution to another IRA only once in any one-year period. The one-year period begins on the date you receive the IRA distribution, not on the date you roll it over into another IRA.

This rule applies separately to each IRA you own. For example, if you have two IRAs, IRA-1 and IRA-2, and you roll over assets of IRA-1 into a new IRA-3, you may also make a rollover from IRA-2 into IRA-3, or into any other IRA, within one year after the rollover distribution from IRA-1. These are both allowable rollovers because you have not received more than one distribution from either IRA within one year. However, you cannot, within the one-year period, again roll over the assets you rolled over into IRA-3 into any other IRA.

Exception. There is an exception to this rule for distributions from certain failed financial institutions. Get Publication 590 for more information.

Partial rollovers. If you withdraw assets from an IRA, you can roll over part of the withdrawal into another IRA and keep the rest of it. The amount you keep is generally taxable (except for the part that is a return of nondeductible contributions) and may be subject to the 10% additional tax on premature distributions, discussed later.

Required distributions. Amounts that must be distributed during a particular year under the required distribution rules (discussed later) are not eligible for rollover treatment.

Inherited IRAs. If you inherit an IRA from your spouse, you generally can roll it over into an IRA established for you.

Not inherited from spouse. If you inherit an IRA from someone other than your spouse you cannot roll it over or allow it to receive a rollover contribution. You must withdraw the IRA assets within a certain period. For more information, get Publication 590.

Reporting rollovers from IRAs. Report any rollover from one IRA to another IRA on lines 15a and 15b, Form 1040, or lines 10a and 10b, Form 1040A. Enter the total amount of the distribution on line 15a, Form 1040, or line 10a, Form 1040A. If the total amount on line 15a, Form 1040, or line 10a, Form 1040A, was rolled over, enter zero on line 15b, Form 1040, or line 10b, Form 1040A. Otherwise, enter the taxable portion of the part that was not rolled over on line 15b, Form 1040, or line 10b, Form 1040A.

Rollover From Employer's Plan Into an IRA

Special rules apply to distributions made from qualified employer plans that are rolled over or transferred to IRAs. The rules primarily relate to requirements affecting rollovers, income tax withholding, and notices to recipients. Get Publication 590 for more information.

Generally, if you receive an ***eligible rollover distribution*** from your (or your deceased spouse's) employer's qualified plan (defined earlier), you can roll over all or part of it into an IRA.

Eligible rollover distribution. Generally, an eligible rollover distribution is the taxable part of any distribution of all or part of the balance to your credit as the employee-participant in a qualified retirement plan ***except:***

1) A required minimum distribution, or
2) Any of a series of substantially equal periodic distributions paid at least once a year over:
   a) Your lifetime or life expectancy,
   b) The lifetimes or life expectancies of you and your beneficiary, or
   c) A period of 10 years or more.

The taxable parts of most other distributions from qualified retirement plans are eligible rollover distributions. See Publication 575 for additional exceptions.

Maximum rollover. The most that you can roll over is the taxable part of any eligible rollover distribution from your employer's qualified plan. The distribution you receive generally will be all taxable unless you have made nondeductible employee contributions to the plan.

Reporting rollovers from employer plans. To report a rollover from an employer retirement plan to an IRA, use lines

16a and 16b, Form 1040, or lines 11a and 11b, Form 1040A. Do not use lines 15a or 15b, Form 1040, or lines 10a or 10b, Form 1040A.

For further information on rollovers, get Publication 590.

Transfers Incident to Divorce

If an interest in an IRA is transferred from your spouse or former spouse to you by a decree of divorce or separate maintenance, or a written document related to such a decree, the interest in the IRA, starting from the date of the transfer, is treated as your IRA. The transfer is tax free. For detailed information, get Publication 590.

When Can I Withdraw or Use Assets From an IRA?

There are rules limiting the withdrawal and use of your IRA assets. Violation of the rules generally results in additional taxes in the year of violation. See *Prohibited Transactions, Premature Distributions (Early Withdrawals), and Excess Accumulations (Insufficient Distributions)* later.

Note. Beginning in 1997, these rules also apply to SIMPLE retirement accounts.

Age 59½ rule. Generally, until you reach the age of 59½, you cannot withdraw assets (money or other property) from your IRA without having to pay an additional tax. However, there are a number of exceptions to that rule. See *Premature Distributions (Early Withdrawals),* later.

Required Distributions

You cannot keep funds in your IRA indefinitely. Eventually you must withdraw them. If you do not, or if you withdraw an amount that is less than the required minimum distribution for a year, you may have to pay a 50% excise tax on the amount not withdrawn as required. See *Excess Accumulations (Insufficient Distributions),* later. The requirements for withdrawing IRA funds differ depending on whether you are the IRA owner or the beneficiary of a decedent's IRA.

IRA owners. If you are an IRA owner, you must choose to withdraw the balance in your IRA in one of the following two ways:

1) By withdrawing the entire balance in your IRA by the required beginning date (defined below), ***or***

2) By starting to withdraw periodic distributions of the balance in your IRA by the required beginning date.

Required beginning date (RBD)—Age 70½ rule. You must receive the entire balance in your IRA or begin receiving periodic distributions from your IRA by April 1 of the year following the year in which you reach age 70½.

If you choose to receive periodic distributions, you must receive at least a minimum amount for each year starting with the year you reach age 70½ (your 70½ year). If you did not receive the minimum in your 70½ year, then you must receive distributions for your 70½ year that reach the minimum amount by April 1 of the next year.

Distributions after the RBD. The required minimum distribution for any year after your 70½ year must be made by December 31 of each year.

Beneficiaries. If you are the beneficiary of a decedent's IRA, the requirements you must satisfy for withdrawing funds from that IRA depend on whether distributions have begun that satisfy the minimum distribution requirement.

For more information, including how to figure your required minimum distribution each year and how to figure your required distribution if you are a beneficiary of a decedent's IRA, get Publication 590.

Tax Treatment of Distributions

In general, include IRA distributions in your gross income in the year you receive them.

Exceptions to this general rule are rollovers and timely withdrawals of contributions, discussed earlier, and the return of nondeductible contributions, discussed next under *Distributions Fully or Partly Taxable.* Distributions, including rollovers, are also discussed under *Savings Incentive Match Plan for Employees (SIMPLE),* later.

Ordinary income. IRA distributions that you must include in income are taxed as ordinary income.

No special treatment. In figuring your tax, you cannot use the special averaging or capital gain treatment that applies to lump-sum distributions from qualified employer plans.

Distributions Fully or Partly Taxable

Your IRA distributions may be fully or partly taxable, depending on whether your IRA includes any nondeductible contributions.

Fully taxable. If only deductible contributions were made to your IRA (or IRAs, if you have more than one) since it was set up, you have no basis in your IRA. Because you have no basis in your IRA, any distributions are fully taxable when received. See *Reporting taxable distributions on your return,* later.

Partly taxable. If you made nondeductible contributions to any of your IRAs, you have a cost basis (investment in the contract) equal to the amount of those contributions. These nondeductible contributions are not taxed when they are distributed to you. They are a return of your investment in your IRA.

When IRA distributions are made, special rules apply in figuring the tax on the distributions if:

- Only nondeductible IRA contributions were made and there are earnings or gains, or
- Both deductible and nondeductible IRA contributions were made.

Only the part of the distribution that represents nondeductible contributions (your cost basis) is not taxable. Once nondeductible contributions have been made, distributions consist partly of nondeductible contributions (basis) and partly of deductible contributions, earnings, or gains. Until you run out of basis, each distribution is partly taxable and partly nontaxable.

Form 8606. You must complete, and attach to your return, Form 8606 if you receive an IRA distribution and have ever made nondeductible IRA contributions. Using the form, you will figure the nontaxable distributions for 1997, and your total IRA basis for 1997 and earlier years.

Distributions reported on Form 1099–R. You will receive Form 1099–R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, Etc.,* or similar statement, if you receive a distribution from your IRA. IRA distributions are shown in boxes 1 and 2 of Form 1099–R. A number or letter code in box 7 tells you what type of distribution you received from your IRA.

Withholding. Federal income tax is withheld from IRA distributions unless you choose not to have tax withheld. See chapter 5.

IRA distributions delivered outside the United States. In general, if you are a U.S. citizen or resident alien and your home address is outside the United States or its possessions, you cannot choose exemption from withholding on your IRA payments.

Reporting taxable distributions on your return. Report fully taxable distributions, including taxable premature distributions, on line 15b, Form 1040 (no entry is required on line 15a), or line 10b, Form 1040A. If only part of the distribution is taxable, enter the total amount on line 15a, Form 1040 (or line 10a, Form 1040A), and the taxable part on line 15b, Form 1040 (or line 10b, Form 1040A). You cannot report distributions on Form 1040EZ.

What Acts Result in Penalties?

The tax advantages of using IRAs for retirement savings can be offset by additional taxes and penalties if you do not follow the rules. For example, there are additions to the regular tax for using your IRA funds in prohibited transactions. There are also additional taxes for:

- Making excess contributions,
- Making early withdrawals (taking premature distributions), and
- Allowing excess amounts to accumulate (failing to make required withdrawals).

There are penalties for overstating the amount of nondeductible contributions and for failure to file a required Form 8606. See *Reporting Nondeductible Contributions,* earlier.

Prohibited Transactions

Generally, a prohibited transaction is any improper use of your IRA by you or any disqualified person.

Examples of disqualified persons include your fiduciary, and members of your family (a spouse, ancestor, lineal descendent, and any spouse of a lineal descendent).

Some examples of prohibited transactions with an IRA are:

- Borrowing money from it,
- Buying property for personal use (present or future) with IRA funds,
- Selling property to it,
- Receiving unreasonable compensation for managing it, or
- Using the IRA as collateral for a loan.

Effect on an IRA account. Generally, if you or your beneficiary engage in a prohibited transaction at any time during the year with your IRA account, it will not be treated as an IRA as of the first day of the year.

Effect on you (or your beneficiary). If you (or your beneficiary) engage in a prohibited transaction with your IRA account at any time during the year, you (or your beneficiary) must include the fair market value of all (or part, in certain cases) of the IRA assets in your gross income for that year. The fair market value is the price at which the IRA assets would change hands between a willing buyer and a willing seller, when neither has any need to buy or sell, and both have reasonable knowledge of the relevant facts.

You must use the fair market value of the assets as of the first day of the year you engaged in the prohibited transaction. You may also have to pay the 10% additional tax on premature distributions, discussed later.

Taxes on prohibited transactions. If someone other than the owner or beneficiary of an IRA engages in a prohibited transaction, that person may be liable for certain taxes. In general, there is a 15% tax on the amount of the prohibited transaction and a 100% additional tax if the transaction is not corrected. For transactions that occurred before August 6, 1997, the 15% tax was 10%.

Investment in collectibles. If your IRA invests in collectibles, the amount invested is considered distributed to you in the year invested. You may have to pay the 10% additional tax on premature distributions and the taxes discussed above may apply.

Collectibles. These include art works, rugs, antiques, metals, gems, stamps, coins, alcoholic beverages, and other tangible personal property if specified by the IRS.

Exception. Your IRA can invest in one, one-half, one-quarter, or one-tenth ounce U.S. gold coins, or one ounce silver coins minted by the Treasury Department.

TIP *Beginning in 1998, your IRA can invest in certain platinum coins and certain gold, silver, palladium, and platinum bullion.*

For more information on prohibited transactions, get Publication 590.

Excess Contributions

Generally, an excess contribution is the amount contributed to your IRA(s) for the year that is more than the smaller of:

- Your taxable compensation for the year, or
- $2,000.

Example. You were single and earned $30,000 in 1997. You contributed $2,500 to your IRA for 1997. Your contribution limit is $2,000. Your reduced IRA deduction, figured using the *Worksheet for Reduced IRA Deduction* in Publication 590, is $1,000. You made an excess contribution for 1997 of $500 ($2,500 minus $2,000).

Tax on excess contributions. In general, if the excess contribution and any earnings on it are not withdrawn by the date your return for the year is due (including extensions), as explained later, you are subject to a 6% tax. You must pay the 6% tax each year on excess amounts that remain in your IRA at the end of your tax year. The excess is taxed for the year the excess contribution is made and for each year after that until you correct it. The tax cannot be more than 6% of the value of your IRA as of the end of your tax year.

Excess contributions you withdraw by the date your return is due. You will not have to pay the 6% tax if you withdraw an excess contribution made during a tax year ***and*** interest or other income earned on it by the date your return for that year is due, including extensions.

Do not include in your gross income an excess contribution that you withdraw from your IRA before your tax return is due if both the following conditions are met.

1) No deduction was allowed for the excess contribution.

2) The interest or other income earned on the excess was also withdrawn.

You must include in your gross income any interest or other income earned on the excess contribution (whether a deductible or nondeductible contribution). Report it on your return for the year in which the excess contribution was made. Your withdrawal of interest or other income may be subject to an additional 10% tax on early withdrawals, discussed later.

Excess contributions you withdraw after your return is due. If the total contributions (other than rollover contributions) for the year were $2,000 or less and there were no employer contributions, you may withdraw any excess contribution after the due date for filing your return for that year, including extensions. You do not include the withdrawn contribution in your income. This exclusion from income applies only to the part of the withdrawn excess contribution for which you did not take a deduction. The 6% tax applies to the excess contribution amount that remains in your IRA at the end of a year. This includes the year of the contribution and any later year.

Premature Distributions (Early Withdrawals)

You must include premature distributions from your IRA in your gross income. Premature distributions (sometimes called early withdrawals or early distributions) are also subject to an ***additional 10% tax.*** See the discussion of Form 5329 under *Reporting Additional Taxes,* later, to figure and report the tax.

CAUTION *Early withdrawals of funds from a SIMPLE retirement plan made within 2 years of beginning participation in the plan are subject to a 25% penalty, rather than 10%.*

Premature distributions defined. Premature distributions are amounts you withdraw from your IRA before you are age $59\frac{1}{2}$.

Exceptions. In certain circumstances, the additional tax does not apply to distributions from your IRA even if they are made before you are age $59\frac{1}{2}$. There are exceptions for:

- Certain medical expenses,
- Death,
- Disability, and
- Annuity distributions.

TIP *Beginning in 1998, the 10% additional tax on premature distributions from an IRA will not apply if the distribution is not more than qualified higher education expenses during the year or is a qualified first-time homebuyer distribution.*

Nondeductible contributions. The tax on premature distributions does not apply to the part of a distribution that represents a return of your nondeductible contributions (basis).

Rollovers. Distributions that are rolled over as discussed under *Rollovers,* earlier, can be made without having to pay the regular income tax or the 10% additional tax.

More information. For more information on premature distributions, get Publication 590.

Excess Accumulations (Insufficient Distributions)

You cannot keep amounts in your IRA indefinitely. Generally, you must begin receiving distributions by April 1 of the year following the year in which you reach age $70\frac{1}{2}$.

Tax on excess. If distributions are less than the required minimum distribution for the year, you may have to pay a 50% excise tax for that year on the amount not distributed as required.

Request to excuse the tax. If the excess accumulation is due to reasonable error and you have taken, or are taking, steps to remedy the insufficient distribution, you can request that the tax be excused.

Exemption from tax. IRAs invested in contracts issued by insurance companies may be unable to make required distributions because the insurance company is in state insurer delinquency proceedings. In this case, the 50% excise tax for failure to make required IRA distributions will not apply. However, to qualify for this exemption, the conditions and requirements of Revenue Procedure 92-10 must be satisfied.

More information. For more information on excess accumulations, get Publication 590.

Reporting Additional Taxes

Generally you must use Form 5329, to report the tax on excess contributions, premature (early) distributions, and excess accumulations.

Form 5329 not required. You do not have to use Form 5329 if any of the following conditions exist.

- Distribution code 1 (early distribution) is shown in box 7 of Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.* Instead, multiply the taxable part of the distribution by 10% and enter the result on line 50 of Form 1040. Write "No" next to line 50 to indicate that you do not have to file Form 5329. However, if you owe this tax and also owe any other additional tax on a distribution, do not enter this 10% additional tax directly on your Form 1040. You must file Form 5329 to report your additional taxes.
- You qualify for an exception to the tax. You need not report the exception if distribution code 2, 3, or 4 is shown in box 7 of Form 1099-R. However, if one of those codes is not shown, or the code shown is incorrect, you must file Form 5329 to report the exception.
- You properly rolled over all distributions you received during the year.

Filing Form 1040. If you file Form 1040, complete Form 5329 and attach it to your Form 1040. Enter the total amount of IRA tax due on line 50, Form 1040.

Note: If you have to file an individual income tax return and Form 5329, you must use Form 1040.

Not filing Form 1040. If you do not have to file a Form 1040 but do have to pay one of the IRA taxes mentioned earlier, file the completed Form 5329 with IRS at the time and place you would have filed your Form 1040. Be sure to include your address on page 1 and your signature on page 2. Enclose, but do not attach, a check or money order payable to the Internal Revenue Service for the tax you owe, as shown on Form 5329. Write your social security number and "1997 Form 5329" on your check or money order.

Simplified Employee Pension (SEP)

A simplified employee pension (SEP) is a written arrangement (a plan) that allows an employer to make contributions toward his or her own (if a self-employed individual) and employees' retirement without becoming involved in more complex retirement plans. The contributions are made to IRAs (SEP-IRAs) of the participants in the plan.

Contribution limit. The SEP rules permit an employer to contribute (and deduct) each year to each participating employee's SEP-IRA up to 15% of the employee's compensation or $30,000, whichever is less. The contributions are funded by the employer.

Figuring the 15% limit. For purposes of determining the 15% limit, compensation is generally limited to $160,000, not including your employer's contribution to your SEP-IRA.

Deduction limit for a self-employed person. If you are self-employed and contribute to your own SEP-IRA, special rules apply when figuring your maximum deduction for these contributions.

Compensation for self-employed. For determining the 15% limit, discussed above, your compensation is your net earnings from self-employment. See *Net earnings from self-employment,* later. Note that, for SEP purposes, your net earnings (compensation) must take into account your deduction for contributions to your own SEP-IRA. Because your deduction amount and your net earnings amount are each dependent on the other, this adjustment presents a problem.

TIP *To solve this problem, you make the adjustment to net earnings indirectly by reducing the contribution rate called for in the plan. Use the worksheets in chapter 7 of Publication 590 to find this reduced contribution rate and your maximum deduction. Make no reduction to the contribution rate for any common-law employees.*

Net earnings from self-employment. For SEP purposes, your net earnings are your gross income from your business that has the plan minus your allowable deductions for that business. Your personal services must be a material income-producing factor in that business. Allowable deductions include contributions to the SEP-IRAs of your employees. You must also reduce your earnings by the deduction for one-half of your self-employment tax and the deduction for contributions to your own SEP-IRA. Net earnings do not include tax-free items or deductions related to them, but do include foreign earned income and housing cost amounts. Net earnings include a partner's distributive share of partnership income or loss (other than separately treated items such as capital gains or losses). If paid for services to or for the partnership, net earnings include guaranteed payments to a limited partner. They do not include distributions of income or loss to a limited partner.

Contributions you make to your SEP-IRA. If you make contributions to your SEP-IRA independent of employer SEP contributions, you can deduct them the same way as contributions to a regular IRA. However, your deduction may be reduced or eliminated because, as a participant in a SEP, you are covered by an employer retirement plan. See *How Much Can I Contribute and Deduct?,* earlier.

Salary reduction arrangement. A SEP may include a salary reduction arrangement. Under it, you can elect to have your employer contribute part of your pay to the SEP-IRA. Only the remaining portion of your pay is currently taxable. The tax on the contribution is deferred. This choice is called an elective deferral.

CAUTION *An employer cannot start a simplified employee pension (SEP) that includes a salary reduction arrangement. Only SEPs that allowed employees to choose elective deferrals as of December 31, 1996, can include salary reduction arrangements.*

Limits on deferrals. In general, the total income you can defer under a salary reduction arrangement included in your SEP and certain other elective deferral arrangements, for 1997, is limited to $9,500. This limit applies only to the amounts that represent a reduction from your salary, not to any contributions from employer funds.

Overall limits on SEP contributions. Contributions, including elective deferrals (salary reductions), made by your employer to the SEP-IRA are subject to the overall limit of 15% of your compensation (generally up to $160,000 for 1997) or $30,000, whichever is less.

Tax treatment of employer's contributions. Your employer's contributions to your SEP-IRA are generally excluded from your income rather than deducted from it. Therefore, your employer's contributions should not be included in your Form W–2 wages, unless there are contributions under a salary reduction arrangement. Form W–2 should include contributions under a salary reduction arrangement for social security and Medicare tax purposes only.

Tax treatment by self-employed individuals. If you are self-employed (a sole proprietor or partner) with a SEP, take your deduction for employer contributions to your own SEP-IRA on line 28, Form 1040. If you also make deductible contributions to your SEP-IRA (or any other IRA you own), independent of your employer contributions, take your deduction on line 23, Form 1040.

Excess contributions. If your employer contributes more to your SEP-IRA than 15% of your compensation or $30,000, whichever is less, you will not have to pay the 6% tax on it if you withdraw this excess amount (and interest or other income earned on it) from your SEP-IRA before the due date for filing your tax return, plus extensions. However, you must include the excess contribution in your gross income.

For more information on a SEP-IRA, get Publication 590.

Savings Incentive Match Plan for Employees (SIMPLE)

A SIMPLE plan is a new tax-favored retirement plan that certain small employers (including self-employed individuals) can set up for the benefit of their employees. Under a SIMPLE plan, SIMPLE retirement accounts for participating employees can be set up as IRAs (SIMPLE IRAs).

A SIMPLE plan is a written agreement (salary reduction arrangement) between an employer and employee that allows an eligible employee (including a self-employed individual) to choose to:

- Reduce his or her compensation by a certain percentage each pay period, and
- Have the employer contribute the salary reductions to a SIMPLE IRA on behalf of the employee. These contributions are called ***salary reduction contributions.***

Contributions

All contributions under a SIMPLE plan must be made to SIMPLE IRAs, not to any other type of IRA. Contributions are made on behalf of ***eligible employees.*** (See *Eligible Employees,* later.) Contributions are also subject to various ***limits.*** (See *Limits,* later.)

In addition to salary reduction contributions, an employer must make either ***matching contributions*** or ***nonelective contributions***.

Salary reduction contributions. During the 60–day period before the beginning of any year, an eligible employee can choose salary reduction contributions expressed either as a percentage of compensation, or as a specific dollar amount (if the employer offers this choice). An employee can choose to cancel the election at any time during the year.

Matching contributions. Employers, unless they choose to make non-elective contributions, must make contributions equal to the salary reduction contributions chosen by the employee, but only up to certain limits. See *Limits,* later. These contributions are in addition to the salary reduction contributions and must be made to the SIMPLE IRAs of all eligible employees (defined later) who chose salary reductions. These contributions are referred to as matching contributions.

Nonelective contributions. Instead of making matching contributions, employers, if they satisfy certain requirements, can choose to make nonelective contributions on behalf of all eligible employees. These nonelective contributions must be made on behalf of each eligible employee who has at least $5,000 of compensation from the employer, whether or not the employee chose salary reductions (See *Limits,* later.).

Eligible Employees

Employees must be allowed to participate in the employer's SIMPLE plan if they:

- Received at least $5,000 in ***compensation*** from the employer during any 2 years prior to the current year, and
- Are reasonably expected to receive at least $5,000 in compensation during the calendar year for which contributions are made.

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Compensation — employee. For purposes of the SIMPLE plan rules, an employee's compensation for a year generally includes the following:

- Wages, tips, and other pay from the employer that is subject to income tax withholding, and
- Deferred amounts elected under any 401(k) plans, 403(b) plans, government (section 457(b)) plans, SEP plans, and SIMPLE plans.

Limits

The limits on contributions to a SIMPLE IRA vary with the type of contribution that is made.

Salary reduction contributions. For 1997, salary reduction contributions (employee-chosen contributions) that an employer can make on behalf of an employee under a SIMPLE plan are limited to $6,000.

Matching employer contributions. An employer can make matching contributions to the SIMPLE IRA of each eligible employee in an amount equal to the employee's salary reduction contributions. These matching contributions cannot be more than 3% of the employee's compensation for the calendar year.

Nonelective employer contributions. If an employer chooses to make nonelective contributions, instead of matching contributions, to each eligible employee's SIMPLE IRA, contributions must be 2% of the employee's compensation for the entire year. For 1997, only $160,000 of the employee's compensation can be taken into account to figure the contribution limit.

Distributions (Withdrawals)

Generally, the same distribution (withdrawal) rules that apply to other IRAs apply to SIMPLE IRAs. These rules are discussed earlier.

An employer cannot restrict an employee from making withdrawals from a SIMPLE IRA.

Tax Treatment

Generally, distributions from a SIMPLE IRA are fully taxable as ordinary income. If the distribution is a premature distribution (discussed earlier), it may be subject to the additional tax on premature distributions. See *Additional tax on premature distributions (early withdrawals),* later.

Rollovers and Transfers Exception Generally, rollovers and trustee-to-trustee transfers are not taxable distributions. See *Two-year rule,* next.

Two-year rule. To qualify as a tax-free rollover (or a tax-free trustee-to-trustee transfer), a rollover distribution (or a transfer) made from a SIMPLE IRA during the two-year period beginning on the date on which the individual first participated in his or her employer's SIMPLE plan, must be contributed (or transferred) to another SIMPLE IRA. The two-year period begins on the first day on which contributions made by the individual's employer are deposited in the individual's SIMPLE IRA.

After the two-year period, amounts in a SIMPLE IRA can be rolled over or transferred tax-free to an IRA other than a SIMPLE IRA.

Additional tax on premature distributions (early withdrawals). The additional tax on premature distributions (discussed earlier) applies to SIMPLE IRAs. If a distribution is a premature distribution and occurs during the two–year period following the date on which the individual first participated in his or her employer's SIMPLE plan, the additional tax on premature distributions is increased from 10% to 25%. Also, if a rollover distribution (or transfer), from a SIMPLE IRA does not satisfy the two-year rule, and is otherwise a premature distribution, the additional tax imposed because of the premature distribution is increased from 10% to 25% of the amount distributed.

19. Moving Expenses

Important Reminders

Standard mileage rate. The standard mileage rate allowed for moving expenses is now 10 cents a mile. See *Travel by car* under *Deductible moving expenses.*

No deduction allowed for certain moving expenses. You cannot deduct as moving expenses amounts you pay for:

- Meals while moving from your old residence to your new residence,
- Travel expenses, meals, and lodging for pre-move househunting trips,
- Meals and lodging while occupying temporary quarters, and
- Qualified residence sale, purchase, and lease expenses.

Distance test. To deduct moving expenses, your new main job location must be at least 50 miles farther from your former home than your old main job location.

Moving expenses no longer an itemized deduction. Allowable moving expenses are no longer an itemized deduction. You can deduct these expenses in figuring your adjusted gross income.

Reimbursements. If your employer reimburses you for your allowable moving expenses, your employer should exclude these reimbursements from your income. You can only deduct allowable moving expenses that your employer did not reimburse.

Change of address. If you change your mailing address, be sure to notify the IRS using Form 8822, *Change of Address.* Mail it to the Internal Revenue Service Center for your old address. Addresses for the Service Centers are on the back of the form.

Introduction

This chapter discusses what expenses you can deduct for a job-related move. The following topics are covered:

- When moving expenses qualify for a deduction,
- Which moving expenses can be claimed, and
- How to report moving expenses on Form 3903, *Moving Expenses.*

You may be able to deduct some of your expenses for moving to a new home because you changed job locations or started a new job. You can qualify for the deduction whether you are self-employed or an employee. However, the *Requirements,* explained later, must be met.

This chapter contains two charts that may help you determine whether your move qualifies for a deduction, and if so, how much you can deduct. The charts are:

- Figure 19–A, *Illustration of Distance Test,* which covers the minimum distance you must move before you qualify to deduct moving expenses, and
- Figure 19–B, *Qualifying Moves Within the United States,* which covers general qualifications.

Moves to the United States. You may be able to deduct the expenses of moving to the United States or its possessions even if the move is not related to a new job. You must have worked outside the United States or be a survivor of someone who did. See *Retirees or Survivors Who Move to the United States,* later.

Moves outside the United States. This chapter does not discuss moves outside the United States. If you are a United States citizen or resident alien who moved outside the United States or its possessions because of your job or business, see Publication 521 for special rules that apply to your move.

Useful Items

You may want to see:

Publication

- ☐ **521** Moving Expenses

Form (and Instructions)

- ☐ **3903** Moving Expenses
- ☐ **3903–F** Foreign Moving Expenses
- ☐ **8822** Change of Address

Requirements

You can deduct your allowable moving expenses if your move is closely related to the start of work. You also must meet the distance test and the time test. These two tests are discussed later.

Related to Start of Work

Your move must be closely related, both in time and in place, to the start of work at your new job location.

Closely related in time. You can generally consider moving expenses incurred within one year from the date you first reported to work at the new location as closely related in time to the start of work. It is not necessary that you arrange to work before moving to a new location, as long as you actually do go to work.

If you do not move within one year, you ordinarily cannot deduct the expenses unless you can show that circumstances existed that prevented the move within that time.

Example. Your family moved more than a year after you started work at a new location. You delayed the move for 18 months to allow your child to complete high school. You can deduct your allowable moving expenses.

Closely related in place. You can generally consider your move closely related in place to the start of work if the distance from your new home to the new job location is not more than the distance from your former home to the new job location. A move that does not meet this requirement can qualify if you can show that:

1) A condition of employment requires you to live at your new home, or
2) You will spend less time or money commuting from your new home to your new job.

Home defined. Your ***home*** means your main home (residence). It can be a house, apartment, condominium, houseboat, house trailer, or similar dwelling. It does not include other homes owned or kept up by you or members of your family. It also does not include a seasonal home, such as a summer beach cottage. Your ***former home*** means your home before you left for your new job location. Your ***new home*** means your home within the area of your new job location.

Distance Test

Your move will meet the distance test if your new main job location is ***at least 50 miles*** farther from your former home than your old main job location was from your former home. For example, if your old job was 3 miles from your former home, your new job must be at least 53 miles from that former home.

The distance between a job location and your home is the shortest of the more commonly traveled routes between them. The distance test considers only the location of your former home. It does not take into account the location of your new home.

Example. You moved to a new home less than 50 miles from your former home because you changed job locations. Your old job was 3 miles from your former home. Your new job is 60 miles from that home. Because your new job is 57 miles farther from your former home than the distance from your former home to your old job, you meet the 50-mile distance test.

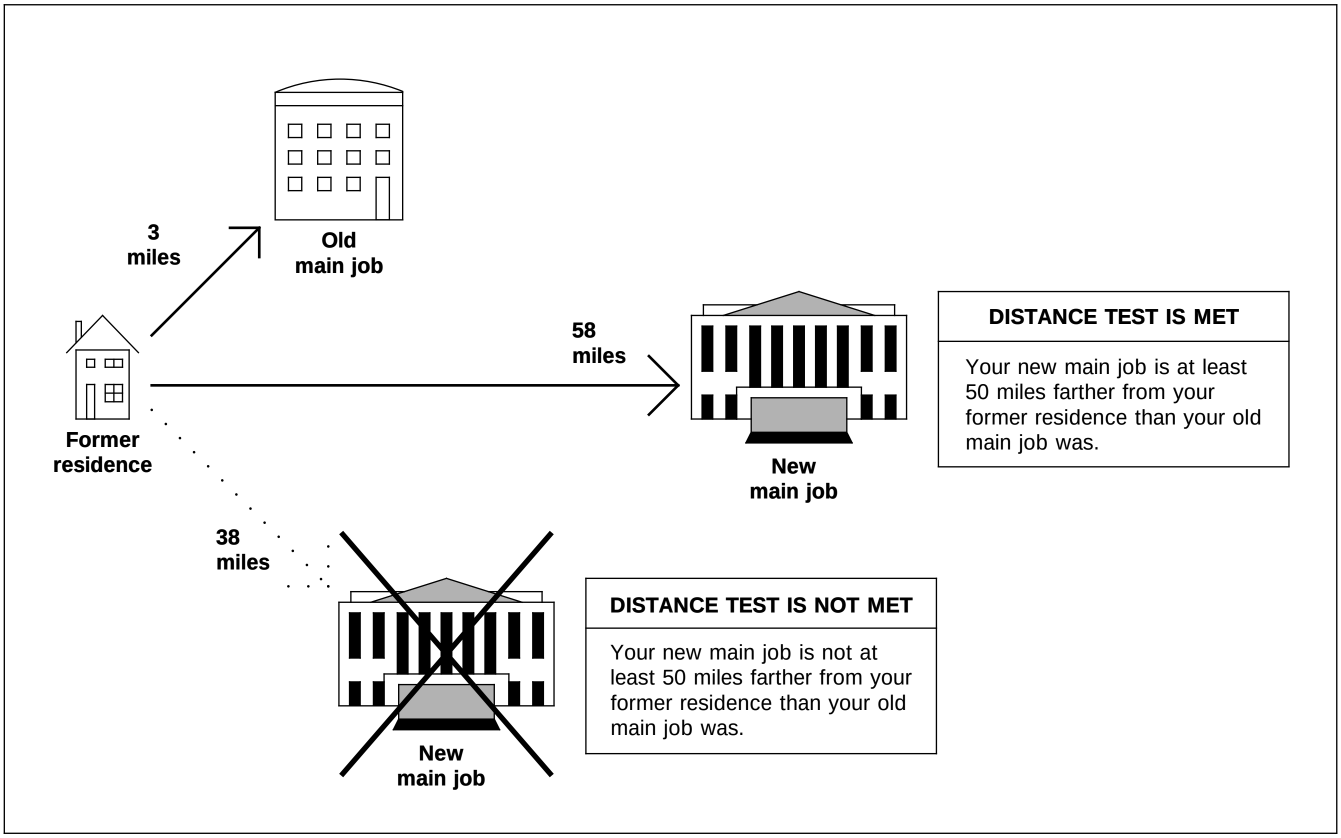
First job or return to full-time work. If you go to work full time for the first time, your place of work must be at least 50 miles from your former home to meet the distance test.

If you go back to full-time work after a substantial period of part-time work or unemployment, your place of work must also be at least 50 miles from your former home.

TIP **Exception for Armed Forces.** *If you are in the Armed Forces and you moved because of a permanent change of station, you do not have to meet the distance test. See* Members of the Armed Forces, *later.*

Main job location. Your main job location is usually the place where you spend most of your working time. A new job location is a new place where you will work permanently or indefinitely rather than temporarily.

Figure 19-A. **Illustration of Distance Test**



If there is no one place where you spend most of your working time, your main job location is the place where your work is centered—for example, where you report for work or are otherwise required to "base" your work.

Union members. If you work for a number of employers on a short-term basis and you get work under a union hall system (such as a construction or building trades worker), your main job location is the union hall.

More than one job. If you have more than one job anytime, your main job location depends on the facts in each case. The more important factors to be considered are:

- The total time you spend at each place,
- The amount of work you do at each place, and
- The money you earn at each place.

Time Test

To deduct your moving expenses, you also must meet one of the following time tests.

Time test for employees. If you are an employee, you must work full time for at least ***39 weeks during the first 12 months*** after you arrive in the general area of your new job location. For this time test, count only your full-time work as an employee; do not count any work you do as a self-employed person. You do not have to work for the same employer for the 39 weeks. You do not have to work 39 weeks in a row. However, you must work full time within the same general commuting area. Full-time employment depends on what is usual for your type of work in your area.

Temporary absence from work. You are considered working full time during any week you are temporarily absent from work because of illness, strikes, lockouts, layoffs, natural disasters, or similar causes. You are also considered a full-time employee during any week you are absent from work for leave or vacation provided for in your work contract or agreement.

Seasonal work. If your work is seasonal, you are considered working full time during the off-season only if your work contract or agreement covers an off-season period and that period is less than 6 months. For example, a school teacher on a 12-month contract who teaches on a full-time basis for more than 6 months is considered a full-time employee for 12 months.

Time test for self-employed persons. If you are self-employed, you must work full time for at least ***39 weeks during the first 12 months AND*** for a total of at least ***78 weeks during the first 24 months*** after you arrive in your new job location. For this time test, count any full-time work you do as an employee or as a self-employed person. You do not have to work for the same employer or be self-employed in the same trade or business for the 78 weeks. If you were both an employee and self-employed, see *Table 29–1* for the requirements.

Self-employment. You are self-employed if you work as the sole owner of an unincorporated business or as a partner in a partnership carrying on a business. You are not considered self-employed if you are semiretired, a part-time student, or work only a few hours each week.

Full-time work. Whether you work full time during any week depends on what is usual for your type of work in your area.

For more information, see *Time test for self-employed persons* in Publication 521.

TIP **Joint return.** *If you are married and file a joint return and both you and your spouse work full time, either of you can satisfy the full-time work test. However, you cannot combine the weeks your spouse worked with the weeks you worked to satisfy that test.*

Time test not yet met. You can deduct your moving expenses even if you have not yet met the time test by the date your 1997 return is due. You can do this if you expect to meet the 39-week test in 1998, or the 78-week test in 1998 or 1999. If you deduct moving expenses but do not meet the time test within 12 or 24 months (whichever applies) you must either:

1) Report your moving expense deduction as other income on your Form 1040 for the year you determine you cannot meet the test, or

2) Amend your 1997 return.

Use Form 1040X, *Amended United States Individual Income Tax Return,* to amend your return.

If you do not deduct your moving expenses on your 1997 return and you later meet the time test, you can file an amended return for 1997 to take the deduction.

Exceptions to the Time Test

You do not have to meet the time test if one of the following applies.

1) You are in the Armed Forces and you moved because of a permanent

Table 19-1. **Satisfying the Time Test for Employees and Self-Employed Persons**

IF you are...	**THEN you satisfy the time test by meeting...**
An employee and become self-employed before satisfying the 39-week test for employees	The 78-week test for self-employed persons.
Self-employed and become an employee before satisfying the 78-week test	The 39-week test for employees, or using the time spent as a full-time employee to satisfy the 78-week test.
Both self-employed and an employee	The 78-week test for a self-employed person or the 39-week test for an employee. You must determine which job you spend the most time on.

change of station—see *Members of the Armed Forces,* later.

2) You moved to the United States because you retired—see *Retirees or Survivors Who Move to the United States,* later.

3) You are the survivor of a person whose main job location at the time of death was outside the United States—see *Retirees or Survivors Who Move to the United States,* later.

4) Your job at the new location ends because of death or disability.

5) You are transferred for your employer's benefit or laid off for a reason other than willful misconduct. For this exception, you must have obtained full-time employment, and you must have expected to meet the test at the time you started the job.

Members of the Armed Forces

If you are a member of the Armed Forces on active duty and you move because of a permanent change of station, you do not have to meet the ***distance and time tests,*** discussed earlier. You can deduct your unreimbursed allowable moving expenses.

A permanent change of station includes:

1) A move from your home to the first post of active duty,

2) A move from one permanent post of duty to another, and

3) A move from your last post of duty to your home or to a nearer point in the United States. The move must occur within one year of ending your active duty or within the period allowed under the Joint Travel Regulations.

Spouse and dependents. If a member of the Armed Forces deserts, is imprisoned, or dies, a permanent change of station for the spouse or dependent includes a move to:

- The place of enlistment,
- The member's, spouse's, or dependent's home of record, or
- A nearer point in the United States.

If the military moves you and your spouse and dependents to or from separate locations, the moves are treated as a single move to your new main job location.

More information. For more information on moving expenses for members of the Armed Forces, and instructions for completing Form 3903, see *Members of the Armed Forces* in Publication 521.

Retirees or Survivors Who Move to the United States

You can deduct your allowable moving expenses if you move to the United States or to a possession of the United States. You do not have to meet the ***time test,*** discussed earlier, but you must meet the requirements discussed below.

Retirees. You can deduct moving expenses for a move to a new home in the United States when you permanently retire. However, both your former main job location and your former home must have been outside the United States.

Permanently retired. You are considered permanently retired when you cease gainful full-time employment or self-employment. If at the time you retire, you intend your retirement to be permanent, you will be considered retired though you later return to work. Your intention to retire permanently will be determined by:

1) Your age and health,

2) The customary retirement age for people who do similar work,

3) Whether you are receiving retirement payments from a pension or retirement fund, and

4) The length of time before you return to full-time work.

Survivors. You can deduct moving expenses for a move to a home in the United States if you are the spouse or the dependent of a person whose main job location at the time of death was outside the United States. The move must begin within 6 months after the decedent's death. It must be from the decedent's former home outside the United States. That home must also have been your home.

A move begins when any of the following occur:

1) You contract for your household goods and personal effects to be moved to your home in the United States, but only if the move is completed within a reasonable time,

2) Your household goods and personal effects are packed and on the way to your home in the United States, or

3) You leave your former home to travel to your new home in the United States.

Deductible Moving Expenses

If you meet the *Requirements* discussed earlier, you can deduct the reasonable expenses of:

1) Moving your household goods and personal effects (including in-transit storage expenses), and

2) Traveling (including lodging) to your new home.

However, you cannot deduct any expenses for meals.

Reasonable expenses. You can deduct only those expenses that are reasonable for the circumstances of your move. For example, the cost of traveling from your former home to your new one should be by the shortest, most direct route available by conventional transportation. If, during your trip to your new home, you make side trips for sightseeing, the additional expenses for your side trips are not deductible as moving expenses.

Travel by car. If you use your car to take yourself, members of your household, or your belongings to your new home, you can figure your expenses by deducting either:

1) Your ***actual expenses,*** such as gas and oil for your car, if you keep an accurate record of each expense, or

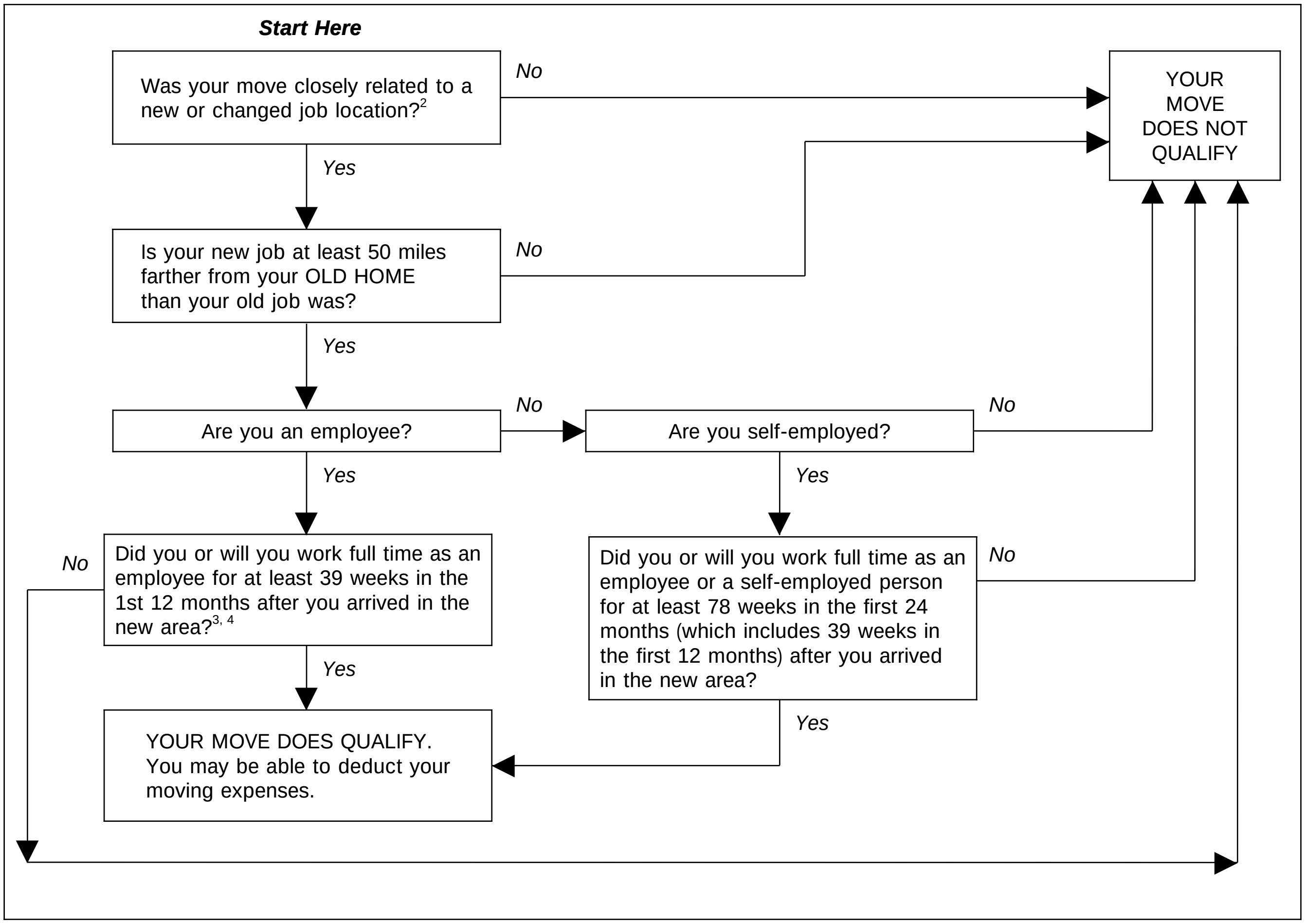
2) ***10 cents a mile.***

You can deduct parking fees and tolls you paid in moving. You cannot deduct any part of general repairs, general maintenance, insurance, or depreciation for your car.

Member of household. You can deduct moving expenses you pay for yourself and members of your household. A member of your household is anyone who has both your former and new home as his or her home. It does not include a tenant or employee, unless you can claim that person as a dependent.

Location of move. There are different rules for moving within or to the United States than for moving outside the United States. This chapter only discusses moves within or to the United States. The rules for moves outside the United States can be found in Publication 521.

Figure 19-B. **Qualifying Moves Within the United States (Non-Military)**[1]



[1]Military persons should see *Members of the Armed Forces* for special rules that apply to them.

[2]Your move must be closely related to the start of work at your new job location. See *Related to Start of Work.*

[3]If you deduct expenses and do not meet this test later, you must either file an amended tax return or report your moving expense deduction as other income. See *Time test not yet met.*

[4]If you become self-employed during the first 12 months, answer YES if your combined time as a full-time employee and self-employed person equals or will equal at least 78 weeks in the first 24 months (including 39 weeks in the first 12 months) after you arrived in the new area.

Household Goods and Personal Effects

You can deduct the cost of packing, crating, and transporting your household goods and personal effects and those of the members of your household from your former home to your new home. If you use your own car to move your things, see *Travel by car,* earlier. You can include the cost of storing and insuring household goods and personal effects ***within any period of 30 consecutive days*** after the day your things are moved from your former home and before they are delivered to your new home.

You can deduct any costs of connecting or disconnecting utilities required because you are moving your household goods, appliances, or personal effects.

You can deduct the cost of shipping your car and household pets to your new home.

You can deduct the cost of moving household goods and personal effects from a place other than your former home. Your deduction is limited to the amount it would have cost to move them from your former home.

CAUTION *You cannot deduct the cost of moving furniture you buy on the way to your new home.*

Travel Expenses

You can deduct the cost of transportation and lodging for yourself and members of your household while traveling from your former home to your new home. This includes expenses for the day you arrive. You can include any lodging expenses you had in the area of your former home within one day after you could not live in your former home because your furniture had been moved. You can deduct expenses for only one trip to your new home for yourself and members of your household. However, all of you do not have to travel together. If you use your own car, see *Travel by car,* earlier.

Nondeductible Expenses

You cannot deduct the following items as moving expenses:

- Pre-move househunting expenses,
- Temporary living expenses,
- Meal expenses,
- Expenses of buying or selling a home,
- Expenses of getting or breaking a lease,
- Security deposits (including any given up due to the move),
- Home improvements to help sell your home,
- Loss on the sale of your home,
- Mortgage penalties,
- Losses from disposing of memberships in clubs,
- Any part of the purchase price of your new home,
- Real estate taxes,

- Car tags,
- Driver's license,
- Refitting carpets and draperies, and
- Storage charges (except those incurred in transit).

Temporary employment. You cannot take a moving expense deduction and a business expense deduction for the same expenses. You must decide if your expenses are deductible as moving expenses or as business expenses. For example, expenses you have for travel, meals, and lodging while temporarily working at a place away from your regular place of work may be deductible as business expenses if you are considered away from home on business. Generally, your work is considered temporary if it does not last more than one year at a single location. See *Temporary Assignment or Job* in chapter 28 for information on deducting your expenses.

How To Report

The following discussions explain how to report your moving expenses and any reimbursements or allowances you received for your move.

Form 3903. Use Form 3903 to report your moving expenses if your move was within or to the United States or its possessions.

Where to deduct. Deduct your moving expenses on line 25 of Form 1040. The amount of moving expenses you can deduct is shown on line 8 of Form 3903.

CAUTION *You cannot deduct moving expenses if you file Form 1040A or Form 1040EZ.*

Reimbursements. If you received an advance, allowance, or reimbursement for your allowable moving expenses, how you report this amount and your expenses depends on whether the reimbursement was paid to you under an accountable plan or a nonaccountable plan.

For more information on reimbursements, see Publication 521.

Form 4782. Your employer must give you an itemized list of payments, reimbursements, or allowances that have been paid to you for moving expenses. Form 4782, *Employee Moving Expense Information,* may be used for this purpose. See Publication 521 for a filled-in Form 4782.

When To Deduct Expenses

If you were not reimbursed, deduct your allowable moving expenses either in the year you had them or in the year you paid them.

Example. In December 1997, your employer transferred you to another city in the United States, where you still work. You are single and were not reimbursed for your moving expenses. In 1997 you paid for moving your furniture. You deducted these expenses in 1997. In January 1998, you paid for travel to the new city. You can deduct these additional expenses in 1998.

Reimbursed expenses. If you are reimbursed for your expenses, you can also deduct your allowable expenses in the year you had them or paid them. If you use the cash method of accounting, you can choose to deduct the expenses in the year you are reimbursed even though you paid the expenses in a different year. For more information, see Publication 521.

Choosing when to deduct. If you use the cash method of accounting, which is used by most individuals, you can choose to deduct moving expenses in the year your employer reimburses you if:

1) You paid the expenses in a year before the year of reimbursement, or
2) You paid the expenses in the year immediately after the year of reimbursement but by the due date, including extensions, for filing your return for the reimbursement year.

How to make the choice. You can choose to deduct moving expenses in the year you received reimbursement by taking the deduction on your return, or amended return, for that year.

CAUTION *You cannot deduct any moving expenses for which you received a reimbursement that was excluded from your income. (Reimbursements are discussed in Publication 521.)*

20.

Alimony

Introduction

This chapter discusses the rules that apply if you pay or receive alimony. It covers the following topics:

- What payments are alimony
- What payments are not alimony, such as child support
- How to deduct alimony you paid
- How to report alimony income you received
- Whether you must recapture the tax benefits of alimony (Recapture means adding back in your income all or part of a deduction you took in a prior year.)

Alimony is a payment to or for a spouse or former spouse under a divorce or separation instrument. It does not include voluntary payments that are not made under a divorce or separation instrument.

Alimony is deductible by the payer and must be included in the spouse's or former spouse's income. Although this chapter is generally written for the payer of the alimony, the recipient can use the information to determine whether an amount received is alimony.

To be alimony, a payment must meet certain requirements. Different requirements apply to payments under instruments executed after 1984 and to payments under instruments executed before 1985. This chapter discusses the rules for payments under instruments executed after 1984. For the rules for payments under pre-1985 instruments, see Publication 504, *Divorced or Separated Individuals.*

Use *Table 20–1* in this chapter as a guide to determine whether certain payments are considered alimony.

Definitions. The following definitions apply throughout this chapter.

Spouse or former spouse. Unless otherwise stated in the following discussions about alimony, the term “spouse” includes former spouse.

Divorce or separation instrument. The term “divorce or separation instrument” means:

1) A decree of divorce or separate maintenance or a written instrument incident to that decree,
2) A written separation agreement, or
3) A decree or any type of court order requiring a spouse to make payments for the support or maintenance of the other spouse. This includes a temporary decree, an interlocutory (not final) decree, and a decree of alimony *pendente lite* (while awaiting action on the final decree or agreement).

Useful Items

You may want to see:

Publication

- ☐ **504** Divorced or Separated Individuals

General Rules

The following rules apply to alimony regardless of when the divorce or separation instrument was executed.

Payments not alimony. Not all payments under a divorce or separation instrument are alimony. Alimony does not include:

1) Child support,
2) Noncash property settlements,
3) Payments that are your spouse's part of community income (See *Community Property* in Publication 504.),
4) Use of property, or
5) Payments to keep up the payer's property.

Payments to a third party. Payments to a third party on behalf of your spouse under the terms of your divorce or separation instrument may be alimony, if they otherwise qualify. These include payments for your spouse's medical expenses, housing costs (rent, utilities, etc.), taxes, tuition, etc. The payments are treated as received by your spouse and then paid to the third party.

Life insurance premiums. Premiums you must pay under your divorce or separation instrument for insurance on your life qualify as alimony to the extent your spouse owns the policy.

Payments for jointly-owned home. If your divorce or separation instrument states that you must pay expenses for a home owned by you and your spouse or former spouse, some of your payments may be alimony.

Mortgage payments. If you must make all the mortgage payments (principal and interest) on a jointly-owned home, and they otherwise qualify, you can deduct one-half of the total payments as alimony. If you itemize deductions and the home is a qualified home, you can include the other half of the interest in figuring your deductible interest. Your spouse must report one-half of the payments as alimony received. If your spouse itemizes deductions and the home is a qualified home, he or she can include one-half of the interest on the mortgage in figuring deductible interest.

Taxes and insurance. If you must pay all the real estate taxes or insurance on a home held as ***tenants in common,*** you can deduct one-half of these payments as alimony. Your spouse must report one-half of these payments as alimony received. If you and your spouse itemize deductions, you can each deduct one-half of the real estate taxes.

If your home is held as ***tenants by the entirety*** or ***joint tenants*** (with the right of survivorship), none of your payments for taxes or insurance are alimony. But if you itemize deductions, you can deduct all of the real estate taxes.

Other payments to a third party. If you made other third-party payments, see Publication 504 to see whether any part of the payments qualify as alimony.

Instruments Executed After 1984

The following rules for alimony apply to payments under divorce or separation instruments executed after 1984. They also apply to payments under earlier instruments that were modified after 1984 to:

1) Specify that these rules will apply, or
2) Change the amount or period of payment or add or delete any contingency or condition.

The rules in this section do not apply to divorce or separation instruments executed after 1984 if the terms for alimony are unchanged from an instrument executed before 1985.

Example 1. In November 1984, you and your former spouse executed a written separation agreement. In February 1985, a decree of divorce was substituted for the written separation agreement. The decree of divorce did not change the terms for the alimony you pay your former spouse. The decree of divorce is treated as executed before 1985. Alimony payments under this decree are not subject to the rules for payments under instruments executed after 1984.

Example 2. Assume the same facts as in Example 1 except that the decree of divorce changed the amount of the alimony. In this example, the decree of divorce is not treated as executed before 1985. The alimony payments are subject to the rules for payments under instruments executed after 1984.

Alimony requirements. A payment to or for a spouse under a divorce or separation instrument is alimony if the spouses do not file a joint return with each other and all the following requirements are met.

1) The payment is in cash.
2) The instrument does not designate the payment as not alimony.
3) The spouses are not members of the same household (if separated under a decree of divorce or separate maintenance),
4) There is no liability to make any payment (in cash or property) after the death of the recipient spouse.
5) The payment is not treated as child support.

Each of these requirements is discussed below.

Payment must be in cash. Only cash payments, including checks and money orders, qualify as alimony. The following do not qualify as alimony:

- Transfers of services or property (including a debt instrument of a third party or an annuity contract),

- Execution of a debt instrument, or
- The use of property.

Payments to a third party. Cash payments to a third party under the terms of your divorce or separation instrument can qualify as a cash payment to your spouse. See *Payments to a third party* under *General Rules,* earlier.

Also, cash payments made to a third party at the written request of your spouse qualify as alimony if all the following requirements are met.

1) The payments are in lieu of payments of alimony directly to your spouse.
2) The written request states that both spouses intend the payments to be treated as alimony.
3) You receive the written request from your spouse before you file your return for the year you made the payments.

Payments designated as not alimony. You and your spouse may designate that otherwise qualifying payments are not alimony. You do this by including a provision in your divorce or separation instrument that states the payments are not deductible by you and are excludable from your spouse's income. For this purpose, any writing signed by both of you that makes this designation and that refers to a previous written separation agreement is treated as a written separation agreement. If you are subject to temporary support orders, the designation must be made in the original or a later temporary support order.

To exclude the payments from income, your spouse must attach a copy of the instrument designating them as not alimony to his or her return for each year the designation applies.

Spouses cannot be members of the same household. Payments to your spouse while you are members of the same household are not alimony if you are separated under a decree of divorce or separate maintenance. A home you formerly shared is considered one household, even if you physically separate yourselves in the home.

You are not treated as members of the same household if one of you is preparing to leave the household and does leave not more than one month after the date of the payment.

Exception. If you are not legally separated under a decree of divorce or separate maintenance, a payment under a written separation agreement, support decree, or other court order may qualify as alimony even if you are members of the same household when the payment is made.

Liability for payments after death of recipient spouse. If you must continue to make payments for any period after your spouse's death, none of the payments made before or after the death are alimony.

The divorce or separation instrument does not have to expressly state that the payments cease upon the death of your spouse if, for example, the liability for continued payments would end under state law.

Example. You must pay your former spouse $10,000 in cash each year for 10 years. Your divorce decree states that the payments will end upon your former spouse's death. You must also pay your former spouse or your former spouse's estate $20,000 in cash each year for 10 years. The death of your spouse would not terminate these payments under state law.

The $10,000 annual payments are alimony. But because the $20,000 annual payments will not end upon your former spouse's death, they are not alimony.

Substitute payments. If you must make any payments in cash or property after your spouse's death as a substitute for continuing otherwise qualifying payments, the otherwise qualifying payments are not alimony. Your payments may be treated as such substitute payments and therefore as not alimony to the extent they begin, accelerate or increase because of the death of your spouse. Whether or not such payments will be treated as not alimony depends on all the facts and circumstances.

Example 1. Under your divorce decree, you must pay your former spouse $30,000 annually. The payments will stop at the end of 6 years or upon your former spouse's death, if earlier.

Your former spouse has custody of your minor children. The decree provides that if any child is still a minor at your spouse's death, you must pay $10,000 annually to a trust until the youngest child reaches the age of majority. The trust income and corpus (principal) are to be used for your children's benefit.

These facts indicate that the payments to be made after your former spouse's death are a substitute for $10,000 of the $30,000 annual payments. $10,000 of each of the $30,000 annual payments is not alimony.

Example 2. Under your divorce decree, you must pay your former spouse $30,000 annually. The payments will stop at the end of 15 years or upon your former spouse's death, if earlier. The decree provides that if your former spouse dies before the end of the 15-year period, you must pay the estate the difference between $450,000 ($30,000 × 15) and the total amount paid up to that time. For example, if your spouse dies at the end of the tenth year, you must pay the estate $150,000 ($450,000 − $300,000).

These facts indicate that the lump-sum payment to be made after your former spouse's death is a substitute for the full amount of the $30,000 annual payments. None of the annual payments are alimony. The result would be the same if the payment required at death were to be discounted by an appropriate interest factor to account for the prepayment.

Child support. A payment that is specifically designated as child support or treated as specifically designated as child support under your divorce or separation instrument is not alimony. The designated amount or part may vary from time to time. Child support payments are neither deductible by the payer nor taxable to the payee.

A payment will be ***treated as specifically designated*** as child support to the extent that the payment is reduced either:

1) On the happening of a contingency relating to your child, or
2) At a time that can be clearly associated with a contingency.

A payment may be treated as specifically designated as child support even if other separate payments are specifically designated as child support.

Contingency relating to your child. A contingency relates to your child if it depends on any event relating to that child. It does not matter whether the event is certain or likely to occur. Events relating to your child include the child's:

Table 20-1. **Alimony Requirements (Instruments executed after 1984)**

Payments ARE alimony if all of the following are true:	**Payments are NOT alimony if any of the following are true:**
Payments are required by a divorce or separation instrument.	Payment is designated as child support.
Payer and recipient spouse do not file a joint return.	Payment is a noncash property settlement.
Payment is in cash (including checks or money orders).	Payments are spouse's part of community income.
Payment is not designated in the instrument as not alimony.	Payments are to keep up the payer's property.
Spouses separated under a decree of divorce or separate maintenance are not members of the same household.	Payments are not required by a divorce or separation instrument.
Payments are not required after death of the recipient spouse.	
Payment is not designated as child support.	
These payments are deductible by the payer and includible in income by the recipient.	*These payments are neither deductible by the payer nor includible in income by the recipient.*

- Reaching a specified age or income level,
- Dying,
- Marrying,
- Leaving school,
- Leaving the household, or
- Becoming employed.

Clearly associated with a contingency. Payments are presumed to be reduced at a time clearly associated with the happening of a contingency relating to your child only in the following situations.

1) The payments are to be reduced not more than 6 months before or after the date the child will reach 18, 21, or the local age of majority.
2) The payments are to be reduced on two or more occasions that occur not more than one year before or after a different child reaches a certain age from 18 to 24. This certain age must be the same for each child, but need not be a whole number of years.

In all other situations, reductions in payments are not treated as clearly associated with the happening of a contingency relating to your child.

Either you or the IRS can overcome the presumption in the two situations above. This is done by showing that the time at which the payments are to be reduced was determined independently of any contingencies relating to your children. For example, if you can show that the period of alimony payments is customary in the local jurisdiction, such as a period equal to one-half of the duration of the marriage, you can treat the amount as alimony.

How To Deduct Alimony Paid

You can deduct alimony you paid, whether or not you itemize deductions on your return. You must file Form 1040; you cannot use Form 1040A or Form 1040EZ.

Enter the amount of alimony you paid on line 30a of Form 1040.

CAUTION *In the space provided on line 30b, enter your spouse's or former spouse's social security number. If you do not, you may have to pay a $50 penalty and your deduction may be disallowed.*

If you paid alimony to more than one person, enter the social security number of one of the recipients. Show the social security number and amount paid to each other recipient on an attached statement. Enter your total payments on line 30a.

How To Report Alimony Received

Report alimony you received on line 11 of Form 1040; you cannot use Form 1040A or Form 1040EZ.

CAUTION *You must give the person who paid the alimony your social security number. If you do not, you may have to pay a $50 penalty.*

Recapture Rule

If your alimony payments decrease or terminate during the first 3 calendar years, you may be subject to the recapture rule. If you are subject to this rule, you have to include in income in the third year part of the alimony payments you previously deducted. Your spouse can deduct in the third year part of the alimony payments previously included in income.

The 3–year period starts with the first calendar year you make a payment qualifying as alimony under a decree of divorce or separate maintenance, or a written separation agreement. Do not include any time in which payments were being made under temporary support orders. The second and third years are the next 2 calendar years, whether or not payments are made during those years.

The reasons for a reduction or termination of alimony payments that can require a recapture include:

- A failure to make timely payments,
- A change in your divorce or separation instrument,
- A reduction in your spouse's support needs, or
- A reduction in your ability to provide support.

When to apply the recapture rule. You are subject to the recapture rule in the third year if the alimony you pay in either the second year or the third year decreases by more than $15,000 from the prior year.

When you figure a decrease in alimony, do not include the following amounts.

1) Payments made under a temporary support order.
2) Payments required over a period of at least 3 calendar years of a fixed part of your income from a business or property, or from compensation for employment or self-employment.
3) Payments that decrease because of the death of either spouse or the remarriage of the spouse receiving the payments.

Figuring the recapture. There is an example of how to figure recaptured alimony and a blank worksheet for your use in Publication 504.

Including the recapture in income. If you must include a recapture amount in income, show it on Form 1040, line 11 (“Alimony received”). Cross out “received” and write “recapture.” On the dotted line next to the amount, enter your spouse's last name and social security number.

Deducting the recapture. If you can deduct a recapture amount, show it on Form 1040, line 30a (“Alimony paid”). Cross out “paid” and write “recapture.” In the space provided, enter your spouse's social security number.

Part Five.

Standard Deduction and Itemized Deductions

After you have figured your adjusted gross income, you are ready to subtract the deductions used to figure taxable income. You can subtract either the standard deduction or itemized deductions. For the most part, itemized deductions are deductions for various kinds of personal expenses that are listed on Schedule A (Form 1040). The ten chapters in this part discuss the standard deduction, each itemized deduction, and the limit on some of your itemized deductions if your adjusted gross income exceeds certain amounts. See chapter 21 for the factors to consider when deciding whether to subtract the standard deduction or itemized deductions.

21. Standard Deduction

Important Changes for 1997

Increase in standard deduction. The standard deduction for taxpayers who do not itemize deductions on Schedule A of Form 1040 is higher in 1997 than it was in 1996. The amount depends upon your filing status. See *1997 Standard Deduction Tables,* later.

Itemized deductions. The amount you can deduct for itemized deductions is limited if your adjusted gross income is more than $121,200 ($60,600 if you are married filing separately). See chapter 22 for more information.

Introduction

This chapter discusses:

- How to figure the amount of your standard deduction,
- The standard deduction for dependents, and
- Whether to take the standard deduction or to itemize your deductions.

The standard deduction is a dollar amount that reduces the amount of income on which you are taxed.

The standard deduction is a benefit that eliminates the need for many taxpayers to itemize actual deductions, such as medical expenses, charitable contributions, or taxes. The benefit is higher for taxpayers who are 65 or older or blind. If you have a choice, you should use the method that gives you the lower tax.

You benefit from the standard deduction if your standard deduction is more than the total of your allowable itemized deductions.

Figuring the Amount

Most taxpayers have a choice of either taking a standard deduction or itemizing their deductions.

Persons not eligible for the standard deduction. Your standard deduction is ***zero*** and you should itemize any deductions you have if:

1) You are married and filing a separate return, and your spouse itemizes deductions,

2) You are filing a tax return for a short tax year because of a change in your annual accounting period, or

3) You are a nonresident or dual-status alien during the year. You are considered a dual-status alien if you were both a nonresident and resident alien during the year.
   Note. If you are a nonresident alien who is married to a U.S. citizen or resident at the end of the year, you can choose to be treated as a U.S. resident. (See Publication 519, *U.S. Tax Guide for Aliens.)* If you make this choice, you can take the standard deduction.

CAUTION *If an exemption for you can be claimed on another person's return (such as your parents' return), your standard deduction may be limited. See Standard Deduction for Dependents, later.*

Standard deduction amount. The standard deduction amounts for most taxpayers are shown in *Table 21–1.*

The amount of the standard deduction for a decedent's final return is the same as it would have been had the decedent continued to live. However, if the decedent was not 65 or older at the time of death, the higher standard deduction for age cannot be claimed.

Higher standard deduction for age (65 or older). If you do not itemize deductions, you are entitled to a higher standard deduction if you are age 65 or older at the end of the year. You are considered 65 on the day before your 65th birthday. Therefore, you can take a higher standard deduction for 1997 if your 65th birthday was on or before January 1, 1998.

Use *Table 21–2* to figure the standard deduction amount.

Higher standard deduction for blindness. If you are blind on the last day of the year and you do not itemize deductions, you are entitled to a higher standard deduction as shown in *Table 21–2.* You qualify for this benefit if you are totally or partly blind.

Totally blind. If you are totally blind, attach a statement to this effect to your return.

Partly blind. If you are partly blind, you must submit with your return each year a certified statement from an eye physician or registered optometrist that:

1) You cannot see better than 20/200 in the better eye with glasses or contact lenses, or

2) Your field of vision is not more than 20 degrees.

If your eye condition will never improve beyond these limits, you can avoid having to get a new certified statement each year by having the examining eye physician include this fact in the certification you attach to your return. In later years just attach a statement referring to the certification. You should keep a copy of the certification in your records.

Spouse 65 or older or blind. You can take the higher standard deduction if your spouse is age 65 or older or blind and:

1) You file a joint return, or

2) You file a separate return, your spouse had no gross income, and an exemption for your spouse could not be claimed by another taxpayer.

You cannot claim the higher standard deduction for an individual, other than your spouse, for whom you can claim an exemption.

Example 1. Larry, 46, and Donna, 33, are filing a joint return for 1997. Neither is blind. They decide not to itemize their deductions. They use *Table 21–1.* Their standard deduction is $6,900.

Example 2. Assume the same facts as in Example 1, except that Larry is blind at the end of 1997. Larry and Donna use *Table 21–2.* Their standard deduction is $7,700.

Example 3. Bill and Terry are filing a joint return for 1997. Both are over age 65. Neither is blind. If they do not itemize deductions, they use *Table 21–2.* Their standard deduction is $8,500.

Standard Deduction for Dependents

The standard deduction for an individual for whom an exemption can be claimed on another person's tax return is generally limited to the greater of (a) $650, or (b) the individual's earned income for the year (but not more than the regular standard deduction amount, generally $4,150).

However, if you are 65 or older or blind, your standard deduction may be higher.

If an exemption for you can be claimed on someone else's return, use *Table 21–3* to determine your standard deduction.

Earned income defined. Earned income is salaries, wages, tips, professional fees, and other amounts received as pay for work you actually perform.

For purposes of the standard deduction, earned income also includes any part of a ***scholarship or fellowship grant*** that you must include in your gross income. See *Scholarship and Fellowship Grants* in chapter 13 for more information on what qualifies as a scholarship or fellowship grant.

Example 1. Michael is single. His parents claim an exemption for him on their 1997 tax return. He has interest income of $780 and wages of $150. He has no itemized deductions. Michael uses *Table 21–3* to find his standard deduction. It is $650 because the greater of $650 and his earned income ($150) is $650.

Example 2. Joe, a 22-year-old full-time college student, is claimed on his parents' 1997 tax return. Joe is married and files a separate return. His wife does not itemize deductions on her separate return.

Joe has $1,500 in interest income and wages of $3,600. He has no itemized deductions. Joe finds his standard deduction by using *Table 21–3.* He enters his earned income, $3,600, on line 1. On line 3 he enters $3,600, the larger of his earned income and $650. Since Joe is married filing a separate return, he enters $3,450 on line 4. On line 5a he enters $3,450 as his standard deduction because it is smaller than $3,600, his earned income.

Example 3. Amy, who is single, is claimed on her parents' 1997 tax return. She is 18 years old and blind. She has interest income of $1,300 and wages of $3,000. She has no itemized deductions. Amy uses *Table 21–3* to find her standard deduction. She enters her wages of $3,000 on line 1. On line 3 she enters $3,000, the larger of her wages on line 1 and the $650 on line 2. Since she is single, Amy enters $4,150 on line 4. She enters $3,000 on line 5a. This is the smaller of the amounts on lines 3 and 4. Because she checked one box in the top part of the worksheet, she enters $1,000 on line 5b. She then adds the amounts on lines 5a and 5b and enters her standard deduction of $4,000 on line 5c.

Who Should Itemize

You should itemize deductions if your total deductions are more than the standard deduction amount. You should itemize if you do not qualify for the standard deduction, as discussed earlier under *Persons not eligible for the standard deduction.*

You should first figure your itemized deductions and compare that amount to your standard deduction to make sure you are using the method that gives you the greater benefit.

You may be subject to a limit on some of your itemized deductions if your adjusted gross income (AGI) is more than $121,200 ($60,600 if you are married filing separately). See chapter 22 and the instructions for Schedule A (Form 1040), line 28, for more information on figuring the correct amount of your itemized deductions.

When to itemize. You may benefit from itemizing your deductions if you:

1) Do not qualify for the standard deduction, or the amount you can claim is limited,

2) Had large uninsured medical and dental expenses during the year,

3) Paid interest and taxes on your home,

4) Had large unreimbursed employee business expenses or other miscellaneous deductions,

5) Had large uninsured casualty or theft losses,

6) Made large contributions to qualified charities, or

7) Have total itemized deductions that are more than the highest standard deduction to which you otherwise are entitled.

These deductions are explained in chapters 23–30.

If you decide to itemize your deductions, complete Schedule A and attach it to your Form 1040. Enter the amount from Schedule A, line 28, on Form 1040, line 35.

Itemizing for state tax or other purposes. If you choose to itemize even though your itemized deductions are less than the amount of your standard deduction, write “IE” (itemized elected) next to line 35 (Form 1040).

Changing your mind. If you do not itemize your deductions and later find that you should have itemized — or if you itemize your deductions and later find you should not have — you can change your return by filing Form 1040X, *Amended U.S. Individual Income Tax Return.* See *Amended Returns and Claims for Refund* in chapter 1 for more information on amended returns.

Married persons who filed separate returns. You can change methods of taking deductions only if you and your spouse both make the same changes. Both of you must file a consent to assessment for any additional tax either one may owe as a result of the change.

You and your spouse can use the method that gives you the lower total tax, even though one of you may pay more tax than the other. You both must use the same method of claiming deductions. If one itemizes deductions, the other should itemize because he or she will not qualify for the standard deduction (see *Persons not eligible for the standard deduction,* earlier).

1997 Standard Deduction Tables

Caution: If you are married filing a separate return and your spouse itemizes deductions, or if you are a dual-status alien, you cannot take the standard deduction even if you were 65 or older or blind.

Table 21-1. Standard Deduction Chart for Most People*

If Your Filing Status is:	Your Standard Deduction is:
Single	$4,150
Married filing joint return or Qualifying widow(er) with dependent child	6,900
Married filing separate return	3,450
Head of household	6,050

*DO NOT use this chart if you were 65 or older or blind, OR if someone else can claim an exemption for you (or your spouse if married filing jointly).

Table 21-2. Standard Deduction Chart for People Age 65 or Older or Blind*

Check the correct number of boxes below. Then go to the chart.

You 65 or older ☐ Blind ☐

Your spouse, if claiming spouse's exemption 65 or older ☐ Blind ☐

Total number of boxes you checked ☐

If Your Filing Status is:	And the Number in the Box Above is:	Your Standard Deduction is:
Single	1	$5,150
	2	6,150
Married filing joint return or Qualifying widow(er) with dependent child	1	7,700
	2	8,500
	3	9,300
	4	10,100
Married filing separate return	1	4,250
	2	5,050
	3	5,850
	4	6,650
Head of household	1	7,050
	2	8,050

*If someone else can claim an exemption for you (or your spouse if married filing jointly), use Table 21-3, instead.

Table 21-3. Standard Deduction Worksheet for Dependents*

If you were 65 or older or blind, check the correct number of boxes below. Then go to the worksheet.

You 65 or older ☐ Blind ☐

Your spouse, if claiming spouse's exemption 65 or older ☐ Blind ☐

Total number of boxes you checked ☐

1. Enter your **earned income** (defined below). If none, enter -0-.	**1.** ______
2. Minimum amount	**2.** $650
3. Enter the **larger** of line 1 or line 2.	**3.** ______
4. Enter the amount shown below for your filing status. • Single, enter $4,150 • Married filing separate return, enter $3,450 • Married filing jointly or Qualifying widow(er) with dependent child, enter $6,900 • Head of household, enter $6,050	**4.** ______
5. Standard deduction.	
a. Enter the **smaller** of line 3 or line 4. If under 65 and not blind, stop here. This is your standard deduction. Otherwise, go on to line 5b.	**5a.** ______
b. If 65 or older or blind, multiply $1,000 ($800 if married or qualifying widow(er) with dependent child) by the number in the box above.	**5b.** ______
c. Add lines 5a and 5b. This is your standard deduction for 1997.	**5c.** ______

Earned income *includes wages, salaries, tips, professional fees, and other compensation received for personal services you performed. It also includes any amount received as a scholarship that you must include in your income.*

*Use this worksheet ONLY if someone else can claim an exemption for you (or your spouse if married filing jointly).

22.

Limit on Itemized Deductions

Introduction

This chapter discusses an overall limit on itemized deductions. The topics include:

- Who is subject to the limit,
- Which itemized deductions are limited, and
- How to figure the limit.

Useful Items

You may want to see:

Form (and Instructions)

☐ **Schedule A (Form 1040)** Itemized Deductions

Are You Subject to the Limit?

You are subject to the limit on certain itemized deductions if your adjusted gross income (AGI) is more than $121,200 ($60,600 if you are married filing separately). Your AGI is the amount on line 32 of your Form 1040.

This limit does not apply to estates or trusts.

Which Deductions Are Affected?

All itemized deductions on Schedule A (Form 1040) are subject to the overall limit, except those listed next. Itemized deductions are discussed in Part Five of this publication.

Exceptions

The Schedule A (Form 1040) deductions listed next are not subject to the overall limit on itemized deductions. However, they are still subject to other applicable limits.

- Medical and dental expenses—line 4
- Investment interest expense—line 13
- Nonbusiness casualty and theft losses—line 19
- Gambling losses—line 27

Check the index at the back of this publication to locate discussions of these deductions.

How Do You Figure the Limit?

If your itemized deductions are subject to the limit, the total of all your itemized deductions is reduced by the smaller of:

1) 3% of the amount by which your AGI exceeds $121,200 ($60,600 if married filing separately), or
2) 80% of your itemized deductions that are affected by the limit. See *Which Deductions Are Affected?,* earlier.

Before you figure the overall limit on itemized deductions, you must first complete lines 1 through 27 of Schedule A (Form 1040), including any appropriate forms (such as Form 2106, Form 4684, etc.).

The overall limit on itemized deductions is figured after you have applied any other limit on the allowance of any itemized deduction. Other limits figured first include charitable contribution limits (chapter 26), the limit on certain meals and entertainment (chapter 28), and the 2% of AGI limit on certain miscellaneous deductions (chapter 30).

Itemized Deductions Worksheet. After you have completed Schedule A (Form 1040) through line 27, you can use the *Itemized Deductions Worksheet* in the Instructions for Form 1040 to figure your limit. Enter the result on line 28 of Schedule A (Form 1040). Keep the worksheet for your records.

TIP *You should compare the amount of your itemized deductions after applying the limit to the amount of your standard deduction. Use the greater amount when completing line 35 of your Form 1040. See chapter 21 for information on how to figure your standard deduction.*

Example

For tax year 1997, Bill and Terry Willow are filing a joint return on Form 1040 and have adjusted gross income of $255,250. Their Schedule A itemized deductions consist of the following.

State income and real estate taxes	$17,900
Home mortgage interest	45,000
Charitable contributions	21,000
Investment interest expense	41,000
Miscellaneous deductions	17,240
Total	$142,140

The Willows' investment interest expense is not subject to the overall limit on itemized deductions. Their deduction for miscellaneous deductions is the total after applying the 2% of AGI limit and does not include any gambling losses.

The Willows figure their overall limit as follows:

Itemized Deductions Worksheet Line 28
(Keep for your records)

1.	Add the amounts on Schedule A, lines 4, 9, 14, 18, 19, 26, and 27.		142,140
2.	Add the amounts on Schedule A, lines 4, 13, and 19, plus any gambling losses included on line 27.		41,000
3.	Subtract line 2 from line 1. (If the result is zero, stop here; enter the amount from line 1 above on Schedule A, line 28.)		101,140
4.	Multiply the amount on line 3 by 80% (.80).	80,912	
5.	Enter the amount from Form 1040, line 33	255,250	
6.	Enter $121,200 ($60,600 if married filing separately)	121,200	
7.	Subtract line 6 from line 5. (If the result is zero or less, stop here; enter the amount from line 1 above on Schedule A, line 28.)	134,050	
8.	Multiply the amount on line 7 by 3% (.03).	4,022	
9.	Enter the smaller of line 4 or line 8.		4,022
10.	**Total itemized deductions.** Subtract line 9 from line 1. Enter the result here and on Schedule A, line 28		138,118

Of their $142,140 total itemized deductions, the Willows can deduct only $138,118. They enter $138,118 on Schedule A, line 28.

23.

Medical and Dental Expenses

Important Changes for 1997

Medical savings account. You may be able to make deductible contributions to a medical savings account (MSA). If you are an employee of a small business (fewer than 50 employees), or self-employed, and covered only by a high deductible health plan, you may be eligible to participate. MSA contributions are deducted on Form 1040, line 24, not on Schedule A as a qualified medical expense. See Publication 969, *Medical Savings Accounts (MSAs)*, for more information.

Qualified long-term care insurance and expenses. Qualified long-term care insurance contracts are generally treated as accident and health insurance contracts beginning January 1, 1997. You can include in medical expenses unreimbursed qualified long-term care expenses, and within certain limits, premiums paid for qualified long-term care insurance. See Publication 525, *Taxable and Nontaxable Income,* for more information.

Self-employed health insurance deduction rate increase. The rate has been increased from 30% to 40%. The rate will increase to 45% for 1998 and 1999.

Important Reminder

Standard mileage rate. The standard amount you can deduct for the use of your car for medical reasons is now 10 cents a mile.

Introduction

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

It will help you determine:

- Whose expenses you can include,
- What expenses you can include,
- How to claim expenses of a decedent, and
- How to figure your deduction.

To deduct any medical and dental expenses, you must itemize your deductions on **Schedule A** (Form 1040). You must reduce the amount of your medical expenses by any reimbursement you receive for these expenses.

There are limits on the amount you can deduct. You can deduct only the amount of your medical and dental expenses that is ***more than 7.5%*** of your adjusted gross income shown on line 33, Form 1040. See *How To Figure Your Deduction.*

Useful Items

You may want to see:

Publication

- ☐ **502** Medical and Dental Expenses

Form (and Instructions)

- ☐ **Schedule A (Form 1040)** Itemized Deductions

Whose Expenses Can You Include?

You can include medical expenses you pay for yourself and for the individuals discussed in this section.

Spouse. You can include medical expenses you paid for your spouse. To claim these expenses, you must have been married either at the time your spouse received the medical services or at the time you paid the medical expenses.

Example 1. Mary received medical treatment before she married Bill. Bill paid for the treatment after they married. Bill can include these expenses in figuring his medical expense deduction even if Bill and Mary file separate returns.

If Mary had paid the expenses before she and Bill married, Bill could not include Mary's medical expenses on his separate return. Mary would include all the medical expenses she paid during the year on her separate return. If they filed a joint return, the medical expenses both paid during the year would be used to figure their medical expense deduction.

Example 2. This year John paid medical expenses for his wife Louise who died last year. John married Belle this year and they file a joint return. Because John was married to Louise when she incurred the medical expenses, he can include those expenses in figuring his medical deduction for this year.

Dependents. You can include medical expenses you paid for your dependent. To claim these expenses, the person must have been your dependent either at the time the medical services were provided or at the time you paid the expenses. A person generally qualifies as your dependent for purposes of the medical expense deduction if:

1) That person lived with you for the entire year as a member of your household or is related to you, and
2) That person was a U.S. citizen or resident, or a resident of Canada or Mexico for some part of the calendar year in which your tax year began, and
3) You provided over half of that person's total support for the calendar year.

You can include the medical expenses of any person who is your dependent even if you cannot claim an exemption for him or her on your return.

Example 1. Last year your son was your dependent. This year he no longer qualifies as your dependent. However, you paid $800 this year for medical expenses your son incurred last year when he was your dependent. You can include the $800 in figuring this year's medical expense deduction. You cannot include this amount on last year's return.

Example 2. You provided more than half of your married daughter's support, including her medical expenses of $1,200. She and her husband file a joint return. Although you may not be able to claim an exemption for your daughter, she is still your dependent, and you can include in your medical expenses the $1,200 you paid.

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

TIP *You may be able to take credit for other expenses related to adoption. See Publication 968,* Tax Benefits for Adoption*, for more information.*

Child of divorced or separated parents. If either parent can claim a child as a dependent under the rules for divorced or separated parents, each parent can include the medical expenses he or she pays for the child even if an exemption for the child is claimed by the other parent.

Support claimed under a multiple support agreement. A multiple support agreement is used when two or more people provide more than half of a person's support, but no one alone provides more than half. If you are considered to have provided more than half under such an agreement, you can include medical expenses you pay, even if you cannot claim the person because he or she had gross income of more than the standard deduction amount or filed a joint return.

Any medical expenses paid by others who joined you in the agreement cannot be included as medical expenses by anyone. However, you can include the entire unreimbursed amount you paid for medical expenses.

Example. You and your three brothers each provide one-fourth of your mother's total support. Under a multiple support agreement, you claim your mother as a dependent. You paid all of her medical expenses. Your brothers repaid you for three-fourths of these expenses. In figuring your medical expense deduction, you can include only one-fourth of your mother's medical expenses. Your brothers cannot include any part of the expenses.

However, if you and your brothers share the nonmedical support items and you separately pay all of your mother's medical expenses, you can include the amount you paid for her medical expenses in your medical expenses.

Medical Expenses

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

Use *Table 23–1* in this chapter as a guide to determine which medical and dental expenses you can include on Schedule A (Form 1040). See Publication 502, *Medical and Dental Expenses,* for information about other expenses you can include.

Medical Insurance Premiums

You can include in medical expenses premiums you pay for policies that provide payment for:

- Hospitalization, surgical fees, and other medical and dental expenses,
- Prescription drugs,
- Replacement of lost or damaged contact lenses, or
- Membership in an association that gives cooperative or so-called "free-choice" medical service, or group hospitalization and clinical care.
- Qualified long-term care insurance contracts (subject to additional limitations). See *Long-term Care Contracts, Qualified* in Publication 502.

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

Cafeteria plans. Do not include in medical and dental expenses (line 1 of Schedule A) insurance premiums paid by an employer-sponsored health insurance plan (cafeteria plan) unless the premiums are included in box 1 of your Form(s) W–2. Also, do not include any other medical and dental expenses paid by the plan unless the amount paid is included in box 1 of your Form(s) W–2.

Medicare A. If you are covered under social security (or if you are a government employee who paid Medicare tax), you are enrolled in Medicare A. The payroll tax paid for Medicare A is not a medical expense.

If you are not covered under social security (or were not a government employee who paid Medicare tax), you can voluntarily enroll in Medicare A. In this situation the premiums paid for Medicare A can be included as a medical expense on your tax return.

Medicare B. Medicare B is supplemental medical insurance. Premiums you pay for Medicare B are a medical expense. If you applied for it at age 65 or after you became disabled, you can deduct the monthly premiums you paid. If you were over age 65 or disabled when you first enrolled, check the information you received from the Social Security Administration to find out your premium.

Prepaid insurance. Premiums you pay before you are 65 for insurance covering medical care for yourself, your spouse, or your dependents after you reach 65 are medical care expenses in the year paid if they are:

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

Unused sick leave used to pay premiums. You must include in gross income cash payments you receive at the time of retirement for unused sick leave.

You must also include in gross income the value of unused sick leave that, at your option, your employer applies to the cost of your continuing participation in your employer's health plan after you retire. You can include this cost of continuing participation in the health plan as a medical expense.

If you participate in a health plan where your employer automatically applies the value of unused sick leave to the cost of your continuing participation in the health plan (and you do not have the option to receive cash), you do not include the value of the unused sick leave in gross income. You cannot include this cost of continuing participation in that health plan as a medical expense.

Health Insurance Costs for Self-Employed Persons

If you were self-employed and had a net profit for the year, were a general partner (or a limited partner receiving guaranteed payments) or if you received wages from an S corporation in which you were a more than 2% shareholder (who is treated as a partner), you may be able to deduct up to 40% of the amount paid for health insurance on behalf of yourself, your spouse, and dependents. You take this deduction on Form 1040. If you itemize your deductions, include the remaining premiums with all other medical care expenses on Schedule A, subject to the 7.5% limit.

You cannot take the deduction for any months in which you were eligible to participate in any subsidized health plan maintained by your employer or your spouse's employer.

If you qualify to take the deduction, use the worksheet in the Form 1040 instructions to figure the amount you can deduct. But, if either of the following applies, do not use the worksheet. If you cannot use the worksheet in the Form 1040 instructions, use the worksheet in Publication 535 to figure your deduction.

- You had more than one source of income subject to self-employment tax.
- You file Form 2555, *Foreign Earned Income,* or Form 2555–EZ, *Foreign Earned Income Exclusion*.

Meals and Lodging

You can include in medical expenses the cost of meals and lodging at a hospital or similar institution if your main reason for being there is to receive medical care. See *Nursing Home,* later.

You may be able to include in medical expenses the cost of lodging not provided in a hospital or similar institution. You can include the cost of such lodging while away from home if you meet all of the following requirements.

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

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

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

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

Transportation

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

Include:

- Bus, taxi, train, and plane fares,
- Ambulance service,
- Car expenses,
- Transportation expenses of a parent who must go with a child who needs medical care,
- Transportation expenses of a nurse or other person who can give injections, medications, or other treatment re-

Table 23-1. **Medical and Dental Expenses Checklist**

You can include:	You cannot include:
• Birth control pills prescribed by your doctor • Capital expenses for equipment or improvements to your home needed for medical care (see Publication 502) • Cost and care of guide dogs or other animals aiding the blind, deaf, and disabled • Cost of lead-based paint removal (see Publication 502) • Expenses of an organ donor • Hospital services fees (lab work, therapy, nursing services, surgery, etc.) • Legal abortion • Legal operation to prevent having children • Long-term care contracts, qualified • Meals and lodging provided by a hospital during medical treatment • Medical and hospital insurance premiums • Medical savings accounts • Medical services fees (from doctors, dentists, surgeons, specialists, and other medical practitioners) • Oxygen equipment and oxygen • Part of life-care fee paid to retirement home designated for medical care • Prescription medicines (prescribed by a doctor) and insulin • Psychiatric care at a specially equipped medical center (includes meals and lodging) • Social Security tax, Medicare tax, FUTA, and state employment tax for worker providing medical care (see *Wages for nursing services,* later). • Special items (artificial limbs, false teeth, eye-glasses, contact lenses, hearing aids, crutches, wheelchair, etc.) • Special school or home for mentally or physically disabled persons (see Publication 502) • Transportation for needed medical care • Treatment at a drug or alcohol center (includes meals and lodging provided by the center) • Wages for nursing services (see Publication 502)	• Bottled water • Diaper service • Expenses for your general health (even if following your doctor's advice) such as— —Health club dues —Household help (even if recommended by a doctor) —Social activities, such as dancing or swimming lessons —Stop smoking program —Trip for general health improvement —Weight loss program • Funeral, burial or cremation expenses • Illegal operation or treatment • Life insurance or income protection policies, or policies providing payment for loss of life, limb, sight, etc. • Maternity clothes • Medical insurance included in a car insurance policy covering all persons injured in or by your car • Medicine you buy without a prescription • Nursing care for a healthy baby • Surgery for purely cosmetic reasons • Toothpaste, toiletries, cosmetics, etc.

quired by a patient who is traveling to get medical care and is unable to travel alone, and

- Transportation expenses for regular visits to see a mentally ill dependent, if these visits are recommended as part of treatment.

Do not include:

- Transportation expenses to and from work even if your condition requires an unusual means of transportation, or
- Transportation expenses if, for non-medical reasons only, you choose to travel to another city, such as a resort area, for an operation or other medical care prescribed by your doctor.

Car expenses. You can include out-of-pocket expenses for your car, such as gas and oil. You cannot include depreciation, insurance, general repair, or maintenance expenses.

If you do not want to figure your actual expenses, you can use a standard rate of ***10 cents a mile*** for use of your car for medical reasons.

Either way, you can include the cost of parking fees and tolls.

Disabled Dependent Care Expenses

Some disabled dependent care expenses may qualify as medical expenses or as work-related expenses for purposes of taking a credit for dependent care. (See chapter 33.) You can choose to apply them either way as long as you do not use the same expenses to claim both a credit and a medical expense deduction.

Impairment-Related Work Expenses

Certain unreimbursed expenses may appear to be deductible as either medical or business expenses. Deduct them as business deductions if they are:

- Necessary for you to do your work satisfactorily,
- For goods or services not required or used, other than incidentally, in your personal activities, and
- Not specifically covered under other income tax laws.

Example. You are blind. To do your work, you must use a reader. You use the reader both during your regular working hours at your place of work and outside your regular working hours away from your place of work. The reader's services are only for your work. You can deduct your expenses for the reader as business expenses.

Decedents

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

Amended returns and claims for refund are discussed in chapter 1.

Example. John properly filed last year's income tax return. He died this year with unpaid medical expenses of $1,500 from last year and $2,000 from this year. His executor will pay the expenses in January of next year. The executor can file an amended return for last year claiming the $1,500 medical expenses. The $2,000 medical expenses from this year can be included on this year's return, which will be the decedent's final return.

Expenses for deceased spouse or dependent. If you paid medical expenses for your deceased spouse or dependent, include them as medical expenses on your Form 1040 in the year paid, whether they are paid before or after the decedent's death. The expenses can be included if the person was your spouse or dependent either at the time the medical services were provided or at the time you paid the expenses.

How To Figure Your Deduction

To figure your medical expense deduction, complete lines 1–4 of Schedule A (Form 1040). If you need more information on itemized deductions or you are not sure whether you can itemize, see chapters 21 and 22.

Write in the amounts you paid for medical and dental care expenses after reducing the amount by payments you received from insurance and other sources. You can deduct only the amount of your medical and dental expenses that is more than 7.5% of your adjusted gross income shown on line 33, Form 1040.

Write the amount of your unreimbursed medical expenses on line 1, Schedule A (Form 1040). For an example, see Publication 502.

Separate returns. If you and your spouse live in a noncommunity property state and file separate returns, each of you can include only the medical expenses each actually paid. Any medical expenses paid out of a joint checking account in which you and your spouse have the same interest are considered to have been paid equally by each of you, unless you can show otherwise.

Community property states. If you and your spouse live in a community property state and file separate returns, any medical expenses paid out of community funds are divided equally. Each of you should include half the expenses. If medical expenses are paid out of the separate funds of one spouse, only the spouse who paid the medical expenses can include them. If you live in a community property state, are married, and file a separate return, see Publication 555, *Community Property.*

What expenses can you include in 1997? You can include only the medical and dental expenses you paid this year, regardless of when the services were provided. (But see *Decedents,* earlier.) If you pay medical expenses by check, the day you mail or deliver the check generally is the date of payment. If you use a “pay-by-phone”, or “on-line” account, the date reported on the statement of the financial institution showing when payment was made is the date of payment. You can include medical expenses you charge to your credit card in the year the charge is made. It does not matter when you actually pay the amount charged.

Reimbursements

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

Generally, you do not have to reduce medical expenses by any payment you received for loss of earnings or damages for personal injury or sickness.

Excess reimbursement. If the total reimbursement you received during the year is the same as or more than your total medical expenses for the year, you cannot take a medical deduction. The following discussions explain whether you need to include excess reimbursement in income.

Premiums paid by you. If you pay the entire premium for your medical insurance or all of the cost of a plan similar to medical insurance, generally do not include an excess reimbursement in your gross income.

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

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

Total annual cost of policy	$2,000
Amount paid by employer	$600
Employer's contribution in relation to the annual cost of the policy ($600 ÷ $2,000)	30%

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

Premiums paid by your employer. If your employer or your former employer pays the total cost of your medical insurance plan and your employer's contributions are not included in your income, you must report all excess reimbursements as other income.

More than one policy. If you are covered under more than one policy, the costs of which are paid by both you and your employer, you must first divide the medical expense among the policies to figure the excess reimbursement from each policy. Then divide the policy costs to figure the part of any excess reimbursement that is from your employer's contribution.

Example. You are covered by your employer's health insurance policy. The annual premium is $1,200. Your employer pays $300, and the balance of $900 is deducted from your wages. You also paid the entire premium of $250 for a personal health insurance policy.

During the year, you paid medical expenses of $3,600. In the same year, you were reimbursed $2,500 under your employer's policy and $1,500 under your personal policy.

You figure the part of any excess reimbursement you receive that is from your employer's contribution like this:

Reimbursement from employer's policy ...	$2,500
Reimbursement from your policy	1,500
Total reimbursement	$4,000
Amount of medical expenses from your policy [($1,500 ÷ $4,000) × $3,600 total medical expenses]	$1,350
Amount of medical expenses from your employer's policy [($2,500 ÷ $4,000) × $3,600 total medical expenses]	2,250
Total medical expenses	$3,600
Excess reimbursement from your employer's policy ($2,500 − $2,250)	$250

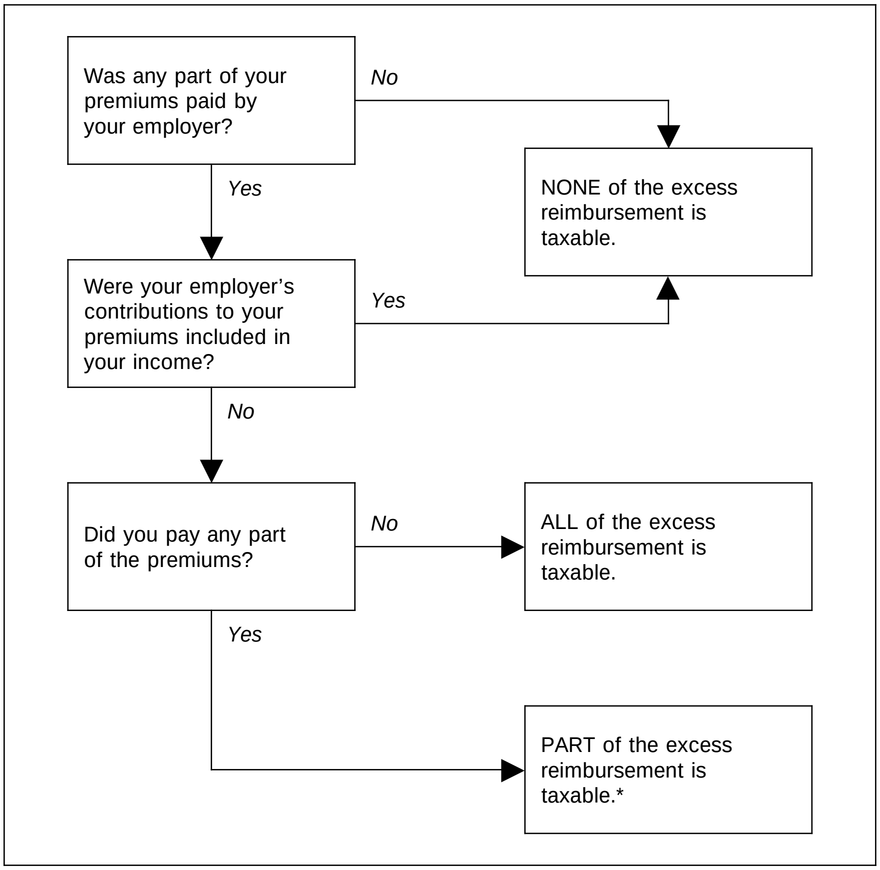
Because both you and your employer contribute to the cost of this policy, you must divide the cost to determine the excess reimbursement from your employer's contribution.

Employer's contribution in relation to the annual cost of the policy ($300 ÷ $1,200)	25%
Amount to report as income (25% × $250)	$62.50

Reimbursement in a later year. If you are reimbursed in a later year for medical expenses you deducted in an earlier year, you must report as income the amount you received from insurance or other sources that is equal to, or less than, the amount you previously deducted as medical expenses. However, do not report as income the reimbursement you received up to the amount of your medical deductions that did not reduce your tax for the earlier year. For more information about the recovery of an amount that you claimed as an itemized deduction in an earlier year, see *Itemized Deduction Recoveries* in chapter 13.

Medical expenses not deducted. If you did not deduct a medical expense in the year you paid it because you did not itemize deductions or because your medical expenses were not more than 7.5% of your adjusted gross income, do not include in income the reimbursement for this expense that you receive in a later year. However, if the reimbursement is more than the expense, see *Excess reimbursement,* earlier.

Figure 23-A. **Is Your Excess Medical Reimbursement Taxable?**



*See *Premiums paid by you and your employer* in this chapter.

Example. In 1997, you have medical expenses of $500. You cannot deduct the $500 because it is not more than 7.5% of your adjusted gross income. If, in a later year, you are reimbursed for any of the $500 medical expenses, you do not include that amount in your gross income.

Damages. If you receive an amount in settlement of a personal injury suit, the part that is for medical expenses deducted in an earlier year is included as income in the later year if your medical deduction in the earlier year reduced your income tax in that year. See *Reimbursement in a later year,* earlier.

Future medical expenses. If you receive an amount in settlement of a damage suit for personal injuries that is properly allocable or determined to be for future medical expenses, you must reduce any medical expenses for these injuries until the amount you received has been completely used.

24. Taxes

Important Reminder

Limit on itemized deductions. If your adjusted gross income is more than $121,200 ($60,600 if you are married filing separately), the overall amount of your itemized deductions may be limited. See chapter 22 for more information about this limit.

Introduction

This chapter discusses which taxes you can deduct if you itemize deductions on Schedule A (Form 1040). It also explains which taxes you can deduct on other schedules or forms and which taxes you cannot deduct.

The chapter covers.

- Income taxes (state, local, or foreign).
- Real estate taxes (state, local, or foreign).
- Personal property taxes (state or local).
- Taxes and fees you cannot deduct.

The end of the chapter explains which form you use to deduct the different types of taxes.

Table. Use *Table 24–1* as a guide to determine which taxes you can deduct.

Business taxes. You can deduct certain taxes only if they are ordinary and necessary expenses of your trade or business or of producing income. For information on these taxes, see Publication 535, *Business Expenses*.

State or local taxes. These are taxes imposed by the 50 states, U.S. possessions, or any of their political subdivisions (such as a county or city), or by the District of Columbia.

Indian tribal government. An Indian tribal government that is recognized by the Secretary of the Treasury as performing substantial government functions will be treated as a state for this purpose. Income taxes, real estate taxes, and personal property taxes imposed by that Indian tribal government (or by any of its subdivisions that are treated as political subdivisions of a state) are deductible.

Foreign taxes. These are taxes imposed by a foreign country or any of its political subdivisions.

Useful Items

You may want to see:

Publication

- ☐ **514** Foreign Tax Credit for Individuals
- ☐ **530** Tax Information for First-time Homeowners

Form (and Instructions)

- ☐ **Schedule A (Form 1040)** Itemized Deductions
- ☐ **Schedule E (Form 1040)** Supplemental Income and Loss
- ☐ **Form 1116** Foreign Tax Credit

Tests to Deduct Any Tax

The following two tests must be met for any tax to be deductible by you.

1) The tax must be imposed on you.
2) The tax must be paid during your tax year.

The tax must be imposed on you. Generally, you can deduct only taxes that are imposed on you.

Generally, you can deduct property taxes only if you are the property owner. If your spouse owns property and pays real estate taxes on it, the taxes are deductible on your spouse's separate return or on your joint return.

The tax must be paid during your tax year. If you are a cash basis taxpayer, you can deduct only those taxes paid during the calendar year for which you file a return. If you pay your taxes by check, the day you mail or deliver the check is generally the date of payment. If you use a pay-by-phone account, the date reported on the statement of the financial institution showing when payment was made is the date of payment. If you question a tax liability and use the cash method of accounting, you can deduct the tax only in the year it is actually paid.

If you use an accrual method of accounting, see Publication 538, *Accounting Periods and Methods,* for more information.

Income Taxes

This section discusses the deductibility of state and local income taxes, employee contributions to state benefit funds, and foreign income taxes.

State and local income taxes. You can deduct state and local income taxes. However, you cannot deduct state and local income taxes you pay on income that is exempt from federal income tax, unless the exempt income is interest income. For example, you cannot deduct the part of a state's income tax that is on a cost-of-living allowance that is exempt from federal income tax.

What to deduct. Deduct state and local income taxes withheld from your salary in the year they are withheld. For 1997, these taxes will be shown in boxes 18 and 21 of your Form W–2. You may also have state or local income tax withheld on Form W–2G (box 14), Form 1099-MISC (box 11), or Form 1099–R (boxes 10 and 13). Deduct payments made on taxes for an earlier year in the year you pay them.

Deduct estimated tax payments you made during the year under a pay-as-you-go plan of a state or local government. However, you must have a reasonable basis for making the estimated tax payments. Any estimated state or local tax payments you make that are not reasonably determined in good faith at the time of payment are not deductible. For example, you made an estimated state income tax payment. However, the estimate of your state tax liability shows that you will get a refund of the full amount of your estimated payment. You had no reasonable basis to believe you had any additional liability for state income taxes and you cannot deduct the estimated tax payment.

Deduct any part of a refund of prior-year state or local income taxes that you chose to have credited to your 1997 estimated state or local income taxes.

Do not reduce your deduction by either of the following:

- Any state or local income tax refund (or credit) you expect to receive for 1997, or
- Any refund of (or credit for) prior year state and local income taxes you actually received in 1997.

Refund (or credit) of state or local income taxes. If you receive a refund of (or credit for) state or local income taxes in a year after the year in which you paid them, you may have to include the refund in income on line 10 of Form 1040, in the year you receive it. This includes refunds resulting from taxes that were overwithheld, applied from a prior year return, not figured correctly, or figured again because of an amended return. If you did not itemize your deductions in the previous year, you do not have to include the refund in income. If you did deduct the taxes in the previous year, include all or part of the refund on line 10, Form 1040, in the year you receive the refund. For a discussion of how much to include, see *Recoveries* in chapter 13.

Separate returns. If you and your spouse file separate state, local, and federal income tax returns, you each can deduct on your federal return only the amount of your own state and local income tax.

If you file separate state and local returns and a joint federal return, you can deduct on your joint federal return the total of the state and local income taxes both of you paid.

If you and your spouse file joint state and local returns and separate federal returns, each of you can deduct on your separate federal return part of the state and local income taxes. You can deduct only the amount of the total taxes that is proportionate to your gross income compared to the combined gross income of you and your spouse. But you cannot deduct more than the amount you actually paid during the year. If you and your spouse are jointly and individually liable for the full amount of the state and local income taxes, you and your spouse can deduct on your separate federal returns the amount you each actually paid.

State benefit funds. As an employee, you can deduct mandatory contributions to state benefit funds that provide protection against loss of wages. Mandatory payments made to the following state benefit funds are

Table 24-1. **Which Taxes Can You Deduct?**

	You Can Deduct	**You Cannot Deduct**
Income Taxes	State and local income taxes Foreign income taxes Employee contributions to state funds listed under *State benefit funds*	Federal income taxes Employee contributions to private or voluntary disability plans
Real Estate Taxes	State and local real estate taxes Foreign real estate taxes Tenant's share of real estate taxes paid by cooperative housing corporation	Taxes for local benefits Trash and garbage pickup fees Rent increase due to higher real estate taxes Homeowners association charges
Personal Property Taxes	State and local personal property taxes	
Other Taxes	Taxes that are expenses of your trade or business or producing income One-half of self-employment tax paid Taxes on property producing rent or royalty income Occupational taxes	Many taxes, such as state and local sales taxes and federal excise taxes, generally are not deductible. See *Taxes and Fees You Cannot Deduct.*
Fees and Charges		Fees and charges, such as for driver's licenses or water bills, generally are not deductible. See *Taxes and Fees You Cannot Deduct.*

deductible as state income taxes on line 5 of Schedule A (Form 1040).

- California.
- New Jersey.
- New York Nonoccupational Disability Benefit Fund.
- Rhode Island Temporary Disability Benefit Fund.
- Washington State Supplemental Workmen's Compensation Fund.

Employee contributions to private or voluntary disability plans are not deductible.

Foreign income taxes. Generally, you can take either a deduction or a credit for income taxes imposed on you by a foreign country or a U.S. possession. However, you cannot take a deduction or credit for foreign income taxes paid on income that is exempt from U.S. tax under the foreign earned income exclusion or the foreign housing exclusion. For information on these exclusions, get Publication 54, *Tax Guide for U.S. Citizens and Resident Aliens Abroad.*

Real Estate Taxes

Deductible real estate taxes are any state, local, or foreign taxes on real property levied for the general public welfare. The taxes must be based on the assessed value of the real property and must be charged uniformly against all property under the jurisdiction of the taxing authority. Deductible real estate taxes generally do not include taxes charged for local benefits and improvements that increase the value of the property. See *Real Estate Items You Cannot Deduct,* later.

An itemized charge for services to specific property or people is not a tax, even if the charge is paid to the taxing authority. You cannot deduct the charge as a real estate tax if it is:

1) A unit fee for the delivery of a service (such as a $5 fee charged for every 1,000 gallons of water you use),
2) A periodic charge for a residential service (such as a $20 per month or $240 annual fee charged to each homeowner for trash collection), or
3) A flat fee charged for a single service provided by your government (such as a $30 charge for mowing your lawn because it was allowed to grow higher than permitted under your local ordinance).

You must look at your real estate tax bill to determine if any nondeductible itemized charges, such as those just listed, are included in the bill. If your taxing authority (or mortgage lender) does not furnish you a copy of your real estate tax bill, ask for it.

Tenant-shareholders in a cooperative housing corporation. Generally, you can deduct your share of the real estate taxes the corporation paid or incurred on the property. The corporation should provide you with a statement showing you your share of the taxes. For more information, see *Special Rules for Cooperatives* in Publication 530.

Purchase or sale of real estate. If you bought or sold real estate during the year, the real estate taxes must be divided between the buyer and the seller.

The buyer and the seller must divide the real estate taxes according to the number of days in the ***real property tax year*** (the period to which the tax imposed relates) that each owned the property. The seller is treated as paying the taxes up to the date of sale. The buyer is treated as paying the taxes beginning with the date of sale. This applies regardless of the lien dates under local law. Generally, this information is included on the settlement statement provided at closing.

If you (the seller) cannot deduct taxes until they are paid because you use the cash method of accounting, and the buyer of your property is personally liable for the tax, ***you are considered to have paid your part of the tax at the time of the sale.*** This lets you deduct the part of the tax to the date of sale even though you did not actually pay it. However, you must also include the amount of that tax in the selling price of the property.

You figure your deduction for taxes on each property bought or sold during the real property tax year as follows.

1. Enter the total real estate taxes for the real property tax year .... ______
2. Enter the number of days in the real property tax year that you owned the property .... ______
3. Divide line 2 by 365 .... ______
4. Multiply line 1 by line 3. This is your deduction. Enter it on line 6 of Schedule A (Form 1040) .... ______

Note. Repeat steps 1 through 4 for each property you bought or sold during the real property tax year.

Delinquent taxes. Do not divide delinquent taxes between the buyer and seller if the taxes are for any real property tax year before the one in which the property is sold. Even if the buyer agrees to pay the delinquent taxes, the buyer cannot deduct them. The buyer must add them to the cost of the property. The seller can deduct these taxes paid by the buyer. However, the seller must include them in the selling price.

The following examples illustrate how real estate taxes are divided between buyer and seller.

Example 1. Dennis and Beth White's real property tax year for both their old home and their new home is the calendar year, with payment due August 1. The tax on their old home, sold on May 6, was $620. The tax on their new home, bought on May 3, was $732. Dennis and Beth are considered to have paid a proportionate share of the real estate taxes on the old home even though they did not actually pay them to the taxing authority. On the other hand, they can claim only a proportionate share of the taxes they paid on their new property even though they paid the entire amount.

Dennis and Beth owned their old home during the real property tax year for 125 days (January 1 to May 5, the day before the sale). They figure their deduction for taxes on their old home as follows.

TAXES ON OLD HOME

1.	Enter the total real estate taxes for the real property tax year	$620
2.	Enter the number of days in the real property tax year that you owned the property	125
3.	Divide line 2 by 365	.34
4.	Multiply line 1 by line 3. This is your deduction. Enter it on line 6 of Schedule A (Form 1040)	$211

Since the buyers of their old home paid all of the taxes, Dennis and Beth also include the $211 in the selling price of the old home. (The buyers add the $211 to their cost of the home.)

Dennis and Beth owned their new home during the real property tax year for 243 days (May 3 to December 31, including their date of purchase). They figure their deduction for taxes on their new home as follows.

TAXES ON NEW HOME

1.	Enter the total real estate taxes for the real property tax year	$732
2.	Enter the number of days in the real property tax year that you owned the property	243
3.	Divide line 2 by 365	.67
4.	Multiply line 1 by line 3. This is your deduction. Enter it on line 6 of Schedule A (Form 1040)	$490

Since Dennis and Beth paid all of the taxes on the new home, they add $242 ($732 paid less $490 deduction) to their basis of the new home. (The sellers add this $242 to their selling price and deduct the $242 as a real estate tax.)

Dennis and Beth's real estate tax deduction for their old and new homes is the sum of $211 and $490, or $701. They will enter this amount on line 6 of Schedule A (Form 1040).

Example 2. George and Helen Brown bought a home on May 2, 1997. Their real property tax year is the calendar year. Real estate taxes for 1996 were assessed in their state on January 1, 1997. The taxes became due on May 31, 1997, and October 31, 1997.

The Browns agreed to pay all taxes due after the date of purchase. Real estate taxes for 1996 were $680. They paid $340 on May 31, 1997, and $340 on October 31, 1997. These taxes were for the 1996 real property tax year. The Browns cannot deduct them since they did not own the property until 1997. Instead, they must add $680 to the basis (cost) of their home.

In January 1998, the Browns receive their 1997 property tax statement for $752, which they will pay in 1998. The Browns owned their new home during the 1997 real property tax year for 244 days (May 2 to December 31). They will figure their 1998 deduction for taxes as follows.

1.	Enter the total real estate taxes for the real property tax year	$752
2.	Enter the number of days in the real property tax year that you owned the property	244
3.	Divide line 2 by 365	.67
4.	Multiply line 1 by line 3. This is your deduction. Claim it on line 6 of Schedule A (Form 1040)	$504

The remaining $248 ($752 paid less $504 deduction) of taxes paid in 1998, along with the $680 paid in 1997, is added to the cost of their home.

Because the taxes up to the date of sale are considered paid by the seller on the date of sale, the seller is entitled to a 1997 tax deduction of $928. This is the sum of the $680 for 1996 and the $248 for the 121 days the seller owned the home in 1997. The seller must also include the $928 in the selling price when he or she completes **Form 2119,** *Sale of Your Home,* (which must be attached to the seller's 1997 tax return). The seller should contact the Browns in January 1998 to find out how much real estate tax is due for 1997.

Form 1099–S. For certain sales or exchanges of real estate, the person responsible for closing the sale (generally the settlement agent) prepares Form 1099–S, *Proceeds From Real Estate Transactions,* to report certain information to the IRS and to the seller of the property. The gross proceeds from the sale appears in box 2 of the form. Generally, gross proceeds includes cash, notes, and liabilities assumed by the buyer, such as any portion of the seller's real estate tax liability that the buyer will pay after the date of sale. The buyer includes these taxes in the cost basis of the property, and the seller both deducts this amount as a tax expense and includes it in the sales price of the property.

For a real estate transaction that involves a home, any real estate tax the seller paid in advance but that is the liability of the buyer appears in box 5 of Form 1099–S. The buyer deducts this amount as a real estate tax expense, and the seller reduces his or her real estate tax expense by the same amount. See *Refund (or rebate),* later.

Taxes placed in escrow. If your monthly mortgage payment includes an amount placed in escrow (put in the care of a third party) for real estate taxes, you cannot deduct the total of these amounts placed in escrow. You can deduct only the real estate tax that the lender actually paid to the taxing authority. If the lender does not notify you of the amount of real estate tax that was paid for you, contact the lender or the taxing authority to find the proper amount to show on your return.

Tenants by the entirety. If you and your spouse held property as tenants by the entirety and you file separate returns, each of you can deduct only the taxes each of you paid on the property.

Divorced individuals. If your divorce or separation agreement states that you must pay the real estate taxes for a home owned by you and your spouse, part of your payments may be deductible as alimony and part as real estate taxes. See Publication 504, *Divorced or Separated Individuals,* for information.

Minister's and military personnel housing allowances. If you are a minister or a member of the uniformed services and receive a housing allowance that you can exclude from income, you still can deduct all of the real estate taxes you pay on your home.

Refund (or rebate). If you receive a refund or rebate in 1997 of real estate taxes you paid in 1997, you must reduce your deduction by the amount refunded to you. If you receive a refund or rebate in 1997 of real estate taxes you deducted in an earlier year, you generally must include the refund or rebate in income in the year you receive it. However, you only need to include the amount of the deduction that reduced your tax in the earlier year. For more information, see *Recoveries* in chapter 13.

TIP *If you did not itemize deductions in the year you paid the tax, do not report the refund as income.*

Real Estate Items You Cannot Deduct

The following are not deductible as real estate taxes:

- Taxes for local benefits,
- Trash and garbage pickup fees,
- Transfer taxes (or stamp taxes),
- Rent increases due to higher real estate taxes, and
- Homeowners association charges.

Taxes for local benefits. Deductible real estate taxes generally do not include taxes charged for local benefits and improvements that increase the value of your property. These include assessments for streets, sidewalks, water mains, sewer lines, public parking facilities, and similar improvements. You should increase the basis of your property by the amount of the assessment.

Local benefit taxes are deductible only if they are for maintenance, repair, or interest charges related to those benefits. If only a part of the taxes is for maintenance, repair, or interest, you must be able to show the amount of that part to claim the deduction. If you cannot determine what part of the tax is for maintenance, repair, or interest, none of it is deductible.

Taxes for local benefits may be included in your real estate tax bill. If your taxing authority (or mortgage lender) does not furnish you a copy of your real estate tax bill, ask for it. You should use the rules above to determine if the local benefit tax is deductible.

Trash and garbage pickup fees. Fees charged for trash and garbage pickup services are not deductible as taxes, even if the fees are paid to your local taxing authority. However, service charges used to maintain or improve services (such as trash collection or police and fire protection) are deductible as real estate taxes if:

- The fees or charges are imposed at a like rate against all property in the taxing jurisdiction,
- The funds collected are not earmarked; instead, they are commingled with general revenue funds, and
- Funds used to maintain or improve services are not limited to or determined by the amount of these fees or charges collected.

Transfer taxes (or stamp taxes). Transfer taxes and similar taxes and charges on the sale of a personal home are not deductible. If they are paid by the seller, they are expenses of the sale and reduce the amount realized on the sale. If paid by the buyer, they are included in the cost basis of the property.

Rent increase due to higher real estate taxes. If your landlord increases your rent in the form of a tax surcharge because of increased real estate taxes, you cannot deduct the increase as taxes.

Homeowners association charges. These charges are not deductible because they are imposed by the homeowners association, rather than the state or local government.

Personal Property Taxes

Personal property tax is deductible if it is a state or local tax that is:

1) Charged on personal property,
2) Based ***only*** on the value of the personal property, and
3) Charged on a yearly basis, even if it is collected more than once a year, or less than once a year.

A tax that meets the above requirements can be considered charged on personal property even if it is for the exercise of a privilege. For example, a yearly tax based on value qualifies as a personal property tax even if it is called a registration fee and is for the privilege of registering motor vehicles or using them on the highways.

Example. Your state charges a yearly motor vehicle registration tax of 1% of value plus 50 cents per hundredweight. You paid $32 based on the value ($1,500) and weight (3,400 lbs.) of your car. You can deduct $15 (1% × $1,500) as a personal property tax, since it is based on the value. The remaining $17 ($.50 × 34), based on the weight, is not deductible.

Taxes and Fees You Cannot Deduct

Many federal, state, and local government taxes are not deductible because they do not fall within the categories discussed earlier. Other taxes and fees are not deductible because they are specifically denied a deduction such as federal income taxes.

Taxes and fees that are generally not deductible include the following items.

- ***Estate, inheritance, legacy, or succession taxes.*** These taxes are generally not deductible. However, you can deduct the estate tax attributable to income in respect of a decedent if you must include that income in gross income. In that case, deduct the estate tax as a miscellaneous deduction that is not subject to the 2%-of-adjusted-gross-income limit. For more information, see *Estate Tax Deduction* in Publication 559, *Survivors, Executors, and Administrators.*
- ***Federal income taxes.*** This includes taxes withheld from your pay.
- ***Fines.*** You can not deduct penalties for violation of any law, including forfeiture of related collateral deposits.
- ***Gift taxes.***
- ***License fees.*** You cannot deduct fees for personal purposes (such as marriage, driver's, dog, etc.).
- ***Social security.*** This includeds social security, Medicare, or railroad retirement taxes withheld from your pay.
- ***Social security and other employment taxes for household workers.*** You generally cannot deduct the social security or other employment taxes you pay on the wages of a household worker. However, you may be able to include them in medical or child care expenses. For more information, see chapters 23 and 33.

Many taxes and fees other than those listed above are also nondeductible, unless they are ordinary and necessary expenses of a business or income-producing activity. For other nondeductible items, see *Real Estate Items You Cannot Deduct,* earlier.

Where To Deduct

You deduct taxes on the following schedules:

State and local income taxes. These taxes are deducted on line 5 of Schedule A (Form 1040), even if your only source of income is from business, rents, or royalties.

Foreign income taxes. Generally, income taxes you pay to a foreign country or U.S. possession can be claimed as an itemized deduction on line 8 of Schedule A (Form 1040), or as a credit against your U.S. income tax on Form 1116. For more information, get Publication 514.

Real estate taxes and personal property taxes. These taxes are deducted on lines 6 and 7 of Schedule A (Form 1040), unless they are paid on property used in your business or on property that produces rent or royalty income. See *Taxes on property producing rent or royalty income,* later.

Self-employment tax. Deduct one-half of your self-employment tax on line 26, Form 1040.

Taxes on property producing rent or royalty income. These taxes generally are deducted on Schedule E (Form 1040).

Other taxes. All other deductible taxes are deducted on line 8 of Schedule A (Form 1040).

25.

Interest Expense

Important Reminders

Personal interest. Personal interest is not deductible. Examples of personal interest include interest charged on credit cards, car loans, and installment plans.

Limit on itemized deductions. Certain itemized deductions (including home mortgage interest) are limited if your adjusted gross income is more than $121,200 ($60,600 if you are married filing a separate return). For more information, see chapter 22.

Points paid by seller. You may be able to deduct points paid on your mortgage by the person who sold you your home. See *Points* later in this chapter.

Introduction

This chapter discusses interest. Interest is the amount you pay for the use of borrowed money.

The types of interest you can deduct as itemized deductions on Schedule A (Form 1040) are:

- Home mortgage interest, including certain points, and
- Investment interest.

This chapter explains the deduction for home mortgage interest. It also explains where to deduct other types of interest and lists some types of interest you cannot deduct.

Use *Table 25–1* to find out where to get more information on other types of interest, including investment interest.

Useful Items

You may want to see:

Publication

☐ **936** Home Mortgage Interest Deduction

Form (and Instructions)

☐ **8396** Mortgage Interest Credit

Home Mortgage Interest

Generally, home mortgage interest is any interest you pay on a loan secured by your home (main home or a second home). The loan may be a mortgage to buy your home, a second mortgage, a line of credit, or a home equity loan.

You can deduct home mortgage interest only if you meet all the following tests.

- You must file Form 1040 and itemize deductions on Schedule A. (See *Where To Deduct,* later, for details about reporting home mortgage interest on Schedule A.)
- You must be legally liable for the loan. You cannot deduct payments you make for someone else if you are not legally liable to make them. Both you and the lender must intend that the loan be repaid. In addition, there must be a true debtor-creditor relationship between you and the lender.
- The mortgage must be a secured debt on a qualified home. (Generally, your mortgage is a secured debt if you put your home up as collateral to protect the interests of the lender. The term “qualified home” means your main home or second home. For details, see Publication 936.)

Limit on the Deduction of Mortgage Interest

In most cases, you will be able to deduct all of your home mortgage interest. Whether you can deduct all of it depends on the date you took out the mortgage, the amount of the mortgage, and your use of its proceeds.

Fully deductible interest. If all of your mortgages fit into one or more of the following three categories at all times during the year, you can deduct ***all*** of the interest on those mortgages. If any one mortgage fits into more than one category, add the debt that fits in each category to your other debt in the same category. (If one or more of your mortgages does not fit into any of these three categories, get Publication 936 to figure the amount of interest you can deduct.)

1) Mortgages you took out on or before October 13, 1987 (called grandfathered debt).

2) Mortgages you took out after October 13, 1987, to buy, build, or improve your home (called home acquisition debt), but only if these mortgages plus any grandfathered debt totaled $1 million or less ($500,000 or less if married filing separately) throughout 1997.

3) Mortgages you took out after October 13, 1987, other than to buy, build, or improve your home (called home equity debt), but only if throughout 1997 these mortgages totaled $100,000 or less ($50,000 or less if married filing separately) and all mortgages on the home totaled no more than its fair market value.

The dollar limits for the second and third categories apply to the combined mortgages on your main home and second home.

You can use *Figure 25–A* to check whether your interest is fully deductible.

Special Situations

This section describes certain items that can be included as home mortgage interest and others that cannot. It also describes certain special situations that may affect your deduction.

Late payment charge on mortgage payment. You can deduct as home mortgage interest a late payment charge if it was not for a specific service performed by your mortgage holder.

Mortgage prepayment penalty. If you pay off your home mortgage early, you may have to pay a penalty. You can deduct that penalty as home mortgage interest.

Sale of home. If you sell your home, you can deduct your allowable home mortgage interest paid up to, but not including, the date of sale.

Example. John and Peggy Harris sold their home on May 7. Through April 30, they made home mortgage interest payments of $1,220. The settlement sheet for the sale of the home showed $50 interest for the 6–day period in May up to, but not including, the date of sale. Their mortgage interest deduction is $1,270 ($1,220 + $50).

Prepaid interest. If you pay interest in advance for a period that goes beyond the end of the tax year, you must spread this interest over the tax years to which it applies. You can deduct in each year only the interest that qualifies as home mortgage interest for that year. However, see *Points,* later.

Mortgage interest credit. You may be able to claim a mortgage interest credit if you were issued a mortgage credit certificate (MCC) by a state or local government. Figure the credit on **Form 8396,** *Mortgage Interest Credit.* If you take this credit, you must reduce your mortgage interest deduction by the amount of the credit.

For more information on the credit, see chapter 36.

Ministers' and military housing allowance. If you are a minister or a member of the uniformed services and receive a housing allowance that is not taxable, you can still deduct all of the deductible interest on your home mortgage.

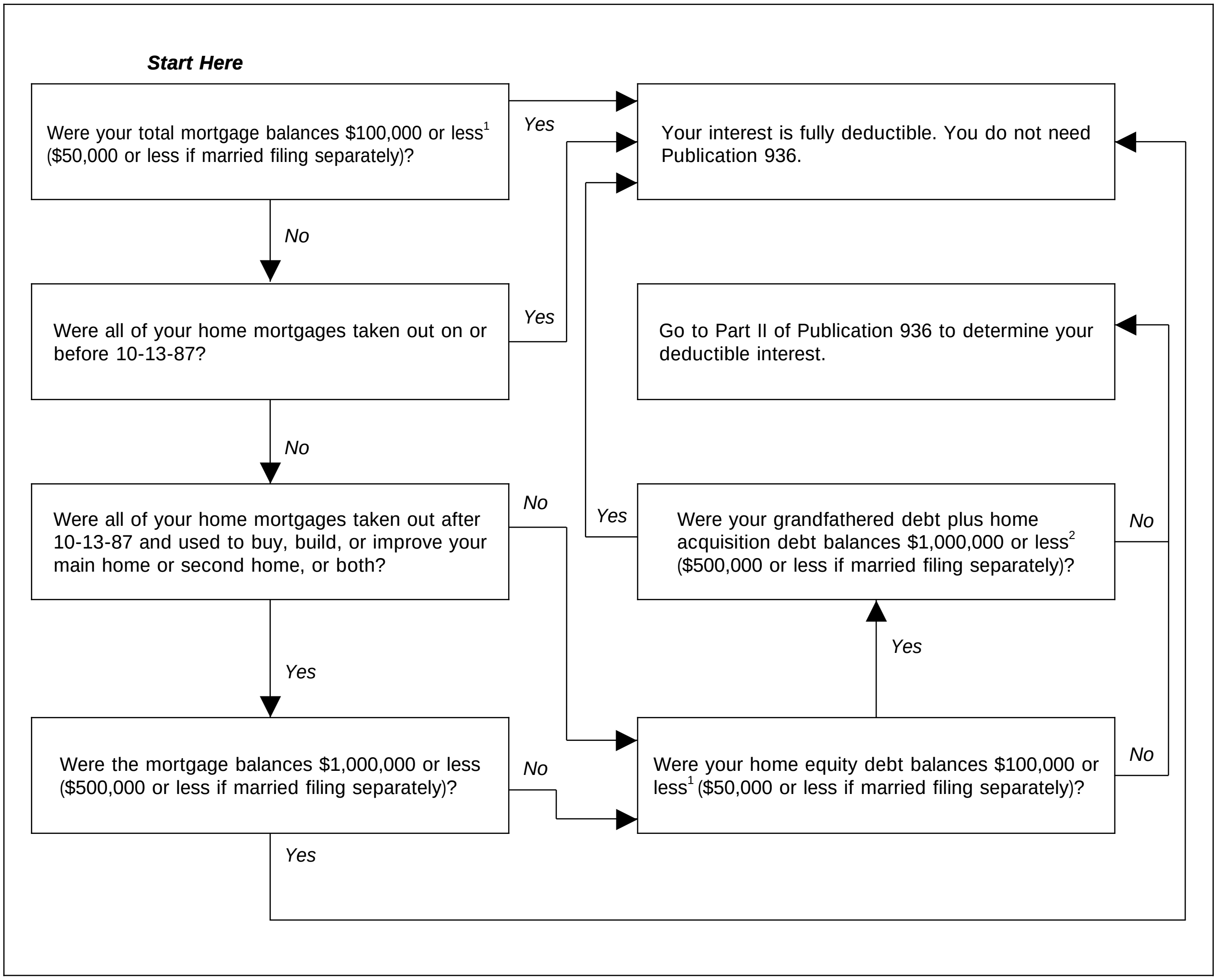
Graduated payment mortgages (GPM). GPMs under section 245 of the National Housing Act provide that monthly payments increase every year for a number of years and then stay the same. During the early years, payments are less than the amount of interest owed on the loan. The interest that is not paid becomes part of the principal. Future interest is figured on the increased unpaid mortgage loan balance.

Subject to any limits that apply, you can deduct the interest you actually paid during the year if you are a cash method taxpayer. For example, if the interest owed is $2,551 but your payment for the year is $2,517, you can deduct $2,517. Add $34 ($2,551 – $2,517) to the loan principal.

Mortgage assistance payments. If you qualify for mortgage assistance payments under section 235 of the National Housing

Figure 25-A. **Is My Interest Fully Deductible?**

(Instructions: Include balances of ALL mortgages secured by your main home and second home. Answer YES only if the answer is true at ALL times during the year.)



[1]If all mortgages on your main or second home exceed the home's fair market value, a lower limit may apply. See *Home equity debt limit* under *Home Equity Debt* in Part II of Publication 936.

[2]Amounts over the $1,000,000 limit ($500,000 if married filing separately) qualify as home equity debt if they are not more than the total home equity debt limit. See Publication 936 for more information about grandfathered debt, home acquisition debt, and home equity debt.

Act, part or all of the interest on your mortgage may be paid for you. You cannot deduct the interest that is paid for you.

No other effect on taxes. Do not include these mortgage assistance payments in your income. Also, do not use these payments to reduce other deductions, such as real estate taxes.

Divorced or separated individuals. If a divorce or separation agreement requires you or your spouse or former spouse to pay home mortgage interest on a home owned by both of you, see the discussion of *Payments for jointly-owned home* in chapter 20.

Redeemable ground rents. If you make annual or periodic rental payments on a redeemable ground rent, you can deduct them as mortgage interest.

Payments made to end the lease and to buy the lessor's entire interest in the land are not ground rents. You cannot deduct them. For more information, see Publication 936.

Nonredeemable ground rent. Payments on a nonredeemable ground rent are not interest. You can deduct them as rent if they are a business expense or if they are for rental property held to produce income.

Refunds of interest. If you receive a refund of interest in the same tax year you paid it, you must reduce your interest expense by the amount refunded to you. If you receive a refund of interest you deducted in an earlier year, you generally must include the refund in income in the year you receive it. However, you need to include it only up to the amount of the deduction that reduced your tax in the earlier year.

If you received a refund of interest you overpaid in an earlier year, you generally will receive a Form 1098, *Mortgage Interest Statement,* showing the refund in box 3. For information about Form 1098, see *Mortgage Interest Statement,* later.

For more information on how to treat refunds of interest deducted in earlier years, see *Recoveries* in chapter 13.

Rental payments. If you live in a house before final settlement on the purchase, any payments you make for that period are rent, not interest, even if the settlement papers call them interest. You cannot deduct these payments as interest.

Reverse mortgage loans. A reverse mortgage loan is a loan that is based on the value of your home and is secured by a mortgage on your home. The lending institution pays you the proceeds of the loan in installments over a period of months or years. The loan agreement may provide that interest will be added to the outstanding loan balance monthly as it accrues. If you are a cash method taxpayer, you deduct the interest on a reverse mortgage loan when you actually pay it, not when it is added to the outstanding loan balance.

Your deduction may be limited because a reverse mortgage loan generally is subject to the limit on home equity debt discussed earlier under *Limit on the Deduction of Mortgage Interest*.

Mortgage proceeds invested in tax-exempt securities. You cannot deduct the interest on grandfathered debt or home equity debt if you used the proceeds of the mortgage to buy securities or certificates that produce tax-free income. Grandfathered debt and home equity debt are defined earlier under *Limit on the Deduction of Mortgage Interest*.

Points

The term “points” is used to describe certain charges paid, or treated as paid, by a borrower to obtain a home mortgage. Points may also be called loan origination fees, maximum loan charges, loan discount, or discount points.

A borrower is treated as paying any points that a home seller pays for the borrower's mortgage. See *Points paid by a seller,* later.

General rule. You cannot deduct the full amount of points in the year paid. Because they are prepaid interest, you must spread the points over the life (term) of the mortgage. Generally, you can deduct an equal portion in each year of the mortgage.

Exception. You can deduct in 1997 the entire amount paid on your loan as points if all the following are true.

1) Your loan is secured by your main home. (Your main home is the one you live in most of the time.)
2) Paying points is an established business practice in the area where the loan was made.
3) The points paid were not more than the points generally charged in that area.
4) You use the cash method of accounting. This means you report income in the year you receive it and deduct expenses in the year you pay them. (If you want more information about this method, see *Accounting Methods* in chapter 1.)
5) The points were not paid in place of amounts that ordinarily are stated separately on the settlement statement, such as appraisal fees, inspection fees, title fees, attorney fees, and property taxes.
6) You use your loan to buy or build your main home.
7) The points were computed as a percentage of the principal amount of the mortgage.
8) The amount is clearly shown on the settlement statement (for example, Form HUD–1) as points charged for the mortgage. The points may be shown as paid from either your funds or the seller's.
9) The funds you provided at or before closing, plus any points the seller paid, were at least as much as the points charged. The funds you provided do not have to have been applied to the points. They can include a down payment, an escrow deposit, earnest money, and other funds you paid at or before closing for any purpose. You cannot have borrowed these funds from your lender or mortgage broker.

Home improvement loan. You can deduct in 1997 the entire amount of points paid on a loan to improve your main home, if statements (1) through (5) above are true.

Figure 25–B. You can use *Figure 25–B* as a quick check to see if points are fully deductible in the year paid.

Amounts charged for services. Amounts charged by the lender for specific services connected to the loan are not interest. Examples are appraisal fees, notary fees, and preparation costs for the mortgage note or deed of trust. You cannot deduct these amounts as points either in the year paid or over the life of the mortgage. For information about the tax treatment of these amounts and other settlement fees and closing costs, see chapter 14.

However, an amount shown on your settlement statement as points may be deductible in the year paid under the *Exception* to the *General rule,* even if it is for services in connection with your mortgage (whether VA, FHA, or conventional). The services must not be any of the specific services for which a charge ordinarily is stated separately on the settlement statement, as described in test (5) of the *Exception.* The other tests under the *Exception* also must be met.

Points paid by a seller. The term “points” includes loan placement fees that the seller pays to the lender to arrange financing for the buyer.

Treatment by seller. The seller ***cannot*** deduct these fees as interest. But they are a selling expense that reduces the seller's amount realized. See chapter 16 for information on how to treat the expenses of selling your home.

Treatment by buyer. The buyer reduces the basis of the home by the amount of the seller-paid points and treats the points as if he or she had paid them. If all the tests under the *Exception* are met, the buyer deducts the points in the year paid. If any of those tests is not met, the buyer deducts the points over the life of the loan.

For information about basis, see chapter 14.

Funds provided are less than points. If you meet all the tests in the *Exception* except that the funds you provided were less than the points charged to you (test 9), you can deduct the points in the year paid, up to the amount of funds you provided. In addition, you can deduct any points paid by the seller.

Example 1. When you took out a $100,000 mortgage loan to buy your home in December 1997, you were charged one point ($1,000). You meet all the nine tests for deducting points in the year paid, except the only funds you provided were a $750 down payment. Of the $1,000 charged for points, you can deduct $750 in 1997.

Example 2. The facts are the same as in Example 1, except that the person who sold you your home also paid one point ($1,000) to help you get your mortgage. In 1997, you can deduct $1,750 ($750 of the amount you were charged plus the $1,000 paid by the seller). You must reduce the basis of your home by the $1,000 paid by the seller.

Excess points. If you meet all the tests in the *Exception* except that the points paid were more than are generally paid in your area (test 3), your deduction in 1997 is limited to the points generally charged. Any additional amount of points paid is interest paid in advance, and you must spread the deduction over the life of the mortgage.

Second home. The *Exception* does not apply to points you pay on loans secured by your second home. You can deduct these points only over the life of the loan.

Mortgage ending early. If you spread your deduction for points over the life of the mortgage, you can deduct any remaining balance in the year the mortgage ends. A mortgage may end early due to a prepayment, refinancing, foreclosure, or similar event.

Example. Dan refinanced his mortgage in 1992 and paid $3,000 in points that he had to spread out over the life of the mortgage. He had deducted $1,000 of these points through 1996.

Dan prepaid his mortgage in full in 1997. He can deduct the remaining $2,000 of points in 1997.

Refinancing. Generally, points you pay to refinance a mortgage are not deductible in full in the year you pay them. This is true even if the new mortgage is secured by your main home. However, if you use part of the refinanced mortgage proceeds to ***improve your main home*** and you meet the first five tests listed under the *Exception,* earlier, you can fully deduct the part of the points related to the improvement in the year paid. You can deduct the remainder of the points over the life of the loan.

For more information on refinancing, see Publication 936.

Limits on deduction. You cannot fully deduct points on a mortgage that exceeds the *Limit on the Deduction of Mortgage Interest* discussed earlier. See Publication 936 for details.

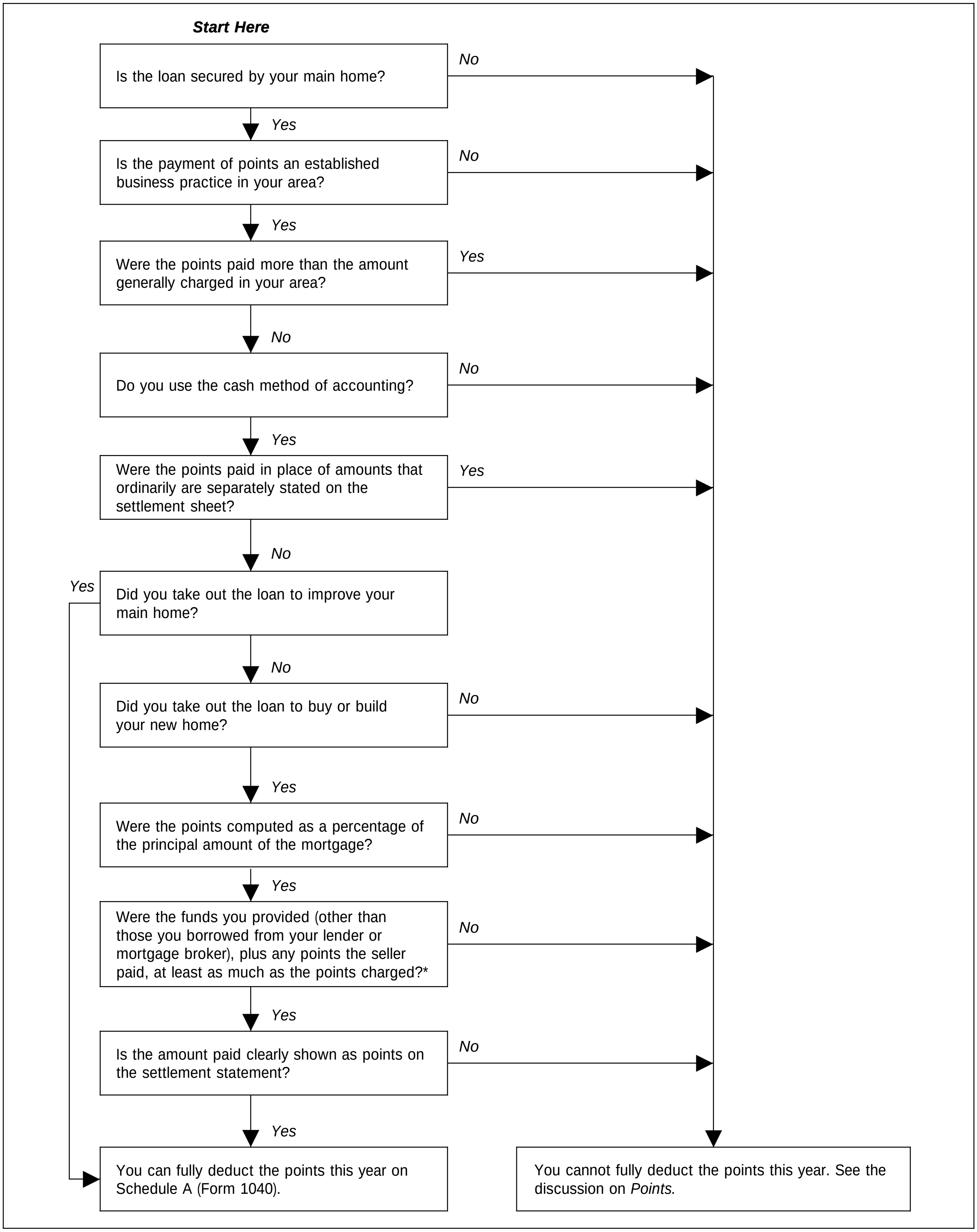
Mortgage Interest Statement

If you paid $600 or more of mortgage interest (including certain points) during the year on any one mortgage, you generally will receive a **Form 1098,** *Mortgage Interest Statement,* or a similar statement. You will receive the statement if you pay interest to a person (including a financial institution or a cooperative housing corporation) in the course of that person's trade or business. A governmental unit is a person for purposes of furnishing the statement.

You should receive the statement by February 2, 1998. The mortgage interest information will also be sent to the IRS.

The statement will show the total interest you paid during the year. If you purchased

Figure 25-B. **Are My Points Fully Deductible This Year?**



*The funds you provided do not have to have been applied to the points. They can include a down payment, an escrow deposit, earnest money, and other funds you paid at or before closing for any purpose.

a main home during 1997, it will also show the deductible points paid during the year, including seller-paid points. However, it should not show any interest that was paid for you by a government agency.

As a general rule, Form 1098 will include only points that you can fully deduct in the year paid. However, certain points not included on Form 1098 also may be deductible, either in the year paid or over the life of the loan. See *Points,* earlier, to determine whether you can deduct points not shown on Form 1098.

Prepaid interest on Form 1098. If you prepaid interest in 1997 that accrued in full by January 15, 1998, this prepaid interest may be included in box 1 of Form 1098. However, even though the prepaid amount may be included in box 1, you cannot deduct the prepaid amount in 1997. (See *Prepaid interest,* earlier.) You will have to figure the interest that accrued for 1998 and subtract it from the amount in box 1. You will include the interest for 1998 with the other interest you pay for 1998. See *Where To Deduct,* later.

More than one borrower. If you and at least one other person (other than your spouse if you file a joint return) were liable for, and paid, interest on a mortgage that was for your home and the other person received a Form 1098 showing the interest that was paid during the year, attach a statement to your return explaining this. Show how much of the interest each of you paid, and give the name and address of the person who received the form. Deduct your share of the interest on line 11, Schedule A, and write “See attached.”

If you are the payer of record on a mortgage on which there are other borrowers entitled to a deduction for the interest shown on the Form 1098 you received, deduct only your share of the interest on line 10, Schedule A. You should tell each of the other borrowers what their share is.

Refunded interest. If you received a refund of interest you overpaid in an earlier year, you generally will receive a Form 1098 showing the refund in box 3. See *Refunds of interest,* earlier.

Items You Cannot Deduct

Some interest payments are not deductible. Certain expenses similar to interest also are not deductible. These items include:

- Personal interest
- Service charges (however, see *Other Expenses* in chapter 30)
- Annual fees for credit cards
- Loan fees
- Credit investigation fees
- FHA mortgage insurance premiums and VA funding fees
- Interest to purchase or carry tax-exempt securities

Table 25-1. **Where To Deduct Your Interest**

Type of interest	☞ Where to deduct	☞ Where to find information
Deductible home mortgage interest and points reported on Form 1098	Schedule A (Form 1040), line 10	Publication 936
Deductible home mortgage interest *not* reported on Form 1098	Schedule A (Form 1040), line 11	Publication 936
Points *not* reported on Form 1098	Schedule A (Form 1040), line 12	Publication 936
Investment interest (other than interest incurred to produce rents or royalties)	Schedule A (Form 1040), line 13	Publication 550
Business interest (non-farm)	Schedule C or C-EZ (Form 1040)	Publication 535
Farm business interest	Schedule F (Form 1040)	Publications 225 and 535
Interest incurred to produce rents or royalties	Schedule E (Form 1040)	Publications 527 and 535
Personal interest	Not Deductible	

Penalties. You cannot deduct fines and penalties for violations of law, regardless of their nature.

Personal Interest

Personal interest is not deductible. Personal interest is any interest that is not home mortgage interest, investment interest, or business interest.

Personal interest includes such items as:

- Interest on car loans (unless you are self-employed and use the car in your business),
- Interest on income tax paid to the IRS or to a state or local tax agency,
- Credit card finance charges,
- Retail installment contract finance charges,
- Revolving charge account finance charges, and
- Late payment charge by a public utility.

Allocation of Interest

If you use the proceeds of a loan for more than one purpose (for example, personal and business), you must allocate the interest on the loan to each use. However, you do not have to allocate home mortgage interest if it is fully deductible regardless of how the funds are used.

You allocate interest (other than fully deductible home mortgage interest) on a loan in the same way as the loan itself is allocated. You do this by tracing disbursements of the debt to specific uses. For details on how to do this, see chapter 8 of Publication 535.

Where To Deduct

You must file Form 1040 to deduct any interest expense on your tax return. Where you deduct your interest expense generally depends on how you use the loan proceeds. See *Table 25–1* for a summary of where to deduct your interest expense.

Home mortgage interest and points. Deduct the interest and points reported to you on Form 1098 on line 10 of Schedule A (Form 1040). If you paid more deductible interest to the financial institution than the amount shown on Form 1098, show the larger deductible amount on line 10. Attach a statement explaining the difference and write “See attached” next to line 10.

Deduct home mortgage interest that was ***not*** reported to you on Form 1098 on line 11 of Schedule A (Form 1040). If you paid home mortgage interest to the person from whom you bought your home, show that person's name, address, and taxpayer identification number (TIN) on the dotted lines next to line 11. The seller must give you this number and you must give the seller your TIN. Failure to meet any of these requirements may result in a $50 penalty for each failure. The TIN can be either a social security number, an individual taxpayer identification number (issued by the Internal Revenue Service), or an employer identification number. See *Social Security Number* in chapter 1 for more information about TINs.

If you can take a deduction for points that were ***not*** reported to you on Form 1098, deduct those points on line 12 of Schedule A (Form 1040).

Mortgage proceeds used for business or investment. If your home mortgage interest deduction is limited by the *Limit on the Deduction of Mortgage Interest* explained earlier, but all or part of the mortgage proceeds were used for business or investment activities, see *Table 25–1.* It shows where to deduct the part of your excess interest that is for those activities.

Investment interest. Deduct investment interest, subject to certain limits discussed in Publication 550, on line 13, Schedule A (Form 1040).

Amortization of bond premium. There are various ways to treat the premium you pay to buy taxable bonds. See *Bond Premium Amortization* in Publication 550.

Income-producing rental or royalty interest. Deduct interest on a loan for income-producing rental or royalty property that is not used in your business in Part I of Schedule E (Form 1040).

Example. You rent out part of your home and borrow money to make repairs. You can deduct only the interest payment for the rented part in Part I of Schedule E (Form 1040). Deduct the rest of the interest payment on Schedule A (Form 1040) if it is deductible home mortgage interest.

26. Contributions

Important Change for 1997

Donations of appreciated stock. The special rule allowing a deduction for the full fair market value of qualified appreciated stock given to certain private foundations has been extended from May 31, 1997 to June 30, 1998. See *Capital gain property,* later, under *Giving Property That Has Increased in Value.*.

Important Change for 1998

Standard mileage rate increase. Beginning in 1998, the standard mileage rate you can deduct for the use of your car in giving services to a charitable organization increases from 12 cents per mile to 14 cents per mile. See *Car expenses,* later, under *Out-of-Pocket Expenses in Giving Services.*

Important Reminders

Disaster relief. You can deduct contributions earmarked for "Earthquake Disaster Relief" or other disaster relief to a qualified organization (defined later under *Organizations That Qualify To Receive Deductible Contributions*). However, you cannot deduct contributions earmarked for relief of a particular individual or family.

Written acknowledgement required. You can claim a deduction for a contribution of $250 or more only if you have a written acknowledgement of your contribution from the qualified organization. For more information, see *Records To Keep,* later in this chapter.

Payment partly for goods or services. A qualified organization that receives a payment from you must give you a written statement if the payment is more than $75 and is partly a contribution and partly for goods or services. The statement must tell you that you can deduct only the amount of your payment that is more than the value of the goods or services you received. See *Contributions From Which You Benefit,* later in this chapter, for more information.

Introduction

This chapter discusses:

- Organizations that are qualified to receive charitable contributions,
- The types of contributions you can deduct,
- How much you can deduct,
- What records to keep, and
- How to report your charitable contributions.

A ***charitable contribution*** is a donation or gift to, or for the use of, a qualified organization. It is voluntary and is made without getting, or expecting to get, anything of equal value.

To deduct a charitable contribution, you must file Form 1040 and itemize deductions on Schedule A. The amount of your deduction may be limited if certain rules and limits explained in this chapter apply to you.

Useful Items

You may want to see:

Publication

- ☐ **78** Cumulative List of Organizations
- ☐ **526** Charitable Contributions
- ☐ **561** Determining the Value of Donated Property

Form (and Instructions)

- ☐ **Schedule A (Form 1040)** Itemized Deductions
- ☐ **8283** Noncash Charitable Contributions

Organizations That Qualify To Receive Deductible Contributions

You can deduct your contributions only if you make them to a ***qualified organization.*** To become a qualified organization, most organizations other than churches and governments, as described below, must apply to the IRS.

TIP *You can ask any organization whether it is a qualified organization, and most will be able to tell you. Or you can check IRS Publication 78, which lists most qualified organizations. You may find Publication 78 in your local library's reference section. If not, you can call the IRS tax help telephone number for your area listed in your tax forms package to find out if an organization is qualified. If you have a computer, you can find the entire contents of Publication 78 on the internet at the IRS's website (http://irs.ustreas.gov).*

Types of Qualified Organizations

Generally, only the five following types of organizations can be qualified organizations:

1) ***A community chest, corporation, trust, fund, or foundation*** organized or created in or under the laws of the United States, any state, the District of Columbia, or any possession of the United States (including Puerto Rico). ***It must be organized and operated only for:***

   a) Charitable,

   b) Religious,

   c) Scientific,

   d) Literary, or

   e) Educational purposes, or

   f) The prevention of cruelty to children or animals.

   Certain organizations that foster national or international sports competition also qualify.

2) ***War veterans' organizations,*** including posts, auxiliaries, trusts, or foundations, organized in the United States or any of its possessions.

3) ***Domestic fraternal societies,*** orders, and associations operating under the lodge system.
   Note: Your contribution to this type of organization is deductible only if it is to be used solely for charitable, religious, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals.

4) ***Certain nonprofit cemetery*** companies or corporations.
   Note: Your contribution to this type of organization is not deductible if it can be used for the care of a specific lot or mausoleum crypt.

5) ***The United States or*** any state, the District of Columbia, a U.S. possession (including Puerto Rico), a political subdivision of a state or U.S. possession, or an Indian tribal government or any of its subdivisions that perform substantial government functions.
   Note: To be deductible, your contribution to this type of organization must be made solely for public purposes.

Examples. Qualified organizations include:

- Churches, a convention or association of churches, temples, synagogues, mosques, and other religious organizations. However, if such religious organizations were not organized in the United States or its possessions, they are not qualified organizations. There are exceptions for certain contributions to ***Canadian*** and ***Mexican*** charities discussed later.
- Most nonprofit charitable organizations such as the Red Cross and the United Way.
- Most nonprofit educational organizations, including the Girl (and Boy) Scouts of America, colleges, museums, and day care centers if substantially all the child care provided is to enable individuals (the parents) to be gainfully employed and the services are available to the general public. However, if your contribution is a substitute for tuition or other enrollment fee, it is not deductible as a charitable contribution, as explained later under *Contributions You Cannot Deduct.*
- Nonprofit hospitals and medical research organizations.

- Utility company emergency energy programs, if the utility company is an agent for a charitable organization that assists individuals with emergency energy needs.
- Nonprofit volunteer fire companies.
- Public parks and recreation facilities.
- Civil defense organizations.

Canadian charities. You may be able to deduct contributions to certain Canadian charitable organizations covered under an income tax treaty with Canada. To deduct your contribution to a Canadian charity, you must generally have income from sources in Canada. See Publication 597, *Information on the United States–Canada Income Tax Treaty,* for information on how to figure your deduction.

Mexican charities. You may be able to deduct contributions to certain Mexican charitable organizations under an income tax treaty with Mexico. The organization must meet tests that are essentially the same as the tests that qualify U.S. organizations to receive deductible contributions. To deduct your contribution, you must have income from sources in Mexico. If you need more information, see Publication 526.

Contributions You Can Deduct

Generally, you can deduct your contributions of money or property that you make to, or for the use of, a qualified organization. A gift or contribution is "for the use of" a qualified organization when it is held in a legally enforceable trust for the qualified organization or in a similar legal arrangement.

If you give property to a qualified organization, you generally can deduct the fair market value of the property at the time of the contribution. See *Contributions of Property,* later in this chapter.

Your deduction for charitable contributions is generally limited to 50% of your adjusted gross income, but in some cases 20% and 30% limits may apply. See *Limit on Deductions,* later.

Table 26–1 lists some examples of contributions you can deduct and some that you cannot deduct.

Table 26-1. **Examples of Charitable Contributions—A Quick Check**

Use the following lists for a **quick check** of contributions you can or cannot deduct. See the rest of this chapter for more information and additional rules and limits that may apply.

Deductible As Charitable Contributions	**Not Deductible As Charitable Contributions**
Money or property you give to:	Money or property you give to:
• Churches, synagogues, temples, mosques, and other religious organizations.	• Civic leagues, social and sports clubs, labor unions, and chambers of commerce
• Federal, state, and local governments, if your contribution is solely for public purposes (for example, a gift to reduce the public debt)	• Foreign organizations (except certain Canadian and Mexican charities)
• Nonprofit schools and hospitals	• Groups that are run for personal profit
• Public parks and recreation facilities	• Groups whose purpose is to lobby for law changes
• Salvation Army, Red Cross, CARE, Goodwill Industries, United Way, Boy Scouts, Girl Scouts, Boys and Girls Clubs of America, etc.	• Homeowners' associations
• War veterans' groups	• Individuals
	• Political groups or candidates for public office
Costs you pay for a student living with you, sponsored by a qualified organization	Cost of raffle, bingo, or lottery tickets
Out-of-pocket expenses when you serve a qualified organization as a volunteer	Dues, fees, or bills paid to country clubs, lodges, fraternal orders, or similar groups
	Tuition
	Value of your time or services
	Value of blood given to a blood bank

Contributions From Which You Benefit (Payments partly for goods or services)

If you receive a benefit as a result of making a contribution to a qualified organization, you can ***deduct only the amount*** of your contribution ***that is more than the value of the benefit*** you receive. Also see *Contributions From Which You Benefit,* under *Contributions You Cannot Deduct,* later.

If you pay more than fair market value to a qualified organization for merchandise, goods, or services, the amount you pay that is more than the value of the item can be a charitable contribution. For the excess amount to qualify, you must pay it with the intent to make a charitable contribution.

Example 1. You pay $65 for a ticket to a dinner-dance at a church. All of the proceeds of the function go to the church. The ticket to the dinner-dance has a fair market value of $25. When you buy your ticket you know that its value is less than your payment. To figure the amount of your charitable contribution, you subtract the value of the benefit you received ($25) from your total payment ($65). You can deduct $40 as a contribution to the church.

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

Athletic events. If you make a payment to, or for the benefit of, a college or university and, as a result, you receive the right to buy tickets to an athletic event in the athletic stadium of the college or university, you can deduct 80% of the payment as a charitable contribution.

If any part of your payment is for tickets (rather than the right to buy tickets), that part is not deductible. In that case, subtract the price of the tickets from your payment. 80% of the remaining amount is a charitable contribution.

Example 1. You pay $300 a year for membership in an athletic scholarship program maintained by a university (a qualified organization). The only benefit of membership is that you have the right to buy one season ticket for a seat in a designated area of the stadium at the university's home football games. You can deduct $240 (80% of $300) as a charitable contribution.

Example 2. The facts are the same as in Example 1 except that your $300 payment included the purchase of one season ticket for the stated ticket price of $120. You must subtract the usual price of a ticket ($120) from your $300 payment. The result is $180. Your deductible charitable contribution is $144 (80% of $180).

Charity benefit events. If you pay a qualified organization more than fair market value for the right to attend a charity ball, banquet, show, sporting event, or other benefit event, you can deduct only the amount that is more than the value of the privileges or other benefits you receive.

If there is an established charge for the event, that charge is the value of your benefit. If there is no established charge, your contribution is that part of your payment that is more than the reasonable value of the right to attend the event. Whether you use the tickets or other privileges has no effect on the amount you can deduct. However, if you return the ticket to the qualified organization for resale, you can deduct the entire amount you paid for the ticket.

Even if the ticket or other evidence of payment indicates that the payment is a "contribution," this does not necessarily mean you can deduct the entire amount. If the ticket shows the price of admission and the amount of the contribution, you can deduct the contribution amount.

Example. You pay $40 to see a special showing of a movie for the benefit of a qualified organization. Printed on the ticket is “Contribution—$40.” If the regular price for the movie is $8, your contribution is $32 ($40 payment – $8 regular price).

Membership fees or dues. You may be able to deduct membership fees or dues you pay to a qualified organization. However, you can deduct only the amount that is more than the value of the benefits you receive. You cannot deduct dues, fees, or assessments paid to country clubs and other social organizations. They are not qualified organizations.

Certain membership benefits can be disregarded. Both you and the organization can disregard certain membership benefits when they are provided in return for an annual payment of $75 or less to the qualified organization. You can pay more than $75 to the organization, if the organization does not require a larger payment for you to receive the benefits. The benefits covered under this rule are:

1) Any rights or privileges, other than those discussed under *Athletic events* earlier, that you can use frequently while you are a member, such as:
   a) Free or discounted admission to the organization's facilities or events,
   b) Free or discounted parking,
   c) Preferred access to goods or services, and
   d) Discounts on the purchase of goods and services;
2) Admission, while you are a member, to events that are open only to members of the organization, if the organization reasonably projects that the cost per person (excluding any allocated overhead) is not more than $6.90 (for 1997 events). This amount may be adjusted annually for inflation.

Token items. You can deduct your entire payment to a qualified organization as a charitable contribution, if both of the following are true:

1) You receive:
   a) As a result of the payment, low-cost items such as bookmarks, calendars, mugs, or caps that have on them the organization's name or logo, or
   b) A low-cost item that you did not order and can keep even if you do not make a contribution.
2) The qualified organization correctly informs you that the value of the item you received is not substantial and that you can deduct your payment in full.

Written statement. A qualified organization must give you a written statement if you make a payment to it that is more than $75 and is partly a contribution and partly for goods or services. The statement must tell you that you can deduct only the amount of your payment that is more than the value of the goods or services you received. It must also give you a good faith estimate of the value of those goods or services.

The organization can give you the statement either when it solicits or when it receives the payment from you.

An organization will not have to give you this statement if one of the following is true:

1) The organization is:
   a) The type of organization described in (5) under *Types of Qualified Organizations,* earlier, or
   b) Formed only for religious purposes, and the only benefit you receive is an intangible religious benefit (such as admission to a religious ceremony) that generally is not sold in commercial transactions outside the donative context.
2) You receive only low-cost items as described under *Token items,* earlier.

Expenses Paid for Student Living With You

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

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

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

Mutual exchange program. You cannot deduct the costs of a foreign student living in your home under a mutual exchange program through which your child will live with a family in a foreign country.

For additional information, see *Expenses Paid for Student Living With You* in Publication 526, *Charitable Contributions.*

Out-of-Pocket Expenses in Giving Services

You may be able to deduct some amounts you pay in giving services to a qualified organization. The amounts must be:

- Unreimbursed,
- Directly connected with the services,
- Expenses you had only because of the services you gave, and
- Not personal, living, or family expenses.

Table 26–2 contains questions and answers that apply to some individuals who volunteer their services.

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

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

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

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

Foster parents. You can deduct some of the costs of being a foster parent (foster care provider) if you have no profit motive in providing the foster care and are not, in fact, making a profit.

You can deduct expenses that are:

1) Greater than any nontaxable payments you receive to provide foster care for individuals placed in your home by a charitable organization, and
2) Spent to provide support for those individuals.

For more information, see *Foster-care providers* under *Income Not Taxed* in chapter 13.

Car expenses. You can deduct unreimbursed out-of-pocket expenses, such as the cost of gas and oil, that are directly related to the use of your car in giving services to a charitable organization. You cannot deduct any part of general repair and maintenance expenses, depreciation, registration fees, or the costs of tires or insurance.

If you do not want to deduct your actual expenses, you can use a standard rate of ***12 cents a mile*** to figure your contribution.

TIP *Beginning in 1998, the standard mileage rate increases to 14 cents per mile.*

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

You must keep reliable written records of your car expenses. For more information, see *Car Expenses* under *Records To Keep,* later.

Travel. Generally, you can claim a charitable contribution deduction for travel expenses necessarily incurred while you are away from home performing services for a charitable organization only ***if there is no significant element of*** personal pleasure, recreation, or vacation in such travel. This applies whether you pay the expenses directly or indirectly. You are paying the expenses indirectly if you make a payment to the charitable organization and the organization pays for your travel expenses.

The deduction for travel expenses will not be denied simply because you enjoy

Table 26-2. **Volunteers' Questions and Answers**

*If you do volunteer work for a qualified organization, the following questions and answers may apply to you. All of the rules explained in this chapter also apply. See, in particular, **Out-of-Pocket Expenses in Giving Services.***

Question	Answer
I do volunteer work 6 hours a week in the office of a qualified organization. The receptionist is paid $6 an hour to do the same work I do. Can I deduct $36 a week for my time?	No, you cannot deduct the value of your time or services.
The office is 30 miles from my home. Can I deduct any of my car expenses for these trips?	Yes, you can deduct the costs of gas and oil that are directly related to getting to the qualified organization where you are a volunteer. If you don't want to figure your actual costs, you can deduct 12 cents for each mile.
I am a Red Cross nurse's aide at a hospital. Can I deduct the cost of uniforms that I must wear?	Yes, you can deduct the cost of buying and cleaning your uniforms if the hospital is a qualified organization, the uniforms are not suitable for everyday use, and you must wear them when volunteering.
I pay a babysitter to watch my children while I do volunteer work for a qualified organization. Can I deduct these costs?	No, you cannot deduct payments for child care expenses as a charitable contribution, even if they are necessary so you can do volunteer work for a qualified organization. (If you have child care expenses so you can work for pay, see Chapter 33.)

providing services to the charitable organization. Even if you enjoy the trip, you can take a charitable contribution deduction for your own travel expenses if you are on duty in a genuine and substantial sense throughout the trip. However, if you have only nominal duties relating to the performance of services for the charity, or for significant portions of the trip you are not required to render services, you cannot deduct your travel expenses.

Example 1. You are a troop leader for a tax-exempt youth group and take the group on a camping trip. You are responsible for overseeing the setup of the camp and for providing the adult supervision for the other activities during the entire trip. You participate in the activities of the group and really enjoy your time with them. You oversee the breaking of camp and you transport the group home. You can deduct your travel expenses.

Example 2. You sail from one island to another and spend 8 hours a day counting whales and other forms of marine life. The project is sponsored by a charitable organization. In most circumstances, you cannot deduct your expenses.

Example 3. You work for several hours each morning on an archaeological excavation sponsored by a charitable organization. The rest of the day is free for recreation and sightseeing. You cannot take a charitable contribution deduction even though you work very hard during those few hours.

Example 4. You spend the entire day attending a charitable organization's regional meeting as a chosen representative. In the evening you go to the theater. You can claim your travel expenses as charitable contributions, but you cannot claim the cost of your evening at the theater.

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

Deductible travel expenses. These include:

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

Because these travel expenses are not business-related, they are not subject to the same limits business-related expenses are. For information on business travel expenses, see *Travel Expenses* in chapter 28.

Contributions You Cannot Deduct

There are some contributions that you cannot deduct, such as those made to individuals (See *Contributions to Individuals,* next.) and those made to nonqualified organizations (See *Contributions to Nonqualified Organizations,* later.). There are others that you can deduct only part of as discussed later under *Contributions From Which You Benefit.*

Contributions To Individuals

You cannot deduct contributions to specific individuals, including:

- Contributions to fraternal societies made for the purpose of paying medical or burial expenses of ***deceased members.***
- Contributions to ***individuals who are needy or worthy.*** This includes contributions to a qualified organization if you indicate that your contribution is for a specific person. ***But*** you can deduct a contribution that you give to a qualified organization that in turn helps needy or worthy individuals if you do not indicate that your contribution is for a specific person.
- Payments to ***a member of the clergy*** that can be spent as he or she wishes, such as for personal expenses.
- Expenses you paid ***for another person*** who provided services to a qualified organization.

  Example. Your son does missionary work. You pay his expenses. You cannot claim a deduction for your son's unreimbursed expenses related to his contribution of services.
- Payments to a hospital that are for services for ***a specific patient*** or for a specific patient's care. You cannot deduct these payments even if the hospital is operated by a city, a state, or other qualified organization.

Contributions To Nonqualified Organizations

You cannot deduct contributions to organizations that are not qualified to receive tax-deductible contributions, including:

1) ***Certain state bar associations,*** if:
   a) The state bar is not a political subdivision of a state,
   b) The bar has private, as well as public, purposes, such as promoting the professional interests of members, and
   c) Your contribution is unrestricted and can be used for private purposes.
2) ***Chambers of commerce*** and other business leagues or organizations.
3) ***Civic leagues and associations.***
4) ***Communist organizations.***
5) ***Country clubs*** and other social clubs.
6) ***Foreign organizations.*** But you can deduct contributions you make to:

a) A U.S. organization that transfers funds to a charitable foreign organization if the U.S. organization controls the use of the funds, or if the foreign organization is only an administrative arm of the U.S. organization, or

b) Certain Canadian or Mexican charitable organizations. See *Canadian charities* and *Mexican charities* under *Organizations That Qualify To Receive Deductible Contributions,* earlier.

7) ***Homeowners' associations.***

8) ***Labor unions.*** (But you may be able to deduct union dues as a miscellaneous itemized deduction, subject to the 2% of adjusted gross income limit, on Schedule A (Form 1040). See chapter 30.)

9) ***Political organizations and candidates.***

Contributions From Which You Benefit

If you receive or expect to receive a financial or economic benefit as a result of making a contribution to a qualified organization, you cannot deduct the part of the contribution that represents the value of the benefit you receive. See *Contributions From Which You Benefit* under *Contributions You Can Deduct,* earlier. These contributions include:

- Contributions for ***lobbying.*** This includes amounts that you earmark for use in or in connection with influencing specific legislation.
- Contributions to a ***retirement home*** that are clearly for room, board, maintenance, or admittance. Also, if the amount of your contribution depends on the type or size of apartment you will occupy, it is not a charitable contribution.
- Costs of ***raffles, bingo, lottery, etc.*** You cannot deduct as a charitable contribution amounts you pay to buy raffle or lottery tickets or to play bingo or other games of chance. For more information on how to report gambling winnings and losses, see *Gambling Losses Up To the Amount of Gambling Winnings* in chapter 30.
- Dues to ***fraternal orders*** and similar groups. However, see *Membership fees or dues* earlier under *Contributions From Which You Benefit.*
- ***Tuition,*** or amounts you pay instead of tuition, even if you pay them for children to attend parochial schools or qualifying nonprofit day care centers. You also cannot deduct any fixed amount you may be required to pay in addition to the tuition fee to enroll in a private school, even if it is designated as a “donation.”

Value of Time or Services

You cannot deduct the value of your time or services, including:

- ***Blood donations*** to the Red Cross or to blood banks.
- ***The value of income lost*** while you work as an unpaid volunteer for a qualified organization.

Personal Expenses

You cannot deduct personal, living, or family expenses, such as:

- ***The cost of meals*** you eat while you perform services for a qualified organization, unless it is necessary for you to be away from home overnight while performing the services.
- ***Adoption expenses,*** including fees paid to an adoption agency and the costs of keeping a child in your home before adoption is final. However, you may be able to claim an exemption for the child. See *Adoption* in chapter 3.

Appraisal Fees

Fees that you pay to find the fair market value of donated property are not deductible as contributions. You can claim them, subject to the 2% of adjusted gross income limit, as miscellaneous deductions on Schedule A (Form 1040). See chapter 30.

Contributions of Property

If you contribute property to a qualified organization, the amount of your charitable contribution is generally the fair market value of the property at the time of the contribution. However, if the property has increased in value, you may have to make some adjustments to the amount of your deduction. See *Giving Property That Has Increased in Value,* later.

For information about the records you must keep and the information you must furnish with your return if you donate property, see *Records To Keep* and *How To Report,* later.

Partial interest in property. Generally, you cannot deduct a charitable contribution, not made by a transfer in trust, of less than your entire interest in property. A contribution of the right to use property, not made by a transfer in trust, is a contribution of less than your entire interest in that property and is not deductible. For exceptions and more information, see *Partial Interest in Property Not in Trust* in Publication 561.

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

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

Determining Fair Market Value

This section discusses general guidelines for determining the fair market value of various types of donated property. Fair market value is the price at which property would change hands between a willing buyer and a willing seller, neither having to buy or sell, and both having reasonable knowledge of all the relevant facts. Publication 561, *Determining the Value of Donated Property,* contains a more complete discussion.

Used clothing and household goods. Generally, the fair market value of used clothing and household goods is far less than its original cost.

For used clothing, you should claim as the value the price that buyers of used items actually pay in used clothing stores, such as consignment or thrift shops.

See *Household Goods* in Publication 561 for information on the valuation of household goods, such as furniture, appliances, and linens.

Cars, boats, and aircraft. If you contribute a car, boat, or aircraft, you must determine its fair market value.

Certain commercial firms and trade organizations publish guides, commonly called “blue books,” containing complete dealer sale prices or dealer average prices for recent model years. The guides may be published monthly or seasonally, and for different regions of the country. These guides also provide estimates for adjusting for unusual equipment, unusual mileage, and physical condition. The prices are not “official” and these publications are not considered an appraisal of any specific donated property. But they do provide clues for making an appraisal and suggest relative prices for comparison with current sales and offerings in your area.

Example. You donate your car to a local high school for use by their students studying automobile repair. Your credit union told you that the “blue book” value of the car is $1,600. However, your car needs extensive repairs and, after some checking, you find that you could sell it for $750. You can deduct $750, the ***true*** fair market value of the car, as a charitable contribution.

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

Giving Property That Has Decreased in Value

If you contribute property with a fair market value that is less than your basis in it, your deduction is limited to fair market value. You cannot claim a deduction for the difference between the property's basis and its fair market value.

Giving Property That Has Increased in Value

If you contribute property with a fair market value that is more than your basis in it, you may have to reduce the fair market value by the amount of appreciation (increase in value) when you figure your deduction.

Your "basis" in property is generally what you paid for it. See chapter 14 if you need more information about basis.

Different rules apply to figuring your deduction, depending on whether the property is:

1) Ordinary income property, or

2) Capital gain property.

Ordinary income property. Property is ordinary income property if its sale at fair market value on the date it was contributed would have resulted in ordinary income or in short-term capital gain. Examples of ordinary income property are inventory, works of art created by the donor, manuscripts prepared by the donor, and capital assets held one year or less.

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

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

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

Amount of deduction — general rule When figuring your deduction for a gift of capital gain property, you usually can use the ***fair market value*** of the gift.

Exceptions. However, in certain situations, you must reduce the fair market value by any amount that would have been long-term capital gain if you had sold the property for its fair market value. Generally, this means reducing the fair market value to the property's cost or other basis.

Bargain sales. A bargain sale of property to a qualified organization (a sale or exchange for less than the property's fair market value) is partly a charitable contribution and partly a sale or exchange. A bargain sale may result in a taxable gain.

For more information on donated appreciated property, see *Giving Property That Has Increased in Value* in Publication 526.

When To Deduct

You can deduct your contributions only in the year you actually make them in cash or other property (or in a later carryover year, as explained later under *Carryovers*). This applies whether you use the cash or an accrual method of accounting.

Usually, you make a contribution at the time of its unconditional delivery. For example, a check that you mail to a charity is considered delivered on the date you mail it. Contributions charged on your bank credit card are deductible in the year you make the charge. If you use a pay-by-phone account, the date you make a contribution is the date the financial institution pays the amount. This date should be shown on the statement the financial institution sends to you.

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

If you issue and deliver a promissory note to a charitable organization as a contribution, it is not a contribution until you make the note payments. Similarly, if you grant an option to buy real property at a bargain price to a charitable organization, you cannot take a deduction until the organization exercises the option.

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

Limit on Deductions

If your total contributions for the year are 20% or less of your adjusted gross income, you do not need to read this section. The limits discussed here do not apply to you.

The amount of your deduction may be limited to either ***20%, 30%, or 50%*** of your adjusted gross income, depending on the type of property you give and the type of organization you give it to. These limits are described below.

If your contributions are more than any of the limits that apply, see *How To Figure Your Deduction When Limits Apply,* in Publication 526.

50% Limit

This limit applies to the total of all charitable contributions you make during the year. This means that your deduction for charitable contributions cannot be more than 50% of your adjusted gross income for the year.

The 50% limit is the only limit that applies to gifts to organizations listed below under *50% limit organizations.* But there is one ***exception.*** The 30% limit also applies to such gifts if they are gifts of capital gain property for which you figure your deduction using fair market value without reduction for appreciation. (See *30% Limit,* later.)

50% limit organizations. You can ask any organization whether it is a 50% limit organization and most will be able to tell you. The following is a partial list of the types of organizations that are 50% limit organizations:

1) Churches, and conventions or associations of churches,

2) Educational organizations,

3) Hospitals and certain medical research organizations associated with these hospitals,

4) Publicly supported charities,

5) Private operating foundations,

6) Private nonoperating foundations that make qualifying distributions of 100% of contributions within 2½ months following the year they receive the contribution, and

7) Certain private foundations whose contributions are pooled in a common fund, the income and principal of which are paid to public charities.

30% Limit

This limit applies to:

- Gifts (other than capital gain property — see *20% Limit,* later) ***for the use of*** any organization, and
- Gifts (other than capital gain property — see *20% Limit,* later) to all qualified organizations other than 50% limit organizations (see *Capital gain property given to 50% limit organizations,* below). This includes gifts to veterans' organizations, fraternal societies, nonprofit cemeteries, and certain private nonoperating foundations.

Capital gain property given to 50% limit organizations. Generally, the 30% limit applies to gifts of capital gain property to 50% limit organizations. For gifts to other organizations, see *20% Limit,* later.

Exception. There is one exception to this general rule. The 30% limit does not apply when you choose to reduce the fair market value of the property by the amount that would have been long-term capital gain if you had sold the property. Instead, only the 50% limit applies. For more information, see the rules for electing the 50% limit for capital gain property under *How To Figure Your Deduction When Limits Apply* in Publication 526.

20% Limit

This limit applies to all gifts of capital gain property to or for the use of qualified organizations other than gifts of capital gain property to 50% limit organizations.

Carryovers

You can carry over your contributions that you are not able to deduct in the current year because they exceed your adjusted gross income limits. You can deduct the excess in each of the next 5 years until it is used up, but not beyond that time. For more information, see *Carryovers* in Publication 526.

Records To Keep

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

Note. An organization generally must give you a written statement if it receives a payment from you that is more than $75 and is partly a contribution and partly for goods or services. (See *Contributions From Which You Benefit* under *Contributions You Can Deduct,* earlier.) Keep the statement for your records. It may satisfy all or part of the recordkeeping requirements explained in the following discussions.

Cash Contributions

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

For a contribution made in cash, the records you must keep depend on whether the contribution is:

1) Less than $250, or
2) $250 or more.

Contributions of Less Than $250

For each cash contribution that is less than $250, you must keep one of the following:

1) A canceled check, ***or*** a legible and readable account statement that shows:
   a) If payment was by check – the check number, amount, date posted, and to whom paid.
   b) If payment was by electronic funds transfer – the amount, date posted, and to whom paid.
   c) If payment was charged to a credit card – the amount, transaction date, and to whom paid.
2) A receipt (or a letter or other written communication) from the charitable organization showing the name of the organization, the date of the contribution, and the amount of the contribution.
3) Other reliable written records that include the information described in (2). Records may be considered reliable if they were made at or near the time of the contribution, were regularly kept by you, or if, in the case of small donations, you have emblems, buttons, or other tokens that are regularly given to persons making small cash contributions.

Contributions of $250 or More

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

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

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

Acknowledgement. The acknowledgement must meet these tests:

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

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

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

Out-of-pocket expenses. If you render services to a qualified organization and have unreimbursed out-of-pocket expenses related to those services, you can satisfy the written acknowledgement requirement just discussed if:

1) You have adequate records to substantiate the amount of the expenditures, and
2) By the required date, you get an acknowledgement from the qualified organization that contains:
   a) A description of the services you provided,
   b) The date the services were provided,
   c) A statement of whether or not the organization provided you any goods or services to reimburse you for the expenses you incurred,
   d) A description and a good faith estimate of the value of any goods or services (other than intangible religious benefits) provided to reimburse you, and
   e) A statement of any intangible religious benefits provided to you.

Car expenses. If you claim expenses directly related to use of your car in giving services to a qualified organization, you must keep reliable written records of your expenses. Whether your records are considered reliable depends on all the facts and circumstances. Generally, they may be considered reliable if you made them regularly and at or near the time you had the expenses.

Your records must show the name of the organization you were serving each time you used your car for a charitable purpose. If you use the standard mileage rate of 12 cents a mile, your records must show the miles you drove your car for the charitable purpose. If you deduct your actual expenses, your records must show the costs of operating the car that are directly related to a charitable purpose.

TIP *Beginning in 1998, the standard mileage rate increases to 14 cents per mile.*

See *Car expenses,* earlier under *Out-of-Pocket Expenses in Giving Services,* for the expenses you can deduct.

Noncash Contributions

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

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

Deductions of Less Than $250

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

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

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

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

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

1) The name and address of the organization to which you contributed.
2) The date and location of the contribution.
3) A description of the property in detail reasonable under the circumstances. For a security, keep the name of the issuer, the type of security, and whether it is regularly traded on a stock exchange or in an over-the-counter market.
4) The fair market value of the property at the time of the contribution, and how you figured the fair market value. If it was determined by appraisal, keep a signed copy of the appraisal.
5) The cost or other basis of the property if you must reduce its fair market value by appreciation. Your records should also include the amount of the reduction and how you figured it. If you choose the 50% limit instead of the special 30% limit on certain capital gain property, you must keep a record showing the years for which you made the choice, contributions for the current year to which the choice applies, and carryovers from preceding years to which the choice applies. See *How To Figure Your Deduction When Limits Apply* in Publication 526 for information on how to make the capital gain property election.
6) The amount you claim as a deduction for the tax year as a result of the contribution, if you contribute less than your entire interest in the property during the tax year. Your records must show the amount you claimed as a deduction in any earlier years for contributions of other interests in this property. They must also include the name and address of each organization to which you contributed the other interests, the place where any such tangible property is located or kept, and the name of the person who has possession of the property, if it is someone other than the organization to which you contributed.
7) The terms of any conditions attached to the gift of property.

If the gift was a "qualified conservation contribution," your records must also include the fair market value of the underlying property before and after the gift and the conservation purpose furthered by the gift. See *Qualified conservation contribution* in Publication 561 for more information.

Deductions of At Least $250 But Not More Than $500

If you claim a deduction of at least $250 but not more than $500 for a noncash charitable contribution, you must get and keep an acknowledgement of your contribution from the qualified organization. This acknowledgement must contain the information in items (1) through (3) listed under *Deductions of Less Than $250,* earlier, and your written records must include the information listed in that discussion under *Additional records.*

The acknowledgement must also meet these tests:

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

Deductions Over $500

You are required to give additional information if you claim a deduction over $500 for noncash charitable contributions. See *Records To Keep* in Publication 526 for more information.

How To Report

Enter your cash contributions (including out-of-pocket expenses) on line 15, Schedule A (Form 1040).

Enter your noncash contributions on line 16 of Schedule A (Form 1040).

If your total deduction for all noncash contributions for the year is over $500, you must also file **Form 8283.** See *How To Report* in Publication 526 for more information.

27. Nonbusiness Casualty and Theft Losses

Introduction

This chapter explains the tax treatment of casualty and theft losses that are personal and ***not*** business related. It also discusses losses on deposits.

This chapter also explains:

- How to figure the amount of your loss,
- How to treat insurance and other reimbursements you receive,
- The deduction limits, and
- When and how to report a casualty or theft.

You must file Form 1040 and itemize your deductions on **Schedule A** (Form 1040) to claim a deduction for a casualty or theft loss of nonbusiness property. You must use **Form 4684** to figure your deduction.

Publication 584 is available to help you make a list of your damaged goods and figure your loss. It includes schedules to help you figure the loss on your home and its contents, and on your motor vehicles.

Casualty and theft losses on nonbusiness property are subject to certain limits. If these limits are more than your losses, you do not have a casualty or theft loss deduction. See *Deduction Limits,* later.

Other sources of information. For information on a casualty or theft loss of business or income-producing property, see Publication 547.

For information on a condemnation of your home, see *Involuntary Conversions* in chapter 1 of Publication 544.

Useful Items

You may want to see:

Publication

- ☐ **544** Sales and Other Dispositions of Assets
- ☐ **547** Casualties, Disasters, and Thefts (Business and Nonbusiness)
- ☐ **584** Nonbusiness Disaster, Casualty, and Theft Loss Workbook

Form (and Instructions)

- ☐ **4684** Casualties and Thefts

Loss on Deposits

A loss on deposits can occur when a bank, credit union, or other financial institution becomes insolvent or bankrupt. If you incurred this type of loss, you have three choices of how to deduct the loss:

1) As a casualty loss,
2) As an ordinary loss, or
3) As a nonbusiness bad debt.

Casualty loss or ordinary loss. You can choose to deduct a loss on deposits as a casualty loss or as an ordinary loss for any year in which you can reasonably estimate how much of your deposits you have lost in an insolvent or bankrupt financial institution. The choice is generally made on the return you file for that year and applies to all your losses on deposits for the year in that particular financial institution. Once you treat the loss as a casualty or ordinary loss, you cannot treat the same amount of the loss as a nonbusiness bad debt when it actually becomes worthless.

Nonbusiness bad debt. If you do not choose to deduct the loss as a casualty loss or as an ordinary loss, you must wait until the actual loss is determined before you can deduct the loss as a nonbusiness bad debt. Once you make this choice, you cannot change it without permission from the Internal Revenue Service.

How to report. The kind of deduction you choose for loss on deposits determines how you report your loss. If you choose:

- Casualty loss — report on Form 4684 first and then on Schedule A (Form 1040).
- Ordinary loss — report on Schedule A (Form 1040).
- Nonbusiness bad debt — report on Schedule D (Form 1040).

More information. For more information, see *Special Treatment for Losses on Deposits in Insolvent or Bankrupt Financial Institutions* in the instructions for Form 4684.

Casualty

A casualty is the damage, destruction, or loss of property resulting from an identifiable event that is sudden, unexpected, or unusual.

- A ***sudden*** event is one that is swift, not gradual or progressive.
- An ***unexpected*** event is one that is ordinarily unanticipated and unintended.
- An ***unusual*** event is one that is not a day-to-day occurrence and that is not typical of the activity in which you were engaged.

Deductible losses. Deductible casualty losses can result from a number of different causes, including:

- Car accidents (but see *Nondeductible losses,* later for exceptions),
- Earthquakes,
- Fires (but see *Nondeductible losses,* later for exceptions),
- Floods,
- Government-ordered demolition or relocation of a home that is unsafe to use because of a disaster as discussed under *Disaster Area Losses* in Publication 547,
- Hurricanes,
- Mine cave-ins,
- Shipwrecks,
- Sonic booms
- Storms,
- Tornadoes,
- Vandalism, and
- Volcanic eruptions.

Nondeductible losses. A casualty loss is not deductible if the damage or destruction is caused by the following.

- Accidentally breaking articles such as glassware or china under normal conditions.
- A family pet.
- A fire if you willfully set it, or pay someone else to set it.
- A car accident if your willful negligence or willful act caused it. The same is true if the willful act or willful negligence of someone acting for you caused the accident.
- Progressive deterioration (explained next).

Progressive deterioration. Loss of property due to progressive deterioration is not deductible as a casualty loss. This is because the damage results from a steadily operating cause or a normal process, rather than from a sudden event. The following are examples of damage due to progressive deterioration.

- The steady weakening of a building due to normal wind and weather conditions.
- The deterioration and damage to a water heater that bursts. ***But,*** the rust and water damage to rugs and drapes caused by the bursting of a water heater ***does qualify*** as a casualty.
- Most losses of property caused by droughts. To be deductible, a drought-related loss generally must be incurred in a trade or business or in a transaction entered into for profit. For details about drought-related losses of business property, see chapter 13 in Publication 225, *Farmer's Tax Guide.*
- Termite or moth damage.
- The damage or destruction of trees, shrubs, or other plants by a fungus, disease, insects, worms, or similar pests. ***But,*** a sudden destruction due to an unexpected or unusual infestation by beetles or other insects may result in a casualty loss.

Theft

A theft is the taking and removing of money or property with the intent to deprive the owner of it. The taking of your property must be illegal under the law of the state where it occurred and it must have been done with criminal intent.

Theft includes the taking of money or property by:

- Blackmail,
- Burglary,
- Embezzlement,
- Extortion,
- Kidnapping for ransom,
- Larceny,
- Robbery, and
- Threats.

Mislaid or lost property. The simple disappearance of money or property is not a theft. However, an accidental loss or disappearance of property can qualify as a casualty if it results from an identifiable event that is sudden, unexpected, or unusual.

Example. A car door is accidentally slammed on your hand, breaking the setting of your diamond ring. The diamond falls from the ring and is never found. The loss of the diamond is a casualty.

Proof of Loss

To deduct a casualty or theft loss, you must be able to prove that you had a casualty or theft. You must be able to support the amount you claim for the loss as discussed later.

For a casualty loss, your records should show all of the following.

1) The type of casualty (car accident, fire, storm, etc.) and when it occurred.
2) That the loss was a direct result of the casualty.
3) That you were the owner of the property or, if you leased the property from someone else, that you were contractually liable to the owner for the damage.

For a theft loss, your records should show all of the following.

1) When you discovered that your property was missing.
2) That your property was stolen.
3) That you were the owner of the property.

Amount of Loss

You figure the amount of your loss using the following steps:

1) Determine your ***adjusted basis*** in the property before the casualty or theft.
2) Determine the ***decrease in fair market value*** of the property as a result of the casualty or theft.
3) From the smaller of the amounts you determined in (1) and (2), subtract any ***insurance or other reimbursement*** you receive or expect to receive.

You must apply the deduction limits, discussed later, to determine the amount of your deductible loss.

Personal property. If a single casualty or theft involves more than one item of personal property, you must figure the loss on each item separately. Then combine the losses to determine your total loss from that casualty or theft. Personal property is any property that is not real property.

Example. A fire in your home destroyed an upholstered chair, an oriental rug, and an antique table. You did not have fire insurance to cover your loss. (This was the only casualty or theft you had during the year.) The chair cost you $750, and you established that it had an FMV of $500 just before the fire. The rug cost you $3,000 and had an FMV of $2,500 just before the fire. You bought the table at an auction for $100, before discovering it was an antique. It had been appraised at $900 before the fire. You figure your loss on each of these items as follows:

	Chair	Rug	Table
1) Basis (cost)	$750	$3,000	$100
2) FMV before fire	$500	$2,500	$900
3) FMV after fire	–0–	–0–	–0–
4) Decrease in FMV	$500	$2,500	$900
5) Loss (smaller of (1) or (4))	$500	$2,500	$100
6) Total loss			**$3,100**

Real property. In figuring a loss on nonbusiness real property, treat the entire property (including any improvements, such as buildings, trees, and shrubs) as one item. Figure the loss using the adjusted basis or the decrease in FMV of the entire property.

Example. You bought your home a few years ago. You paid $50,000 ($10,000 for the land and $40,000 for the house). You also spent $2,000 for landscaping. This year a fire destroyed your home. The fire also damaged the shrubbery and trees in your yard. The fire was your only casualty or theft loss this year. Competent appraisers valued the property as a whole at $75,000 before the fire, but only $15,000 after the fire. (The loss to your household furnishings is not shown in this example but would be figured separately, as explained earlier under *Personal property.*) Shortly after the fire, the insurance company paid you $45,000 for the loss. Your adjusted gross income is $48,000. You figure your casualty loss as follows:

1) Adjusted basis of the entire property (cost of land, building, and landscaping)	$52,000
2) FMV of entire property before fire	$75,000
3) FMV of entire property after fire	15,000
4) Decrease in FMV of entire property	$60,000
5) Loss (smaller of (1) or (4))	$52,000
6) Subtract insurance	45,000
7) Amount of loss	$7,000

Leased property. If you are liable for casualty damage to property you lease, your loss is the amount you must pay to repair the property minus any insurance or the reimbursement you receive or expect to receive.

Adjusted Basis

Adjusted basis is your basis (usually cost) increased or decreased by various events, such as improvements and casualty losses. For more information, see chapter 14.

Decrease In Fair Market Value

Fair market value (FMV) is the price for which you could sell your property to a willing buyer when neither of you have to sell or buy and both of you know all the relevant facts.

The decrease in FMV is the difference between the property's ***fair market value*** immediately before and immediately after the casualty or theft.

FMV of stolen property. The FMV of property immediately after a theft is considered to be zero, since you no longer have the property.

Recovered property. If you get your stolen property back, determine the decrease in the FMV of the property from the time it was stolen until it is recovered. If you get the property back after you have already claimed a theft loss deduction, you must refigure your loss.

If your refigured loss is less than the loss you deducted, you generally have to report the difference as income in the recovery year. But report the difference only up to the amount of the loss that reduced your tax. For more information on the amount to report, see *Recoveries* in chapter 13.

Figuring Decrease in FMV—Items To Consider

To figure the decrease in FMV because of a casualty or theft, you generally need a competent appraisal. But, other measures can also be used to establish certain decreases.

Appraisal. The appraisal to determine the difference between the FMV of the property immediately before a casualty or theft and immediately afterwards should be made by a competent appraiser. The appraiser should be reliable and experienced. The appraiser must recognize the effects of any general market decline that may occur along with the casualty. This is necessary so that any deduction is limited to the actual loss resulting from damage to the property.

Several factors are important in evaluating the accuracy of an appraisal, including the appraiser's:

- Familiarity with your property before and after the casualty or theft,
- Knowledge of sales of comparable property in the area,
- Knowledge of conditions in the area of the casualty, and
- Method of appraisal.

Appraisal fees. The appraisal fee is not a part of the casualty or theft loss. You can deduct it as a miscellaneous deduction subject to the 2% of adjusted gross income limit on Schedule A (Form 1040). For information about miscellaneous deductions, see chapter 30.

Cost of cleaning up or making repairs. The cost of repairing damaged property is not part of a casualty loss. Neither is the cost of cleaning up after a casualty. But, you can use the cost of cleaning up or of making repairs after a casualty as a measure of the decrease in FMV if you meet all the following conditions.

1) The repairs are necessary to bring the property back to its condition before the casualty.
2) The amount spent for repairs is not excessive.
3) The repairs take care of the damage only.
4) The value of the property after the repairs is not, due to the repairs, more than the value of the property before the casualty.

Landscaping. The cost of restoring landscaping to its original condition after a casualty may indicate the decrease in FMV. You may be able to measure your loss by what you spend on the following:

1) Removing destroyed or damaged trees and shrubs minus any salvage you receive,
2) Pruning and other measures taken to preserve damaged trees and shrubs, and
3) Replanting necessary to restore the property to its approximate value before the casualty.

Cars. Books issued by various automobile organizations may be useful in figuring the value of your car if your car is listed in the books. You can use the books' retail values and modify them by such factors as mileage and the condition of your car to figure its value. The prices are not "official," but they may be useful in determining value and suggesting relative prices for comparison with current sales and offerings in your area. If your car is not listed in the books, you determine its value from other sources. A dealer's offer for your car as a trade-in on a new car is not usually a measure of its true value.

Figuring Decrease in FMV—Items Not To Consider

You generally should not consider the following items when attempting to establish the decrease in the FMV of your property.

Replacement costs. The cost of replacing stolen or destroyed property is not part of a casualty or theft loss.

The cost of protection. The cost of protecting your property against a casualty or theft is not part of a casualty or theft loss. For example, you cannot deduct what you spend on insurance or to board up your house against a storm.

If you make permanent improvements to your property to protect it against a casualty or theft, add the cost of these improvements to your basis in the property. An example would be the cost of a dike to prevent flooding.

Related expenses. The incidental expenses you have due to a casualty or theft, such as expenses for the treatment of personal injuries, for temporary housing, or for a rental car, are not part of your casualty or theft loss.

Sentimental value. Do not consider sentimental value when determining your loss. If a family portrait, heirloom, or keepsake is damaged, destroyed, or stolen, you must base your loss only on its actual market value.

General decline in market value. A decrease in the value of your property because it is in or near an area that suffered a casualty, or that might again suffer a casualty, is not to be taken into consideration. You have a loss only for actual casualty damage to your property. However, if your home is in a federally declared disaster area, see *Disaster Area Losses* in Publication 547.

Photographs. Photographs taken after a casualty will be helpful in establishing the condition and value of the property after it was damaged. Photographs showing the condition of the property after it was repaired, restored, or replaced may also be helpful.

The cost of photographs obtained for this purpose is not a part of the loss. You can claim this cost as a miscellaneous deduction subject to the 2% of adjusted gross income limit on Schedule A (Form 1040). For information about miscellaneous deductions, see chapter 30.

Insurance and Other Reimbursements

If you receive insurance or another type of reimbursement, you must subtract the reimbursement when you figure your loss. You do not have a casualty or theft loss to the extent you are reimbursed.

If there is a reasonable prospect you will be reimbursed for part or all of your loss, you must subtract the expected reimbursement when you figure your loss. You must reduce your loss even if you do not receive payment until a later tax year. See *Reimbursement Received After Deducting Loss,* later.

Failure to file claim for reimbursement. If your property is covered by insurance, you should file a timely insurance claim for reimbursement of your loss. Otherwise, you cannot deduct this loss as a casualty or theft loss. However, this does not apply to the portion of the loss not covered by insurance (for example, a deductible).

Example. You have a car insurance policy with a $500 deductible. Because your insurance did not cover the first $500 of an auto collision, the $500 would be deductible (subject to the deduction limits discussed later). This is true, even if you do not file an insurance claim, since your insurance policy would never have reimbursed you for it.

Gain from reimbursement. If your reimbursement is more than your adjusted basis in the property, you have a gain. This is true even if the decrease in the FMV of the property is more than your adjusted basis. If you have a gain, you may have to pay tax on it, or you may be able to postpone reporting the gain. See Publication 547 for more information on how to treat a gain from the reimbursement for a casualty or theft.

Types of Reimbursements

An insurance payment for your stolen or damaged property is the most common type of reimbursement. Other types of reimbursements are discussed next. Also see the *Instructions for Form 4684.*

Employer's emergency disaster fund. If you receive money as an employee from your employer's emergency disaster fund, and you must use that money to rehabilitate or replace property on which you are claiming a casualty loss deduction, then you must take that money into consideration in computing the casualty loss deduction. You take it into consideration to the extent you used it to replace your destroyed or damaged property.

Example. Your home was extensively damaged by a tornado. Your loss after reimbursement from your insurance company was $10,000. Your employer set up a disaster relief fund for its employees. Employees receiving money from the fund had to use it to rehabilitate or replace their damaged or destroyed property. You received $5,000 from the fund and spent the entire amount on repairs to your home. In figuring your casualty loss, you must reduce your unreimbursed loss ($10,000) by the $5,000 you received from your employer's fund. Your casualty loss before applying the deduction limits discussed later is $5,000.

Cash gifts. If you are a disaster victim who receives excludable cash gifts, and there are no limits on how you can use the money, you do not reduce your casualty loss by the amount of these gifts. This applies even if you use the money to pay for repairs to property damaged in the disaster.

Example. Your home was damaged by a hurricane. Relatives and neighbors made cash gifts to you which were excludable from your income. You applied part of the cash gifts to the cost of repairing your home. There were no limits or restrictions on how you could use the cash gifts. The money you received as excludable gifts, including amounts used to pay for repairs, does not reduce the amount of your casualty loss on the damaged home.

Insurance payments for living expenses. You do not reduce your casualty loss by insurance payments you receive to cover living expenses when:

1) You lose the use of your main home because of a casualty, or
2) Government authorities do not allow you access to your main home because of a casualty or threat of a casualty.

Inclusion in income. If these insurance payments are more than the temporary increase in your living expenses, you must include the excess in your income. Report this amount on line 21 of Form 1040.

The temporary increase in your living expenses is the actual living expenses incurred by you and your family during the period you could not use your home *minus* your normal living expenses for that period. Actual living expenses are the reasonable and necessary expenses incurred because of the loss of your main home. Generally, these expenses include the amounts you pay for the following:

- Renting suitable housing,
- Transportation,
- Food,
- Utilities, and
- Miscellaneous services.

Normal living expenses consist of these same expenses that you would have incurred but did not incur because of the casualty.

Example. As a result of a fire, you vacated your apartment for a month and moved to a motel. You normally pay $525 a month rent. None was charged for the month the apartment was vacated. Your motel rent for this month was $1,200. You normally pay $200 a month for food. Your food expenses for the month you lived in the motel were $400. You received $1,100 from your insurance company to cover your living expenses. You determine the amount of the payment you must include in income as follows.

1) Insurance payment for living expenses	$1,100
2) Actual expenses during the month you are unable to use your home because of the fire	$1,600
3) Normal living expenses	725
4) Temporary increase in living expenses: Subtract line 3 from line 2	875
5) Amount of payment includible in income: Subtract line 4 from line 1.	$225

Tax year of inclusion. You include the taxable part of the insurance payment in your income for the year you regain the use of your main home, or if later, for the year you receive the taxable part of the insurance payment.

Example. Your main home was destroyed by a tornado in August 1996. You regained use of your main home in November 1997. The insurance payments you received in 1996 and 1997 were $1,500 more than the temporary increase in your living expenses during those years. You include this amount in income on your 1997 Form 1040. If, in 1998, you receive further payments to cover the living expenses you had in 1996 and 1997, you must include those payments in income on your 1998 Form 1040.

Disaster relief. Food, medical supplies, and other forms of assistance you receive do not reduce your casualty loss unless they are replacements for lost or destroyed property. These items are not taxable income to you.

Reimbursement Received After Deducting Loss

If you figured your casualty or theft loss using your expected reimbursement, you may have to adjust the tax return for the tax year in which you get your actual reimbursement. This section explains the adjustment you may have to make.

Actual reimbursement less than expected. If you later receive less reimbursement than you expected, you include that difference as a loss with your other losses (if any) on your return for the year in which you can reasonably expect no more reimbursement.

Example. Your personal car had an FMV of $2,000 when it was destroyed in a collision with another car last year. The accident was due to the negligence of the other driver. At the end of the year, there was a reasonable prospect that the owner of the other car would reimburse you in full. You subtracted the expected reimbursement when you figured your loss. You did not have a loss last year.

This January, the court awards you a judgment of $2,000. However, in July it becomes apparent that you will be unable to collect any amount from the other driver. You can claim this as a casualty loss, subject to the deduction limits discussed later.

Actual reimbursement more than expected. If you receive more reimbursement than you expected after you have claimed a deduction for the loss, you may have to include the extra reimbursement in your income for the year you receive it. However, if any part of your original deduction did not reduce your tax for the earlier year, do not include that part of the reimbursement in your income. You do not refigure your tax for the year you claimed the deduction. For more information, see *Recoveries* in chapter 13.

Actual reimbursement same as expected. If you receive exactly the reimbursement you expected to receive, you do not have any amount to include in your income or any loss to deduct.

Example. Last December, you had a collision while driving your personal car. Repairs to the car cost $950. You had $100 deductible collision insurance. Your insurance company agreed to reimburse you for the rest of the damage. As a result of your expected reimbursement from the insurance company, you did not have a casualty loss deduction last year. And because of the $100 rule (discussed later under *Deduction Limits),* you cannot deduct the $100 you paid.

When you receive the $850 from the insurance company this year, you do not have to report it as income.

Deduction Limits

After you have figured the amount of your loss, as discussed earlier, you must figure how much of the loss you can deduct. If your loss was to property you had for your own or your family's personal use, there are ***two limits*** on the amount you can deduct for your casualty or theft loss.

1) You must reduce each casualty or theft loss by $100 ($100 rule).
2) You must further reduce the total of all your losses by 10% of your adjusted gross income (10% rule).

You make these reductions on Form 4684.

These rules are explained next, and *Table 27–1* summarizes how to apply the $100 rule and the 10% rule in various situations. For more detailed explanations and examples, get Publication 547.

Property used partly for business and partly for personal purposes. When property is used partly for personal (nonbusiness) purposes and partly for business or income-producing purposes, the casualty or theft loss deduction must be figured separately for the nonbusiness portion and for the business portion. You must figure each loss separately because the $100 rule and the 10% rule apply only to the casualty or theft loss on the nonbusiness portion of the property.

$100 Rule

After you have figured the amount of your casualty or theft loss, as discussed earlier, you must reduce that loss by $100. This reduction applies to each casualty or theft loss. It does not matter how many pieces of property are involved in an event; only a single $100 reduction applies.

Example. A hailstorm damages your home and your car. Determine the amount of loss, as discussed earlier, for each of these items. Since the losses are due to a single event, you combine the losses and reduce the combined amount by $100.

Single event. Generally, events closely related in origin cause a single casualty. It is a single casualty when the damage is from two or more closely related causes, such as wind and flood damage caused by the same storm.

10% Rule

You must reduce the total of all your casualty or theft losses by 10% of your adjusted gross income. Apply this rule after you reduce each loss by $100. If you have both gains and losses from casualties or thefts, see *Gains and losses,* later in this discussion.

Example 1. In June, you discovered that your house had been burglarized. Your loss after insurance reimbursement was $2,000. Your adjusted gross income is $29,500. You first apply the $100 rule and then the 10% rule. Figure your theft loss deduction as follows.

1. Amount of loss $2,000

Table 27-1. **Deduction Limit Rules**

	$100 Rule	10% Rule
Definition of Rule	Your must reduce each casualty or theft loss by $100 when figuring your deduction. Apply this rule after you have figured the amount of your loss.	You must reduce your total casualty or theft loss by 10% of your adjusted gross income. Apply this rule after you reduce each loss by $100 (the $100 rule).
Single Event	Apply this rule only once, even if many pieces of property are affected.	Apply this rule only once, even if many pieces of property are affected.
More Than One Event	Apply this rule to the loss from each event.	Apply this rule to the total of all your losses from all events.
More Than One Person- With Loss From the Same Event (other than a married couple filing jointly)	Apply this rule separately to each person.	Apply this rule separately to each person.
Married Couple— With Loss From the Same Event		
Filing jointly	Apply this rule as if you were one person.	Apply this rule as if you were one person.
Filing separately	Apply this rule separately to each spouse.	Apply this rule separately to each spouse.
More Than One Owner (other than a married couple filing jointly)	Apply this rule separately to each owner of jointly owned property.	Apply this rule separately to each owner of jointly owned property.

2. Subtract $100	100
3. Loss after $100 rule	$1,900
4. Subtract 10% of $29,500 AGI	2,950
5. **Theft loss deduction**	**–0–**

You do not have a theft loss deduction because your loss ($1,900) is less than 10% of your adjusted gross income ($2,950).

Example 2. In March, you had a car accident that totally destroyed your car. You did not have collision insurance on your car, so you did not receive any insurance reimbursement. Your loss on the car was $1,200. In November, you had a fire that damaged your basement and totally destroyed the furniture, washer, dryer, and other items you had stored there. Your loss on the basement items after reimbursement was $1,700. Your adjusted gross income is $25,000. You figure your casualty loss deduction as follows.

	Car	Basement
1. Amount of loss	$1,200	$1,700
2. Subtract $100	100	100
3. Loss after $100 rule	$1,100	$1,600
4. Total loss		$2,700
5. Subtract 10% of $25,000 AGI		2,500
6. **Casualty loss deduction**		**$200**

Gains and losses. If you had both gains and losses from casualties or thefts to nonbusiness property, you must compare your total gains to your total losses. Do this after you have reduced each loss by $100.

Losses more than gains. If your losses are more than your gains, subtract your gains from your losses and reduce the result by 10% of your adjusted gross income. The rest is your deductible loss.

Gains more than losses. If your gains are more than your losses, subtract your losses from your gains. The difference is treated as capital gain. The 10% rule does not apply to your losses.

When To Report

If you have insurance or other reimbursement that is more than your adjusted basis in the destroyed or stolen property, you have a ***gain*** from the casualty or theft. You must include this gain in your income in the year you receive the reimbursement, unless you choose to postpone the gain as explained in Publication 547.

If you have a ***loss,*** see *Table 27–2.*

Loss on deposits. If your loss is a loss on deposits in an insolvent or bankrupt financial institution, see *Loss on Deposits,* earlier.

Casualty losses. Generally, you can deduct casualty losses only in the tax year in which the casualty occurred. This is true even if you do not repair or replace the damaged property until a later year.

Disaster area losses. If you have a casualty loss in a federally declared disaster area, you can choose to deduct the loss on your tax return for the year immediately preceding the year in which the disaster occurred. This may enable you to get an immediate refund of taxes you already paid. For more information, see *Disaster Area Losses* in Publication 547.

Theft losses. You can generally deduct a theft loss only in the year you discover your property was stolen. You must be able to show that there was a theft, but you do not have to know when the theft took place. However, you should show when you discovered that your property was missing.

How To Report

Use Form 4684 to determine if you have a gain or a deductible loss from a casualty or theft. If you have more than one casualty or theft, use a separate Form 4684 to determine your gain or loss for each event. Combine the gains and losses on one Form 4684. Follow the form instructions as to which lines to fill out.

If you have a:	Report it on:
Gain	Schedule D (Form 1040)
Loss	Schedule A (Form 1040)

Adjustments to basis. If you have a casualty or theft loss, you must reduce your adjusted basis in the property by any deductible loss and any insurance or other reimbursements. Amounts you spend to restore your property after a casualty increase your adjusted basis. See *Adjusted Basis* in chapter 14 for more information.

Net operating loss. If your casualty or theft loss deduction is more than your income, you may have a net operating loss. You can use a net operating loss to lower your taxes in an earlier year, allowing you to get a refund for taxes that you have already paid. Or, you can use it to lower your taxes in a later year. You do not have to be in business to have a net operating loss from a casualty or theft. For more information, get Publication 536, *Net Operating Losses.*

Table 27-2. **When To Deduct a Loss**

Type of Loss	Tax Year Deducted
Loss on deposits	
• Casualty loss	Year a reasonable estimate can be made
• Bad debt	Year deposits are totally worthless
• Ordinary loss	Year a reasonable estimate can be made
Casualty losses	Year loss occurred
Federal disasters	Year the disaster occurred or the year immediately before the disaster
Thefts	Year of discovery of the theft

28. Car Expenses and Other Employee Business Expenses

Important Changes for 1997

Increase in standard meal allowance. The standard meal allowance for most areas in the United States has increased to $30. Use of the standard meal allowance is explained under *Travel Expenses.*

Standard meal allowance for travel days you depart and return. When you travel away from home, you can claim 3/4 of the standard meal allowance for the days you depart and return. See *Travel for days you depart and return* under *Standard Meal Allowance* for more information.

Increase in standard mileage rate. The standard mileage rate for the cost of operating your car in 1997 is 31½ cents a mile for all business miles. Use of the standard mileage rate is explained under *Local Transportation Expenses.*

Federal crime investigations. Certain federal employees who are participating in federal crime investigations are not subject to the 1–year rule for deducting temporary travel expenses. See *Exception for federal crime investigations* under *Temporary Assignment or Job.*

Officials paid on a fee basis. Certain fee-basis officials can claim their employee business expenses whether or not they itemize their other deductions on Schedule A (Form 1040). See *Special Rules* under *How To Report.*

Important Reminder

Limits that apply to employee deductions. If you are an employee, deduct your work-related expenses discussed in this chapter as a miscellaneous itemized deduction on Schedule A (Form 1040). Generally, the amount you can deduct is limited to the amount that exceeds 2% of your adjusted gross income. It may be further limited if your adjusted gross income is more than $121,200 ($60,600 if you are married filing separately). For more information, see chapters 22 and 30 and the instructions for Schedule A (Form 1040).

Introduction

This chapter discusses rules for deducting business-related expenses connected with:

- Travel away from home,
- Entertainment,
- Gifts,
- Local transportation, and
- Business use of a car.

This chapter also discusses:

- What records you need to prove your expenses,
- How to handle reimbursements of your employee business expenses, and
- How to report your expenses on Forms 2106 and 2106–EZ.

Expenses fully reimbursed. You will not need to read this chapter if ***all*** of the following are true.

1) You fully accounted to your employer for your work-related expenses.
2) You received full reimbursement for your expenses.
3) Your employer required you to return any excess reimbursement and you did so.
4) Box 13 of your Form W–2 shows no amount with a code **L.**

If you meet these four conditions, there is no need to show the expenses or the reimbursements on your return. See *Reimbursements,* later, if you would like more information on reimbursements and accounting to your employer.

If you do not meet all of these conditions, you must complete Form 2106 or 2106–EZ and itemize your deductions to claim your expenses. See *Completing Forms 2106 and 2106–EZ,* later.

TIP *If you meet these conditions and your employer included reimbursements on your Form W–2 in error, ask your employer for a corrected Form W–2.*

Useful Items

You may want to see:

Publication

- ☐ **463** Travel, Entertainment, Gift, and Car Expenses
- ☐ **535** Business Expenses

Form (and Instructions)

- ☐ **Schedule A (Form 1040)** Itemized Deductions
- ☐ **Schedule C (Form 1040)** Profit or Loss From Business
- ☐ **Schedule C–EZ (Form 1040)** Net Profit From Business
- ☐ **Schedule F (Form 1040)** Profit or Loss From Farming
- ☐ **Form 2106** Employee Business Expenses
- ☐ **Form 2106–EZ** Unreimbursed Employee Business Expenses

Travel Expenses

If you temporarily travel away from your tax home, you can use this section to determine if you have deductible travel expenses. This section defines “tax home,” “temporary,” and different types of travel expenses. It also discusses the rules for travel inside and outside the United States and deductible convention expenses.

Travel expenses defined. For tax purposes, travel expenses are the ordinary and necessary expenses of traveling away from home for your business, profession, or job. An ordinary expense is one that is common and accepted in your field of business, trade, or profession. A necessary expense is one that is helpful and appropriate to your business. An expense does not have to be indispensable to be considered necessary. However, you cannot deduct expenses to the extent they are lavish or extravagant.

You will find examples of deductible travel expenses in *Table 28–1.*

Traveling away from home. You are traveling away from home if:

1) Your duties require you to be away from the general area of your tax home (defined later) substantially longer than an ordinary day's work, and
2) You need to get sleep or rest to meet the demands of your work while away from home.

This rest requirement is not satisfied by merely napping in your car. You do not have to be away from your tax home for a whole day or from dusk to dawn as long as your relief from duty is long enough to get necessary sleep or rest.

Example 1. You are a railroad conductor. You leave your home terminal on a regularly scheduled round-trip run between two cities and return home 16 hours later. During the run, you have 6 hours off at your turnaround point where you eat two meals and rent a hotel room to get necessary sleep before starting the return trip. You are considered to be away from home, and you can deduct travel expenses.

Example 2. You are a truck driver. You leave your terminal and return to it later the same day. You get an hour off at your turnaround point to eat. Because you are not off to get necessary sleep and the brief time off is not an adequate rest period, your trip is not considered as travel away from home. You cannot deduct travel expenses.

Tax Home

To deduct travel expenses, you must first determine the location of your tax home.

Generally, your tax home is your regular place of business or post of duty, regardless of where you maintain your family home. It includes the ***entire city or general area*** in which your business or work is located. If you have more than one regular place of business, your tax home is your main place of business. If you do not have a regular or a main place of business because of the nature of your work, then your tax home may be the place where you regularly live. See *No main place of business or work,* later.

If you do not have a regular place of business or post of duty and there is no place where you regularly live, you are considered a transient (an itinerant) and your tax home is wherever you work. As a transient, you cannot claim a travel expense deduction because you are never considered away from home.

Main place of business or work. If you have more than one place of work, you should use the following factors to determine your main place of business or work:

1) The total time you ordinarily spend working in each area,
2) The degree of your business activity in each area, and
3) The relative amount of your income from each area.

Example. You live in Cincinnati where you have a seasonal job for 8 months and earn $25,000. You work the remaining 4 months in Miami, also at a seasonal job, and earn $9,000. Cincinnati is your main place of work because you spend most of your time there and earn most of your income there.

No main place of business or work. You may have a tax home even if you do not have a regular or main place of work. Your tax home may be the home where you regularly live.

Factors used to determine tax home. If you do not have a regular or main place of business or work, use the following three factors to see if you have a tax home.

1) You have part of your business in the area of your main home and use that home for lodging while doing business there.
2) You have living expenses at your main home that you duplicate because your business requires you to be away from that home.
3) You have not left the area in which both your traditional place of lodging and your main home are located; you have a member or members of your family living at your main home; or you often use that home for lodging.

If you meet all three factors, your tax home is the home where you regularly live, and you may be able to deduct travel expenses. If you meet only two of the factors, you may have a tax home depending on all the facts and circumstances. If you meet only one factor, you are a transient; each place you work becomes your tax home and you cannot deduct travel expenses.

Example. You are single and live in Boston in an apartment you rent. You have worked for your employer in Boston for a number of years. Your employer enrolls you in a 12-month executive training program. You do not expect to return to work in Boston after you complete your training.

During your training, you do not do any work in Boston. Instead, you receive classroom and on-the-job training throughout the United States. You keep your apartment in Boston and return to it frequently. You use your apartment to conduct your personal business. You also keep up your community contacts in Boston. When you complete your training, you are transferred to Los Angeles.

You have not satisfied factor (1) because you did not work in Boston. You have satisfied factor (2) because you have duplicate living expenses. You also satisfy factor (3) because you do not abandon your apartment in Boston as your traditional home, you keep your community contacts, and you frequently return to live in your apartment. You have a tax home in Boston for travel expense deduction purposes.

Transient workers. If you move from job to job, maintain no fixed home, and are not associated with any particular business locality, each place you work becomes your main place of business and your tax home. You cannot deduct your expenses for meals and lodging.

Living away from your tax home. If you (and your family) live in an area outside your tax home (main place of work), you cannot deduct travel expenses between your tax home and your family home. You also cannot deduct the cost of meals and lodging while at your tax home. See *Example 1,* below.

If you are working temporarily in the same city where you and your family live, you may be considered as traveling away from home. See *Example 2,* below.

Example 1. You are a truck driver and you and your family live in Tucson. You are employed by a trucking firm that has its terminal in Phoenix. At the end of your long runs, you return to your home terminal in Phoenix and spend one night there before returning home. You cannot deduct any of your travel costs in Phoenix because Phoenix is your tax home.

Example 2. Your family home is in Pittsburgh, where you work 12 weeks a year. The rest of the year you work for the same employer in Baltimore. In Baltimore, you eat in restaurants and sleep in a rooming house. Your salary is the same whether you are in Pittsburgh or Baltimore.

Because you spend most of your working time and earn most of your salary in Baltimore, that city is your tax home. You cannot deduct any expenses you have for meals and lodging there. However, when you return to work in Pittsburgh, you are away from your tax home even though you stay at your family home. You can deduct the cost of your round trip between Baltimore and Pittsburgh. You can also deduct your part of your family's living expenses for meals and lodging while you are living and working in Pittsburgh.

Temporary Assignment or Job

You may regularly work or carry on your business activities within the city or general area of your tax home and also work or conduct business at another location. It may not be practical to return home from this other location at the end of each day's work.

If your assignment or job away from your main place of work is ***temporary,*** your tax home does not change. You are considered to be away from home for the whole period, and your travel expenses are deductible. Generally, a temporary assignment in a single location is one that is realistically expected to last (and does in fact last) for one year or less.

However, if your assignment or job is ***indefinite,*** that location becomes your new tax home and you cannot deduct your travel expenses while there. Your assignment or job in a single location is considered indefinite if it is realistically expected to last for more than one year, whether or not it actually lasts for more than one year.

If your assignment is indefinite, you must include in your income any amounts you receive from your employer for living expenses, even if they are called travel allowances and you account to your employer for them. You may be able to deduct the cost of relocating to your new tax home as a moving expense. See chapter 19 for more information.

Exception for federal crime investigations. If you are a federal employee participating in a federal crime investigation, you may be able to deduct travel expenses even if you are away from your tax home for more than one year.

The Attorney General must certify that you are traveling:

1) For the federal government,
2) In a temporary duty status, and
3) To investigate or provide support services for the investigation of a federal crime.

If you qualify, the 1-year rule for deducting business travel expenses when away from your tax home does not apply.

CAUTION *As this publication was being prepared for print, Congress was considering legislation that would expand the definition in (3) to include prosecution of a federal crime. See Publication 553,* Highlights of 1997 Tax Changes.

Determining temporary or indefinite. You must determine whether your assignment is temporary or indefinite when you start work. If you expect employment to last for one year or less, it is temporary unless there are facts and circumstances that indicate otherwise. Employment that is initially temporary may become indefinite due to changed circumstances. A series of assignments to the same location, all for short periods but that together cover a long period, may be considered an indefinite assignment.

Going home on days off. If you go back to your tax home from a temporary assignment on your days off, you are not considered away from home while you are in your hometown. You cannot deduct the cost of your meals and lodging there. However, you can deduct your travel expenses, including meals and lodging, while traveling from the area of your temporary place of work to your hometown and back to work. You can claim these expenses up to the amount it would have cost you for meals and lodging had you stayed at your temporary place of work.

If you keep your hotel room during your visit home, you can deduct the cost of your hotel room. In addition, you can deduct your expenses of returning home up to the amount you would have spent for meals had you stayed at your temporary place of work.

Probationary work period. If you take a job that requires you to move, with the understanding that you will keep the job if your work is satisfactory during a probationary period, the job is indefinite. You cannot deduct any expenses for meals and lodging during the probationary period.

Members of the Armed Forces. If you are a member of the U.S. Armed Forces on a permanent duty assignment overseas, you are not traveling away from home. You cannot deduct your expenses for meals and lodging. You cannot deduct these expenses even if you have to maintain a home in the United States for your family members who are not allowed to accompany you overseas. If you are transferred from one permanent duty station to another, you may have deductible moving expenses, which are explained in chapter 19.

A naval officer assigned to permanent duty aboard a ship that has regular eating and living facilities has a tax home aboard ship for travel expense purposes.

What Are Travel Expenses?

Once you have determined that you are traveling away from your tax home, you can determine what travel expenses are deductible.

When you travel away from home on business, you should keep records of all the expenses you incur and any advances you receive from your employer. You can use a log, diary, notebook, or any other written record to keep track of your expenses. The types of expenses you need to record, along with supporting documentation, are described in *Table 28–2.*

Deductible Travel Expenses

Deductible travel expenses include those ordinary and necessary expenses you incur while traveling away from home on business. The type of expense you can deduct depends on the facts and your circumstances.

Table 28–1 summarizes travel expenses you may be able to deduct. You may have other deductible travel expenses that are not covered there, depending on the facts and your circumstances.

Additional rules on the cost of meals and on paying travel expenses for others are explained next.

Table 28-1. **Travel Expenses You Can Deduct**

This chart summarizes expenses you can deduct when you travel away from home for business purposes. Additional rules on meals and paying travel expenses for others are explained under *Deductible Travel Expenses.*

IF you have expenses for:	THEN you can deduct the costs of:
Transportation	Travel by airplane, train, bus, or car between your home and your business destination. If you were provided with a ticket or you are riding free as a result of a frequent traveler or similar program, your cost is zero. If you travel by ship, see *Luxury Water Travel* and *Cruise ships* (under *Conventions*) in Publication 463 for additional rules and limits.
Taxi, commuter bus, and airport limousine	Fares for these and other types of transportation that take you to or from: 1) The airport or station and your hotel, and 2) The hotel and the work location of your customers or clients, your business meeting place, or your temporary work location.
Baggage and shipping	Sending baggage and sample or display material between your regular and temporary work locations.
Car	Operating and maintaining your car when traveling away from home on business. You may deduct actual expenses or the standard mileage rate (if you own the car), including business-related tolls and parking. If you lease a car while away from home on business, you can deduct only the business-related costs of the lease. This includes gas, oil, and repairs.
Lodging and meals	Your lodging and meals if your business trip is overnight or long enough that you need to stop for sleep or rest to properly perform your duties. Meals include amounts spent for food, beverages, taxes, and related tips. See *Meals* for additional rules and limits.
Cleaning	Dry cleaning and laundry.
Telephone	Business calls while on your business trip. This includes business communication by fax machine or other communication devices.
Tips	Tips you pay for any expenses in this chart.
Other	Other similar ordinary and necessary expenses related to your business travel. These expenses might include transportation to or from a business meal, public stenographer's fees, computer rental fees, and operating and maintaining a house trailer.

Meals. You cannot deduct the cost of meals if it is not necessary for you to stop for sleep or rest to properly perform your duties unless you meet the rules for business entertainment. These rules are explained later under *Entertainment Expenses.*

50% limit on meals. You can use either the actual cost of your meals or a standard amount to figure your meals expense. (See *Standard Meal Allowance* later in this section.) However, you can deduct only 50% of the cost of your unreimbursed business-related meals.

If you are reimbursed for these expenses, how you apply the 50% limit depends on whether your employer's reimbursement plan was accountable or nonaccountable. This limit applies whether the unreimbursed meal expense is for business travel or business entertainment. The 50% limit is explained later under *Entertainment Expenses.* Accountable and nonaccountable plans are discussed later under *How To Report.*

Lavish or extravagant. You cannot deduct expenses for meals to the extent they are lavish or extravagant. An expense is not considered lavish or extravagant if it is reasonable based on the facts and circumstances. Expenses will not be disallowed merely because they are more than a fixed dollar amount or take place at deluxe restaurants, hotels, nightclubs, or resorts.

Travel expenses for another individual. If a spouse, dependent, or other individual goes with you (or your employee) on a business trip or to a business convention, you generally cannot deduct his or her travel expenses. You can only deduct the travel expenses you pay or incur for an accompanying individual if that individual:

1) Is your employee,
2) Has a bona fide business purpose for the travel, and
3) Would otherwise be allowed to deduct the travel expenses.

Exception for business associate. If a business associate travels with you and meets the conditions in (2) and (3) above, you can claim the deductible travel expenses you pay for that person. A business associate is someone with whom you can reasonably expect to actively conduct business. It does not matter if you have already conducted business with the person as long as you reasonably expect to do so. A business associate can be a customer, client, supplier, employee, agent, partner, or professional advisor.

Bona fide business purpose. For a bona fide business purpose to exist, you must prove a real business purpose for the individual's presence. Incidental services, such as typing notes or assisting in entertaining customers, are not enough to warrant a deduction.

Example. Jerry drives to Chicago on business and takes his wife, Linda, with him. Linda is not Jerry's employee. Even if her presence serves a bona fide business purpose, her expenses are not deductible.

Jerry pays $115 a day for a double room. A single room costs $90 a day. He can deduct the total cost of driving his car to and from Chicago, but only $90 a day for his hotel room. If he uses public transportation, he can deduct only his fare.

Standard Meal Allowance

You generally can deduct a standard amount for your daily meals and incidental expenses **(M&IE)** while you are traveling away from home on business. Incidental expenses include, but are not limited to, your costs for the following items:

1) Laundry, dry cleaning, and pressing of clothing, and
2) Fees and tips for persons who provide services, such as food servers and luggage handlers.

Incidental expenses do not include taxicab fares or the costs of telegrams or telephone calls. In this chapter, "standard meal allowance" refers to the federal rate for M&IE (meals and incidental expenses).

The standard meal allowance method is an alternative to the actual cost method and allows you to deduct a set amount, depending on where and when you travel, instead of keeping records of your actual costs. If you use the standard meal allowance, you still must keep records to prove the time, place, and business purpose of your travel. See the recordkeeping rules explained later under *Recordkeeping.*

CAUTION *There is no optional standard lodging amount similar to the standard meal allowance. Your allowable lodging expense deduction is your actual cost.*

Who can use the standard meal allowance. You can use the standard meal allowance whether you are an employee or self-employed, and whether or not you are reimbursed for your traveling expenses. You cannot use the standard meal allowance, however, if you are related to your employer as defined next.

Related to employer. You are related to your employer if:

1) Your employer is your brother or sister, half-brother or half-sister, spouse, ancestor, or lineal descendant,
2) Your employer is a corporation in which you own, directly or indirectly, more than 10% in value of the outstanding stock, or
3) Certain fiduciary relationships exist between you and your employer involving grantors, trusts, beneficiaries, etc.

You may be considered to indirectly own stock, for purposes of (2), if you have an interest in a corporation, partnership, estate, or trust that owns the stock or if a family member or partner owns the stock.

Limit on standard meal allowance. If you are not reimbursed or if you are reimbursed under a nonaccountable plan for meal expenses, you can deduct only 50% of the standard meal allowance. If you are reimbursed under an accountable plan and you are deducting amounts that are more than your reimbursements, you can deduct only 50% of the excess amount. Accountable and nonaccountable plans are discussed later under *How To Report.*

Other expenses that can qualify for the standard meal allowance. You can use the standard meal allowance to prove meal expenses you incur when traveling in connection with ***investment*** and other ***income-producing property.*** You can also use it to prove meal expenses you incur when traveling for qualifying ***educational purposes.*** You ***cannot*** use the standard meal allowance to prove the amount of your meals if you are traveling for medical or charitable purposes.

Amount of standard meal allowance. The standard meal allowance is the federal M&IE rate. For travel in 1997, the rate is ***$30 a day*** for most areas in the United States. Other locations in the United States are designated as high-cost areas, qualifying for higher standard meal allowances. *Appendix A* in Publication 463 lists the locations qualifying for rates of $34, $38, or $42 a day for travel on or after January 1, 1997.

If you travel to more than one location in one day, use the rate in effect for the area where you stop for sleep or rest. If you work in the transportation industry, however, see *Special rate for transportation workers,* later in this section.

Standard meal allowance for areas outside the continental United States. The standard meal allowance rates do not apply to travel in Alaska, Hawaii, or any other locations outside the continental United States. The federal per diem rates for these locations are published monthly in the *Maximum Travel Per Diem Allowances for Foreign Areas.*

Your employer may have these rates available, or you can purchase the publication from the:

Superintendent of Documents
U.S. Government Printing Office
P.O. Box 371954
Pittsburgh, PA 15250–7954

You can also order it by calling the Government Printing Office at 1–202–512–1800 (not a toll-free number).

Internet addresses. Per diem rates are also available on the Internet.

If you have a computer and a modem, you can access domestic per diem rates at:

www.policyworks.gov/perdiem

You can access foreign per diem rates at:

www.state.gov/www/perdiems

Special rate for transportation workers. You can use a special standard meal allowance if you work in the transportation industry. You are in the transportation industry if your work:

1) Directly involves moving people or goods by airplane, barge, bus, ship, train, or truck, and
2) Regularly requires you to travel away from home and, during any single trip, usually involves travel to areas eligible for different standard meal allowance rates.

If this applies to you, you can claim a ***$36 a day*** standard meal allowance ($40 for travel outside the continental United States).

Using the special rate for transportation workers eliminates the need for you to determine the standard meal allowance for every area where you stop for sleep or rest. If you choose to use the special rate for any trip, however, you must continue to use the special rate (and not use the regular standard meal allowance rates) for all trips you take that year.

Travel for days you depart and return. For both the day your travel begins and the day your travel ends, you must prorate the standard meal allowance. You can do so by one of two methods.

1) You can claim $\frac{3}{4}$ of the standard meal allowance, or
2) You can use any method that you consistently apply and that is in accordance with reasonable business practice.

Example. Jen is employed in New Orleans as a convention planner. In March, her employer sent her on a three-day trip to Washington, DC, to attend a planning seminar. She left her home in New Orleans at 10 a.m. on Wednesday and arrived in Washington, DC, at 5:30 p.m. After spending two nights there, she flew back to New Orleans on Friday and arrived back home at 8:00 p.m. Jen's employer gave her a flat amount to cover her expenses and included it with her wages.

Under Method 1, Jen can claim $2\frac{1}{2}$ days of the standard meal allowance for Washington, DC: $\frac{3}{4}$ of the daily rate for Wednesday and Friday (the days she departed and returned), and the full daily rate for Thursday.

Under Method 2, Jen could also use any method that she applies consistently and that is in accordance with reasonable business practice. For example, she could claim 3 days of the standard meal allowance even though a federal employee would be limited to only $2\frac{1}{2}$ days.

Travel in the United States

The following discussion applies to travel in the United States. For this purpose, the United States includes the 50 states and the District of Columbia. The treatment of your travel expenses depends on how much of your trip was business related and on how much of your trip occurred within the United States.

Trip Primarily for Business

You can deduct all your travel expenses if your trip was entirely business related. If your trip was primarily for business and, while at your business destination, you extended your stay for a vacation, made a nonbusiness side trip, or had other nonbusiness activities, you can deduct your business-related travel expenses. These expenses include the travel costs of getting to and from your business destination and any business-related expenses at your business destination.

Example. You work in Atlanta and take a business trip to New Orleans. On your way home, you stop in Mobile to visit your parents. You spend $630 for the 9 days you are away from home for travel, meals, lodging, and other travel expenses. If you had not stopped in Mobile, you would have been gone only 6 days, and your total cost would have been $580. You can deduct $580 for your trip, including the round-trip transportation to and from New Orleans. The cost of your meals is subject to the 50% limit on meals mentioned earlier.

Trip Primarily for Personal Reasons

If your trip was primarily for personal reasons, such as a vacation, the entire cost of the trip is a nondeductible personal expense. However, you can deduct any expenses you have while at your destination that are directly related to your business.

A trip to a resort or on a cruise ship may be a vacation even if the promoter advertises that it is primarily for business. The scheduling of incidental business activities during a trip, such as viewing videotapes or attending lectures dealing with general subjects, will not change what is really a vacation into a business trip.

Part of Trip Outside the United States

If part of your trip is outside the United States, use the rules described later under *Travel Outside the United States* for that part of the trip. For the part of your trip that is inside the United States, use the rules in this section. Travel outside the United States does not include travel from one point in the United States to another point in the United States. The following discussion can help you determine whether your trip was entirely within the United States.

Public transportation. If you travel by public transportation, any place in the United States where that vehicle makes a scheduled stop is a point in the United States. Once the vehicle leaves the last scheduled stop in the United States on its way to a point outside the United States, you apply the rules under *Travel Outside the United States.*

Example. You fly from New York to Puerto Rico with a scheduled stop in Miami. You return to New York nonstop. The flight from New York to Miami is in the United States, so only the flight from Miami to Puerto Rico is outside the United States. Because there are no scheduled stops between Puerto Rico and New York, all of the return trip is outside the United States.

Private car. Travel by private car in the United States is travel between points in the United States, even when you are on your way to a destination outside the United States.

Example. You travel by car from Denver to Mexico City and return. Your travel from Denver to the border and from the border back to Denver is travel in the United States, and the rules in this section apply. The rules under *Travel Outside the United States* apply to your trip from the border to Mexico City and back to the border.

Private plane. If you travel by private plane, any trip, or part of a trip, for which both your takeoff and landing are in the United States is travel in the United States. This is true even if part of your flight is over a foreign country.

Example. You fly nonstop from Seattle to Juneau. Although the flight passes over Canada, the trip is considered to be travel in the United States. This is because both your takeoff and landing are in the United States.

Travel Outside the United States

If any part of your business travel is outside the United States, some of your deductions for the cost of getting to and from your destination may be limited. For this purpose, the United States includes the 50 states and the District of Columbia.

How much of your travel expenses you can deduct depends in part upon how much of your trip outside the United States was business related.

See chapter 1 of Publication 463 for information on luxury water travel.

Travel Entirely for Business or Considered Entirely for Business

Even if your trip is not entirely for business, it may be considered entirely for business if certain conditions are met.

Travel entirely for business. If you travel outside the United States and you spend the entire time on business activities, all your expenses of getting to and from your business destination are deductible.

Travel considered entirely for business. Even if you did not spend your entire time on business activities, your trip is considered entirely for business and you can deduct all of your business-related travel expenses if you meet at least one of the following four exceptions.

Exception 1 – No substantial control. Your trip is considered entirely for business if you did not have substantial control over arranging the trip. You are not considered to have substantial control merely because you have control over the timing of your trip.

You are considered not to have substantial control over your trip if you:

1) Are an employee who was reimbursed or paid a travel expense allowance,
2) Are not related to your employer, and
3) Are not a managing executive.

"Related to your employer" was defined earlier in this chapter under *Standard Meal Allowance.* A "managing executive" is an employee who has the authority and responsibility, without being subject to the veto of another, to decide on the need for the business travel.

A self-employed person generally has substantial control over arranging business trips.

Exception 2 – Outside U.S. no more than a week. Your trip is considered entirely for business if you were outside the United States for a week or less, combining business and nonbusiness activities. One week means seven consecutive days. In counting the days, do not count the day you leave the United States, but count the day you return to the United States.

Exception 3 – Less than 25% of time on personal activities. Your trip is considered entirely for business if you were outside the United States for more than a week, but you spent less than 25% of the total time you were outside the United States on nonbusiness activities. For this purpose, count both the day your trip began and the day it ended.

Exception 4 – Vacation not a major consideration. Your trip is considered entirely for business if you can establish that a personal vacation was not a major consideration, even if you have substantial control over arranging the trip.

Travel not entirely for business. If you do not meet any of the above exceptions, you may still be able to deduct some of your expenses. See *Travel Primarily for Business,* next.

Travel Primarily for Business

If you travel outside the United States primarily for business purposes but spend some of your time on nonbusiness activities, you generally cannot deduct all of your travel expenses. You can only deduct the business portion of your cost of getting to and from your destination. You must make an allocation between your business and nonbusiness activities to determine your deductible amount. These travel allocation rules are discussed in chapter 1 of Publication 463.

Exception. You do not have to allocate your travel expense deduction if you meet one of the four exceptions listed earlier under *Travel considered entirely for business.* In those cases, you can deduct the total cost of getting to and from your destination.

Travel Primarily for Vacation

If you travel outside the United States primarily for vacation or for **investment** purposes, the entire cost of the trip is a nondeductible personal expense. This is true even if you spend some time attending brief professional seminars or a continuing education program. You can, however, deduct your registration fees and any other expenses incurred that were directly related to your business.

Conventions

You can deduct your travel expenses when you attend a convention if you can show that your attendance benefits your trade or business. You cannot deduct the travel expenses for your family. If the convention is for **investment,** political, social, or other purposes unrelated to your trade or business, you cannot deduct the expenses. Nonbusiness expenses, such as social or sightseeing expenses, are personal expenses and are not deductible.

Your appointment or election as a delegate does not, in itself, entitle you to or deprive you of a deduction. Your attendance must be connected to your own trade or business.

Convention agenda. The agenda of the convention does not have to deal specifically with your official duties or the responsibilities of your position or business. It is enough if the agenda is so related to your active trade or business and your responsibilities that attendance for a business purpose is justified.

Foreign conventions. See chapter 1 of Publication 463 for information on conventions held outside the North American area.

Entertainment Expenses

You may be able to deduct business-related entertainment expenses you have for entertaining a client, customer, or employee.

To be deductible, the expense must be both ordinary and necessary. An ordinary expense is one that is common and accepted in your field of business, trade, or profession. A necessary expense is one that is helpful and appropriate for your business. An expense does not have to be indispensable to be considered necessary.

In addition, the entertainment expense must meet one of two tests:

1) Directly-related test, or
2) Associated test.

You must also meet the requirements discussed later in this chapter under *Recordkeeping.*

Even if you meet all the requirements for claiming a deduction for entertainment expenses, the amount you can deduct may be limited. Generally, you can deduct only 50% of your unreimbursed entertainment expenses. This limit is discussed later under *50% Limit.*

Club dues and membership fees. You cannot deduct dues (including initiation fees) for membership in any club organized for business, pleasure, recreation, or other social purpose. This rule applies to any membership organization if one of its principal purposes is to conduct entertainment activities for members or their guests, or to provide members or their guests with access to entertainment facilities.

The purposes and activities of a club, not its name, will determine whether or not you can deduct the dues. You cannot deduct dues paid to country clubs, golf and athletic clubs, airline clubs, hotel clubs, and clubs operated to provide meals under circumstances generally considered to be conducive to business discussions.

Entertainment. Entertainment includes any activity generally considered to provide entertainment, amusement, or recreation. Examples include entertaining guests at nightclubs; at social, athletic, and sporting clubs; at theaters; at sporting events; on yachts; or on hunting, fishing, vacation, and similar trips. You cannot deduct expenses for entertainment to the extent they are lavish or extravagant. If you buy a ticket to an entertainment event for a client, you generally cannot deduct more than the face value of the ticket.

A meal as a form of entertainment. Entertainment includes the cost of a meal you provide to a customer, or client, whether the meal is a part of other entertainment or by itself. A meal sold in the normal course of your business is not entertainment. Generally, to deduct an entertainment-related meal, you or your employee must be present when the food or beverages are provided.

A meal expense includes the cost of food, beverages, taxes, and tips for the meal.

No double deduction allowed for meals. You cannot claim the cost of your meal as an entertainment expense if you are also claiming the cost of your meal as a travel expense.

Taking turns paying for meals or entertainment. Expenses are ***not*** deductible when a group of business acquaintances take turns picking up each others' meal or entertainment checks without regard to whether any business purposes are served.

Trade association meetings. You can deduct expenses for entertainment that are directly related to and necessary for attending business meetings or conventions of certain exempt organizations. These organizations include business leagues, chambers of commerce, real estate boards, trade associations, and professional associations. The expenses of your attendance must be related to your active trade or business. These expenses are subject to the 50% limit on entertainment expenses.

Additional information. For more information on entertainment expenses, including discussions of the directly-related and associated tests, see chapter 2 of Publication 463.

50% Limit

In general, you can deduct only 50% of your business-related meal and entertainment expenses. This limit applies to employees or their employers, and to self-employed persons (including independent contractors) or their clients, depending on whether the expenses are reimbursed. *Figure 28–A* summarizes the general rules explained in this section.

The 50% limit applies to meals or entertainment expenses incurred while:

1) Traveling away from home (whether eating alone or with others) on business,
2) Entertaining business customers at your place of business, a restaurant, or other location, or
3) Attending a business convention or reception, business meeting, or business luncheon at a club.

Covered expenses. Taxes and tips relating to a business meal or entertainment activity are included in the amount that is subject to the 50% limit. Expenses such as cover charges for admission to a nightclub, rent paid for a room in which you hold a dinner or cocktail party, or the amount paid for parking at a sports arena are also subject to the 50% limit. However, the cost of transportation to and from a business meal or a business-related entertainment activity is not subject to the 50% limit.

Separating costs. If you pay or incur an expense for goods and services consisting of meals, entertainment, and other services (such as lodging or transportation), you must allocate that expense between the cost of meals and entertainment and the cost of the other services. You must have a reasonable basis for making this allocation. For example, you must allocate your expenses if a hotel includes one or more meals in its room charge, or if you are provided with one per diem amount to cover both your lodging and meal expenses.

Application of 50% limit. The 50% limit on meal and entertainment expenses applies if the expense is otherwise deductible and is not covered by the exception discussed later in this section.

The 50% limit also applies to activities that are not a trade or business. It applies to meal and entertainment expenses incurred for the production of income, including rental or royalty income. It also applies to the cost of meals included in deductible educational expenses.

When to apply the 50% limit. You apply the 50% limit after determining the amount that would otherwise qualify for a deduction. You first determine the amount of meal and entertainment expenses that would be deductible under the rules discussed in this chapter.

To determine the actual amount you can deduct if you are an employee, you must apply the 2%-of-adjusted-gross-income limit on Schedule A (Form 1040).

Example 1. You spend $100 for a business-related meal. If $40 of that amount is not allowable because it is considered lavish and extravagant, the remaining $60 is subject to the 50% limit. Your deduction cannot be more than $30 (.50 × $60).

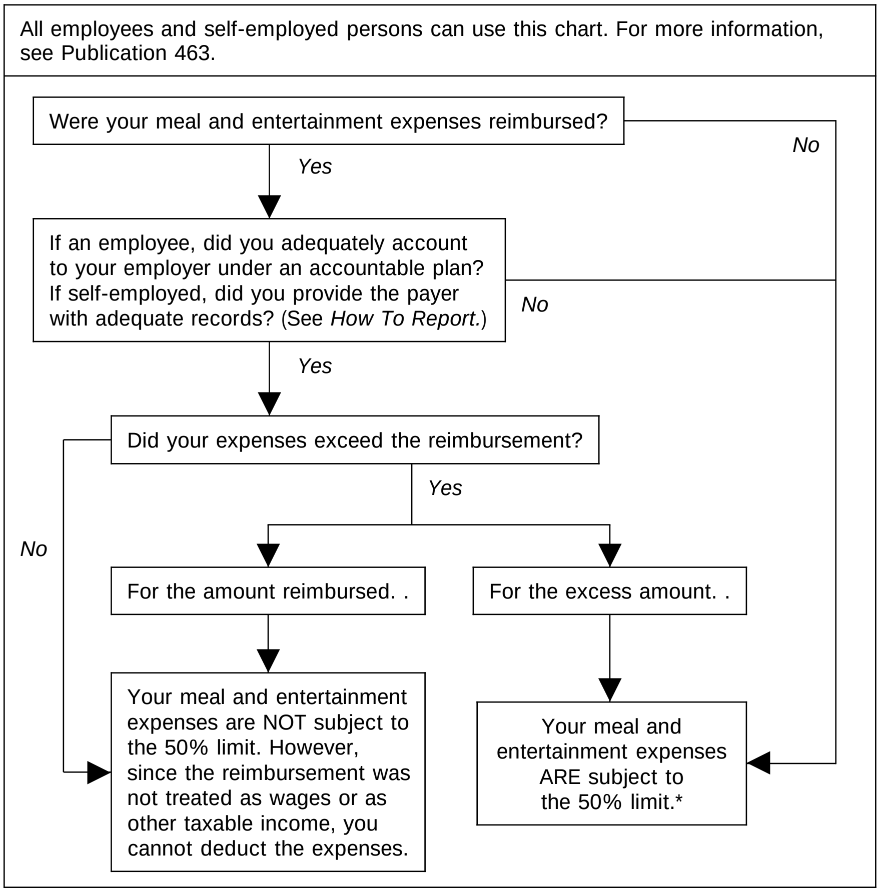
Example 2. You purchase two tickets to a concert and give them to a client. You purchased the tickets through a ticket agent. You paid $150 for the two tickets, which had a face value of $60 each ($120 total). Your deduction cannot be more than $60 (.50 × $120).

Exception to the 50% Limit

The 50% limit on meal and entertainment expenses applies if the expense is otherwise deductible based on the tests and rules explained in this chapter.

You can use *Figure 28–A* to help you determine if the 50% limit applies to you. Your meal or entertainment expense is ***not***

Figure 28-A. **Does the 50% Limit Apply to Your Expenses?**



*There are exceptions to this rule. For example, you are not subject to the 50% limit on meals and entertainment if:

A) You incur the expenses as a means of advertising to, or promoting goodwill in, the general community,
B) You pay the expenses as part of a package deal that includes a ticket to a charitable sports event, or
C) Your business involves the sale of meals and/or entertainment to the public.

subject to the 50% limit if the expense meets the following exception.

Employee's reimbursed expenses. As an employee, you are not subject to the 50% limit if your employer reimburses you under an accountable plan and does not treat your reimbursement as wages. Accountable plans are discussed later under *Reimbursements.*

Business Gift Expenses

If you give business gifts in the course of your trade or business, you can deduct the cost subject to the limits and rules in this section.

$25 limit on business gifts. You can deduct no more than $25 for business gifts you give directly or indirectly to any one person during your tax year. A gift to a company that is intended for the eventual personal use or benefit of a particular person or a limited class of people will be considered an indirect gift to that particular person or to the individuals within that class of people who receive the gift.

A gift to the spouse of a business customer or client is generally an indirect gift to the customer or client. This rule does not apply if you have an independent bona fide business connection with the spouse and the gift is not intended for the other spouse's eventual use or benefit. These rules also apply to gifts to any other family member.

If you and your spouse both give gifts, both of you are treated as one taxpayer. It does not matter whether you have separate businesses, are separately employed, or whether each of you has an independent connection with the recipient. If a partnership gives gifts, the partnership and the partners are treated as one taxpayer.

Incidental costs. Incidental costs, such as engraving on jewelry, or packaging, insuring, and mailing, are generally not included in determining the cost of a gift for purposes of the $25 limit.

A related cost is considered incidental only if it does not add substantial value to the gift. For example, the cost of gift wrapping is considered an incidental cost. However, the purchase of an ornamental basket for packaging fruit is not considered an incidental cost of packaging if the basket has a substantial value compared to the value of the fruit.

Exceptions. The following items are not included in the $25 limit for business gifts.

1) An item that costs $4 or less and:
   a) Has your name clearly and permanently imprinted on the gift, and
   b) Is one of a number of identical items you widely distribute.

   Examples include pens, desk sets, and plastic bags and cases.

2) Signs, display racks, or other promotional material to be used on the business premises of the recipient.

Gift or entertainment. Any item that might be considered either a gift or an entertainment expense generally will be considered an entertainment expense. However, if you give a customer packaged food or beverages that you intend the customer to use at a later date, treat it as a gift expense.

If you give a business customer tickets to a theater performance or sporting event and you do not go with the customer to the performance or event, you have a choice. You can choose to treat the tickets as either a gift or entertainment expense, whichever is to your advantage.

You can change your treatment of the tickets at a later date, but not after the time allowed for the assessment of income tax. In most instances, this assessment period ends 3 years after the due date of your income tax return.

If you go with the customer to the event, you must treat the cost of the tickets as an entertainment expense. You cannot choose, in this case, to treat the tickets as a gift expense.

Local Transportation Expenses

This section discusses expenses you can deduct for local business transportation. This includes the cost of transportation by air, rail, bus, taxi, etc., and the cost of driving and maintaining your car.

Local business transportation does ***not*** include expenses you have while traveling away from home overnight. Those expenses are deductible as travel expenses and are discussed earlier. However, if you use your car while traveling away from home overnight, use the rules in this section to figure your deduction. See *Car Expenses,* later.

Local transportation expenses include the ordinary and necessary costs of:

- Getting from one workplace to another in the course of your business or profession when you are traveling within your tax home (Tax home is defined earlier under *Travel Expenses.),*
- Visiting clients or customers,
- Going to a business meeting away from your regular workplace, or
- Getting from your home to a temporary workplace when you have one or more regular places of work. These temporary workplaces can be either within the area of your tax home or outside that area.

You can deduct your expenses for local business transportation, including the business use of your car, if the expenses are ordinary and necessary. An ordinary expense is one that is common and accepted in your field of trade, business, or profession. A necessary expense is one that is helpful and appropriate for your business. An expense does not have to be indispensable to be considered necessary.

The following discussions apply to you if you have a regular or main job away from your home (residence). If your principal place of business is in your home, see *Office in the home,* later.

Illustration of local transportation. *Figure 28–B* illustrates the rules for when you can deduct local transportation expenses when you have a regular or main job away from your home. You may want to refer to it when deciding whether you can deduct your local business transportation expenses.

Temporary work location. If you have one or more regular places of business and commute to a temporary work location, you can deduct the expenses of the daily round-trip transportation between your home and the temporary location. The temporary work must be irregular or short term (generally a matter of days or weeks).

If the temporary work location is beyond the general area of your regular place of work and you stay overnight, you are traveling away from home. You may have deductible travel expenses as discussed earlier in this chapter.

If you have no regular place of work but ordinarily work in the metropolitan area where you live, you can deduct daily transportation costs between home and a temporary work site ***outside*** that metropolitan area. Generally, a metropolitan area includes the area within the city limits and the suburbs that are considered part of that metropolitan area. You cannot deduct daily transportation costs between your home and temporary work sites ***within*** your metropolitan area. These are nondeductible commuting costs.

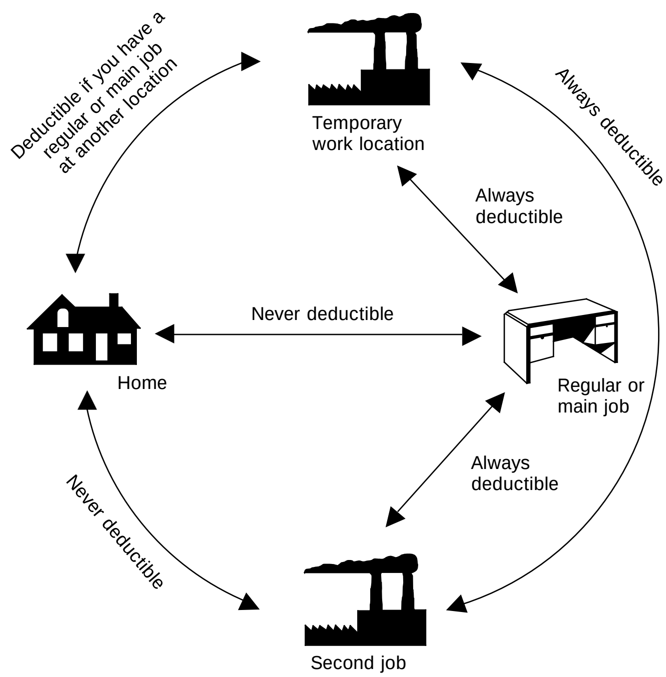
Two places of work. If you work at two places in a day, whether or not for the same employer, you can deduct the expense of getting from one workplace to the other. However, if for some personal reason you do not go directly from one location to the other, you can deduct only the amount it would have cost you to go directly from the first location to the second. Transportation expenses you have in going between home and a part-time job on a day off from your main job are commuting expenses. You cannot deduct them.

Armed Forces reservists. A meeting of an Armed Forces reserve unit is considered a second place of business if the meeting is held on a day on which you work at your regular job. You can deduct the expense of getting to or from one workplace to the other as just discussed under *Two places of work.*

You usually cannot deduct the expense if the reserve meeting is held on a day on which you do not work at your regular job. In this case, your transportation is generally considered a nondeductible commuting cost. However, you can deduct your expenses if the location of the meeting is temporary and you have one or more regular places of work.

Figure 28-B. **When Are Local Transportation Expenses Deductible?**

All employees and self-employed persons can use this chart.
(Do not use this chart if your home is your principal place of business. See *Office in the home.)*



Home: The place where you reside. Transportation expenses between your home and your main or regular place of work are personal commuting expenses.

Regular or main job: Your principal place of business. If you have more than one job, you must determine which one is your regular or main job. Consider the time you spend at each, the activity you have at each, and the income you earn at each.

Temporary work location: A place where your work assignment is irregular or short-term, generally a matter of days or weeks. Unless you have a regular place of business, you can only deduct your transportation expenses to a temporary location outside your metropolitan area.

Second job: If you regularly work at two or more places in one day, whether or not for the same employer, you can deduct your transportation expenses of getting from one workplace to another. You cannot deduct your transportation costs between your home and a second job on a day off from your main job.

If you ordinarily work in a particular metropolitan area but not at any specific location and the reserve meeting is held at a temporary location outside that metropolitan area, you can deduct your daily transportation expenses.

If you travel away from home overnight to attend a guard or reserve meeting, you can deduct your travel expenses. These are discussed earlier under *Travel Expenses.*

Commuting expenses. You cannot deduct the costs of taking a bus, trolley, subway, taxi, or driving a car between ***your home*** and your main or regular place of work. These costs are personal commuting expenses. You cannot deduct commuting expenses no matter how far your home is from your regular place of work. You cannot deduct commuting expenses even if you work during the commuting trip.

Example. You had a telephone installed in your car. You sometimes use that telephone to make business calls while commuting to and from work. Sometimes business associates ride with you to and from work, and you have a business discussion in the car. These activities do not change the trip's expenses from commuting to business. You cannot deduct your commuting expenses.

Parking fees. Fees you pay to park your car at your place of business are nondeductible commuting expenses. You can, however, deduct business-related parking fees when visiting a customer or client.

Advertising display on car. The use of your car to display material that advertises your business does not change the use of your car from personal use to business use. If you use this car for commuting or other personal uses, you cannot deduct your expenses for those uses.

Car pools. You cannot deduct the cost of using your car in a nonprofit car pool. Do not include payments you receive from the passengers in your income. These payments are considered reimbursements of your expenses. However, if you operate a car pool for a profit, you must include these payments from passengers in your income.

You can then deduct your car expenses (using the rules in this chapter).

Hauling tools or instruments. If you haul tools or instruments in your car while commuting to and from work, this does not make your car expenses deductible. However, if you have additional costs for hauling tools or instruments (such as for renting a trailer you tow with your car), you can deduct those additional costs.

Union members' trips from a union hall. If you get your work assignments at a union hall and then go to your place of work, the costs of getting from the union hall to your place of work are nondeductible commuting expenses.

Office in the home. If you have an office in your home that qualifies as a ***principal place of business,*** you can deduct your daily transportation costs between your home and another work location in the same trade or business. (See chapter 30 for information on determining if your home office qualifies as a principal place of business.)

If your home office does not qualify as a principal place of business, follow the general rules explained earlier.

Examples of deductible local transportation. The following examples illustrate when you can deduct local transportation expenses based on the location of your work and your home.

Example 1. You regularly work in an office in the city where you live. Your employer sends you to a one-week training session at a different office in the same city. You travel directly from your home to the training location and return each day. You can deduct the cost of your daily round-trip transportation between your home and the training location.

Example 2. Your principal place of business is in your home. You can deduct the cost of round-trip transportation between your qualifying home office and your client's or customer's place of business.

Example 3. You have no regular office, and you do not have an office in your home. In this case, the location of your first business contact is considered your office. Transportation expenses between your home and this first contact are nondeductible commuting expenses. Transportation expenses between your last business contact and your home are also nondeductible commuting expenses. Although you cannot deduct the costs of these first and last trips, you can deduct the costs of going from one client or customer to another.

Car Expenses

If you use your car for business purposes, you may be able to deduct car expenses. You generally can use one of two methods to figure your expenses: actual expenses or the standard mileage rate. In this chapter, “car” includes a van, pickup, or panel truck.

TIP *You may be entitled to a tax credit for an electric vehicle or a deduction from gross income for a part of the cost of a clean-fuel vehicle that you place in service during the year. The vehicle must meet certain requirements, and you do not have to use it in your business to qualify for the credit or the deduction. For more information, see chapter 15 of Publication 535.*

Standard Mileage Rate

You may be able to use the standard mileage rate to figure the deductible cost of operating your car for business purposes. You can use the standard mileage rate only for a car that you own.

For 1997, the standard mileage rate is ***31½ cents*** a mile for all business miles (47¼ cents a mile for U.S. Postal Service employees with rural routes). These rates are adjusted periodically for inflation.

CAUTION *If you choose to use the standard mileage rate, you* **cannot** *deduct your actual car expenses.*

You generally can use the standard mileage rate regardless of whether you are reimbursed and whether any reimbursement is more or less than the amount figured using the standard mileage rate. See *Reimbursements* later in this chapter.

Choosing the standard mileage rate. If you want to use the standard mileage rate for a car, you must choose to use it in the first year the car is available for use in your business. Then in later years, you can choose to use the standard mileage rate or actual expenses.

If you choose to use the standard mileage rate, you are considered to have chosen not to use the depreciation methods under the modified accelerated cost recovery system (MACRS). This is because the standard mileage rate includes an allowance for depreciation. You also cannot claim the section 179 deduction. If you change to the actual expenses method in a later year, but before your car is considered fully depreciated, you have to estimate the remaining useful life of the car and use straight line depreciation. For information on how to figure that depreciation, see the exception in *Methods of depreciation* under *Depreciation Deduction* in chapter 4 of Publication 463.

Standard mileage rate not allowed. You cannot use the standard mileage rate if you:

1) Do not own the car,
2) Use the car for hire (such as a taxi),
3) Operate two or more cars at the same time (as in fleet operations),
4) Claimed a deduction for the car in an earlier year using ACRS or MACRS depreciation, or
5) Claimed a section 179 deduction on the car.

Two or more cars. If you own two or more cars that are used for business at the same time, you cannot use the standard mileage rate for the business use of any car. However, you may be able to deduct a part of the actual expenses for operating each of the cars. See *Actual Car Expenses* in chapter 4 of Publication 463 for information on how to figure your deduction.

You are ***not*** using two or more cars for business at the same time if you alternate using (use at different times) the cars for business.

Example 1. Marcia, a salesperson, owns a car and a van that she alternates using for calling on her customers. She can use the standard mileage rate for the business mileage of the car and the van.

Example 2. Maureen owns a car and a van that are both used in her housecleaning business. Her employees use the car and she uses the van to travel to the various customers. Maureen cannot use the standard mileage rate for the car or the van. This is because both vehicles are used in Maureen's business at the same time. She must use actual expenses for both vehicles.

Parking fees and tolls. In addition to using the standard mileage rate, you can deduct any business-related parking fees and tolls. (Parking fees that you pay to park your car at your place of work are nondeductible commuting expenses.)

Actual Car Expenses

If you do not choose to use the standard mileage rate, you may be able to deduct your actual car expenses.

TIP *If you qualify to use both methods, figure your deduction both ways to see which gives you a larger deduction.*

Actual car expenses include the costs of:

Depreciation	Lease fees	Rental fees
Garage rent	Licenses	Repairs
Gas	Oil	Tires
Insurance	Parking fees	Tolls

Business and personal use. If you use your car for both business and personal purposes, you must divide your expenses between business and personal use.

Example. You are a contractor and drive your car 20,000 miles during the year: 12,000 miles for business use and 8,000 miles for personal use. You can claim only 60% (12,000 ÷ 20,000) of the cost of operating your car as a business expense.

Interest on car loans. If you are an employee, you cannot deduct any interest paid on a car loan. This interest is treated as personal interest and is not deductible. However, if you are self-employed and use your car in that business, see chapter 8 of Publication 535.

Taxes paid on your car. If you are an employee, you can deduct personal property taxes paid on your car if you itemize deductions. Enter the amount paid on line 7 of Schedule A (Form 1040). (See chapter 24 for more information on taxes.) If you are not an employee, see your form instructions for information on how to deduct personal property taxes paid on your car.

You cannot deduct luxury or sales taxes, even if you use your car 100% for business. Luxury and sales taxes are part of your car's basis and may be recovered through depreciation, discussed later.

Fines and collateral. Fines and collateral for traffic violations are not deductible.

Depreciation and section 179 deductions. If you use your car for business purposes as an employee or as a sole proprietor, you may be able to recover its cost by claiming a depreciation or section 179 deduction. The amount you may claim depends on the year you placed the car in service and the amount of your business use.

For more information, see the instructions for Form 2106 (if you are an employee) or Form 4562 (if you are self-employed). Also see chapter 4 of Publication 463 for a detailed discussion of these deductions.

Leasing a car. If you lease a car that you use in your business, you can deduct the part of each lease payment that is for the use of the car in your business. You cannot deduct any part of a lease payment that is for commuting to your regular job or for any other personal use of the car.

You must spread any advance payments over the entire lease period. You cannot deduct any payments you make to buy a car even if the payments are called lease payments.

If you lease a car that you use in your business for 30 days or more, you may have to include an "inclusion amount" in your income for each tax year you lease the car. For information on reporting lease inclusion amounts, see *Leasing a Car* in chapter 4 of Publication 463.

Sale, Trade-in, or Other Disposition

If you sell, trade in, or otherwise dispose of your car, you may have a taxable gain, a deductible loss, or an adjustment to the basis of your new car. This is true whether you used the standard mileage rate or actual car expenses to deduct the business use of your car. Chapter 14 has information on basis of property and chapter 15 has information on sales of property. For details on adjusting the basis of your car, see *Disposition of a Car* in chapter 4 of Publication 463.

Recordkeeping

This section discusses the records you need to keep if you plan to deduct an expense discussed in this chapter.

RECORDS By keeping timely and accurate records, you will have support to show the IRS if your tax return is ever examined. Or, you will have proof of expenses that your employer may require if you are reimbursed under an accountable plan. These plans are discussed later under *Reimbursements.*

How To Prove Expenses

This section explains the items you need to prove depending on which expense you are deducting. It also discusses rules for the records you must keep. These rules may apply to more than one type of expense. The topics include:

- A chart showing what is needed to prove expenses,
- A discussion of adequate records,
- How to treat confidential information,
- When you need documentary evidence,
- Duplicate information,
- When to record information,
- When expenses must be kept separate,
- When expenses can be combined,
- What if your records are incomplete, and
- What if your return is examined.

Chart that shows proof needed. You must be able to prove (substantiate) certain elements of expense to deduct travel, entertainment, business gift, and local transportation expenses. *Table 28–2* summarizes the elements for each expense discussed in this publication. You must be able to prove the elements listed across the top of the chart. You prove them by having the information and receipts (where needed) for the expenses listed in the first column. You cannot deduct amounts that you approximate or estimate.

Adequate records. You should keep adequate records that prove your expenses or have sufficient evidence that will support your own statement. Written evidence has considerably more value than oral evidence alone, and you must generally prepare a written record for it to be considered adequate. However, if you prepare a record in a computer memory device with the aid of a logging program, it is considered an adequate record.

You should keep the proof you need in an account book, diary, statement of expense, or similar record, and keep documentary evidence (such as receipts, canceled checks, or bills) that together will support each element of an expense. A receipt is ordinarily the best evidence to prove the amount of an expense. You cannot deduct amounts that are considered lavish or extravagant.

Confidential information. You do not need to put confidential information relating to an element of a deductible expense (such as the place, business purpose, or business relationship) in your account book, diary, or other record. However, you do have to record the information elsewhere at or near the time of the expense and have it available to fully prove that element of the expense.

Documentary evidence. You generally must have documentary evidence, such as receipts, canceled checks, or bills, to support your expenses. However, this evidence is not needed if any of the following apply:

1) You have meals or lodging expenses while traveling away from home for which you account to your employer under an accountable plan and you use a per diem allowance method that includes meals and/or lodging,
2) Your expense, other than lodging, is less than $75, or
3) You have a transportation expense for which a receipt is not readily available.

Accountable plans and per diem allowances are discussed later under *Reimbursements.*

Adequate evidence. Documentary evidence ordinarily will be considered adequate if it shows the amount, date, place, and essential character of the expense.

For example, a hotel receipt is enough to support expenses for business travel if it has:

1) The name and location of the hotel,
2) The dates you stayed there, and
3) Separate amounts for charges such as lodging, meals, and telephone calls.

A restaurant receipt is enough to prove an expense for a business meal if it has:

1) The name and location of the restaurant,
2) The number of people served, and
3) The date and amount of the expense.

If a charge is made for items other than food and beverages, the receipt must show that this is the case.

Canceled check. A canceled check, together with a bill from the payee, ordinarily establishes the cost. However, a canceled check by itself does not prove a business expense without other evidence to show that it was for a business purpose.

Proving business purpose. You must generally provide a written statement of the business purpose of an expense. However, the degree of proof varies according to the circumstances in each case. If the business purpose of an expense is clear from the surrounding circumstances, then you do not need to give a written explanation.

Duplicate information. You do not have to record information in your account book or other record that duplicates information shown on a receipt as long as your records and receipts complement each other in an orderly manner. You do not have to record amounts your employer pays directly for any ticket or other travel item. However, if you charge these items to your employer, through a credit card or otherwise, you must keep a record of the amounts you spend.

Timely recordkeeping. You do not need to write down the elements of every expense at the time of the expense. However, a record of the elements of an expense or of a business use made at or near the time of the expense or use, and supported by sufficient documentary evidence, has more value than a statement prepared later when generally there is a lack of accurate recall.

A log maintained on a weekly basis, which accounts for use during the week, is considered a timely record. An expense account statement you give your employer, client, or customer can also be considered a timely record. This is true if it is copied from your account book, diary, statement of expense, or similar record.

Separating expenses. Each separate payment usually is considered a separate expense. For example, if you entertain a customer or client at dinner and then go to the theater, the dinner expense and the cost of the theater tickets are two separate expenses. You must record them separately in your records.

Allocating total cost. If you prove the total cost of travel or entertainment but you cannot prove how much it cost for each person, you must divide the cost among you and your guests to determine the business and nonbusiness cost. To do so, divide the total cost by the total number of persons.

Table 28-2. **How To Prove Certain Business Expenses**

IF you have expenses for:	THEN you must keep records that show details of the following elements.			
	Amount	**Time**	**Place or Description**	**Business Purpose and Business Relationship**
Travel	Cost of each separate expense for travel, lodging, and meals. Incidental expenses may be totaled in reasonable categories such as taxis, daily meals for traveler, etc.	Dates you left and returned for each trip and number of days spent on business.	Destination or area of your travel (name of city, town, or other designation).	Purpose: Business purpose for the expense or the business benefit gained or expected to be gained. Relationship: N/A
Entertainment	Cost of each separate expense. Incidental expenses such as taxis, telephones, etc., may be totaled on a daily basis.	Date of entertainment. (Also see *Business Purpose.*)	Name and address or location of place of entertainment. Type of entertainment if not otherwise apparent. (Also see *Business Purpose.*)	Purpose: Business purpose for the expense or the business benefit gained or expected to be gained. For entertainment, the nature of the business discussion or activity. If the entertainment was directly before or after a business discussion: the date, place, nature, and duration of the business discussion, and the identities of the persons who took part in both the business discussion and the entertainment activity. Relationship: Occupations or other information (such as names, titles, or other designations) about the recipients that shows their business relationship to you. For entertainment, you must also prove that you or your employee was present if the entertainment was a business meal.
Gifts	Cost of the gift.	Date of the gift.	Description of the gift.	
Transportation (Car)	Cost of each separate expense. For car expenses, the cost of the car and any improvements, the date you started using it for business, the mileage for each business use, and the total miles for the year.	Date of the expense. For car expenses, the date of the use of the car.	Your business destination (name of city, town, or other designation).	Purpose: Business purpose for the expense. Relationship: N/A

The result is the amount you use to figure your deductible expense for each qualifying person.

Combining items. You can make one daily entry for reasonable categories of expenses such as taxi fares, telephone calls, or other incidental travel costs. Meals should be in a separate category. You can include tips with the costs of the services you received.

Expenses of a similar nature occurring during the course of a single event are considered a single expense. For example, if during entertainment at a cocktail lounge, you pay separately for each serving of refreshments, the total expense for the refreshments is treated as a single expense.

Incomplete records. If you do not have complete records to prove an element of an expense, then you must prove the element by:

1) Your own statement, whether written or oral, that contains specific information about the element, and

2) Other supporting evidence that is sufficient to establish the element.

If your return is examined. If your return is examined, you may have to provide additional information to the IRS. This information could be needed to clarify or to establish the accuracy or reliability of information contained in your records, statements, testimony, or documentary evidence before a deduction is allowed.

How Long To Keep Records and Receipts

You must keep proof to support your claim to a deduction as long as your income tax return can be examined. Generally, it will be necessary for you to keep your records for 3 years from the date you file the income tax return on which the deduction is claimed. A return filed early is considered filed on the due date.

Reimbursed for expenses. Employees who give their records and documentation to their employers and are reimbursed for their expenses generally do not have to keep duplicate copies of this information. However, you may have to prove your expenses if:

1) You claim deductions for expenses that are more than reimbursements,

2) Your expenses are reimbursed under a nonaccountable plan,

3) Your employer does not use adequate accounting procedures to verify expense accounts, or

4) You are related to your employer, as defined earlier under *Standard Meal Allowance.*

See the next section, *How To Report,* for a discussion of reimbursements, adequate accounting, and nonaccountable plans.

Additional information. Chapter 5 of Publication 463 has more information on recordkeeping, including examples.

How To Report

This section explains how and where to report the expenses discussed in this chapter. It discusses reimbursements, including treatment of accountable and nonaccountable plans, adequate accounting, per diem allowances, and car or mileage allowances. This section ends by showing you how to complete Forms 2106 and 2106–EZ.

Self-employed. You must report your income and expenses on Schedule C or C–EZ (Form 1040) if you are a sole proprietor, or on Schedule F (Form 1040) if you are a farmer. You do not use Form 2106 or Form 2106–EZ. See your form instructions for information on how to complete your tax return. You can also find information in chapter 16 of Publication 535 if you are a sole proprietor, or in Publication 225, *Farmer's Tax Guide,* if you are a farmer.

Both self-employed and an employee. If you are both self-employed and an employee, you must keep separate records for each business activity. Report your business expenses for self-employment on Schedule C, Schedule C–EZ, or on Schedule F, as discussed earlier. Report your business expenses for your work as an employee on Form 2106 or Form 2106–EZ, as discussed next.

Employees. If you are an employee, you generally must complete Form 2106 to deduct your travel, transportation, and entertainment expenses. However, you can use Form 2106–EZ instead of Form 2106 if you meet both of the following conditions.

1) You were not reimbursed for your expenses or, if you were reimbursed, the reimbursement was included in your income (box 1 of your Form W–2).

2) If you claim car expenses, you use the standard mileage rate.

For more information on how to report your expenses on Forms 2106 and 2106–EZ, see *Completing Forms 2106 and 2106–EZ,* later.

Gifts. If you did not receive any reimbursements (or the reimbursements were all included in box 1 of your Form W–2) and the only business expense you are claiming is for business gifts, do not complete Form 2106 or 2106–EZ. Instead, claim the amount of your deductible business gifts directly on line 20 of Schedule A (Form 1040). Otherwise, you must complete Form 2106 or 2106–EZ.

Statutory employees. If you received a Form W–2 and the "Statutory employee" box in box 15 was checked, you report your income and expenses related to that income on Schedule C or C–EZ (Form 1040). Do not complete Form 2106 or Form 2106–EZ.

Statutory employees include full-time life insurance salespersons, certain agent or commission drivers, traveling salespersons, and certain homeworkers.

CAUTION *If you are entitled to a reimbursement from your employer but you do not claim it, you cannot claim a deduction for the expenses to which that* **unclaimed reimbursement** *applies.*

Reimbursement for personal expenses. If your employer reimburses you for nondeductible personal expenses, such as for vacation trips, your employer must report the reimbursement as wage income (in box 1 of your Form W–2). You cannot deduct personal expenses.

Reimbursements

This section explains what to do when you receive an advance or are reimbursed for any of the employee business expenses discussed in this chapter.

If you received an advance, allowance, or reimbursement for your expenses, how you report this amount and your expenses depends on whether the reimbursement was paid to you under an accountable plan or a nonaccountable plan.

This section explains the two types of plans, how per diem and car or mileage allowances simplify proving the amount of your expenses, and the tax treatment of your reimbursements and expenses.

Your employer should tell you what method of reimbursement is used and what records you must provide.

No reimbursement. If you are paid a salary or commission with the understanding that you will pay your own expenses, you are not reimbursed or given an allowance for your expenses. In this situation, you have no reimbursement or allowance arrangement, and you deduct your expenses using either Form 2106 or Form 2106–EZ and Schedule A (Form 1040), or only Schedule A (Form 1040) if you are only claiming business gift expenses. You do not have to read this section on reimbursements. Instead, see *Completing Forms 2106 and 2106–EZ,* later, for information on completing your tax return.

Accountable Plans

To be an accountable plan, your employer's reimbursement or allowance arrangement must include all three of the following rules.

1) Your expenses must have a business connection — that is, you must have paid or incurred deductible expenses while performing services as an employee of your employer.

2) You must adequately account to your employer for these expenses within a reasonable period of time.

3) You must return any excess reimbursement or allowance within a reasonable period of time.

"Adequate accounting" and "returning excess reimbursements" are discussed later.

An ***excess reimbursement or allowance*** is any amount you are paid that is more than the business-related expenses that you adequately accounted for to your employer. See *Returning Excess Reimbursements,* later, for information on how to handle these excess amounts.

The definition of ***reasonable period of time*** depends on the facts of your situation. The IRS will consider it reasonable for you to:

1) Receive an advance within 30 days of the time you have an expense,

2) Adequately account for your expenses within 60 days after they were paid or incurred, and

3) Return any excess reimbursement within 120 days after the expense was paid or incurred.

If you are given a periodic statement (at least quarterly) that asks you to either return or adequately account for outstanding reimbursements and you comply within 120 days of the statement, the IRS will consider the amount adequately accounted for or returned within a reasonable period of time.

Employee meets accountable plan rules. If you meet the three rules for accountable plans, your employer should not include any reimbursements in your income in box 1 of your Form W–2. If your expenses equal your reimbursement, you do not complete Form 2106. You have no deduction since your expenses and reimbursement are equal.

TIP *If your employer included reimbursements in box 1 of your Form W–2 and you meet all three rules for accountable plans, ask your employer for a corrected Form W–2.*

Employee does not meet accountable plan rules. Even though you are reimbursed under an accountable plan, some of your expenses may not meet all three rules.

If your expenses are reimbursed under an otherwise accountable plan but you do not return, within a reasonable period of time, any reimbursement of expenses for which you did not adequately account, then only the amount for which you did adequately account is considered as paid under an accountable plan. The remaining expenses are treated as having been reimbursed under a nonaccountable plan (discussed later).

If you received an allowance or advance that was higher than the federal rate, see *Returning Excess Reimbursements,* later. In this chapter, "federal rate" means any of the three per diem allowances or the standard mileage rate.

Reimbursement of nondeductible expenses. You may be reimbursed under your employer's accountable plan for expenses related to that employer's business, some of which are deductible as employee business expenses and some of which are not deductible. The reimbursements you receive for the nondeductible expenses are treated as paid under a nonaccountable plan.

Example. Your employer's plan may reimburse you for travel expenses while away from home on business, and for meals when you work late at the office, even though you are not away from home. The part of the arrangement that reimburses you for the nondeductible meals when you work late at the office is treated as a second arrangement. The payments under this second arrangement are treated as paid under a nonaccountable plan.

Per diem allowances. If you are reimbursed by a per diem allowance (daily amount) that you received under an accountable plan, two facts affect your reporting:

- The federal rate for the area where you traveled, and
- Whether the allowance or your actual expenses were more than the federal rate.

For this purpose, the ***federal rate*** can be figured by using any one of the following three methods:

1) The regular federal per diem rate (discussed later in this chapter),
2) The high-low rate (discussed later in this chapter), or
3) The standard meal allowance (discussed earlier under *What Are Travel Expenses?).*

The following discussions explain where to report your expenses depending upon how the amount of your per diem allowance compares to the federal rate.

Per diem allowance LESS than or EQUAL to the federal rate. If your per diem allowance is less than or equal to the federal rate, the allowance will not be included in box 1 of your Form W–2. You do not need to report the related expenses or the per diem allowance on your return if your expenses are equal to or less than the allowance.

However, if your actual expenses (or your expenses using the standard meal allowance) are more than your per diem allowance, you can complete Form 2106 and deduct the excess amount on Schedule A (Form 1040). If you are using actual expenses, you must be able to prove to the IRS the total amount of your expenses and reimbursements for the entire year. If you are using the standard meal allowance, you do not have to prove that amount.

Example. In April, Jeremy takes a 2-day business trip to Denver. The federal rate in Denver is $126 per day. As required by his employer's accountable plan, he accounts for the time (dates), place, and business purpose of the trip. His employer reimburses him $126 a day ($252 total) for living expenses. Jeremy's living expenses in Denver are not more than $126 a day.

Jeremy's employer does not include any of the reimbursement on his Form W–2. Jeremy does not deduct the expenses on his return.

Per diem allowance MORE than the federal rate. If your per diem allowance is more than the federal rate, your employer must include the allowance amount up to the federal rate in box 13 (code **L**) of your Form W–2. This amount is not taxable. However, the per diem allowance that is more than the federal rate will be included in box 1 of your Form W–2. You must report this part of your reimbursement as if it were wage income.

If your actual expenses are less than or equal to the federal rate, you do not complete Form 2106 or claim any of your expenses on your return.

However, if your actual expenses are more than the federal rate, you can complete Form 2106 and deduct those expenses that are more than the federal rate. You must report on Form 2106 your reimbursements up to the federal rate (as shown in box 13 of your Form W–2) and all your expenses. You should be able to prove these amounts to the IRS.

Example 1. Laura lives and works in Austin. Her employer sent her to Albuquerque for 2 days on business. Laura's employer paid the hotel directly for her lodging and reimbursed Laura $40 a day ($80 total) for meals and incidental expenses. Laura's actual meal expenses did not exceed the federal rate for Albuquerque, which is $34 per day.

Her employer included the $12 that was more than the federal rate [($40 − $34) × 2] in box 1 of Laura's Form W–2. Her employer shows $68 ($34 a day × 2) in box 13 of her Form W–2. This amount is not included in Laura's income. Laura does not have to complete Form 2106; however, she must include the $12 in her gross income as wages (by reporting the total amount shown in box 1 of her Form W–2).

Example 2. Joe also lives in Austin and works for the same employer as Laura. In May the employer sent Joe to San Diego for 4 days and paid the hotel directly for his hotel bill. The employer reimbursed Joe $45 a day for his meals and incidental expenses. The federal rate for San Diego is $38 a day.

Joe can prove that his actual meal expenses totaled $290. His employer's accountable plan will not pay more than $45 a day for travel to San Diego so Joe does not give his employer the records that prove that he actually spent $290. However, he does account for the time, place, and business purpose of the trip. This is Joe's only business trip in 1997.

Joe was reimbursed $180 ($45 × 4 days), which is $28 more than the federal rate of $152 ($38 × 4 days). The employer includes the $28 as income on Joe's Form W–2 in box 1. The employer also enters $152 in box 13 of Joe's Form W–2, along with a code **L.**

Joe completes Form 2106 to figure his deductible expenses. He enters the total of his actual expenses for the year ($290) on Form 2106. He also enters the reimbursements that were not included in his income ($152). His total deductible expense, before the 50% limit, is $138. After he figures the 50% limit on his unreimbursed meals and entertainment, he will include the balance, $69, as an itemized deduction.

Car or mileage allowances. How you report a car or mileage allowance that you received under an accountable plan depends on whether the reimbursement or your actual expenses were more than the standard mileage rate of 31½ cents a mile

Table 28-3. **Reporting Travel, Entertainment, Gift, and Car Expenses and Reimbursements**

IF the type of reimbursement (or other expense allowance) arrangement is under:	THEN the employer reports on Form W-2:	AND the employee reports on Form 2106: *
An accountable plan with:		
Actual expense reimbursement: Adequate accounting made and excess returned	No amount.	No amount.
Actual expense reimbursement: Adequate accounting and return of excess both required but excess not returned	The excess amount as wages in box 1.	No amount.
Per diem or mileage allowance up to the federal rate: Adequate accounting made and excess returned	No amount.	All expenses and reimbursements only if excess expenses are claimed. Otherwise, form is not filed.
Per diem or mileage allowance up to the federal rate: Adequate accounting and return of excess both required but excess not returned	The excess amount as wages in box 1. The amount up to the federal rate is reported only in box 13—it is not reported in box 1.	No amount.
Per diem or mileage allowance exceeds the federal rate: Adequate accounting up to the federal rate only and excess not returned.	The excess amount as wages in box 1. The amount up to the federal rate is reported only in box 13—it is not reported in box 1.	All expenses (and reimbursements reported on Form W-2, box 13) only if expenses in excess of the federal rate are claimed. Otherwise, form is not filed.
A nonaccountable plan with:		
Either adequate accounting or return of excess, or both, not required by plan	The entire amount as wages in box 1.	All expenses.
No reimbursement plan:	The entire amount as wages in box 1.	All expenses.

* You may be able to use Form 2106-EZ. See *Completing Forms 2106 and 2106-EZ*.

for 1997. The standard mileage rate is considered to be the federal rate. If your allowance was equal to or less than $31\frac{1}{2}$ cents a mile, see *Per diem allowance LESS than or EQUAL to the federal rate,* earlier. If your allowance was more than $31\frac{1}{2}$ cents a mile, see *Per diem allowance MORE than the federal rate,* earlier.

Example 1. Nicole drives 10,000 miles a year for business. Under her employer's accountable plan, she accounts for the time (dates), place, and business purpose of each trip. Her employer pays her a mileage allowance of $31\frac{1}{2}$ cents a mile. Nicole's expenses of operating her car are not more than $31\frac{1}{2}$ cents a mile.

Nicole's employer does not include any of the reimbursement on her Form W–2 because the mileage allowance is not more than the standard mileage rate. Nicole does not deduct the expenses on her return because her expenses are not more than the allowance she received.

Example 2. The facts in Debbie's case are the same as in *Example 1,* except Debbie gets reimbursed 35 cents a mile, which is $3\frac{1}{2}$ cents a mile more than the standard mileage rate. Her employer must include the reimbursement amount up to the standard mileage rate, $3,150 (10,000 miles $\times$ $31\frac{1}{2}$ cents), in box 13 (code **L**) of her Form W–2. That amount is not taxable.

Debbie's employer must also include $350 (10,000 miles $\times$ $3\frac{1}{2}$ cents) in box 1 of her Form W–2. This is the reimbursement that is more than the standard mileage rate. Because her reimbursement is equal to or more than her expenses, Debbie does not complete Form 2106.

TIP *The employer makes the decision whether to reimburse employees under an accountable plan or a nonaccountable plan. If you are an employee who receives payments under a nonaccountable plan, you cannot convert these amounts to payments under an accountable plan by voluntarily accounting to your employer for the expenses and voluntarily returning excess reimbursements to the employer.*

Adequate Accounting

One of the three rules (listed earlier) for a reimbursement or other expense allowance arrangement to qualify as an accountable plan is that you adequately account to your employer for your expenses. You adequately account by giving your employer documentary evidence of your travel, mileage, and other employee business expenses, along with a statement of expense, an account book, a diary, or a similar record in which you entered each expense at or near the time you had it. Documentary evidence includes receipts, canceled checks, and bills. (See *Recordkeeping,* earlier.)

You must account for ***all*** amounts received from your employer during the year as advances, reimbursements, or allowances for travel, entertainment, gifts, business use of your car, or any other expenses. This includes amounts that were charged to your employer by credit card or other method. You must give your employer the same type of records and supporting information that you would have to give to the IRS if the IRS questioned a deduction on your return. You must pay back the amount of any reimbursement or other expense allowance for which you do not adequately account or that exceeds the amount for which you accounted.

Per diem allowance or reimbursement. You may be able to prove the amount of your travel expenses by using a per diem allowance amount. This is a fixed amount of daily reimbursement that your employer gives you for your lodging, meal, and incidental expenses when you are away from home on business. The term "incidental expenses" is defined earlier under *Standard Meal Allowance.*

A per diem allowance satisfies the adequate accounting requirements for the amount in question if all four of the following conditions apply.

1) Your employer reasonably limits payments of the travel expenses to those that are ordinary and necessary in the conduct of the trade or business.
2) The allowance is similar in form to and not more than the federal per diem (that is, your allowance varies based on where, when, and how long you were traveling).
3) You are not related to your employer (as defined earlier under *Standard Meal Allowance).*
4) The time, place, and business purpose of the travel are proved, as explained in *Table 28–2.*

If the IRS finds that an employer's travel allowance practices are not based on reasonably accurate estimates of travel costs, including recognition of cost differences in different areas, you will not be considered to have accounted to your employer. In this case, you may have to prove your expenses to the IRS.

Allowance for meals. These rules also apply if you are reimbursed only for your meal expenses or get a separate per diem allowance for meals and incidental expenses. Your reimbursement or allowance must not be more than the standard meal allowance. A per diem allowance is paid separately for meals and incidental expenses if your employer furnishes lodging in kind, pays you a meal allowance plus the actual cost of your lodging, or pays the hotel, motel, etc. directly for your lodging. A per diem allowance is also paid separately for meals and incidental expenses if your employer does not have a reasonable belief that you incurred lodging expenses, such as when you stay with friends or relatives or sleep in the cab of your truck.

Proving your expenses with a per diem allowance. If your employer pays for your expenses using a per diem allowance, including a meals only allowance, you can generally use the allowance as proof for the amount of your expenses. However, the amount of expense that you can prove this way cannot be more than:

1) The federal M&IE rate (if you receive only a meal allowance), or
2) The regular federal per diem rate or the high-low rate (if you receive a per diem allowance for lodging and meals).

You can only use the per diem allowance for which you make an adequate accounting to your employer to prove the cost of meals and/or lodging reimbursed by your employer's accountable plan. You must still provide other proof of the time, place, and business purpose for each expense.

Regular federal per diem rate. The regular federal per diem rate is the highest amount that the federal government will pay to its employees for lodging, meals, and incidental expenses (or meals and incidental expenses only) while they are traveling away from home in a particular area. The rates are different for different locations. You must use the rate in effect for the area where you stop for sleep or rest. Your employer should have these rates available. (Employers can get Publication 1542, *Per Diem Rates,* which gives the rates in the continental United States for the current year.)

The federal rates for M&IE are the same as those rates discussed earlier under *Standard Meal Allowance.*

High-low rate. This is a simplified method of computing the federal per diem rate for travel within the continental United States. It eliminates the need to keep a current list of the per diem rate in effect for each city in the continental United States.

Under the high-low method, the per diem amount for travel during 1997 is $166 for certain locations. All other areas have a per diem amount of $109. Employers can get Publication 1542 that gives the areas eligible for the $166 per diem amount under the high-low method for all or part of the year.

Prorating the standard meal allowance on partial days of travel. The standard meal allowance is for a full 24-hour day of travel. If you travel for part of a day, such as on the days you depart and return, you must prorate the full-day M&IE rate. You can use either of the following methods to figure the federal M&IE for that day.

1) *Method 1:*
   a) For the day you depart, add $\frac{3}{4}$ of the standard meal allowance amount for that day.
   b) For the day you return, add $\frac{3}{4}$ of the standard meal allowance amount for the preceding day.
2) *Method 2:* Prorate the standard meal allowance using any method that you consistently apply and that is in accordance with reasonable business practice. For example, an employer can treat 2 full days of per diem (that includes M&IE) paid for travel away from home from 9 a.m. of one day to 5 p.m. of the next day as being no more than the federal rate. This is true even though a federal employee would be limited to a reimbursement of M&IE for only $1\frac{1}{2}$ days of the federal M&IE rate.

These rules apply whether your employer uses the regular federal per diem rate or the high-low rate.

Car or mileage allowance. You may be able to prove the amount of your expense by using a car or mileage allowance amount. A car or mileage allowance satisfies the adequate accounting requirements for the amount if all three of the following conditions apply.

1) Your employer reasonably limits payments of the car expenses to those that are ordinary and necessary in the conduct of the trade or business.
2) The allowance is paid at the standard mileage rate, at another rate per mile, or other acceptable method.
3) You prove the time (dates), place, and business purpose of using your car to your employer within a reasonable period of time.

However, if you are related to your employer (as defined earlier under *Standard Meal Allowance),* you must be able to prove your expenses to the IRS. This is true even if you have already adequately accounted to your employer and returned any excess reimbursement. (You can still use the standard mileage rate to adequately account to your employer and the IRS.)

Proving your expenses with a car or mileage allowance. If your employer pays for your expenses using a car or mileage allowance, you can generally use the allowance as proof for the amount of your expenses. However, the amount of expense that you can prove this way cannot be more than the standard mileage rate or the amount of the fixed and variable rate allowance that your employer does ***not*** include in box 1 of your Form W–2.

You can only use a car or mileage allowance to prove the amount of business car expense. You must still prove the time (dates), place, and business purpose for each expense.

Returning Excess Reimbursements

Under an accountable plan, you are required to return any excess reimbursement for your business expenses to the person paying the reimbursement or allowance. ***Excess reimbursement*** means any amount for which you did not adequately account within a reasonable period of time. For example, if you received a travel advance and you did not spend all the money on business-related expenses, or if you do not have proof of all your expenses, you have an excess reimbursement.

“Adequate accounting” and “reasonable period of time” were discussed earlier.

Travel advance. If your employer provides you with an expense allowance before you actually have the expense, and the allowance is reasonably calculated not to exceed your expected expenses, you have received a travel advance. Under an accountable plan, you are required to adequately account to your employer for this advance and to return any excess within a reasonable period of time. See *Accountable Plans,* earlier. If you do not adequately account for or do not return any excess advance within a reasonable period of time, the amount you do not account for or return will be treated as having been paid under a nonaccountable plan (discussed later).

Unproved amounts. If you do not prove that you actually traveled on each day for which you received a per diem or car allowance (proving the elements described in *Table 28–2),* you must return this unproved amount of the travel advance within a reasonable period of time. If you fail to do this, your employer will include as income in box 1 of your Form W–2 the unproved amount of per diem or car allowance as excess reimbursement. This unproved amount is considered paid under a nonaccountable plan (discussed later).

Per diem MORE than federal rate. If your employer's accountable plan pays you a per diem or similar allowance that is higher than the federal rate for the area you traveled to, you do not have to return the difference between the two rates for the period you can prove business-related travel expenses. However, the difference will be reported as wages on your Form W–2. This excess amount is considered paid under a nonaccountable plan (discussed later).

Example. Your employer sends you on a 5-day business trip to Phoenix and gives you a $225 ($45 × 5 days) advance to cover your meals and incidental expenses. The federal per diem for meals and incidental expenses in Phoenix is $38. Your trip lasts only 3 days. Under your employer's accountable plan, you must return the $90 ($45 × 2 days) advance for the 2 days you did not travel. You do not have to return the $21 difference between the allowance you received and the federal rate for Phoenix [($45 − $38) × 3 days]. However, the $21 will be reported on your Form W–2 as wages.

Nonaccountable Plans

A nonaccountable plan is a reimbursement or expense allowance arrangement that does not meet the three rules listed earlier under *Accountable Plans.*

In addition, the following payments made under an accountable plan will be treated as being paid under a nonaccountable plan:

1) Excess reimbursements you fail to return to your employer, and
2) Reimbursements of nondeductible expenses related to your employer's business. See *Reimbursement of nondeductible expenses* earlier under *Accountable Plans.*

If you are not sure if the reimbursement or expense allowance arrangement is an accountable or nonaccountable plan, see your employer.

Your employer will combine the amount of any reimbursement or other expense allowance paid to you under a nonaccountable plan with your wages, salary, or other pay. Your employer will report the total in box 1 of your Form W–2.

You must complete Form 2106 or 2106–EZ and itemize your deductions to deduct your expenses for travel, transportation, meals, or entertainment. Your meal and entertainment expenses will be subject to the 50% limit discussed earlier under *Entertainment Expenses.* Also, your total expenses will be subject to the 2%-of-adjusted-gross-income limit that applies to most miscellaneous itemized deductions.

Example. Kim's employer gives her $500 a month ($6,000 for the year) for her business expenses. Kim does not have to provide any proof of her expenses to her employer, and Kim can keep any funds that she does not spend.

Kim is being reimbursed under a nonaccountable plan. Her employer will include the $6,000 on Kim's Form W–2 as if it were wages. If Kim wants to deduct her business expenses, she must complete Form 2106 or Form 2106–EZ and itemize her deductions.

Completing Forms 2106 and 2106–EZ

This section briefly describes how employees complete Forms 2106 and 2106–EZ. *Table 28–3* explains what the employer reports on Form W–2 and what the employee reports on Form 2106. The instructions for the forms have more information on completing them.

Form 2106–EZ. You may be able to use Form 2106–EZ to claim your employee business expenses. You qualify to use this form if you meet both of the following conditions.

1) You were not reimbursed for your expenses or, if you were reimbursed, the reimbursement was included in your income (box 1 of your Form W–2).
2) If you claim car expenses, you use the standard mileage rate.

Car expenses. If you used a car to perform your job as an employee, you may be able to deduct certain car expenses. These are generally figured in Part II of Form 2106, and then claimed on line 1, Column A, of Part I of Form 2106. Car expenses using the standard mileage rate can also be figured on Form 2106–EZ by completing Part III and line 1 of Part II.

Local transportation expenses. Show your local business transportation expenses that did not involve overnight travel on line 2, Column A, of Form 2106 or on line 2, Part II, of Form 2106–EZ. Also include on this line business expenses you have for parking fees and tolls. Do not include expenses of operating your car or expenses of commuting between your home and work.

Employee business expenses other than meals and entertainment. Show your other employee business expenses on lines 3 and 4, Column A, of Form 2106 or Form 2106–EZ. Do not include expenses for meals and entertainment on those lines. Line 4 is for expenses such as business gifts, educational expenses (tuition and books), office-in-the-home expenses, and trade and professional publications.

TIP *If line 4 expenses are the only ones you are claiming and you received no reimbursements (or the reimbursements were all included in box 1 of your Form W–2), do not complete Form 2106 or 2106–EZ. Instead, claim these amounts directly on line 20 of Schedule A (Form 1040). List the type and amount of each expense on the dotted lines next to line 20 and include the total on line 20.*

Meal and entertainment expenses. Show the full amount of your expenses for business-related meals and entertainment on line 5, Column B, of Form 2106. Include meals you paid for while away from your tax home overnight and other business meals and entertainment. Enter 50% of the line 8 meal and entertainment expenses on line 9, Column B, of Form 2106.

If you file Form 2106–EZ, enter the full amount of your meals and entertainment on the line to the left of line 5 and multiply the total by 50%. Enter the result on line 5.

Reimbursements. Enter on line 7 of Form 2106 the amounts your employer (or third party) reimbursed you for employee business expenses that were ***not*** included in box 1 of your Form W–2. (You cannot use Form 2106–EZ.) This includes any reimbursement reported under code **L** in box 13 of Form W–2.

Allocating your reimbursement. If you were reimbursed under an accountable plan and want to deduct excess expenses that were not reimbursed, you may have to allocate your reimbursement. This is necessary if your employer does both of the following:

1) Pays you a single amount that covers meals and/or entertainment, as well as other business expenses, and

2) Does not clearly identify how much is for deductible meals and/or entertainment.

You must allocate the reimbursement so that you know how much to enter in Column A and Column B of line 7 of Form 2106.

Example. Rob's employer paid him an expense allowance of $5,000 this year under an accountable plan. The $5,000 payment consisted of $2,000 for airfare and $3,000 for entertainment and car expenses. The employer did not clearly show how much of the $3,000 was for the cost of deductible entertainment. Rob actually spent $6,500 during the year ($2,000 for airfare, $2,000 for entertainment, and $2,500 for car expenses).

Since the airfare allowance was clearly identified, Rob knows that $2,000 of the payment goes in Column A of line 7 of Form 2106. To allocate the remaining $3,000, Rob uses the worksheet from the instructions for Form 2106. His completed worksheet is shown next.

1.	Enter the total amount of reimbursements your employer gave you that **were not** reported to you in box 1 of Form W–2	3,000
2.	Enter the total amount of your expenses for the periods covered by this reimbursement	4,500
3.	Of the amount on line 2, enter your total expense for meals and entertainment	2,000
4.	Divide line 3 by line 2. Enter the result as a decimal (to at least two places)	.44
5.	Multiply line 1 by line 4. Enter the result here and in Column B, line 7 .	1,320
6.	Subtract line 5 from line 1. Enter the result here and in Column A, line 7 .	1,680

On line 7 of Form 2106, Rob enters $3,680 ($2,000 airfare and $1,680 of the $3,000) in Column A and $1,320 (of the $3,000) in Column B.

After you complete the form. After you have completed your Form 2106 or 2106–EZ, follow the directions on that form to deduct your expenses on the appropriate line of your tax return. For most taxpayers this is on line 20 of Schedule A (Form 1040). However, if you are a government official paid on a fee basis, a performing artist, or a disabled employee with impairment-related work expenses, see *Special Rules,* later.

Limits on employee business expenses. Your employee business expenses may be subject to any of the three limits described next. These limits are figured in the following order on the specified form.

1. Limit on meals and entertainment. Certain meal and entertainment expenses are subject to a 50% limit. Employees figure this limit on line 9 of Form 2106 or line 5 of Form 2106–EZ. See *50% Limit* under *Entertainment Expenses,* earlier.

2. Limit on employee business expenses. Employees deduct employee business expenses (as figured on Form 2106 or 2106–EZ) on line 20 of Schedule A (Form 1040). Most miscellaneous itemized deductions, including employee business expenses, are subject to a 2%-of-adjusted-gross-income limit. This limit is figured on line 25 of Schedule A (Form 1040).

3. Limit on total itemized deductions. If your adjusted gross income (line 32 of Form 1040) is more than $121,200 ($60,600 if you are married filing separately), the amount of your overall itemized deductions, including employee business expenses, may be limited. See chapter 22 for more information on this limit.

Special Rules

This section discusses special rules that apply only to government officials who are paid on a fee basis, performing artists, and disabled employees with impairment-related work expenses.

Officials paid on a fee basis. Certain fee-basis officials can claim their employee business expenses whether or not they itemize their other deductions on Schedule A (Form 1040).

Fee-basis officials are persons who are employed by a state or local government and who are paid in whole or in part on a fee basis. They can deduct their business expenses in performing services in that job as an adjustment to gross income rather than as a miscellaneous itemized deduction.

After you complete Form 2106 or 2106–EZ, include your employee business expenses from line 10 of Form 2106 or line 6 of Form 2106–EZ in the total on line 31 of Form 1040. Write “FBO” and the amount of your employee business expenses on the dotted line next to line 31 of Form 1040.

TIP *This special rule is retroactive to 1987, and you can file an amended return on Form 1040X,* Amended U.S. Individual Income Tax Return, *for any year that is affected by this change. However, you generally must file the amendment within three years from the time you filed the return or within two years from the time you paid the tax, whichever is later. See chapter 1 for more information on amended returns.*

Expenses of certain performing artists. If you are a performing artist, you may qualify to deduct your employee business expenses as an adjustment to gross income rather than as a miscellaneous itemized deduction. To qualify, you must meet ***all*** of the following requirements.

1) During the tax year, you perform services in the performing arts for at least two employers.

2) You receive at least $200 each from any two of these employers.

3) Your related performing-arts business expenses are more than 10% of your gross income from the performance of those services.

4) Your adjusted gross income is not more than $16,000 before deducting these business expenses.

Special rules for married persons. If you are married, you must file a joint return unless you lived apart from your spouse at all times during the tax year.

If you file a joint return, you must figure requirements (1), (2), and (3) separately for both you and your spouse. However, requirement (4) applies to your and your spouse's combined adjusted gross income.

Where to report. If you meet all of the above requirements, you should first complete Form 2106 or 2106–EZ. Then you include your performing-arts-related expenses from line 10 of Form 2106 or line 6 of Form 2106–EZ in the total on line 31 of Form 1040. Write “QPA” and the amount of your performing-arts-related expenses on the dotted line next to line 31 of Form 1040.

If you do not meet all of the above requirements, you do not qualify to deduct your expenses as an adjustment to gross income. Instead, you must complete Form 2106 or 2106–EZ and deduct your employee business expenses as an itemized deduction on line 20 of Schedule A (Form 1040).

Impairment-related work expenses of disabled employees. If you are an employee with a physical or mental disability, your impairment-related work expenses are not subject to the 2%-of-adjusted-gross- income limit that applies to most other employee business expenses. After you complete Form 2106 or 2106–EZ, enter your impairment-related work expenses from line 10 of Form 2106 or line 6 of Form 2106–EZ on line 27 of Schedule A (Form 1040), and identify the type and amount of this expense on the dotted line next to line 27. Enter your employee business expenses that are ***unrelated*** to your disability from line 10 of Form 2106 or line 6 of Form 2106–EZ on line 20 of Schedule A.

Impairment-related work expenses are your allowable expenses for attendant care at your workplace and other expenses you have in connection with your workplace that are necessary for you to be able to work. For more information, see chapter 23.

Illustrated Example

Bill Wilson is an employee of Fashion Clothing Co. in Manhattan, NY. In a typical week, Bill leaves his home on Long Island on Monday morning and drives to Albany to exhibit the Fashion line for 3 days to prospective customers. Then he drives to Troy to show Fashion's new line of merchandise to Town Department Store, an old customer. While in Troy, he talks with Tom Brown, purchasing agent for Town Department Store, to discuss the new line. He later takes John Smith of Attire Co. out to dinner to discuss Attire Co.'s buying Fashion's new line of clothing.

Bill purchased his car on January 3, 1995. He uses the standard mileage rate for car expense purposes. He records his total mileage, business mileage, parking fees, and tolls for the year. Bill timely records his expenses and other pertinent information in a travel expense log (not shown). He obtains receipts for his expenses for lodging and for any other expenses of $75 or more.

During the year, Bill drove a total of 25,000 miles of which 20,000 miles were for business. Following the instructions for Part II of Form 2106, he answers all the questions and figures his car expense to be $6,300 (20,000 business miles × 31½ cents standard mileage rate).

His total employee business expenses are shown in the following table.

Type of Expense	Amount
Parking fees and tolls	$825
Car expenses	6,300
Meals	2,632
Lodging, laundry, dry cleaning	8,975
Entertainment	1,870
Gifts, education, etc.	430
Total	**$ 20,532**

Bill received an allowance of $3,600 ($300 per month) to help offset his expenses. Bill did not have to account to his employer for the reimbursement, and the $3,600 was included as income in box 1 of his Form W–2.

Because Bill's reimbursement was included in his income and he is using the standard mileage rate for his car expenses, he files Form 2106–EZ with his tax return. His filled-in form is shown at the end of this chapter.

Form **2106-EZ**

Department of the Treasury
Internal Revenue Service

Unreimbursed Employee Business Expenses

► **Attach to Form 1040.**

OMB No. 1545-1441

1997

Attachment Sequence No. **54A**

Your name	Social security number	Occupation in which you incurred expenses
Bill Wilson	555 00 5555	Sales

Part I **General Information**

You May Use This Form ONLY if All of the Following Apply:

- You are an employee deducting expenses attributable to your job.
- You **do not** get reimbursed by your employer for any expenses (amounts your employer included in box 1 of your Form W-2 are not considered reimbursements).
- If you are claiming vehicle expense,
  - **a** You own your vehicle, and
  - **b** You are using the standard mileage rate for 1997 **and** also used it for the year you first placed the vehicle in service.

Part II **Figure Your Expenses**

1	Vehicle expense using the standard mileage rate. Complete Part III and multiply line 8a by 31½¢ (.315)	**1**	6,300
2	Parking fees, tolls, and transportation, including train, bus, etc., that **did not** involve overnight travel or commuting to and from work	**2**	325
3	Travel expense while away from home overnight, including lodging, airplane, car rental, etc. **Do not** include meals and entertainment	**3**	8,975
4	Business expenses not included on lines 1 through 3. **Do not** include meals and entertainment	**4**	430
5	Meals and entertainment expenses: $ 4,502 x 50% (.50)	**5**	2,251
6	**Total expenses.** Add lines 1 through 5. Enter here and **on line 20 of Schedule A (Form 1040).** (Fee-basis state or local government officials, qualified performing artists, and individuals with disabilities: See the instructions for special rules on where to enter this amount.)	**6**	18,281

Part III **Information on Your Vehicle.** Complete this part **ONLY** if you are claiming vehicle expense on line 1.

7 When did you place your vehicle in service for business purposes? (month, day, year) ► 1 / 3 / 95

8 Of the total number of miles you drove your vehicle during 1997, enter the number of miles you used your vehicle for:

a Business 20,000 **b** Commuting 2,600 **c** Other 2,400

9 Do you (or your spouse) have another vehicle available for personal use? ☑ **Yes** ☐ **No**

10 Was your vehicle available for use during off-duty hours? ☑ **Yes** ☐ **No**

11a Do you have evidence to support your deduction? ☑ **Yes** ☐ **No**

b If "Yes," is the evidence written? ☑ **Yes** ☐ **No**

General Instructions

Section references are to the Internal Revenue Code.

Changes To Note

- The standard mileage rate has been increased to 31½ cents for each mile of business use in 1997.
- For tax years beginning after 1986, a fee-basis state or local government official can deduct the expenses incurred for services performed in that job in figuring adjusted gross income, rather than as a miscellaneous itemized deduction subject to the 2% limit. See the line 6 instructions for more details. You should file Form 1040X to amend any prior year income tax return affected by this retroactive change. However, you generally must file Form 1040X within 3 years after the date you filed your original return or within 2 years after the date you paid the tax, whichever is later.

Purpose of Form

You may use Form 2106-EZ instead of Form 2106 if you meet all the requirements listed in Part I of this form.

Recordkeeping

You cannot deduct expenses for travel (including meals unless you used the standard meal allowance), entertainment, gifts, or use of a car or other listed property, unless you keep records to prove the time, place, business purpose, business relationship (for entertainment and gifts), and amounts of these expenses. Generally, you must also have receipts for all lodging expenses (regardless of the amount) and any other expense of $75 or more.

For Paperwork Reduction Act Notice, see back of form. Cat. No. 20604Q Form **2106-EZ** (1997)

29.

Employee's Educational Expenses

Important Changes for 1997

Employer-provided educational assistance. The exclusion from income of up to $5,250 of employer-provided educational assistance benefits, which expired for tax years beginning after May 31, 1997, has been reinstated retroactively and extended. It will now expire for courses beginning after May 31, 2000. See *Employer-Provided Educational Assistance* in Publication 508, *Educational Expenses.*

TIP *If you received employer-provided educational assistance benefits in 1995 or 1996, you may be entitled to a refund of taxes you paid on the benefits. See* Refund Procedures *under* Employer-Provided Educational Assistance *in Publication 508.*

Standard mileage rate. Generally, if you use your car for transportation to school, you can deduct 31.5 cents per mile. For more information see *Using your car* under *What Educational Expenses are Deductible.*

Limit on itemized deductions. If your adjusted gross income is more than $121,200 ($60,600 if you are married filing separately), your itemized deductions may be limited. See chapter 22 if you need more information about this limit.

Introduction

This chapter discusses how employees deduct their costs of work-related education. To figure the deduction, you must know:

- Whether the courses qualify,
- What expenses are deductible, and
- How to report the expenses.

First, you must determine whether the courses you are taking are qualifying courses. Not all courses are qualifying education. Courses must meet certain requirements before the related expenses can be deducted. This is explained under *Qualifying Education.*

If your courses qualify, you can then determine which expenses qualify to be deducted. Only certain expenses of education are deductible. This is explained under *What Educational Expenses Are Deductible.*

If you know which expenses qualify, you can then determine how to report those educational expenses. You may not be able to fully deduct all of your expenses. This is explained under *Where To Deduct Expenses.*

Useful Items

You may want to see:

Publication

☐ **463** Travel, Entertainment, Gift, and Car Expenses

☐ **508** Educational Expenses

Form (and Instructions)

☐ **2106–EZ** Unreimbursed Employee Business Expenses

☐ **2106** Employee Business Expenses

Qualifying Education

You can deduct educational expenses only if they are for qualifying education. This is education that meets at least one of the following tests:

1) The education is required by your employer or the law to keep your present salary, status, or job (and serve a business purpose of your employer), or

2) The education maintains or improves skills needed in your present work.

You can deduct the expenses for qualifying education even if the education could lead to a degree.

Education that does not qualify. Even if the education meets one of the tests above, it does not qualify if it:

1) Is needed to meet the minimum educational requirements of your present trade or business, or

2) Is part of a program of study that can qualify you for a new trade or business, even it you do not plan to enter that trade or business.

Education Required by Employer or by Law

Once you have met the minimum educational requirements for your job, your employer or a law may require you to get more education. This additional education must be required for you to keep your present salary, status, or job. It must serve a business purpose of your employer and not be part of a program that will qualify you for a new trade or business.

When you get more education than your employer or the law requires, the additional education is qualifying only if it maintains or improves skills required in your present work. See *Education To Maintain or Improve Skills,* next.

Example. You are a teacher who has satisfied the minimum requirements for teaching. Your employer requires you to take an additional college course each year to keep your teaching job. You take a course and pay for it yourself. This is qualifying education even if you eventually receive a master's degree and an increase in salary because of this extra education.

Education To Maintain or Improve Skills

If your education is not required by your employer or a law, it must maintain or improve skills needed in your work. Education to maintain or improve skills includes refresher courses, courses on current developments, and academic or vocational courses. Courses you take that are needed to meet the minimum educational requirements for your work or to qualify you for a new trade or business are not qualifying education.

Example. You repair televisions, radios, and stereo sets for XYZ Store. To keep up with the latest changes, you take special courses in radio and stereo service. These courses maintain and improve skills required in your work.

Present work. Education that relates to work you may enter in the future is not qualifying education. Education that prepares you for a future occupation includes any education that keeps you up-to-date for a return to work or that qualifies you to reenter a job you had in the past.

Temporary absence. If you stop work for a year or less and then go back to the same kind of work, your absence is ordinarily considered temporary. Education during a vacation, temporary leave, or other temporary absence from your job is considered related to your present job. However, after your temporary absence you must return to the same kind of work.

Example. You quit your biology research job to become a full-time biology graduate student for one year. If you return to work in biology research after completing the courses, the education is related to your present work. You may even choose to take a similar job with another employer.

Nonqualifying Education

You cannot deduct the costs of nonqualifying education, even if it meets one of the tests described earlier for qualifying education. Nonqualifying education is education that:

1) Is needed to meet the minimum educational requirements of your present trade or business, or

2) Is part of a program of study that can qualify you for a new trade or business.

Education To Meet Minimum Requirements

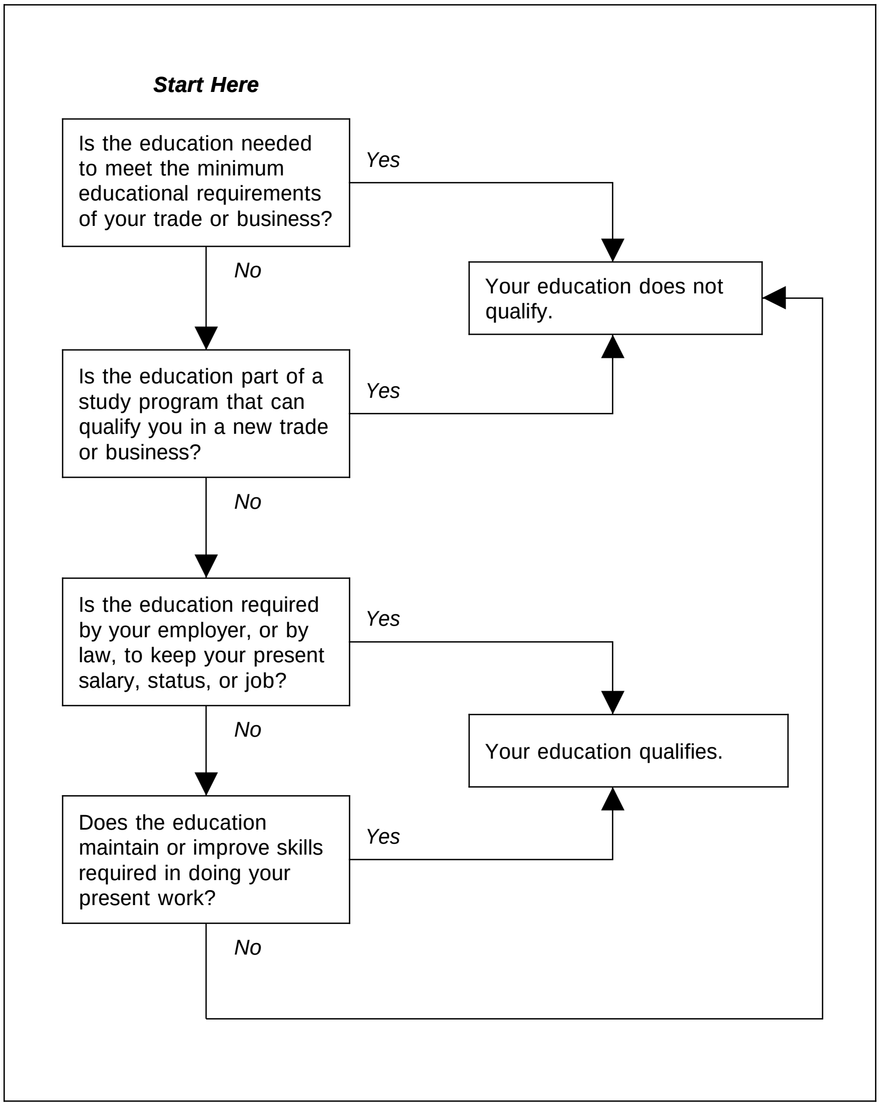
Education needed to meet the minimum educational requirements for your present trade or business is nonqualifying education. The minimum education necessary is determined by:

1) Laws and regulations,

2) Standards of your profession, trade, or business, and

3) Your employer's requirements.

Figure 29-A. **Does Your Education Qualify?**



Once you have met the minimum educational requirements that were in effect when you were hired, you do not have to meet minimal educational requirements again. This means that if the minimum requirements change after you were hired, any education you need to meet the new requirements is qualifying education.

CAUTION *You have not necessarily met the minimum educational requirements of your trade or business simply because you are already doing the work.*

Example 1. You are a full-time engineering student. You work part time as an engineer for a firm that will employ you after you finish college as a full-time engineer. Although your college engineering courses improve your skills in your present job, you have not met the minimum job requirements for a full-time engineer. The education is nonqualifying education.

Example 2. You are an accountant and you have met the minimum educational requirements of your employer. Your employer later changes the minimum educational requirements and requires you to take college courses to keep your job. These additional courses are not minimum requirements because you have already satisfied the initial minimum requirements. The education is qualifying education.

However, a new accountant coming into the firm has to satisfy these new minimum requirements. The education the new accountant needs to meet the new minimum requirements is nonqualifying education.

Requirements for Teachers

This discussion applies to teachers and others employed by educational organizations. The state or school district usually sets the minimum educational requirements for teachers. It is the minimum number of college hours or a college degree usually required of a person hired for that position.

If no requirements exist, you will have met the minimum educational requirement when you become a faculty member. You generally will be considered a faculty member when one of the following occurs:

1) You have tenure,
2) Your years of service count toward obtaining tenure,
3) You have a vote in faculty decisions, or
4) Your school makes contributions for you to a retirement plan other than social security or a similar program.

Example 1. Your state law requires beginning secondary school teachers to have a bachelor's degree, including ten professional education courses. In addition, to keep the job, a teacher must complete a fifth year of training within 10 years from the date of hire. If the employing school certifies to the state Department of Education that qualified teachers cannot be found, the school may hire persons with only 3 years of college. However, to keep their jobs, these teachers must get a bachelor's degree and the required professional education courses within 3 years.

Under these facts, the bachelor's degree, whether or not it includes the ten professional education courses, is considered the minimum educational requirement for qualification as a teacher in your state.

If you have all of the required education except the fifth year, you have met the minimum educational requirements. The fifth year of training is qualifying education unless it is part of a program of study that will qualify you for a new trade or business.

Example 2. Assume the same facts as in Example 1 except that you have a bachelor's degree and only six professional education courses. The additional four education courses are qualifying education. Although you do not have all the required courses, you have already met the minimum educational requirements.

Example 3. Assume the same facts as in Example 1 except that you are hired with only 3 years of college. The courses you take that lead to a bachelor's degree (including those in education) are nonqualifying education. They are needed to meet the minimum educational requirements for employment as a teacher.

Example 4. You have a bachelor's degree and you work as a temporary instructor at a university. At the same time, you take graduate courses toward an advanced degree. The rules of the university state that you may become a faculty member only if you get a graduate degree. Also, you may keep your job as an instructor only as long as you show satisfactory progress toward getting this degree. You have not met the minimum educational requirements to qualify you as a faculty member. The graduate courses are nonqualifying education.

Certification in a new state. Once you have met the minimum educational requirements for teachers for your state, you are considered to have met the minimum educational requirements in a new state. This is true even if you must get additional education to be certified in the new state. Any additional education you need is qualifying education.

Example. You hold a permanent teaching certificate in State A and are employed as a teacher in that state for several years. You move to State B and are promptly hired as a school teacher. You are required, however, to complete certain prescribed courses to get a permanent teaching certificate in State B. These additional courses are qualifying education because the teaching position in State B involves the same general kind of work for which you were qualified in State A. You have already met the minimum requirements for teaching and have not entered a new trade or business.

Education That Qualifies You for a New Trade or Business

Education that is part of a program of study that can qualify you for a new trade or business is nonqualifying education. This is true even if you are not seeking a new job.

If you are an employee, a change of duties is not a new trade or business if the new duties involve the same general work you did in your old job.

Example 1. You are an accountant. Your employer requires you to get a law degree at your own expense. You register at a law school for the regular curriculum that leads to a law degree. Even if you do not intend to become a lawyer, the education is nonqualifying because the law degree will qualify you for a new trade or business.

Example 2. You are a general practitioner of medicine. You take a 2-week course to review new developments in several specialized fields of medicine. The course does not qualify you for a new profession. It is qualifying education because it maintains or improves skills required in your present profession.

Bar or CPA Review Course

Review courses to prepare for the bar examination or the certified public accountant (CPA) examination are nonqualifying education. These are personal expenses that qualify you for a new profession.

Qualifications for Teachers

All teaching and related duties are considered the same general kind of work. A change in duties in any of the following ways, is not considered a change to a new business.

1) Elementary school teacher to secondary school teacher.
2) Teacher of one subject, such as biology, to teacher of another subject, such as art.
3) Classroom teacher to guidance counselor.
4) Classroom teacher to school administrator.

What Educational Expenses Are Deductible

If your education meets the requirements described earlier under *Qualifying Education,* you can generally deduct your educational expenses. If you are not self-employed, you must itemize your deductions. However, see *Expenses Relating to Tax-Exempt and Excluded Income,* later.

Deductible expenses. The following educational expenses can be deducted.

- Tuition, books, supplies, lab fees, and similar items.
- Certain transportation and travel costs.
- Other educational expenses, such as costs of research and typing when writing a paper as part of an educational program.

Nondeductible expenses. Educational expenses do not include personal or capital expenses. For example, you cannot deduct the dollar value of vacation time or annual leave you take to attend classes. This amount is a personal expense.

Unclaimed reimbursement. If you do not claim reimbursement that you are entitled to receive from your employer, you cannot deduct the expenses that apply to the reimbursement. For example, your employer agrees to pay your educational expenses if you file a voucher showing your expenses. You do not file a voucher, and you do not get reimbursed. Because you did not file a voucher, you cannot deduct the expenses on your tax return.

Transportation Expenses

If your education qualifies, you can deduct local transportation costs of going directly from work to school. If you are regularly employed and go to school on a ***temporary basis,*** you can also deduct the costs of returning from school to home. A temporary basis is irregular or short-term attendance, generally a matter of days or weeks.

If you are regularly employed and go directly from home to school on a temporary basis, you can deduct the round-trip costs of transportation in going from your home to school to home. This is true regardless of the location of the school, the distance traveled, or whether you attend school on nonwork days.

Transportation expenses include the actual costs of bus, subway, cab, or other fares, as well as the costs of using your own car. Transportation expenses do not include amounts spent for travel, meals, or lodging while you are away from home overnight.

Example 1. You regularly work in Camden, New Jersey, and go directly from work to your home. You also attend school every night for 3 weeks to take a course that improves your job skills. Since you are attending school on a temporary basis, you can deduct your daily round-trip transportation expenses in going between home and school. This is true regardless of the distance traveled.

Example 2. Assume the same facts as in Example 1 except that on certain nights you go directly from work to school and then home. You can deduct your transportation expenses from your regular work site to school and then home.

Example 3. Assume the same facts as in Example 1 except that you attend the school for 6 consecutive Saturdays, nonwork days. Since you are attending school on a temporary basis, you can deduct your round-trip transportation expenses in going between home and school.

Example 4. Assume the same facts as in Example 1 except that you attend classes twice a week for one year. Since your attendance in school is not considered temporary, you cannot deduct your transportation expenses in going between home and school. If you go directly from work to school, you can deduct the one-way transportation expenses of going from work to school. If you go from work to home to school and return home, your transportation expenses cannot be more than if you had gone directly from work to school.

Using your car. If you use your car for transportation to school, you can deduct your actual expenses or use the standard mileage rate to figure the amount you can deduct. The standard mileage rate for 1997 is 31.5 cents per mile. Whichever method you use, you may also deduct parking fees and tolls. See *Car Expenses* in chapter 28 for information on deducting your actual expenses of using a car.

Travel Expenses

You can deduct expenses for travel, meals (subject to the 50% limit), and lodging if:

1) You travel overnight to obtain qualified education, and
2) The main purpose of the trip is to attend a work-related course or seminar.

Travel expenses for qualifying education are treated the same as travel expenses for other employee business purposes. For more information see chapter 28.

CAUTION: *You cannot deduct expenses for personal activities, such as sightseeing, visiting, or entertaining.*

Mainly personal travel. If your travel away from home is mainly personal, you cannot deduct all of your expenses for travel, meals, and lodging. However, during the time you attend the qualified educational activities, you can deduct your expenses for lodging and 50% of your expenses for meals.

Whether a trip's purpose is mainly personal or educational depends upon the facts and circumstances. An important factor is the comparison of time spent on personal activities with time spent on educational activities. If you spend more time on personal activities, the trip is considered mainly educational only if you can show a substantial nonpersonal reason for traveling to a particular location.

Example 1. John works in Newark, New Jersey. He traveled to Chicago to take a deductible one-week course at the request of his employer. While there, he took a sightseeing trip, entertained some friends, and took a side trip to Pleasantville for a day. Since the trip was mainly for business, he can deduct his round-trip airfare to Chicago, but he cannot deduct his transportation expenses of going to Pleasantville. He can deduct only the meals and lodging connected with his educational activities.

Example 2. Dave works in Nashville and recently traveled to California to take a deductible 2-week seminar. While there, he spent an additional 8 weeks on personal activities. The facts, including the extra 8-week stay, show that his main purpose was to take a vacation. He cannot deduct his round-trip airfare or his meals and lodging for the 8 weeks. He can deduct only his expenses for meals and lodging for the 2 weeks he attended the seminar.

Cruises and conventions. Certain cruises and conventions offer seminars or courses as part of their itinerary. Even if these are work related, your deduction for travel may be limited. This applies to:

1) Travel by ocean liner, cruise ship, or other form of luxury water transportation, and
2) Conventions outside the North American area.

For a discussion of the limits on travel expense deductions that apply to cruises and conventions, see *Luxury Water Travel* and *Conventions* in Publication 463.

Meal Expenses

If your educational expenses qualify for deduction, you can deduct the cost of meals that qualify as travel expenses.

50% limit. You can deduct only 50% of your qualifying business-related meals if you were not reimbursed by your employer. This includes meals while traveling away from home to obtain your education. Employees must use Form 2106–EZ or 2106 to apply the 50% limit.

Travel as Education

You cannot deduct the cost of travel that is a form of education even if it is directly related to your duties in your work or business.

Example. You are a French language teacher. While on sabbatical leave granted for travel, you traveled through France to improve your knowledge of the French language. You chose your itinerary and most of your activities to improve your French language skills. You cannot deduct your travel expenses as educational expenses. This is true even if you spent most of your time learning French by visiting French schools and families, attending movies or plays, and engaging in similar activities.

Expenses Relating to Tax-Exempt and Excluded Income

Some educational assistance you receive may be tax-exempt or excluded income. This is income you receive that you are not required to report as income on your tax return.

Since you do not pay tax on this income, you may not be able to deduct the related expenses. Examples of tax-exempt or excluded income include scholarships, veterans' educational assistance, and the education savings bond program. If you received assistance from any of these sources, see *Expenses Relating to Tax-Exempt and Excluded Income* in Publication 508.

Where To Deduct Expenses

Self-employed persons and employees report their educational expenses differently. The following information explains what forms you must use to deduct your qualified educational expenses.

This section explains how to deduct your expenses of qualified education. If you are an employee, you must take into account any reimbursement you receive. How you treat the reimbursement depends on the type of reimbursement arrangement and the amount of the reimbursement. For information on how to report your reimbursement, see chapter 28.

Self-Employed Persons

If you are self-employed, you must report your qualified educational expenses on the appropriate form used to report your business income and expenses (Schedule C, Schedule C-EZ, or Schedule F).

For example, if you use Schedule C, list and total your educational expenses for tuition, books, laboratory fees, and similar items in Part V and enter the total on line 27. Include educational expenses that are car and truck expenses on line 10. Include your travel expenses on line 24a. Include your meals on line 24b. See the instructions for the form that you file for more information.

Employees

If you are an employee, you can deduct qualified educational expenses only if they were not reimbursed by your employer or exceeded your reimbursement. (Amounts your employer paid under a nonaccountable plan and included in box 1 of your Form W-2 are not considered reimbursements.)

Include your qualified educational expenses with your deduction for any other employee business expenses on line 20 of Schedule A (Form 1040). (A special rule for certain performing artists is explained later.) This deduction is subject to the 2%-of-adjusted-gross-income limit that applies to most miscellaneous itemized deductions.

Form 2106 or Form 2106–EZ. To figure your deduction for employee business expenses, including qualified educational expenses, you generally must complete Form 2106 or Form 2106–EZ.

Form not required. Do not complete either Form 2106 or Form 2106–EZ if:

- You were not reimbursed for any of your expenses, and
- you are not claiming travel, transportation, or meal expenses.

If you meet both of these requirements, enter the expenses directly on line 20 of Schedule A (Form 1040). (A special rule for certain performing artists is explained later.)

Using Form 2106–EZ. This form is shorter and easier to use than Form 2106. You can use this form if:

- You were not reimbursed for any of your expenses, and
- If you are claiming vehicle expenses, you are using the standard mileage rate.

If you do not meet both of these requirements, use Form 2106.

Performing artists. If you are a qualified performing artist, include your qualified educational expenses with any other employee business expenses on Form 1040, line 31. You do not have to itemize your deductions on Schedule A (Form 1040), and the deduction is not subject to the 2%-of-adjusted-gross-income limit. You must complete Form 2106 or 2106–EZ to figure your deduction even if you meet the requirements described earlier under *Form not required.*

For more information on qualified performing artists, see chapter 28.

Impairment-related work expense. If you are disabled and have impairment-related work expenses that enable you to get qualifying education, they are not subject to the 2%-of-adjusted-gross-income limit. To deduct these expenses, you must complete Form 2106 or 2106–EZ even if you meet the requirements described earlier under *Form not required.*

For more information on impairment-related work expenses, see chapter 28.

Recordkeeping

RECORDS

You must keep records as proof of any deduction claimed on your tax return. Generally, you should keep your records for 3 years from the date of filing the return and claiming the deduction. A return filed early is considered as filed on the due date. For specific information about keeping records of business expenses, see *Recordkeeping* in chapter 28.

30. Miscellaneous Deductions

Important Change for 1997

Limit on itemized deductions. For 1997, if your adjusted gross income is more than $121,200 ($60,600 if you are married filing separately), you may have to reduce the amount of certain itemized deductions, including your miscellaneous deductions.

Introduction

This chapter explains what expenses you can claim as miscellaneous itemized deductions on **Schedule A** (Form 1040). You must reduce the total of most miscellaneous itemized deductions by 2% of your adjusted gross income. This chapter identifies:

- Deductions subject to the 2% limit,
- Deductions not subject to the 2% limit, and
- Expenses you cannot deduct.

RECORDS You must keep records to verify your deductions. You should keep receipts, canceled checks, financial account statements, and other documentary evidence. For more information on recordkeeping, get Publication 552, *Recordkeeping for Individuals.*

Useful Items

You may want to see:

Publication

- ☐ **463** Travel, Entertainment, Gift, and Car Expenses
- ☐ **525** Taxable and Nontaxable Income
- ☐ **529** Miscellaneous Deductions
- ☐ **535** Business Expenses
- ☐ **587** Business Use of Your Home (Including Use by Day-Care Providers)
- ☐ **946** How To Depreciate Property

Form (and Instructions)

- ☐ **2106** Employee Business Expenses
- ☐ **2106–EZ** Unreimbursed Employee Business Expenses

Deductions Subject to the 2% Limit

You can deduct the following expenses as miscellaneous itemized deductions on Schedule A (Form 1040). You can claim the amount of expenses that is more than 2% of your adjusted gross income. You figure your deduction on Schedule A (Form 1040) by subtracting 2% of your adjusted gross income from the total amount of these expenses. You can find your adjusted gross income on line 32, Form 1040.

Generally, you apply the 2% limit after you apply any other deduction limit. For example, the 50% limit on business-related meals and entertainment is applied before you subtract 2% of your adjusted gross income.

Deductions subject to the 2% limit are discussed in the two general categories that are shown on Schedule A (Form 1040): unreimbursed employee expenses and other expenses.

Exception for performing artists. If you are a qualifying performing artist, you may be able to deduct your employee business expenses as an adjustment to gross income rather than as a miscellaneous itemized deduction. See *Special Rules* in chapter 28 if you need more information about this exception.

Exception for impairment-related work expenses. If you have a physical or mental disability, certain expenses you incur that allow you to work may not be subject to the 2% limit. See *Impairment-Related Work Expenses,* under *Deductions Not Subject to the 2% Limit,* later.

Unreimbursed Employee Expenses

To be deductible, an unreimbursed employee expense must be:

1) Paid or incurred during your tax year,
2) For carrying on your trade or business of being an employee, and
3) An ordinary and necessary business expense.

An expense is ***ordinary*** if it is common and accepted in that type of trade or business. An expense is ***necessary*** if it is appropriate and helpful to your trade or business.

Examples of unreimbursed business expenses you may be able to deduct are listed next. The list is followed by a discussion of additional expenses that are more common to employees.

- Business bad debt of employee.
- Education that is employment related (see chapter 29).
- Laboratory breakage fees.
- Licenses and regulatory fees.
- Malpractice insurance premiums.
- Medical examinations required by employer.
- Occupational taxes you paid.
- Passport for business trip.
- Subscriptions to professional journals and trade magazines related to your work.
- Travel, transportation, entertainment, gift, and car expenses related to your work (see chapter 28).

Business Liability Insurance

You can deduct insurance premiums you paid for protection against personal liability for wrongful acts on the job.

Damages for Breach of Employment Contract

If you break an employment contract, you can deduct damages you pay your former employer if the damages are attributable to the pay you received from that employer.

Depreciation on Computers or Cellular Telephones

If you purchased a computer or cellular telephone, you can claim a depreciation deduction if you use these items in your work as an employee and you meet the following two tests. Your use of these items must be:

1) For the convenience of your employer, and
2) Required as a condition of your employment.

For more information about the rules and exceptions to the rules affecting the allowable deductions for a home computer or cellular telephone, see Publication 529.

Dues to Chamber of Commerce and Professional Societies

You may be able to deduct dues paid to a chamber of commerce, similar organizations, and professional societies, if membership helps you carry out the duties of your job. Similar organizations include:

- Boards of trade,
- Business leagues,
- Civic or public service organizations,
- Professional associations such as bar associations and medical associations,
- Real estate boards, and
- Trade associations.

You ***cannot*** deduct dues paid to an organization if one of its main purposes is to:

1) Conduct entertainment activities for members or their guests, or
2) Provide members or their guests with access to entertainment facilities.

See *Club Dues* under *Nondeductible Expenses* for more information.

Lobbying and political activities. You may not be able to deduct that part of your dues that is for certain lobbying and political activities. See *Dues* under *Lobbying Expenses,* later.

TIP *Dues paid to airline, hotel, and luncheon clubs are not deductible.*

Home Office

If you use a part of your home regularly and exclusively for business purposes, you may be able to deduct a part of the operating and depreciation expenses on your home. You cannot deduct any part of your personal expenses that are for family household purposes.

Requirements for employees claiming the deduction. You can deduct certain expenses for operating a part of your home only if that part of your home is used ***regularly*** and ***exclusively*** as:

1) Your principal place of business for any trade or business in which you engage, or

2) A place to meet or deal with your patients, clients, or customers in the normal course of your trade or business.

You can also deduct certain expenses of operating a separate structure not attached to your home, if you use it regularly and exclusively for your trade or business.

The regular and exclusive business use must be ***for the convenience of your employer*** and not just appropriate and helpful in your job. Get Publication 587 for more detailed information and a worksheet.

Job Search Expenses

You can deduct certain expenses you have in looking for a new job in your present occupation, even if you do not get a new job. You cannot deduct these expenses if:

1) You are looking for a job in a new occupation, or

2) You had a substantial break between the time of your last job and your looking for a new one.

CAUTION *You cannot deduct your expenses if you are seeking employment for the first time.*

Employment and outplacement agency fees. You can deduct employment and outplacement agency fees you pay in looking for a new job in your present occupation.

Employer pays you back. If, in a later year, your employer pays you back for employment agency fees, you must include the amount you receive in your gross income up to the amount of your tax benefit in the earlier year (see *Recoveries* in chapter 13).

Employer pays back the employment agency. If your employer pays the fees directly to the employment agency and you were not responsible for them, you do not include them in your gross income.

Resumé. You can deduct amounts you spend for typing, printing, and mailing copies of a resumé to prospective employers if you spent the amounts in looking for a new job in your present occupation.

Travel and transportation expenses. If you travel to an area and, while there, you look for a new job in your present occupation, you may be able to deduct travel expenses to and from the area. You can deduct the travel expenses if the trip is primarily to look for a new job. The amount of time you spend on personal activity compared to the amount of time you spend in looking for work is important in determining whether the trip is primarily personal or to look for a new job.

Even if you cannot deduct the travel expenses to and from an area, you can deduct the expenses of looking for a new job in your present occupation, while in the area.

If you use the standard mileage rate to figure your car expenses, use 31.5 cents per mile. See chapter 28 for more information.

Licenses and Regulatory Fees

Licenses and regulatory fees for your trade, business, or profession paid each year to state or local governments are deductible.

Repayment of Income Aid Payment

An "income aid payment" is one that is received under an employer's plan to aid employees who lose their jobs because of lack of work. If you repay a lump-sum income aid payment that you received and included in income in an earlier year, you can deduct the repayment.

Research Expenses of a College Professor

If you are a college professor, you can deduct research expenses, including travel expenses, for teaching, lecturing, or writing and publishing on subjects that relate directly to the field of your teaching duties. You must have undertaken the research as a means of carrying out the duties expected of a professor and without expectation of profit apart from salary. However, you cannot deduct the cost of travel as a form of education.

Tools Used in Your Work

Generally, you can deduct amounts you spend for tools used in your work if the tools wear out and are thrown away within one year from the date of purchase. You can depreciate the cost of tools expected to last more than a year. For more information about depreciation, get Publication 946.

Union Dues and Expenses

You can deduct dues and initiation fees you pay for union membership.

You can also deduct assessments for benefit payments to unemployed union members. However, you cannot deduct the part of the assessments or contributions that provides funds for the payment of sick, accident, or death benefits. Also, you cannot deduct contributions to a pension fund even if the union requires you to make such contributions.

You may not be able to deduct amounts you pay to the union that are related to certain lobbying and political activities. See *Lobbying Expenses* under *Nondeductible Expenses,* later.

Work Clothes and Uniforms

You can deduct the cost and upkeep of work clothes only if:

1) You must wear them as a condition of your employment, and

2) They are not suitable for everyday wear.

It is not enough that you wear distinctive clothing. The clothing must be specifically required by your employer. Nor is it enough that you do not in fact wear your work clothes away from work. The clothing must not be suitable for taking the place of your regular clothing.

Examples of workers who may be able to deduct the cost and upkeep of work clothes are: delivery workers, firefighters, health care workers, law enforcement officers, letter carriers, professional athletes, and transportation workers (air, rail, bus, etc.).

Musicians and entertainers can deduct the cost of theatrical clothing and accessories if they are not suitable for everyday wear.

However, work clothing consisting of white cap, white shirt or white jacket, white bib overalls, and standard work shoes, which a painter is required by his union to wear on the job, is not distinctive in character or in the nature of a uniform. Similarly, the costs of buying and maintaining blue work clothes worn by a welder at the request of a foreman are not deductible.

Protective clothing. You can deduct the cost of protective clothing required in your work, such as safety shoes or boots, safety glasses, hard hats, and work gloves.

Examples of workers who may be required to wear safety items are: carpenters, cement workers, chemical workers, electricians, fishing boat crew members, machinists, oil field workers, pipe fitters, steamfitters, and truck drivers.

Military uniforms. You generally cannot deduct the cost of your uniforms if you are on full-time active duty in the armed forces. However, if you are an armed forces reservist, you can deduct the unreimbursed cost of your uniform if military regulations restrict you from wearing it except while on duty as a reservist. In figuring the deduction, you must reduce the cost by any nontaxable allowance you receive for these expenses.

If local military rules do not allow you to wear fatigue uniforms when you are off duty, you can deduct the amount by which the cost of buying and keeping up these uniforms is more than the uniform allowance you receive.

If you are a student at an armed forces academy, you cannot deduct the cost of your uniforms if they replace regular clothing. However, you can deduct the cost of insignia, shoulder boards, and related items.

You can deduct the cost of your uniforms if you are a civilian faculty or staff member of a military school.

Other Expenses

You can deduct certain other expenses as miscellaneous itemized deductions subject to the 2%-of-adjusted-gross-income limit. These are expenses you pay:

1) To produce or collect income that must be included in your gross income,
2) To manage, conserve, or maintain property held for producing such income, or
3) To determine, contest, pay, or claim a refund of any tax.

You can deduct other expenses you pay for the purposes in (1) and (2) above only if they are reasonably and closely related to these purposes. Some of these other expenses are explained in the following discussions.

If the expenses you pay produce income that is only partially taxable, see *Tax-Exempt Income Expenses,* later, under *Nondeductible Expenses.*

Appraisal Fees

You can deduct appraisal fees if you pay them to figure a casualty loss or the fair market value of donated property.

Clerical Help and Office Rent

You can deduct office expenses, such as rent and clerical help, that you have in connection with your investments and collecting the taxable income on them.

Depreciation on Home Computer

You can deduct depreciation on your home computer if you use it to produce income (for example, managing your investments that produce taxable income). If you work as an employee and use the computer in that work, see Publication 946.

Excess Deductions of an Estate

If the total deductions in the estate's last tax year are more than the estate's gross income for that year, the beneficiaries succeeding to the estate's property can claim such excess as a miscellaneous deduction. Do not include deductions for personal exemptions and charitable contributions when figuring the total deductions. The beneficiaries can claim the deduction only for the tax year in which or with which the estate terminates, whether the year of termination is a normal year or a short tax year. For more information, see Publication 559.

Fees to Collect Interest and Dividends

You can deduct fees you pay to a broker, bank, trustee, or similar agent to collect your taxable bond interest or dividends on shares of stock. But you cannot deduct a fee you pay to a broker to buy investment property, such as stocks or bonds. You must add the fee to the cost of the property.

You cannot deduct the fee you pay to a broker to sell securities unless you are a dealer in securities. You must offset the fee against the selling price.

Hobby Expenses

You can generally deduct hobby expenses, but only up to the amount of hobby income. A hobby is not a business because it is not carried on to make a profit. See *Activity not for profit* in chapter 13 under *Miscellaneous Taxable Income.*

Indirect Deductions of Pass-Through Entities

Pass-through entities include partnerships, S corporations, and mutual funds. Deductions of pass-through entities are passed through to the partners or shareholders. If the deductions are miscellaneous itemized deductions, they are generally subject to the 2% limit.

Information returns. You should receive information returns from pass-through entities. Partnerships and S corporations issue **Schedule K–1,** which lists the items and amounts you must report, and identifies the tax return schedules and lines to use.

Example. You are a member of an investment club that is formed solely to invest in securities. The club is treated as a partnership. The partnership's income is solely from taxable dividends, interest, and gains from sales of securities. In this case, you can deduct your share of the partnership's operating expenses as a miscellaneous itemized deduction subject to the 2% limit. However, if the investment club partnership has investments that also produce nontaxable income, you cannot deduct your share of the partnership's expenses that produce the nontaxable income. You should receive a copy of Schedule K–1 (Form 1065), *Partner's Share of Income, Credits, Deductions, Etc.*

Allocated expenses of mutual funds. The allocable investment expenses of non-publicly offered mutual funds are subject to the 2% limit. Publicly offered mutual funds do not pass investment expenses through to shareholders.

A "publicly offered" mutual fund is one that is:

1) Continuously offered pursuant to a public offering,
2) Regularly traded on an established securities market, or
3) Held by or for at least 500 persons at all times during the tax year.

CAUTION *Contact your mutual fund if you are not sure if your fund is publicly offered.*

Nonpublicly offered mutual funds. These funds will send you a Form 1099–DIV, *Dividends and Distributions,* or a substitute form, showing your share of gross income and investment expenses. You can claim the expenses only as a miscellaneous itemized deduction subject to the 2% limit.

Publicly offered mutual funds. These funds will send you a Form 1099–DIV, or a substitute form, showing the net amount of dividend income (gross dividends minus investment expenses). This net figure is the amount you report on your return.

Investment Fees and Expenses

You can deduct investment fees, custodial fees, trust administration fees, and other expenses you paid for managing your investments that produce taxable income.

Legal Expenses

You can usually deduct legal expenses that you incur in attempting to produce or collect taxable income or that you pay in connection with the determination, collection, or refund of any tax.

You can also deduct legal expenses that are:

- Related to either doing or keeping your job, such as those you paid to defend yourself against criminal charges arising out of your trade or business.
- For tax advice related to a divorce if the bill specifies how much is for tax advice and it is determined in a reasonable way.
- To collect taxable alimony.

You deduct expenses of resolving tax issues relating to profit or loss from business (Schedule C or C–EZ), rentals or royalties (Schedule E), or farm income and expenses (Schedule F), on the appropriate schedule. You deduct the expenses of resolving nonbusiness tax issues on Schedule A (Form 1040).

Loss on Deposits in an Insolvent or Bankrupt Financial Institution

For information on whether, and if so how, you may deduct a loss on your deposit in a qualified financial institution, see *Loss on deposits in an insolvent or bankrupt financial institution* in chapter 15.

Repayments of Income

If you had to repay an amount that you included in income in an earlier year, you may be able to deduct the amount you repaid. If the amount you had to repay was ordinary income of $3,000 or less, the deduction is subject to the 2% limit. If it is more than $3,000, see *Repayments Under Claim of Right* under *Deductions Not Subject to the 2% Limit,* later.

Repayments of Social Security Benefits

For information on how to deduct your repayments of certain social security benefits, see *Repayments More Than Gross Benefits* in chapter 12.

Safe Deposit Box Rent

You can deduct safe deposit box rent if you use the box to store taxable income-producing stocks, bonds, or investment-related papers and documents. You cannot deduct the rent if you use the box only for jewelry or other personal items or for tax-exempt securities.

Service Charges on Dividend Reinvestment Plans

You can deduct service charges you pay as a subscriber in a dividend reinvestment plan. These service charges include payments for:

1) Holding shares acquired through a plan,
2) Collecting and reinvesting cash dividends, and
3) Keeping individual records and providing detailed statements of accounts.

Tax Preparation Fees

You can usually deduct tax preparation fees in the year you pay them. Thus, on your 1997 return, you can deduct fees paid in 1997 for preparing your 1996 return.

These fees include the cost of tax preparation software programs and tax publications. It also includes any fee you paid for electronic filing of your return.

Deduct expenses of preparing tax schedules relating to profit or loss from business (Schedule C or C–EZ), rentals or royalties (Schedule E), or farm income and expenses (Schedule F) on the appropriate schedule. Deduct the expenses of preparing the remainder of the return on line 21, Schedule A (Form 1040).

Trustee's Administrative Fees for IRA

You can deduct an IRA trustee's administrative fees that are billed separately and that you paid in connection with your individual retirement arrangement (IRA). They are deductible (if they are ordinary and necessary) as a miscellaneous deduction on Schedule A (Form 1040). You cannot separately deduct disguised IRA contributions or capital expenditures such as brokers' commissions that you must add to the cost of securities you buy through brokers. These trustee's fees are not subject to the contribution limit. For more information about IRAs, see chapter 18.

Deductions Not Subject to the 2% Limit

You can deduct the following expenses as miscellaneous itemized deductions. They are not subject to the 2% limit. Report these expenses on line 27, Schedule A (Form 1040).

List of Deductions

- Amortizable premium on taxable bonds.
- Federal estate tax on income in respect of a decedent.
- Gambling losses up to the amount of gambling winnings.
- Impairment-related work expenses of persons with disabilities.
- Repayments under a claim of right if more than $3,000.
- Unrecovered investment in a pension.

Amortizable Premium on Taxable Bonds

A premium is the amount you pay for a bond that is more than the face value of the bond. You can choose to amortize the premium on taxable bonds.

Bond purchased before October 23, 1986. The amortization of the premium is a miscellaneous itemized deduction not subject to the 2% limit.

Bond acquired after October 22, 1986, and before January 1, 1988. The amortization of the premium is investment interest expense subject to the investment interest limit, unless you choose to treat it as an offset to interest income on the bond.

Bond acquired after December 31, 1987. The amortization of the premium is an offset to interest income on the bond rather than a separate interest deduction item.

More information. See *Bond Premium Amortization* in chapter 3 of Publication 550, *Investment Income and Expenses.*

Federal Estate Tax on Income in Respect of a Decedent

You can deduct the federal estate tax attributable to income in respect of a decedent that you as a beneficiary include in your gross income. Income in respect of the decedent is gross income that the decedent would have received had death not occurred and that was not properly includible in the decedent's final income tax return. See chapter 4 for more information.

Gambling Losses Up to the Amount of Gambling Winnings

You must report the full amount of your gambling winnings on line 21, Form 1040. You deduct your gambling losses on line 27, Schedule A (Form 1040). You cannot deduct gambling losses that are more than your winnings.

CAUTION *You cannot reduce your gambling winnings by your gambling losses. You must report the full amount of your winnings as income and claim your losses as an itemized deduction. Therefore, your records should show your winnings separately from your losses. Only gambling losses incurred during the year can be deducted on Schedule A (Form 1040).*

Diary of winnings and losses. You must keep an accurate diary or similar record of your losses and winnings. Your diary should contain at least the following information:

1) The date and type of your specific wager or wagering activity,
2) The name and address or location of the gambling establishment,
3) The names of other persons present with you at the gambling establishment, and
4) The amount(s) you won or lost.

See Publication 529 for more information.

Impairment-Related Work Expenses

If you have a physical or mental disability that limits your being employed, or substantially limits one or more of your major life activities, such as performing manual tasks, walking, speaking, breathing, learning, and working, you can deduct your impairment-related work expenses.

Impairment-related work expenses are ordinary and necessary business expenses for attendant care services at your place of work and other expenses in connection with your place of work that are necessary for you to be able to work.

Where to report. If you are an employee, you enter impairment-related work expenses on Form 2106 or Form 2106–EZ. From the amount on line 10 of Form 2106, or line 6 of Form 2106–EZ, you enter the amount that is related to your impairment on line 27, Schedule A (Form 1040). Enter the amount that is unrelated to your impairment on line 20, Schedule A (Form 1040).

Repayments Under Claim of Right

If you had to repay more than $3,000 that you included in your income in an earlier year because at the time you thought you had an unrestricted right to it, you may be able to deduct the amount you repaid, or take a credit against your tax. See *Repayments* in chapter 13 for more information.

Unrecovered Investment in Pension

If a retiree had contributed to the cost of a pension or annuity, the retiree can exclude from income a part of each payment received as a tax-free return of the retiree's investment. If the retiree dies before the entire investment is recovered, any unrecovered investment can be deducted on the retiree's final income tax return. See chapter 11 for more information about the tax treatment of pensions and annuities.

Nondeductible Expenses

Examples of nondeductible expenses are listed next. The list is followed by discussions of additional nondeductible expenses that are more common to most people.

List of Expenses

- Burial or funeral expenses, including the cost of a cemetery lot.
- Capital expenses.
- Fees and licenses, such as car licenses, marriage licenses, and dog tags.
- Hobby losses.
- Home repairs, insurance, and rent.
- Illegal bribes and kickbacks—See *Bribes and kickbacks* in chapter 16 of Publication 535.
- Losses from the sale of your home, furniture, personal car, etc.
- Personal disability insurance premiums.
- Personal, living, or family expenses.

Campaign Expenses

Campaign expenses of a candidate for any office, even if the candidate is running for reelection to the office, are not deductible. These include qualification and registration fees for primary elections.

Legal fees. You cannot deduct legal fees paid to defend charges that arise from participation in a political campaign.

Check-Writing Fees

If you have a personal checking account, you cannot deduct fees charged by the bank for the privilege of writing checks, even if the account pays interest.

Club Dues

Generally, you cannot deduct the cost of membership in any club organized for business, pleasure, recreation, or other social purpose. This includes business, social, athletic, luncheon, sporting, airline, and hotel clubs. For exceptions, see *Dues to Chamber of Commerce and Professional Societies* under *Unreimbursed Employee Expenses,* earlier.

Commuting Expenses

You cannot deduct commuting expenses (the cost of transportation between your home and your main or regular place of work). If you haul tools, instruments, etc., in your car to and from work, you can deduct only additional costs, such as renting a trailer you tow with your vehicle.

Fines or Penalties

You cannot deduct fines or penalties you pay to a governmental unit for violating a law. This includes an amount paid in settlement of your actual or potential liability for a fine or penalty (civil or criminal). Fines or penalties include parking tickets, tax penalties, and penalties deducted from teachers' paychecks after an illegal strike.

Health Spa Expenses

You cannot deduct health spa expenses, even if there is a job requirement to stay in excellent physical condition, such as might be required of a law enforcement officer.

Homeowners' Insurance Premiums

You cannot deduct premiums that you pay or that are placed in escrow for insurance on your home, such as fire and liability or mortgage insurance.

Investment-Related Seminars

You cannot deduct any expenses for attending a convention, seminar, or similar meeting for investment purposes.

Life Insurance Premiums

You cannot deduct premiums you pay on your life insurance. You may be able to deduct, as alimony, premiums you pay on life insurance policies assigned to your ex-spouse. See chapter 20 for information on alimony.

Lobbying Expenses

You cannot deduct amounts paid or incurred for lobbying expenses. These include expenses to:

1) Influence legislation,
2) Participate, or intervene, in any political campaign for, or against, any candidate for public office,
3) Attempt to influence the general public, or segments of the public, about elections, legislative matters, or referendums, or
4) Communicate directly with covered executive branch officials in any attempt to influence the official actions or positions of such officials.

Lobbying expenses also include any amounts paid or incurred for research, preparation, planning, or coordination of any of these activities.

Dues. You cannot deduct that portion of your dues or other amounts you pay to a tax-exempt organization that notifies you that such amounts are used to pay nondeductible lobbying expenses. See *Lobbying Expenses* in Publication 529 for information on *Exceptions.*

Lost or Mislaid Cash or Property

You cannot deduct a loss based on the mere disappearance of money or property. However, an accidental loss or disappearance of property can qualify as a casualty if it results from an identifiable event that is sudden, unexpected, or unusual.

Example. A car door is accidentally slammed on your hand, breaking the setting of your diamond ring. The diamond falls from the ring and is never found. The loss of the diamond is a casualty.

Lunches with Co-Workers

You cannot deduct the expenses of lunches with co-workers, except while traveling away from home on business. See chapter 28 for information on these deductible expenses.

Meals While Working Late

You cannot deduct the cost of meals while working late. However, you may be able to claim a deduction if it is a deductible entertainment expense or you are traveling away from home. See chapter 28 for information on these deductible expenses.

Personal Legal Expenses

You cannot deduct personal legal expenses such as those for:

1) Custody of children,
2) Breach of promise (to marry) suit,
3) Civil or criminal charges resulting from a personal relationship,
4) Damages for personal injury,
5) Preparation of a title (or to defend or perfect title),
6) Preparation of a will, and
7) Property claims or property settlement in a divorce.

You cannot deduct these expenses even if a result of the legal proceeding is the loss of income-producing property.

Political Contributions

You cannot deduct contributions made to a political candidate, a campaign committee, or a newsletter fund.

Professional Accreditation Fees

You cannot deduct professional accreditation fees such as the following:

1) Accounting certificate fees paid for the initial right to practice accounting,
2) Bar exam fees and incidental expenses in securing admission to the bar, and
3) Medical and dental license fees paid to get initial licensing.

Professional Reputation

You cannot deduct expenses of radio and TV appearances to increase your personal prestige or establish your professional reputation.

Relief Fund Contributions

You cannot deduct contributions paid to a private plan that pays benefits to any covered employee who cannot work because of any injury or illness not related to the job.

Residential Telephone Service

You cannot deduct any charge (including taxes) for basic local telephone service for the first telephone line to your residence, even if it is used in a trade or business.

Stockholders' Meetings

You cannot deduct transportation and other expenses you pay to attend stockholders' meetings of companies in which you own stock but have no other interest. You cannot deduct these expenses even if you are attending the meeting to get information that would be useful in making further investments.

Tax-Exempt Income Expenses

You cannot deduct expenses to produce tax-exempt income. You cannot deduct interest on a debt incurred or continued to buy or carry tax-exempt securities.

If you have expenses to produce both taxable and tax-exempt income, but you cannot identify the expenses that produce each type of income, you must divide the expenses based on the amount of each type of income to determine the amount that you can deduct.

Example. During the year, you received taxable interest of $4,800 and tax-exempt interest of $1,200. In earning this income, you had total expenses of $500 during the year. You cannot identify the amount of each expense item that is for each income item. Therefore, you calculate that 80% ($4,800/$6,000) of the expense is for the taxable interest and 20% ($1,200/$6,000) is for the tax-exempt interest. You can deduct, subject to the 2% limit, expenses of $400 (80% of $500).

Travel Expenses for Another Individual

You generally cannot deduct travel expenses you pay or incur for a spouse, dependent, or other individual who accompanies you (or your employee) on business travel. See chapter 28 for more information on deductible travel expenses.

Voluntary Unemployment Benefit Fund Contributions

You cannot deduct voluntary unemployment benefit fund contributions you make to a union fund or a private fund. However, you can deduct contributions as taxes if state law requires you to make them to a state unemployment fund that covers you for the loss of wages from unemployment caused by business conditions.

Wristwatches

You cannot deduct the cost of a wristwatch, even if there is a job requirement that you know the correct time to properly perform your duties.

Part Six.

Figuring Your Taxes and Credits

The six chapters in this part explain how to figure your tax and how to figure the tax of certain children who have more than $1,300 of investment income. They also discuss tax credits. Credits, unlike deductions, are subtracted directly from your tax and reduce your tax, dollar for dollar. There are tax credits for the elderly or the permanently and totally disabled, for the expense of having your child or disabled spouse or dependent cared for so that you can work, for adoption expenses, for the purchase of a qualified electric vehicle, and for other kinds of expenses. Chapter 35 discusses the earned income credit and how you may be able to get part of the credit paid to you in advance throughout the year.

31.

How To Figure Your Tax

Introduction

After you have figured your income and deductions as explained in Parts One through Five, your next step is to figure your tax. This chapter discusses:

- The general steps you take to figure your tax,
- An additional tax you may have to pay called the alternative minimum tax, and
- The conditions you must meet if you want the IRS to figure your tax.

Figuring Your Tax

The amount of income tax you must pay is based on your taxable income. After you figure your income tax, you then subtract from it any credits you may have and add any other taxes you may owe. The result is your total tax. Finally, you compare your total tax with your total payments to determine whether you are entitled to a refund or owe additional tax.

This section provides a general outline of how to figure your tax. You can find step-by-step directions in the instructions for Forms 1040EZ, 1040A, and 1040. If you are unsure of which tax form you should file, see *Which Form Should I Use?* in chapter 1.

Tax. Most taxpayers use either the Tax Table or the Tax Rate Schedules to figure their income tax. However, there are special methods you may have to use for the following items.

- Capital gain income (see chapter 17).
- Investment income over $1,300 of children under age 14 (see chapter 32).
- Lump-sum distributions (see chapter 11).

Credits. After you figure your income tax, you can determine whether you can claim any tax credits. This chapter does not explain whether you are eligible for these credits. You can find that information in chapters 33 through 36 and your form instructions. Scan the credits listed in the following table to see what you may be able to subtract from your income tax.

CREDITS

For information on:	See chapter:
Adoption	36
Child and dependent care	33
Elderly or disabled	34
Foreign tax	36
Mortgage interest	36
Prior year minimum tax	36
Qualified electric vehicle	36

There are other credits that are not discussed in this publication. These include the following irems.

- General business credit, which is made up of a number of separate business-related credits. These are reported on Form 3800, *General Business Credit,* and are discussed in chapter 4 of Publication 334.
- Empowerment zone employment credit, which is for employers with employees who are engaged in a business in an empowerment zone. See the instructions for Form 8844, *Empowerment Zone Employment Credit.*
- First-time District of Columbia homebuyer credit, which is for certain persons who buy a main home in the District. See the instructions for Form 8859, *District of Columbia First-Time Homebuyer Credit.*
- Credit for fuel from a nonconventional source, which is for the person who sold the fuel. See the instructions for line 45 of Form 1040 and Internal Revenue Code section 29.

Other taxes. After you determine whether you have any tax credits, you must determine if there are any other taxes you must pay. This chapter does not explain whether you must pay these other taxes. You can find that information in other chapters of this publication and your form instructions. Scan the taxes listed in the following table to see what you may need to add to your income tax.

OTHER TAXES

For information on:	See chapter:
Additional taxes on qualified retirement plans and IRAs	11, 18
Advance earned income credit payments	35
Household employment taxes	33
Social security and Medicare tax on unreported tips	7
Uncollected employee tax on tips	7

Another tax you may have to pay, the alternative minimum tax, is discussed later in this chapter.

There are other taxes that are not discussed in this publication. These include the following items.

1) *Self-employment tax.* You must figure this tax if either of the following applies to you (or your spouse if you file a joint return):

   a) You were self-employed and your net earnings from self-employment from other than church employee income were $400 or more, or

   b) You had church employee income of $108.28 or more.

   See the instructions for Schedule SE (Form 1040) and Publication 533, *Self-Employment Tax.*

2) *Recapture taxes.* You may have to pay these taxes if you previously claimed an investment tax credit, a low-income housing credit, a mortgage interest credit, a qualified electric vehicle credit, an Indian employment credit, or if you sold a home that was financed from the proceeds of a tax-exempt qualified mortgage bond. See the instructions for line 53 of Form 1040.

3) *Section 72(m)(5) excess benefits tax.* If you are (or were) a 5% owner of a business and you received a distribution that exceeds the benefits provided for you under the qualified pension or annuity plan formula, you may have to pay this additional tax. See Publication 560, *Retirement Plans for Small Business (SEP, Keogh, and SIMPLE Plans).*

4) *Uncollected social security and Medicare tax on group-term life insurance.*

If you quit or retired from your job and your former employer provided you with more than $50,000 of group-term life insurance coverage, this tax applies to you. Former employees must pay the employee part of social security and Medicare taxes on those premiums with Form 1040. See the instructions for line 53 of Form 1040.

5) *Tax on golden parachute payments.* This tax applies if you, as a key employee, received an "excess parachute payment" (EPP) due to a change in a corporation's ownership or control. See the instructions for line 53 of Form 1040.

6) *Tax on accumulated distribution of trusts.* This applies if you are the beneficiary of a trust that accumulated its income instead of distributing it currently. See the instructions for Form 4970, *Tax on Accumulation Distribution of Trusts.*

7) *Additional tax on MSAs.* If amounts contributed to, or distributed from, your medical savings account do not meet the rules for these accounts, you may have to pay additional taxes. See Publication 969, *Medical Savings Accounts,* and Forms 8853, *Medical Savings Accounts and Long-Term Care Insurance Contracts,* and 5329, *Additional Taxes Attributable to Qualified Retirement Plans (Including IRAs), Annuities, Modified Endowment Contracts, and MSAs.*

Payments. After you determine whether you owe any other taxes, you must figure the total payments you have already made during the year. Include credits that are treated as payments (listed in the following table or the discussion that follows the table). This chapter does not explain these payments and credits. You can find that information in other chapters of this publication and your form instructions. Scan the following table to see what amounts you can include in your total payments.

PAYMENTS

For information on:	See chapter:
Earned income credit	35
Estimated tax paid	5
Excess social security and RRTA tax withheld	36
Federal income tax withheld	5
Regulated investment company credit	36
Tax paid with extension	1

Another credit that is treated as a payment is the credit for *federal excise tax paid on fuels.* This credit is for persons who have a nontaxable use of certain fuels in their trade or business, and it is claimed on line 59 of Form 1040. See Publication 378, *Fuel Tax Credits and Refunds,* and Form 4136, *Credit for Federal Tax Paid on Fuels.*

Refund or balance due. By comparing your total payments with your total tax, you determine whether you are entitled to a refund or owe additional tax. If you are entitled to a refund, see your form instructions for information on having it directly deposited into your financial account instead of receiving a paper check.

Alternative Minimum Tax

This section briefly discusses an additional tax you may have to pay.

The tax law gives special treatment to some kinds of income and allows special deductions and credits for some kinds of expenses. Taxpayers who benefit from the law in these ways may have to pay at least a minimum amount of tax through an additional tax. This additional tax is called the alternative minimum tax (AMT).

You may have to pay the alternative minimum tax if your taxable income for regular tax purposes, combined with certain adjustments and tax preference items, is more than:

- $45,000 if your filing status is married filing a joint return (or a qualifying widow(er) with dependent child),
- $33,750 if your filing status is single or head of household, or
- $22,500 if your filing status is married filing a separate return.

Adjustments and tax preference items. The more common adjustments and tax preference items include:

- Addition of ***personal exemptions,***
- Addition of the ***standard deduction*** (if claimed),
- Addition of ***itemized deductions*** claimed for state and local taxes, certain interest, most miscellaneous deductions, and part of medical expenses,
- Subtraction of any ***refund of state and local taxes*** included in gross income,
- Changes to accelerated ***depreciation,***
- Difference between ***gain or loss*** on the sale of property reported for regular tax purposes and AMT purposes,
- Addition of certain income from ***incentive stock options,***
- Change in income from certain ***installment sales*** for which the installment method cannot be used for AMT purposes,
- Change in certain ***passive activity loss*** deductions,
- Addition of certain ***depletion*** that is more than the adjusted basis of the property,
- Addition of part of the deduction for certain ***intangible drilling costs***, and
- Addition of ***tax-exempt interest*** on certain private activity bonds.

More information. For more information about the alternative minimum tax, see the instructions for Form 1040, line 48, and **Form 6251,** *Alternative Minimum Tax—Individuals.*

Tax Figured by IRS

If you file by April 15, 1998, you can have the IRS figure your tax for you on Form 1040EZ, Form 1040A, or Form 1040.

If the IRS figures your tax and you paid too much, you will receive a refund. If you did not pay enough, you will receive a bill for the balance. You may avoid interest or the penalty for late payment if you pay the bill within 30 days of the date of the bill or by the due date for your return, whichever is later.

When the IRS cannot figure your tax. The IRS cannot figure your tax for you if:

1) You want your refund directly deposited,

2) You want any of your refund applied to your 1998 estimated tax,

3) Any of your income for the year was from ***other than*** wages, salaries, tips, interest, dividends, taxable social security benefits, unemployment compensation, IRA distributions, pensions, and annuities,

4) Your taxable income is more than $100,000,

5) You itemize deductions, or

6) You file any of the following forms.

   a) Form 2555, *Foreign Earned Income.*

   b) Form 2555-EZ, *Foreign Earned Income Exclusion.*

   c) Form 4137, *Social Security and Medicare Tax on Unreported Tip Income.*

   d) Form 4970, *Tax on Accumulation Distribution of Trusts.*

   e) Form 4972, *Tax on Lump-Sum Distributions.*

   f) Form 6198, *At-Risk Limitations.*

   g) Form 6251, *Alternative Minimum Tax—Individuals.*

   h) Form 8615, *Tax for Children Under Age 14 Who Have Investment Income of More Than $1,300.*

   i) Form 8814, *Parents' Election To Report Child's Interest and Dividends.*

   j) Form 8839, *Qualified Adoption Expenses.*

   k) Form 8853, *Medical Savings Accounts and Long-Term Care Insurance Contracts.*

Filing the Return

After you complete the line entries for the tax form you are filing (discussed later), you must attach the peel-off label, sign the return, and mail it.

Name, address, and social security number. Put your peel-off label on your return. If you do not have a label, fill in your name, address, and social security number. If you are married, give the social security numbers of both spouses even if you file separately.

Signature and attachments. Sign and date your return. Also fill in your occupation. If you are filing a joint return, both you and your spouse must sign it. Show both of your occupations on a joint return.

Attach Copy B or the first copy of all your Form(s) W–2 to your return. If you are filing Form 1040A or Form 1040, also attach Copy B of any Form 1099–R you received that has withholding tax in box 4.

Mailing. Mail the return to the Internal Revenue Service Center for the area where you live. The addresses are in your tax form instruction booklet.

Form 1040EZ Line Entries

Read lines 1 through 8 and fill in the lines that apply to you. If you are filing a joint return, use the space under the "Note" to the left of line 6 to separately show your taxable income and your spouse's taxable income.

Earned income credit. If you can take this credit, as discussed in chapter 35, the IRS will figure it for you. Enter the amount and type of any nontaxable earned income in the boxes for line 8b. Print "EIC" in the space to the right of the word "below" on line 8b.

Form 1040A Line Entries

Read lines 1 through 22 and fill in the lines that apply to you. If you file a joint return, use the space to the left of line 22 to separately show your own and your spouse's taxable income. Complete lines 24a, 24b, 24c, 26, 27, and 29a through 29d if they apply to you. But do not fill in lines 24b and 29c if you want the IRS to figure the credits shown on those lines. Also, enter any write-in information that applies to you in the space to the left of line 29e.

Credit for child and dependent care expenses. If you can take this credit, as discussed in chapter 33, complete Schedule 2 and attach it to your return. Enter the amount of the credit on line 24a (Form 1040A). The IRS will not figure this credit.

Credit for the elderly or the disabled. If you can take this credit, as discussed in chapter 34, attach Schedule 3 to your return and print "CFE" in the space to the left of line 24b (Form 1040A). The IRS will figure this credit for you. Check the box in Part I of Schedule 3 for your filing status and age, and fill in Part II and lines 11 and 13 of Part III if they apply.

Earned income credit. If you can take this credit, as discussed in chapter 35, the IRS will figure it for you. Print "EIC" directly to the right of line 29c. Enter the amount and type of any nontaxable earned income in the spaces provided on line 29d. If you have a qualifying child, you must fill in Schedule EIC and attach it to your return.

Form 1040 Line Entries

Read lines 1 through 38 and fill in the lines that apply to you.

If you are filing a joint return, use the space above the words "Adjusted Gross Income" on the front of your return to separately show your taxable income and your spouse's taxable income.

Read lines 40 through 59. Fill in the lines that apply to you, but do not fill in the "Total" lines. Do not fill in lines 41 and 56 if you want the IRS to figure the credits shown on those lines. Please be sure to fill in line 54 for federal income tax withheld.

Fill in any forms or schedules asked for on the lines you completed, and attach them to your return when you file it.

Credit for child and dependent care expenses. If you can take this credit, as discussed in chapter 33, complete Form 2441 and attach it to your return. Enter the amount of the credit on line 40 (Form 1040). The IRS will not figure this credit.

Credit for the elderly or the disabled. If you can take this credit, as discussed in chapter 34, attach Schedule R. Print "CFE" on the dotted line next to line 41 of Form 1040. The IRS will figure the credit for you. On Schedule R, check the box in Part I for your filing status and age, and fill in Part II and lines 11 and 13 of Part III if they apply.

Earned income credit. If you can take this credit, as discussed in chapter 35, the IRS will figure it for you. Print "EIC" directly to the right of line 56a of Form 1040. Enter the amount and type of any nontaxable earned income in the spaces provided for line 56b. If you have a qualifying child, you must fill in Schedule EIC and attach it to your return.

32. Tax on Investment Income of Certain Minor Children

Important Reminder

Investment income of child under age 14. If a child's investment income is more than $1,300, part of it may be taxed at the parent's rate. See *Tax for Children Under Age 14 Who Have Investment Income of More Than $1,300.*

Introduction

This chapter discusses two special tax rules that apply to certain investment income of a child under age 14.

1) A child's parent may be able to choose to include the child's interest and dividend income on the parent's return rather than file a return for the child. See *Parent's Election To Report Child's Interest and Dividends,* later.

2) If a child's interest, dividends, and other investment income total more than $1,300, part of that income may be taxed at the parent's tax rate instead of the child's tax rate. See *Tax for Children Under Age 14 Who Have Investment Income of More Than $1,300,* later.

In both cases, the term “child” includes a legally adopted child and a stepchild. These rules apply whether or not the child is a dependent.

These rules do ***not*** apply if:

1) The child is not required to file a tax return, or

2) Neither of the child's parents were living at the end of the tax year.

Useful Items

You may want to see:

Publication

☐ **929** Tax Rules for Children and Dependents

Form (and Instructions)

☐ **8615** Tax for Children Under Age 14 Who Have Investment Income of More Than $1,300

☐ **8814** Parents' Election To Report Child's Interest and Dividends

Which Parent's Return To Use

If the parents file a joint return, use the joint return to figure the tax on the investment income of a child under 14. For parents who do not file a joint return, the following discussions explain which parent's tax return must be used to figure the tax. Only the parent whose tax return is used can make the election described under *Parent's Election To Report Child's Interest and Dividends.* The tax rate and other return information from that parent's return are used in the computations explained later under *Tax for Children Under Age 14 Who Have Investment Income of More Than $1,300.*

Parents are married. If the child's parents file separate returns, use the return of the parent with the greater taxable income.

Parents not living together. If a child's parents are married to each other but not living together, and the parent with whom the child lives (the custodial parent) is considered unmarried, use the return of the custodial parent. If the custodial parent is not considered unmarried, use the return of the parent with the greater taxable income.

For an explanation of when a married person living apart from his or her spouse is considered unmarried, see *Head of Household* in chapter 2.

Parents are divorced. If a child's parents are divorced or legally separated, and the parent who had custody of the child for the greater part of the year (the custodial parent) has not remarried, use the return of the custodial parent.

Custodial parent remarried. If the custodial parent has remarried, the stepparent (rather than the noncustodial parent) is treated as the child's other parent. Therefore, if the custodial parent and the stepparent file a joint return, use that joint return. Do not use the return of the noncustodial parent.

If the custodial parent and the stepparent are married, but file separate returns, use the return of the one with the greater taxable income. If the custodial parent and the stepparent are married but not living together, the earlier discussion under *Parents not living together,* applies.

Parents never married. If a child's parents did not marry each other, but lived together all year, use the return of the parent with the greater taxable income. If the parents did not live together all year, the rules explained earlier under *Parents are divorced,* apply.

Widows and widowers. If a widow or widower remarries, the new spouse is treated as the child's other parent. The rules explained earlier under *Custodial parent remarried,* apply.

Parent's Election To Report Child's Interest and Dividends

You may be able to elect to include your child's interest and dividend income on your tax return. If you do, your child will not have to file a return.

You can make this election for 1997 only if ***all*** the following conditions are met.

1) Your child was under age 14 on January 1, 1998.

2) Your child is required to file a return for 1997 unless you make this election.

3) Your child had income only from interest and dividends (including Alaska Permanent Fund dividends).

4) The dividend and interest income was less than $6,500.

5) No estimated tax payment was made for 1997 and no 1996 overpayment was applied to 1997 under your child's name and social security number.

6) No federal income tax was taken out of your child's income under the backup withholding rules.

7) You are the parent whose return must be used when applying the special tax rules for children under 14. (See *Which Parent's Return To Use,* earlier.)

These conditions are also shown in *Figure 32–A.*

Making the election. Make the election by attaching **Form 8814** to your Form 1040 or Form 1040NR. Attach a separate Form 8814 for each child for whom you make the election. If you file Form 8814, you cannot file Form 1040A or Form 1040EZ.

CAUTION *The federal income tax on your child's income may be more if you make the Form 8814 election rather than file a return for the child.*

By making the Form 8814 election, you cannot take certain deductions the child would be entitled to on his or her return, as explained next.

Deductions you cannot take. If you use Form 8814, you cannot take any of the following deductions that could have been taken on your child's return:

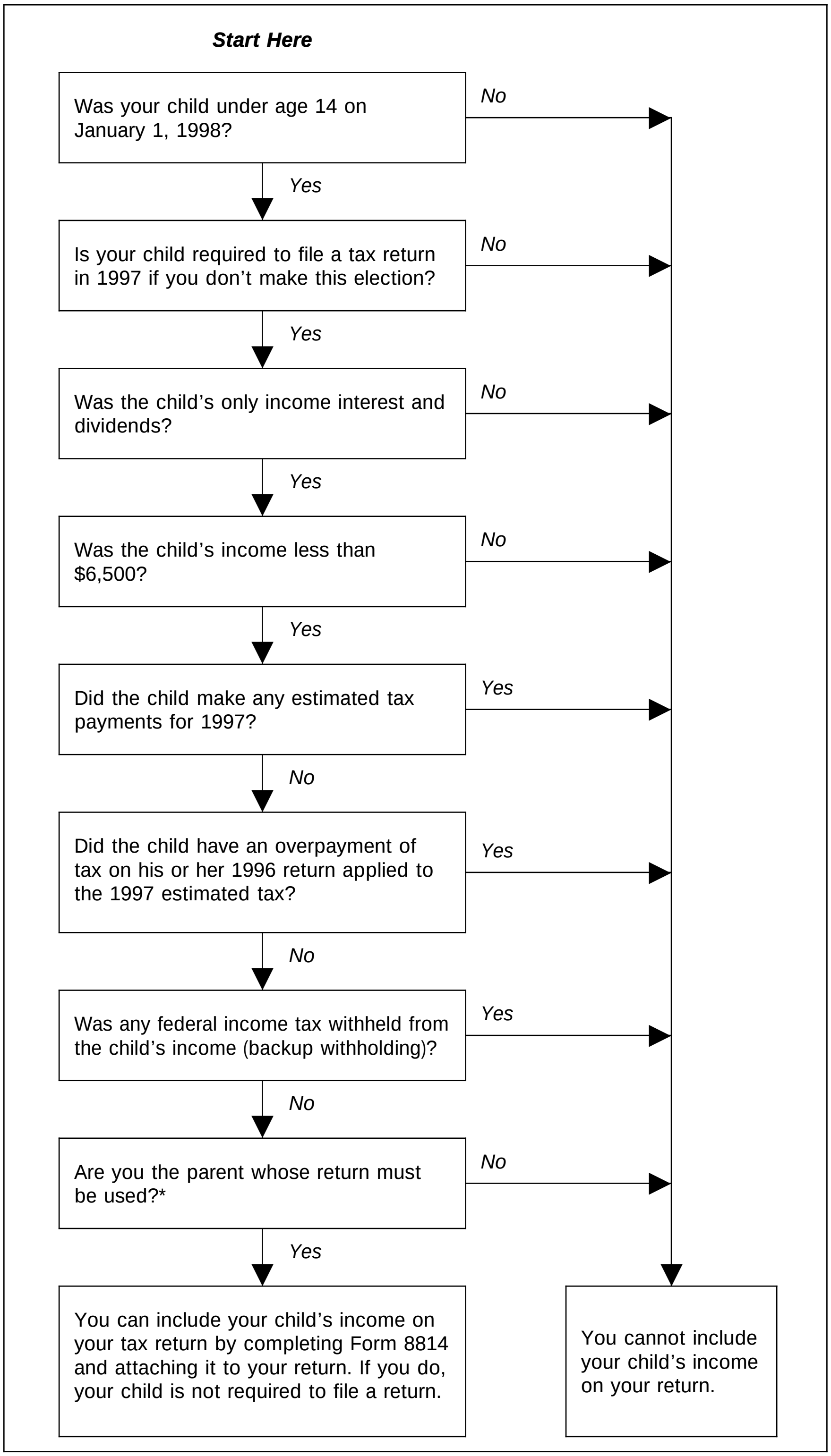
1) A higher standard deduction if your child was blind,

2) Deduction for penalty on early withdrawal of your child's savings, and

3) Itemized deductions (such as your child's investment expenses or charitable contributions).

Increased adjusted gross income. If you use Form 8814, your increased adjusted gross income may reduce certain items on your return, such as your deduction for contributions to an individual retirement account (IRA), and any itemized deductions for medical expenses, casualty and theft losses, and certain miscellaneous expenses.

Figure 32-A. **Can You Include Your Child's Income On Your Tax Return?**



*See *Which Parent's Return To Use*

Penalty for underpayment of estimated tax. If you make this election for 1997 and did not have enough tax withheld or pay enough estimated tax to cover the tax you owe, you may be subject to a penalty. If you plan to make this election for 1998, you may need to increase your federal income tax withholding or your estimated tax payments to avoid the penalty. See chapter 5 for more information.

Figuring Child's Income

Use ***Step 1*** of Form 8814 to figure your child's interest and dividend income to report on your return. Only the amount over $1,300 is added to your income. This amount is shown on line 5 of Form 8814. If you file more than one Form 8814, include the total amounts from line 5 of all your Forms 8814 on line 21, Form 1040 or Form 1040NR. In the space next to line 21, write "Form 8814".

Capital gain distributions. If your child's dividend income included any capital gain distributions, get Publication 929 and see the discussion under *Capital gain distributions* in *Part 2.*

Figuring Additional Tax

Use ***Step 2*** of Form 8814 to figure the tax on your child's interest and dividends that you do not include in your income. This tax is added to the tax figured on your income.

This additional tax is the ***smaller*** of:

1) 15% × (your child's gross income — $650), or

2) $97.50.

Include the amount from line 8 of all your Forms 8814 in the total on line 39, Form 1040, or line 38, Form 1040NR. Check box a on Form 1040, line 39, or Form 1040NR, line 38.

Illustrated Example

David and Linda Parks are married and will file separate tax returns for 1997. Their only child, Philip, is 8. Philip received a Form 1099-INT for 1997 showing $3,200 taxable interest income and a Form 1099-DIV showing $300 ordinary dividends. His parents decide to include that income on one of their returns so they will not have to file a return for Philip.

First, David and Linda each figure their taxable income (Form 1040, line 38) without Philip's income. David's taxable income is $41,700 and Linda's is $59,300. Because her taxable income is greater, Linda can elect to include Philip's income on her return.

On Form 8814, Linda enters her name and social security number, then Philip's name and social security number. She enters Philip's taxable interest income, $3,200, on line 1a. Philip had no tax-exempt interest income, so she leaves line 1b blank. Linda enters Philip's ordinary dividends, $300, on line 2a. Philip did not have any nontaxable distributions, so she leaves line 2b blank and enters $300 on line 2c.

Linda adds lines 1a and 2c and enters the result, $3,500, on line 3. From that amount she subtracts the $1,300 base amount shown on line 4 and enters the result, $2,200, on line 5. This is the part of Philip's income that Linda must add to her income.

Linda includes the $2,200 in the total on line 21 of her Form 1040 and in the space next to that line writes "Form 8814 – $2,200." Adding that amount to her income increases each of the amounts on lines 22, 32, 33, 36, and 38 of her Form 1040 by $2,200. Linda is not claiming any deductions or credits that are affected by the increase to her income. Therefore, her revised taxable income on line 38 is $61,500 ($59,300 + $2,200).

On Form 8814, Linda subtracts the $650 shown on line 6 from the $3,500 on line 3 and enters the result, $2,850, on line 7. Because that amount is $650 or more, she enters $97.50 on line 8. This is the tax on the $1,300 of Philip's income that Linda did not add to her income. She must add this additional tax to the tax figured on her revised taxable income.

The tax on her $61,500 revised taxable income is $14,901. She adds $97.50, and enters the $14,998.50 total on line 39 of Form 1040, and checks box a.

Linda attaches Form 8814 to her Form 1040.

Tax for Children Under Age 14 Who Have Investment Income of More Than $1,300

Part of a child's 1997 investment income may be subject to tax at the parent's tax rate if:

1) The child was under age 14 on January 1, 1998,
2) The child's investment income was more than $1,300, and
3) The child is required to file a return for 1997.

Figure 32–B illustrates these requirements.

If you do not or cannot choose to include the child's income on your return, figure the child's tax on **Form 8615.** Attach the form to the child's Form 1040, Form 1040A, or Form 1040NR.

On Form 8615, enter your name and social security number and your child's name and social security number in the spaces provided. (If you filed a joint return, enter the name and social security number listed first on the joint return.) Check the box for the your filing status. Then figure the child's tax on Form 8615 in the following steps.

1. Figure the child's net investment income.

2. Figure a tentative tax on the net investment income based on the parent's tax rate.

3. Figure the child's tax.

Alternative minimum tax. A child may be subject to alternative minimum tax (AMT) if he or she has certain items given preferential treatment under the tax laws or certain adjustments to taxable income that total more than an exemption amount. See *Alternative Minimum Tax* in chapter 31.

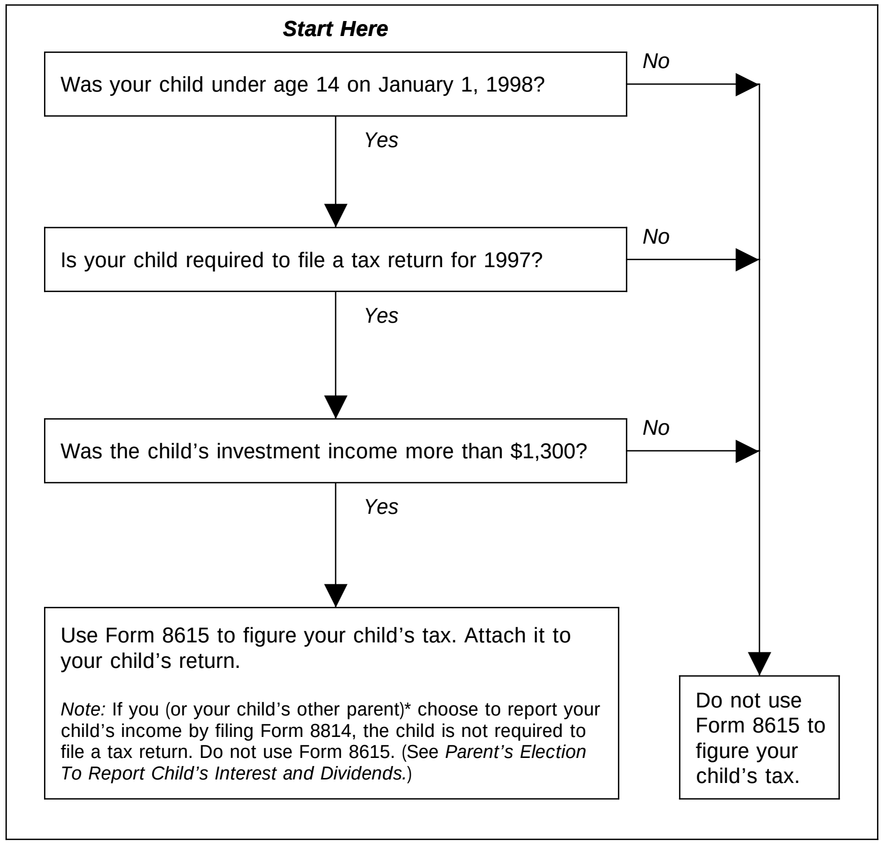
AMT is figured on Form 6251. For information on special limits that apply to a child who files Form 6251, see *Alternative Minimum Tax* in Publication 929.

Parent's return. See *Which Parent's Return To Use,* at the beginning of this chapter, for information on which parent's return information must be used on Form 8615.

Different tax years. If you and the child do not have the same tax year, complete Form 8615 using the information on your return for the tax year that ends in the child's tax year.

Estimated information. If the information needed from your return is not known by the time the child's return is due (usually April 15), you can file the return using estimates.

Figure 32-B. **Do You Have To Use Form 8615 To Figure Your Child's Tax?**



*See *Which Parent's Return To Use*

You can use any reasonable estimate. This includes using information from last year's return. If you use an estimated amount on Form 8615, write "Estimated" on the line next to the amount.

When you get the correct information, file an amended return on Form 1040X, *Amended U.S. Individual Income Tax Return.*

Instead of using estimated information, you may want to request an extension of time to file. Extensions are discussed in chapter 1.

Part I. Figuring Net Investment Income

The first step in figuring a child's tax using Form 8615 is to figure the child's net investment income. To do that, use Part I of Form 8615.

Line 1 (investment income). If the child had ***no earned income,*** enter the adjusted gross income shown on the child's return. Adjusted gross income is shown on line 33 of Form 1040; line 16 of Form 1040A; or line 33 of Form 1040NR. Form 1040EZ cannot be used if Form 8615 must be filed.

If the child had ***earned income,*** figure the amount to enter on line 1 of Form 8615 by using the worksheet in the instructions for the form.

However, if the child has excluded any foreign earned income or deducted either a loss from self-employment or a net operating loss from another year, use the worksheet in Publication 929 to figure the amount to enter on line 1.

Investment income defined. Investment income is generally all income other than salaries, wages, and other amounts received as pay for work actually done. It includes taxable interest, dividends, capital gains, the taxable part of social security and pension payments, and certain distributions from trusts. Investment income includes amounts produced by assets the child obtained with earned income (such as interest on a savings account into which the child deposited wages).

Nontaxable income. For this purpose, investment income includes only amounts that the child must include in total income. Nontaxable investment income, such as tax-exempt interest and the nontaxable part of social security and pension payments, is not included.

Income from gifts. A child's investment income includes all income produced by property belonging to the child. This is true even if the property was transferred to the child regardless of when the property was transferred or purchased or who transferred it.

A child's investment income includes income produced by property given as a gift to the child. This includes gifts to the child from grandparents or any other person and gifts made under the Uniform Gift to Minors Act.

Example. Amanda Black, 13, received the following income.

- Dividends — $600
- Wages — $2,100
- Taxable interest — $1,200

Form **8814**

Department of the Treasury
Internal Revenue Service

Parents' Election To Report Child's Interest and Dividends

▶ See instructions below and on back.
▶ Attach to parents' Form 1040 or Form 1040NR.

OMB No. 1545-1128

1997

Attachment Sequence No. **40**

Name(s) shown on your return	Your social security number
Linda Parks	119 00 1111
A Child's name (first, initial, and last)	**B** Child's social security number
Philip Parks	009 00 0000

C If more than one Form 8814 is attached, check here . . . . ▶ ☐

Step 1 **Figure amount of child's interest and dividend income to report on your return**

1a	Enter your child's **taxable** interest income. If this amount is different from the amounts shown on the child's Forms 1099-INT and 1099-OID, see the instructions			**1a**	3,200
b	Enter your child's **tax-exempt** interest income. **DO NOT** include this amount on line 1a	**1b**			
2a	Enter your child's gross dividends, including any Alaska Permanent Fund dividends. If none, enter -0- on line 2c and go to line 3. If your child received any capital gain distributions or dividends as a nominee, see the instructions	**2a**	300		
b	Enter your child's nontaxable distributions that are included on line 2a. These should be shown in box 1d of Form 1099-DIV	**2b**			
c	Subtract line 2b from line 2a			**2c**	300
3	Add lines 1a and 2c. If the total is $1,300 or less, skip lines 4 and 5 and go to line 6. If the total is $6,500 or more, **do not** file this form. Your child **must** file his or her own return to report the income			**3**	3,500
4	Base amount			**4**	1,300 00
5	Subtract line 4 from line 3. If you checked the box on line C above or if line 2a includes any capital gain distributions, see the instructions. Also, include this amount in the total on Form 1040, line 21, or Form 1040NR, line 21. In the space next to line 21, enter "Form 8814" and show the amount. Go to line 6 below . . . . ▶			**5**	2,200

Step 2 **Figure your tax on the first $1,300 of child's interest and dividend income**

6	Amount not taxed	**6**	650 00
7	Subtract line 6 from line 3. If the result is zero or less, enter -0-	**7**	2,850
8	**Tax.** Is the amount on line 7 less than $650? **No.** Enter $97.50 ($98 if you round) here and see the **Note** below. **Yes.** Multiply line 7 by 15% (.15). Enter the result here and see the **Note** below. . .	**8**	97 50

Note: *If you checked the box on line C above, see the instructions. Otherwise, include the amount from line 8 in the tax you enter on Form 1040, line 39, or Form 1040NR, line 38. Be sure to check box* ***a*** *on Form 1040, line 39, or Form 1040NR, line 38.*

General Instructions

A Change To Note

If your child received any capital gain distributions, the Federal income tax on his or her income may be less if you file a return for the child instead of making this election. This is because of the new lower capital gains tax rates. If you make this election, part or all of any capital gain distributions included on line 5 of Form 8814 must be reported on your **Schedule D** (Form 1040) even if you are not otherwise required to file the schedule. See **Pub. 929,** Tax Rules for Children and Dependents, for details.

Purpose of Form. Use this form if you elect to report your child's income on your return. If you do, your child will not have to file a return. You can make this election if your child meets **all** of the following conditions:

- Was under age 14 on January 1, 1998.
- Is required to file a 1997 return.
- Had income only from interest and dividends, including Alaska Permanent Fund dividends.
- Had gross income for 1997 that was less than $6,500.
- Had no estimated tax payments for 1997 (including any overpayment of tax from his or her 1996 return applied to 1997 estimated tax).
- Had no Federal income tax withheld from his or her income.

You must also qualify as explained on page 2 of these instructions.

How To Make the Election. To make the election, complete and attach Form 8814 to your tax return and file your return by the due date (including extensions). A separate Form 8814 must be filed for **each** child whose income you choose to report.

TIP: *The Federal income tax on your child's income may be less if you file a tax return for the child instead of making this election. This is because you cannot take certain deductions that your child would be entitled to on his or her own return. For details, see* ***Deductions You May Not Take*** *on page 2.*

For Paperwork Reduction Act Notice, see back of form. Cat. No. 10750J Form **8814** (1997)

- Tax-exempt interest — $100
- Net capital gains — $100

The dividends were on stock given to her by her grandparents. Amanda's investment income is $1,900. This is the total of the dividends ($600), taxable interest ($1,200), and net capital gains ($100). Her wages are earned (not investment) income because they are pay received for work actually done. Her tax-exempt interest is not included because it is nontaxable.

Trust income. If a child is the beneficiary of a trust, distributions of taxable interest, dividends, capital gains, and other investment income from the trust are investment income to the child.

Line 2 (deductions). If the child does not itemize deductions on Schedule A (Form 1040 or Form 1040NR), enter $1,300 on line 2.

If the child does itemize deductions, enter on line 2 the larger of:

1) $650 plus the child's itemized deductions on Schedule A (Form 1040 or Form 1040NR) that are directly connected with the production of investment income, or
2) $1,300.

Directly connected. Itemized deductions are directly connected with the production of investment income if they are for expenses paid to produce or collect taxable income or to manage, conserve, or maintain property held for producing income. These expenses include custodian fees and service charges, service fees to collect taxable interest and dividends, and certain investment counsel fees.

These expenses are added to certain other miscellaneous deductions on Schedule A (Form 1040). Only the amount greater than 2% of the child's adjusted gross income can be deducted. See chapter 30 for more information.

Example 1. Roger, 12, has investment income of $8,000, no other income, no adjustments to income, and itemized deductions of $300 that are directly connected with his investment income. His adjusted gross income is $8,000, which is entered on line 1. Line 2 is $1,300 because $1,300 is more than the sum of $650 and his directly-connected itemized deductions of $300.

Example 2. Eleanor, 8, has investment income of $16,000 and an early withdrawal penalty of $100. She has no other income. She has itemized deductions of $1,100 that are directly connected with the production of her investment income. Her adjusted gross income, entered on line 1, is $15,900 ($16,000 − $100). Line 2 is $1,750. This is the larger of:

1) $650 plus the $1,100 of directly connected itemized deductions, or
2) $1,300.

Eleanor's net investment income is $14,150 ($15,900 − $1,750).

Part II. Figuring Tentative Tax at Parent's Tax Rate

The tentative tax is the difference between the tax on the parent's taxable income figured with the child's net investment income and the tax figured without it. Figure it on lines 6 through 13 of Form 8615.

When figuring the tentative tax, do not refigure any of the exclusions, deductions, or credits on the parent's return because the child's net investment income is included on the parent's return. For example, do not refigure the medical expense deduction.

Trusts. See the Form 8615 instructions for lines 6 and 10 for information about a special rule that may apply if the parent is the grantor of a trust.

Note. If the child has any capital gains or losses, get Publication 929 for help in completing Part II of Form 8615.

More Than One Child

The tax return information of the child's parent may be used on Forms 8615 for other children (including adopted children and stepchildren).

Line 7 (net investment income of other children). If the tax return information of the parent is also used on any other child's Form 8615, enter on line 7 the total amounts from line 5 of all the other children's Forms 8615. Do not include the amount from line 5 of the Form 8615 being completed.

Example. Paul and Jane Persimmon have three children, Sharon, Jerry, and Mike, who must attach Form 8615 to their tax returns. The children's net investment income amounts on line 5 of their Forms 8615 are as follows.

- Sharon — $800
- Jerry — $600
- Mike — $1,000

Line 7 of Sharon's Form 8615 would show $1,600, the total amounts on line 5 of Jerry's and Mike's Forms 8615.

Line 7 of Jerry's Form 8615 would show $1,800 ($800 + $1,000).

Line 7 of Mike's Form 8615 would show $1,400 ($800 + $600).

Other children's information not available. If the net investment income of the other children is not available when the return is due, either file the return using estimates or use an extension of time to file. See *Estimated information,* earlier.

Lines 12a and 12b (dividing the tentative tax). If an amount is entered on line 7, divide the tentative tax shown on line 11 among the children according to each child's share of the total net investment income. This is done on lines 12a, 12b, and 13. Add line 7 to line 5 and enter the total on line 12a. Divide line 5 by line 12a and enter the result as a decimal on line 12b.

Example. In the earlier example under *Line 7 (net investment income of other children),* Sharon's Form 8615 shows $1,600 on line 7. Line 12a is $2,400, the total of lines 5 and 7 ($800 + $1,600). The decimal on line 12b is .333, figured as follows and rounded to three places.

$$\frac{\$800}{\$2,400} = .333$$

Part III. Figuring the Child's Tax

The final step in figuring a child's tax using Form 8615 is to determine the ***larger*** of:

1) The total of:
   a) The child's share of the tentative tax based on the parent's tax rate, plus
   b) The tax on the child's taxable income in excess of net investment income, figured at the child's tax rate, or
2) The tax on the child's taxable income, figured at the child's tax rate.

This is the child's tax. It is figured on lines 14 through 18 of Form 8615.

Illustrated Example

The following example includes a completed Form 8615.

John and Laura Brown have one child, Sara. She is 13 and has $2,500 taxable interest and dividend income and $1,500 earned income. She does not itemize deductions. John and Laura file a joint return with John's name and social security number listed first. They claim three exemptions, including an exemption for Sara, on their return.

Because Sara has both earned and unearned income and her gross income is more than $650, she must file a tax return. Because she is under age 14 and has more than $1,300 investment income, part of her income may be subject to tax at her parents' rate. A completed Form 8615 must be attached to her return.

Sara's father, John, fills out Sara's return for her.

John enters his name and social security number on Sara's Form 8615 because his name and number are listed first on the joint return he and Laura are filing. He checks the box for married filing jointly.

He enters Sara's investment income, $2,500, on line 1. Sara does not itemize deductions, so John enters $1,300 on line 2. He enters $1,200 on line 3 ($2,500 − $1,300).

Sara's taxable income, as shown on line 22 of her Form 1040A, is $2,500. This is her total income ($4,000) minus her standard deduction ($1,500). Her standard deduction is limited to the amount of her earned income. John enters $2,500 on line 4.

John compares lines 3 and 4 and enters the smaller amount, $1,200, on line 5.

John enters $48,000 on line 6. This is the taxable income from line 38 of their joint Form 1040 return. Sara is an only child, so line 7 is blank. He adds line 5 ($1,200), line 6 ($48,000), and line 7 and enters $49,200 on line 8.

Using the column for married filing jointly in the Tax Table, John finds the tax on $49,200. He enters the tax, $8,427, on line 9. He enters $8,091 on line 10. This is the tax from line 39 of John and Laura's Form 1040. He enters $336 on line 11 ($8,427 − $8,091).

Because line 7 is blank, John skips lines 12a and 12b and enters $336 on line 13.

John subtracts line 5 ($1,200) from line 4 ($2,500) and enters the result, $1,300, on line 14. Using the column for single filing status in the Tax Table, John finds the tax on $1,300. He enters this tax, $197, on line 15. He adds lines 13 ($336) and 15 ($197) and enters $533 on line 16.

Using the column for single filing status in the Tax Table, John finds the tax on $2,500 (line 4). He enters this tax, $377, on line 17.

John compares lines 16 and 17 and enters the larger amount, $533, on line 18 of Sara's Form 8615. He also enters that amount on line 23 of Sara's Form 1040A.

John also completes Schedule 1 (Form 1040A), for Sara.

Form **8615**

Department of the Treasury
Internal Revenue Service

Tax for Children Under Age 14 Who Have Investment Income of More Than $1,300

► **Attach ONLY to the child's Form 1040, Form 1040A, or Form 1040NR.**

OMB No. 1545-0998

1997

Attachment Sequence No. **33**

Child's name shown on return	**Child's social security number**
Sara L. Brown	117 : 00 : 1111
A Parent's name (first, initial, and last). **Caution:** *See instructions on back before completing.*	**B Parent's social security number**
John J. Brown	007 : 00 : 0001

C Parent's filing status (check one):

☐ Single ☑ Married filing jointly ☐ Married filing separately ☐ Head of household ☐ Qualifying widow(er)

Part I Child's Net Investment Income

1	Enter the child's investment income, such as taxable interest and dividends. See instructions. If this amount is $1,300 or less, **stop;** do not file this form	**1**	2,500
2	If the child **did not** itemize deductions on Schedule A (Form 1040 or Form 1040NR), enter $1,300. If the child **did** itemize deductions, see instructions	**2**	1,300
3	Subtract line 2 from line 1. If the result is zero or less, **stop;** do not complete the rest of this form but **do** attach it to the child's return	**3**	1,200
4	Enter the child's **taxable** income from Form 1040, line 38; Form 1040A, line 22; or Form 1040NR, line 37 ►	**4**	2,500
5	Enter the **smaller** of line 3 or line 4 ►	**5**	1,200

Part II Tentative Tax Based on the Tax Rate of the Parent Listed on Line A

6	Enter the parent's **taxable** income from Form 1040, line 38; Form 1040A, line 22; Form 1040EZ, line 6; TeleFile Tax Record, line J; Form 1040NR, line 37; or Form 1040NR-EZ, line 13. If the parent transferred property to a trust, see instructions	**6**	48,000
7	Enter the total net investment income, if any, from Forms 8615, line 5, of **all other** children of the parent identified above. **Do not** include the amount from line 5 above	**7**	
8	Add lines 5, 6, and 7	**8**	49,200
9	Enter the tax on line 8 based on the **parent's** filing status. See instructions. If **Schedule D** (Form 1040) is used to figure the tax, check here ► ☐	**9**	8,427
10	Enter the parent's tax from Form 1040, line 39; Form 1040A, line 23; Form 1040EZ, line 10; TeleFile Tax Record, line J; Form 1040NR, line 38; or Form 1040NR-EZ, line 14. If **Schedule D** (Form 1040) was used to figure the tax, check here ► ☐	**10**	8,091
11	Subtract line 10 from line 9 and enter the result. If line 7 is blank, enter on line 13 the amount from line 11 and go to **Part III**	**11**	336
12a	Add lines 5 and 7 **12a**		
b	Divide line 5 by line 12a. Enter the result as a decimal (rounded to three places)	**12b**	× .
13	Multiply line 11 by line 12b ►	**13**	336

Part III Child's Tax—If lines 4 and 5 above are the same, enter -0- on line 15 and go to line 16.

14	Subtract line 5 from line 4 **14** 1,300		
15	Enter the tax on line 14 based on the **child's** filing status. See instructions. If **Schedule D** (Form 1040) is used to figure the tax, check here ► ☐	**15**	197
16	Add lines 13 and 15	**16**	533
17	Enter the tax on line 4 based on the **child's** filing status. See instructions. If **Schedule D** (Form 1040) is used to figure the tax, check here ► ☐	**17**	377
18	Enter the **larger** of line 16 or line 17 here and on Form 1040, line 39; Form 1040A, line 23; or Form 1040NR, line 38 ►	**18**	533

General Instructions

Section references are to the Internal Revenue Code.

Purpose of form. For children under age 14, investment income over $1,300 is taxed at the parent's rate if the parent's rate is higher than the child's rate. If the child's investment income is more than $1,300, use this form to figure the child's tax.

Investment income. As used on this form, "investment income" includes all taxable income other than earned income as defined on page 2. It includes taxable interest, dividends, capital gains, rents, royalties, etc. It also includes pension and annuity income and income (other than earned income) received as the beneficiary of a trust.

Who must file. Generally, Form 8615 must be filed for any child who was under age 14 on January 1, 1998, had more than $1,300 of investment income, and is required to file a tax return. But if neither parent was alive on December 31, 1997, do not use Form 8615. Instead, figure the child's tax in the normal manner.

Note: *The parent may be able to elect to report the child's interest and dividends on his or her return. If the parent makes this election, the child will not have to file a return or Form 8615. For more details, see* ***Form 8814,*** *Parents' Election To Report Child's Interest and Dividends.*

Additional information. For more details, see **Pub. 929,** Tax Rules for Children and Dependents.

Incomplete information for parent. If the parent's taxable income or filing status or the net investment income of the parent's other children is not known by the due

For Paperwork Reduction Act Notice, see back of form. Cat. No. 64113U Form **8615** (1997)

33. Child and Dependent Care Credit

Important Changes for 1997

Taxpayer identification number needed for each qualifying person. You must include on line 2 of your 1997 Form 2441 or Schedule 2 (Form 1040A) the name and taxpayer identification number (generally the social security number) of each qualifying person. If the correct information is not shown, the credit may be reduced or disallowed.

Adoption taxpayer identification number (ATIN). If you are claiming the child and dependent care credit for a child who was placed with you by an authorized adoption agency, you must enter the child's name and taxpayer identification number on the form you use to claim the credit. If you do not know the child's birth social security number (SSN), you must get an ATIN for the child by filing Form W–7A, *Application for Taxpayer Identification Number for Pending U.S. Adoptions.*

Important Reminders

Individual taxpayer identification number (ITIN) for aliens. The IRS will issue an ITIN to a nonresident or resident alien who does not have and is not eligible to get an SSN. To apply for an ITIN, Form W–7 must be filed with the IRS. It usually takes about 30 days to get an ITIN. The ITIN is entered wherever an SSN is requested on a tax return. If you are required to include another person's SSN on your return and that person does not have and cannot get an SSN, enter that person's ITIN.

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

You may have to pay employment taxes. If you pay someone to come to your home and care for your dependent or spouse, you may be a household employer who has to pay employment taxes. Usually, you are ***not*** a household employer if the person who cares for your child or dependent does so at his or her home or place of business. See *Employment Taxes for Household Employers.*

Introduction

This chapter discusses the credit for child and dependent care expenses and covers the following topics.

- Tests you must meet to claim the credit.
- How to figure the credit.
- How to claim the credit.
- Employment taxes you may have to pay as a household employer.

If you pay someone to care for your dependent who is under age 13 or for your spouse or dependent who is not able to care for himself or herself, you may be able to get a credit of up to 30% of your expenses. To qualify, you must pay these expenses so you can work or look for work.

Dependent care benefits. If you received any dependent care benefits from your employer in 1997, you may be able to exclude from your income all or part of them. You must complete Part III of Form 2441 or Schedule 2 (Form 1040A) before you can figure the amount of your credit. See *Employer's Dependent Care Benefits* under *How To Figure the Credit.*

Useful Items

You may want to see:

Publication

- ☐ **503** Child and Dependent Care Expenses
- ☐ **926** Household Employer's Tax Guide

Form (and Instructions)

- ☐ **2441** Child and Dependent Care Expenses
- ☐ **6251** Alternative Minimum Tax—Individuals
- ☐ **Schedule 2 (Form 1040A)** Child and Dependent Care Expenses for Form 1040A Filers
- ☐ **Schedule H (Form 1040)** Household Employment Taxes
- ☐ **W–10** Dependent Care Provider's Identification and Certification

Tests To Claim the Credit

To be able to claim the credit for child and dependent care expenses, you must meet ***all*** the following tests. These tests are presented in *Figure 33–A* and are also explained in detail in this chapter. To claim the credit, you must file Form 1040 or Form 1040A, not Form 1040EZ.

1) The care must be for one or more qualifying persons who are identified on the form you use to claim the credit. (See *Qualifying Person Test.)*
2) You (and your spouse if you are married) must keep up a home that you live in with the qualifying person or persons. (See *Keeping Up a Home Test.)*
3) You (and your spouse if you are married) must have earned income during the year. (However, see *Rule for student-spouse or spouse not able to care for self* under *Earned Income Test.)*
4) You must pay child and dependent care expenses so you (and your spouse if you are married) can work or look for work. (See *Work-Related Expense Test.)*
5) You must make payments for child and dependent care to someone you (or your spouse) cannot claim as a dependent. If you make payments to your child, he or she cannot be your dependent and must be age 19 or older by the end of the year. (See *Payments to Relatives* under *Work-Related Expense Test.)*
6) Your filing status must be single, head of household, qualifying widow(er) with dependent child, or married filing jointly. You must file a joint return if you are married, unless an exception discussed later under *Joint Return Test* applies to you.
7) You must identify the care provider on your tax return. (See *Provider Identification Test.)*
8) You must exclude less than $2,400 (less than $4,800 if two or more qualifying persons were cared for) of dependent care assistance benefits. (See *Reduced Dollar Limit* under *How To Figure the Credit).*

Qualifying Person Test

Your child and dependent care expenses must be for the care of one or more members of your home who are qualifying persons. A qualifying person is:

1) Your dependent who was under age 13 when the care was provided and for whom you can claim an exemption,
2) Your spouse who was physically or mentally not able to care for himself or herself, or
3) Your dependent who was physically or mentally not able to care for himself or herself and for whom you can claim an exemption (or could claim an exemption except the person had $2,650 or more of gross income).

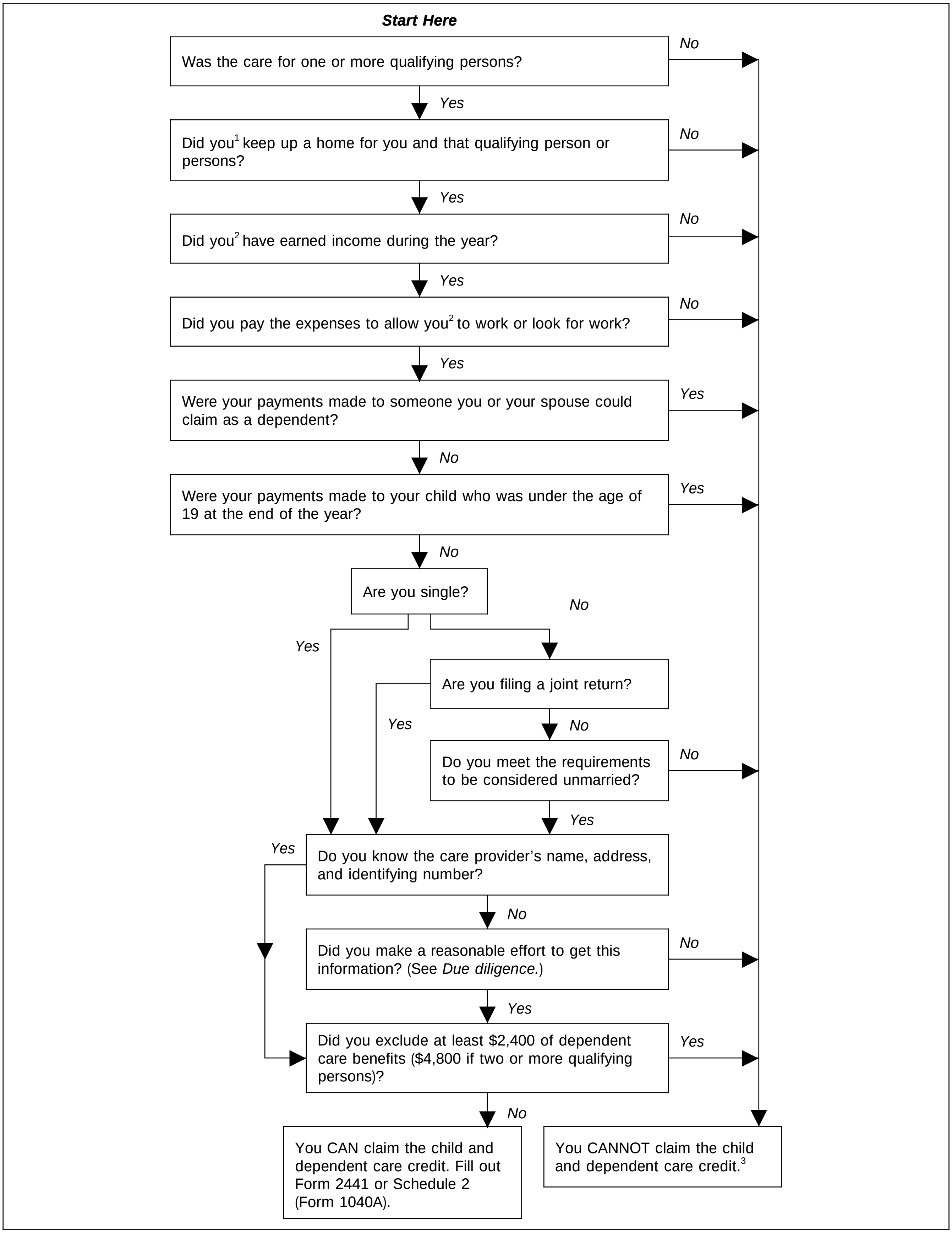
You must include on your return the name and taxpayer identification number (generally the social security number) of the qualifying person(s). If the correct information is not shown, the credit may be reduced or disallowed.

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

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

Person qualifying for part of year. You determine a person's qualifying status each day. For example, if the person for whom you pay child and dependent care expenses no longer qualifies on September 16, count only those expenses through September 15.

Figure 33-A. **Can You Claim the Credit?**



[1]This includes your spouse if you were married.
[2]This also applies to your spouse, unless your spouse was disabled or a full-time student.
[3]If you had expenses that met the requirements for 1996, except that you did not pay them until 1997, you may be able to claim those expenses in 1997. See *Expenses not paid until the following year* under *How To Figure the Credit.*

Also see *Dollar Limit* under *How To Figure the Credit,* later.

Child of Divorced or Separated Parents

To be a qualifying person, your child usually must be your dependent for whom you can claim an exemption. But an exception may apply if you are divorced or separated. Under the exception, if you are the custodial parent, you can treat your child as a qualifying person even if you cannot claim the child's exemption. If you are the noncustodial parent, you cannot treat your child as a qualifying person even if you can claim the child's exemption.

This exception applies if all of the following are true.

1) One or both parents had custody of the child for more than half of the year.
2) One or both parents provided more than half of the child's support for the year.
3) Either—
   a) The custodial parent signed Form 8332, *Release of Claim to Exemption for Child of Divorced or Separated Parents,* or a similar statement, agreeing not to claim the child's exemption for the year, or
   b) The noncustodial parent provided at least $600 for the child's support and can claim the child's exemption under a pre-1985 decree of divorce or separate maintenance, or written agreement.

For purposes of 3(a), a similar statement includes a divorce decree or separation agreement that went into effect after 1984 that allows the noncustodial parent to claim the child's exemption without any conditions, such as payment of support.

You can use *Figure 33–B* to see whether this exception applies to you. If it applies, only the custodial parent can treat the child as a qualifying person. If the exception does not apply, follow the regular rules for a qualifying person under *Qualifying Person Test,* earlier.

Example. You are divorced and have custody of your 8-year-old child. You sign Form 8332 to allow your ex-spouse to take the exemption. You pay child care expenses so you can work. Your child is a qualifying person and you, the custodial parent, can claim the credit for those expenses, even though your ex-spouse claims an exemption for the child.

Custodial parent. You are the custodial parent if, during the year, you have custody of your child longer than your child's other parent has custody.

Divorced or separated. For purposes of determining whether your child is a qualifying person, you are considered divorced or separated if either of the following applies.

1) You are divorced or separated under a decree of divorce or separate maintenance or a written separation agreement, or
2) You lived apart from your spouse for all of the last 6 months of the year.

Keeping Up a Home Test

To claim the credit, you (and your spouse if you are married) must keep up a home that you live in with one or more qualifying persons. You are keeping up a home if you pay more than half the cost of running it for the year.

Home. The term “home” means the main home for both you and the qualifying person. Your home can be the main home even if the qualifying person does not live there all year because of his or her:

1) Birth,
2) Death, or
3) Temporary absence due to:
   a) Sickness,
   b) School,
   c) Business,
   d) Vacation,
   e) Military service, or
   f) Custody agreement.

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

The costs of keeping up a home do not include payments for clothing, education, medical treatment, vacations, life insurance, transportation, or mortgage principal. They also do not include the purchase, permanent improvement, or replacement of property. For example, you cannot include the cost of replacing a water heater. However, you can include the cost of repairing a water heater.

Earned Income Test

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

Earned income includes wages, salaries, tips, other employee compensation, and net earnings from self-employment. A net loss from self-employment reduces earned income. Earned income also includes strike benefits and any disability pay you report as wages. It also includes nontaxable earned income such as parsonage allowances, meals and lodging furnished for the convenience of the employer, voluntary salary deferrals, military basic quarters and subsistence allowances and in-kind quarters and subsistence, and military pay earned in a combat zone.

Members of the clergy and religious workers. Certain income earned by ministers, members of religious orders, and Christian Science practitioners may not be considered earned income for this purpose. See *Earned Income Test* in Publication 503.

Earned income does not include pensions or annuities, social security payments, workers' compensation, interest, dividends, or unemployment compensation. It also does not include scholarship or fellowship grants, except for amounts paid to you (and reported on Form W–2) for teaching, research, or other services.

Rule for student-spouse or spouse not able to care for self. Your spouse is treated as having earned income for any month that he or she is:

1) A full-time student, or
2) Physically or mentally not able to care for himself or herself.

Figure the earned income of the nonworking spouse as shown under *Earned Income Limit,* later.

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

Full-time student. You are a full-time student if you are enrolled at and attend a school for the number of hours or classes that the school considers full time. You must have been a student for some part of each of 5 calendar months during the year. (The months need not be consecutive.) If you attend school only at night, you are not a full-time student. However, as part of your full-time course of study, you may attend some night classes.

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

Work-Related Expense Test

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

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

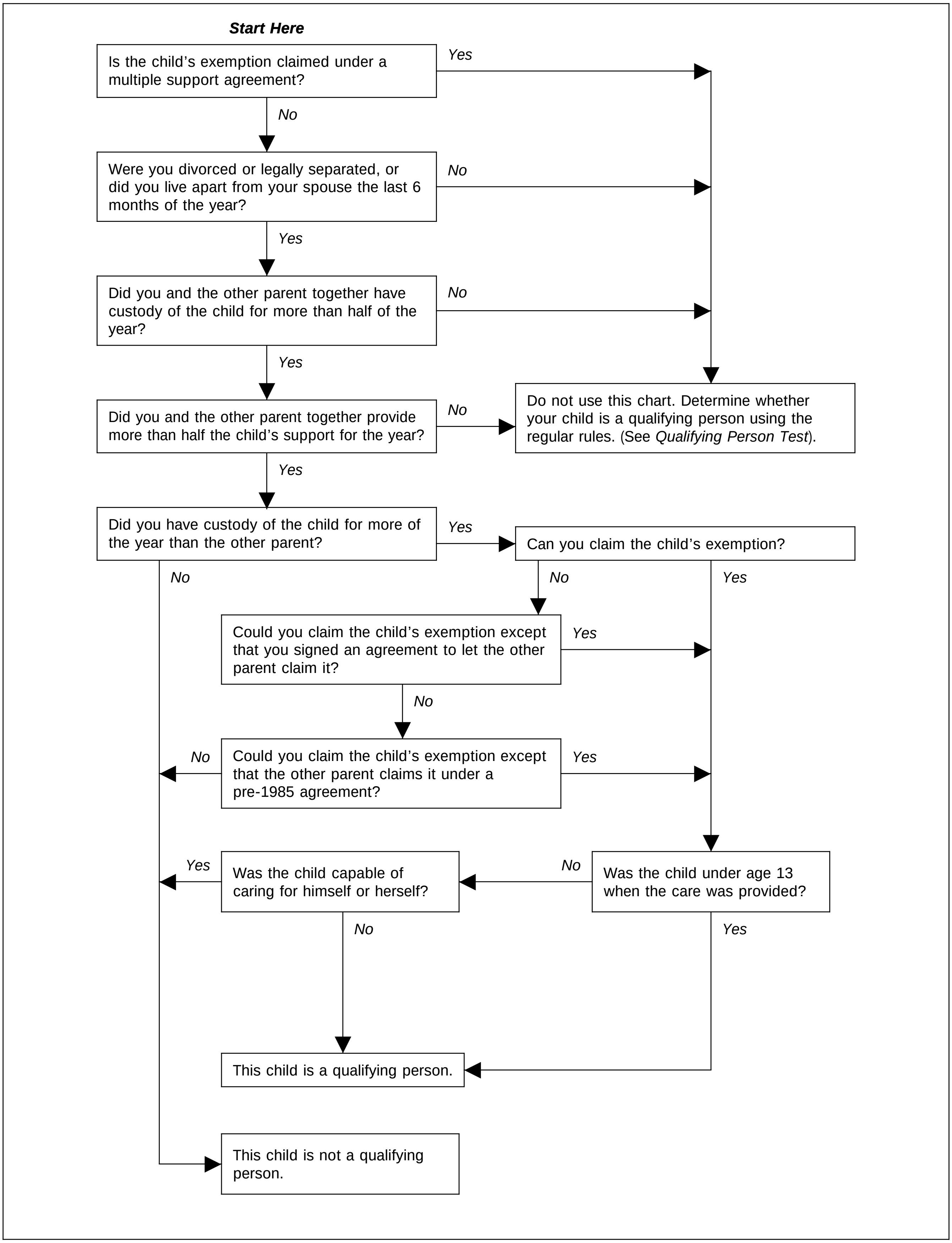
Working or Looking for Work

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

Your work can be for others or in your own business or partnership. It can be either full time or part time. Work also includes actively looking for work. However, if you do not find a job and have no earned income for the year, you cannot take this credit. See *Earned Income Test,* earlier.

Whether your expenses allow you to work or look for work depends on the facts. For example, the cost of a sitter while you and your spouse go out to eat is not normally a work-related expense. Expenses are not considered work related merely because you had them while you were working. They must enable you to be gainfully employed. For example, you are not gainfully employed if you do unpaid volunteer work or volunteer work for a nominal salary.

Figure 33-B. **Is a Child of Divorced or Separated Parents a Qualifying Person?**



Work for part of year. If you work or actively look for work during only part of the period covered by the expenses, then you must figure your expenses for each day. For example, if you work all year and pay care expenses of $120 a month ($1,440 for the year), all the expenses are work related. However, if you work or look for work for only 2 months and 15 days during the year and pay expenses of $120 a month, your work-related expenses are limited to $300 ($2\frac{1}{2}$ months $\times$ $120).

Payments while you are out sick. Do not count as work-related expenses amounts you pay for child and dependent care while you are off work because of illness. These amounts are not paid to allow you to work. This applies even if you get sick pay and are still considered an employee.

Care of a Qualifying Person

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

Expenses for household services qualify if part of the services is for the care of qualifying persons. See *Household services,* later.

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 you pay for food, clothing, and entertainment. However, if these amounts are incident to and cannot be separated from the cost of caring for the qualifying person, you can count the total cost.

Schooling. You can count the total cost of sending your child to school if both of the following are true.

1) Your child is in a grade level below the first grade.
2) The amount you pay for schooling is incident to and cannot be separated from the cost of care.

If your child is in the first grade or higher, or if the cost of schooling can be separated, you must divide the total cost between the cost of care and the cost of schooling. You can count only the cost of care in figuring your credit.

Example 1. You take your 3-year-old child to a nursery school that provides lunch and educational activities as a part of its preschool child-care service. You can count the total cost in figuring the credit.

Example 2. Your 5-year-old child goes to kindergarten in the morning. In the afternoon, she attends an after-school day care program at the same school. Your total cost for sending her to the school is $3,000, of which $1,800 is for the after-school program. Only the $1,800 qualifies for figuring the credit.

Example 3. You place your 10-year-old child in a boarding school so you can work full time. Only the part of the boarding school expense that is for the care of your child is a work-related expense. You cannot count any part of the amount you pay the school for your child's education.

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

Dependent care center. You can count care provided outside your home by a dependent care center only if the center complies with all state and local regulations that apply to these centers. A dependent care center is a place that provides care for more than six persons (other than persons who live there) and receives a fee, payment, or grant for providing services for any of those persons, even if the center is not run for profit.

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

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

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

Household services are ordinary and usual services done in and around your home that are necessary to run your home. They include the services of a housekeeper, maid, or cook. However, they do not include the services of a chauffeur, bartender, or gardener. See *Household Services* in Publication 503 for more information.

In this chapter, the term “housekeeper” refers to any household employee whose services include the care of a qualifying person.

Taxes paid on wages. The taxes you pay on wages for qualifying child and dependent care services are work-related expenses. See *Employment Taxes for Household Employers,* later.

Payments to Relatives

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

1) A dependent for whom you (or your spouse if you are married) can claim an exemption, or
2) Your child who was under age 19 at the end of the year, even if he or she is not your dependent.

Joint Return Test

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

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

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

1) You file a separate return.
2) Your home is the home of a qualifying person for more than half the year.
3) You pay more than half the cost of keeping up your home for the year.
4) Your spouse does not live in your home for the last 6 months of the year.

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

Provider Identification Test

You must identify all persons or organizations that provide care for your child or dependent. Use Part I of Form 2441 or Schedule 2 (Form 1040A) to show the information.

Information needed. To identify the care provider, you must give the provider's:

1) Name,
2) Address, and
3) Taxpayer identification number.

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

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

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

Getting the information. You can use **Form W–10** to request the required information from the care provider. If you do not use Form W–10, you can get the required information from:

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

You should keep this information with your tax records. Do not send Form W–10 (or other document containing this information) to the Internal Revenue Service.

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

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

Provider refusal. If the provider refuses to give you their identifying information, you should report whatever information you have (such as the name and address) on the form you use to claim the credit. Write "See page 2" in the columns calling for the information you do not have. On the bottom of page 2, explain that you requested the information from the care provider, but the provider did not give you the information. This statement will show that you used due diligence in trying to furnish the necessary information.

How To Figure the Credit

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

Figuring Total Work-Related Expenses

To figure the credit for 1997 work-related expenses, count only those you paid by December 31, 1997.

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

Expenses not paid until the following year. Do ***not*** count 1996 expenses that you paid in 1997 as work-related expenses for 1997. You may be able to claim an additional credit for them on your 1997 return, but you must figure it separately. See *Payments for previous year's expenses* under *Amount of Credit* in Publication 503.

If you had expenses in 1997 that you did not pay until 1998, you cannot count them when figuring your 1997 credit. You may be able to claim a credit for them on your 1998 return.

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

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

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

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

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

Employer's Dependent Care Benefits

Dependent care benefits include:

1) Amounts your employer pays directly to either you or your care provider for the care of your qualifying person while you work, and
2) The fair market value of care in a day-care facility provided or sponsored by your employer.

Your salary may have been reduced to pay for these benefits.

Exclusion. If your employer provides dependent care benefits under a qualified plan, you may be able to exclude these benefits from your income. Your employer can tell you whether your benefit plan qualifies. If it does, you must complete Part III of either Form 2441 or Schedule 2 (Form 1040A) to claim the exclusion even if you cannot take the credit. You cannot use Form 1040EZ.

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

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

Statement for employee. Your employer must give you a Form W–2, *Wage and Tax Statement* (or similar statement), showing in box 10 the total amount of dependent care benefits provided to you during the year under a qualified plan. Your employer will also include any dependent care benefits over $5,000 in your wages shown in box 1 of your Form W–2.

Forfeitures. Forfeitures are amounts credited to your dependent care benefit account and included in the amount shown in box 10 of your Form W–2, but not received because you did not incur the expense. When figuring your exclusion, subtract any forfeitures from the total dependent care benefits reported by your employer. To do this, enter the forfeited amount on line 11 of Form 2441 or Schedule 2 (Form 1040A).

Forfeitures do not include amounts that you expect to receive in the future.

Claiming the credit. If you exclude dependent care benefits from your income, the amount of the excluded benefits:

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

Earned Income Limit

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

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

Earned income is defined under *Earned Income Test,* earlier.

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

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

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

Community property laws. You should disregard community property laws when you figure earned income for this credit.

Student-spouse or spouse not able to care for oneself. Your spouse who is either a full-time student or not able to care for himself or herself is treated as having earned income. His or her earned income for each month is considered to be at least $200 if there is one qualifying person in your home, or at least $400 if there are two or more. If your spouse works during that month, use the higher of $200 (or $400) or his or her actual earned income for that month. If your spouse is a full-time student or not able to care for himself or herself for only part of a month, the full $200 (or $400) still applies for that month.

If, in the same month, both you and your spouse are either full-time students or not able to care for yourselves, only one spouse can be considered to have this earned income of $200 (or $400) for that month.

Dollar Limit

There is a dollar limit on the amount of your work-related expenses you can use to figure the credit. This limit is $2,400 for one qualifying person, or $4,800 for two or more qualifying persons.

Yearly limit. The dollar limit is a yearly limit. The amount of the limit remains the same no matter how long you have a qualifying person in your household. Use the $2,400 limit if you paid work-related expenses for the care of one qualifying person at any time during the year. Use $4,800 if you paid work-related expenses for the care of more than one qualifying person at any time during the year.

Reduced Dollar Limit

If you received dependent care benefits from your employer that you exclude from your income, you must subtract that amount from the dollar limit that applies to you. Your reduced dollar limit is figured on lines 20 through 24 of Form 2441 or Schedule 2 (Form 1040A). See *Employer's Dependent Care Benefits,* earlier, for information on excluding these benefits.

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

Although the dollar limit for his work-related expenses is $2,400 (one qualifying person), George figures his credit on only $1,400 of the $1,900 work-related expenses he paid. This is because his dollar limit is reduced as shown next.

George's Reduced Dollar Limit

1)	Maximum allowable expenses for one qualifying person	$2,400
2)	***Minus:*** Dependent care benefits George excludes from income	–1,000
3)	Reduced dollar limit on expenses George can use for the credit	$1,400

Amount of Credit

To determine the amount of your credit, multiply your work-related expenses (after applying the earned income and dollar limits) by a percentage. This percentage depends on your adjusted gross income shown on line 33 of Form 1040 or line 17 of Form 1040A. The following table shows the percentage to use based on adjusted gross income.

Adjusted Gross Income		Percentage
Over	**But not over**	
$0	$10,000	30%
10,000	12,000	29%
12,000	14,000	28%
14,000	16,000	27%
16,000	18,000	26%
18,000	20,000	25%
20,000	22,000	24%
22,000	24,000	23%
24,000	26,000	22%
26,000	28,000	21%
28,000	No limit	20%

CAUTION *Your credit may be limited because of the alternative minimum tax. See your form instructions for details.*

How To Claim the Credit

To claim the credit, you can file Form 1040 or Form 1040A. You cannot claim the credit on Form 1040EZ.

Form 1040. You must complete **Form 2441** and attach it to your Form 1040. Enter the credit on line 40 of your Form 1040. An example of a filled-in Form 2441 is at the end of this chapter.

Form 1040A. You must complete **Schedule 2 (Form 1040A)** and attach it to your Form 1040A. Enter the credit on line 24a of your Form 1040A.

Tax credit not refundable. Your credit for child and dependent care expenses cannot be more than the amount of your tax liability. This means that you cannot get a refund for any part of the credit that is more than your tax.

RECORDS You should keep records of your work-related expenses. Also, if your dependent or spouse is not able to care for himself or herself, your records should show both the nature and the length of the disability. Other records you should keep to support your claim for the credit are described earlier under *Provider Identification Test.*

Employment Taxes for Household Employers

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

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

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

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

Social security and Medicare taxes are generally withheld from the employee's pay and matched by the employer. Federal unemployment (FUTA) tax is paid by the employer only and is for the employee's unemployment insurance. Federal income tax is withheld from the employee's total pay if the employee asks you to do so and you agree.

For more information on a household employer's tax responsibilities, see Publication 926 and Schedule H (Form 1040).

You may also be subject to state income tax withholding and state unemployment tax. You should contact your state unemployment tax office for information on how to file the state tax returns and for a state reporting number.

Example

The following example shows how to figure the credit for child and dependent care expenses for two children when employer dependent care benefits are involved. The filled-in Form 2441 is shown at the end of this chapter.

Illustrated example. Joan Thomas is divorced and has two children, ages 3 and 9. She works at ACME Computers. Her adjusted gross income (AGI) is $29,000, and the entire amount is earned income.

Joan's younger child (Susan) stays at her employer's on-site child-care center while she works. The benefits from this child-care center qualify to be excluded from her income. Her employer reports the value of this service as $3,000 for the year. This $3,000 is shown in box 10 of her Form W–2, but is not included in taxable wages in box 1.

A neighbor cares for Joan's older child (Seth) after school, on holidays, and during the summer. She pays her neighbor $2,400 for this care.

Joan figures her credit on Form 2441 as follows.

Work-related expenses Joan paid	$2,400
Dollar limit	$4,800
Minus: Dependent care benefits excluded from Joan's income	–3,000
Reduced dollar limit	$1,800
Lesser of Expenses paid ($2,400) or Dollar limit ($1,800)	$1,800
Percentage for AGI of $29,000	20%
Amount of credit (20% of $1,800)	$360

Form **2441**

Department of the Treasury
Internal Revenue Service

Child and Dependent Care Expenses

► **Attach to Form 1040.**

► **See separate instructions.**

OMB No. 1545-0068

1997

Attachment Sequence No. **21**

Name(s) shown on Form 1040	Your social security number
Joan Thomas	559 00 3436

Before you begin, you need to understand the following terms. See **Definitions** on page 1 of the instructions.

- **Dependent Care Benefits**
- **Qualifying Person(s)**
- **Qualified Expenses**
- **Earned Income**

Part I **Persons or Organizations Who Provided the Care—**You **must** complete this part. (If you need more space, use the bottom of page 2.)

1 (a) Care provider's name	(b) Address (number, street, apt. no., city, state, and ZIP code)	(c) Identifying number (SSN or EIN)	(d) Amount paid (see instructions)
Pat Green	12 Ash Avenue Hometown, TX 75240	240-00-3811	2,400
ACME Computers	(See W-2)		

Did you receive **dependent care benefits?**

NO → Complete only Part II below.

YES → Complete Part III on the back next.

Caution: *If the care was provided in your home, you may owe employment taxes. See the instructions for Form 1040, line 52.*

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 1997 for the person listed in column (a)
Seth	Thomas	559 00 1234	2,400
Susan	Thomas	559 00 5678	

3	Add the amounts in column (c) of line 2. DO NOT enter more than $2,400 for one qualifying person or $4,800 for two or more persons. If you completed Part III, enter the amount from line 24	3	1,800
4	Enter YOUR **earned income**	4	29,000
5	If married filing a joint return, enter YOUR SPOUSE'S earned income (if student or disabled, see the instructions); **all others,** enter the amount from line 4	5	29,000
6	Enter the **smallest** of line 3, 4, or 5	6	1,800
7	Enter the amount from Form 1040, line 33 — 7: 29,000		
8	Enter on line 8 the decimal amount shown below that applies to the amount on line 7	8	× .20

If line 7 is— Over	But not over	Decimal amount is	If line 7 is— Over	But not over	Decimal amount is
$0—	10,000	.30	$20,000—	22,000	.24
10,000—	12,000	.29	22,000—	24,000	.23
12,000—	14,000	.28	24,000—	26,000	.22
14,000—	16,000	.27	26,000—	28,000	.21
16,000—	18,000	.26	28,000—	No limit	.20
18,000—	20,000	.25			

9	Multiply **line 6** by the decimal amount on line 8. Enter the result. Then, see the instructions for the amount of credit to enter on Form 1040, line 40	9	360

For Paperwork Reduction Act Notice, see page 3 of the instructions. Cat. No. 11862M Form **2441** (1997)

Part III Dependent Care Benefits

10	Enter the total amount of **dependent care benefits** you received for 1997. This amount should be shown in box 10 of your W-2 form(s). DO NOT include amounts that were reported to you as wages in box 1 of Form(s) W-2			10	3,000
11	Enter the amount forfeited, if any. See the instructions			11	
12	Subtract line 11 from line 10			12	3,000
13	Enter the total amount of **qualified expenses** incurred in 1997 for the care of the **qualifying person(s)**	13	5,400		
14	Enter the **smaller** of line 12 or 13	14	3,000		
15	Enter YOUR **earned income**	15	29,000		
16	If married filing a joint return, enter YOUR SPOUSE'S earned income (if student or disabled, see the line 5 instructions); if married filing a separate return, see the instructions for the amount to enter; **all others,** enter the amount from line 15	16	29,000		
17	Enter the **smallest** of line 14, 15, or 16	17	3,000		
18	**Excluded benefits.** Enter here the **smaller** of the following: • The amount from line 17, or • $5,000 ($2,500 if married filing a separate return **and** you were required to enter your spouse's earned income on line 16).			18	3,000
19	**Taxable benefits.** Subtract line 18 from line 12. Also, include this amount on Form 1040, line 7. On the dotted line next to line 7, write "DCB"			19	-0-

To claim the child and dependent care credit, complete lines 20–24 below.

20	Enter $2,400 ($4,800 if two or more qualifying persons)	20	4,800
21	Enter the amount from line 18	21	3,000
22	Subtract line 21 from line 20. If zero or less, **STOP.** You cannot take the credit. **Exception.** If you paid 1996 expenses in 1997, see the line 9 instructions	22	1,800
23	Complete line 2 on the front of this form. DO NOT include in column (c) any excluded benefits shown on line 18 above. Then, add the amounts in column (c) and enter the total here	23	2,400
24	Enter the **smaller** of line 22 or 23. Also, enter this amount on line 3 on the front of this form and complete lines 4–9	24	1,800

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34.

Credit for the Elderly or the Disabled

Introduction

This chapter explains:

- Who qualifies for the credit for the elderly or the disabled, and
- How to figure this credit.

The maximum credit available is $1,125. You may be able to take this credit if you are:

- 65 or older, or
- Retired on permanent and total disability.

Useful Items

You may want to see:

Publication

- ☐ **524** Credit for the Elderly or the Disabled
- ☐ **554** Older Americans' Tax Guide

Forms (and Instructions)

- ☐ **Schedule 3 (Form 1040A)** Credit for the Elderly or the Disabled for Form 1040A Filers
- ☐ **Schedule R (Form 1040)** Credit for the Elderly or the Disabled

Can You Take the Credit?

You can take the credit for the elderly or the disabled if:

1) You are a ***qualified individual,*** and
2) Your income is not more than certain limits.

You can use *Figure 34–A* and *Figure 34–B* as guides to see if you qualify.

Use *Figure 34–A* first to see if you are a qualified individual. If you are, go to *Figure 34–B* to make sure your income is not too high to take the credit.

CAUTION *You can take the credit only if you file Form 1040 or Form 1040A. You cannot take the credit if you file Form 1040–EZ.*

Qualified Individual

You are a qualified individual for this credit if you are a U.S. citizen or resident and:

1) You are age 65 or older by the end of the tax year, or
2) You are under age 65 at the end of the tax year, and
   a) You are retired on permanent and total disability,
   b) You did not reach mandatory retirement age before 1997, and
   c) You received taxable disability income in 1997.

Age 65. You are considered 65 on the day before your 65th birthday. Therefore, you are 65 by the end of the year if your 65th birthday is on January 1 of the following year.

U.S. Citizen or Resident

You must be a U.S. citizen or resident (or be treated as a resident) to take the credit. Generally, you cannot take the credit if you were a nonresident alien at any time during the tax year.

Exception. If you are a nonresident alien and are married to a U.S. citizen or resident at the end of the tax year and you both choose to be treated as U.S. residents and be taxed on your worldwide income, you may be able to take the credit.

If you were a nonresident alien at the beginning of the year and a resident at the end of the year, and you were married to a U.S. citizen or resident at the end of the year, you can both choose to be treated as U.S. residents for the entire year and you may be allowed to take the credit. For information on these choices, see chapter 1 of Publication 519, *U.S. Tax Guide for Aliens.*

Married Persons

Generally, if you are married at the end of the tax year, you and your spouse must file a joint return to take the credit. If you and your spouse did not live in the same household at any time during the tax year, you can file either joint or separate returns and still take the credit.

You can file as head of household and qualify to take the credit even if your spouse lived with you during the first 6 months of the year if you meet all the tests. See *Head of Household* in chapter 2 for the tests you must meet.

Under Age 65

If you are under age 65, you can qualify for the credit only if you are retired on permanent and total disability.

You are retired on permanent and total disability if:

1) You were permanently and totally disabled when you retired, and
2) You retired on disability before the close of the tax year.

If you retired on disability before 1977 and were not permanently and totally disabled at that time, you can qualify for the credit if you were permanently and totally disabled on January 1, 1976, or January 1, 1977.

You are considered retired on disability, even if you do not retire formally, when you have stopped working because of your disability.

Permanent and total disability. You are permanently and totally disabled if you cannot engage in any substantial gainful activity because of your physical or mental condition. A physician must certify that the condition has lasted or can be expected to last continuously for 12 months or more, or that the condition can be expected to result in death. See *Physician's statement,* later.

Substantial gainful activity. Substantial gainful activity is the performance of significant duties over a reasonable period of time while working for pay or profit, or in work generally done for pay or profit.

Full-time work (or part-time work done at your employer's convenience) in a competitive work situation for at least the minimum wage conclusively shows that you are able to engage in substantial gainful activity. The minimum wage was $4.75 an hour. It increased to $5.15 an hour beginning September 1, 1997.

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

The fact that you have not worked for some time is not, of itself, conclusive evidence that you cannot engage in substantial gainful activity.

The following examples illustrate the tests of substantial gainful activity.

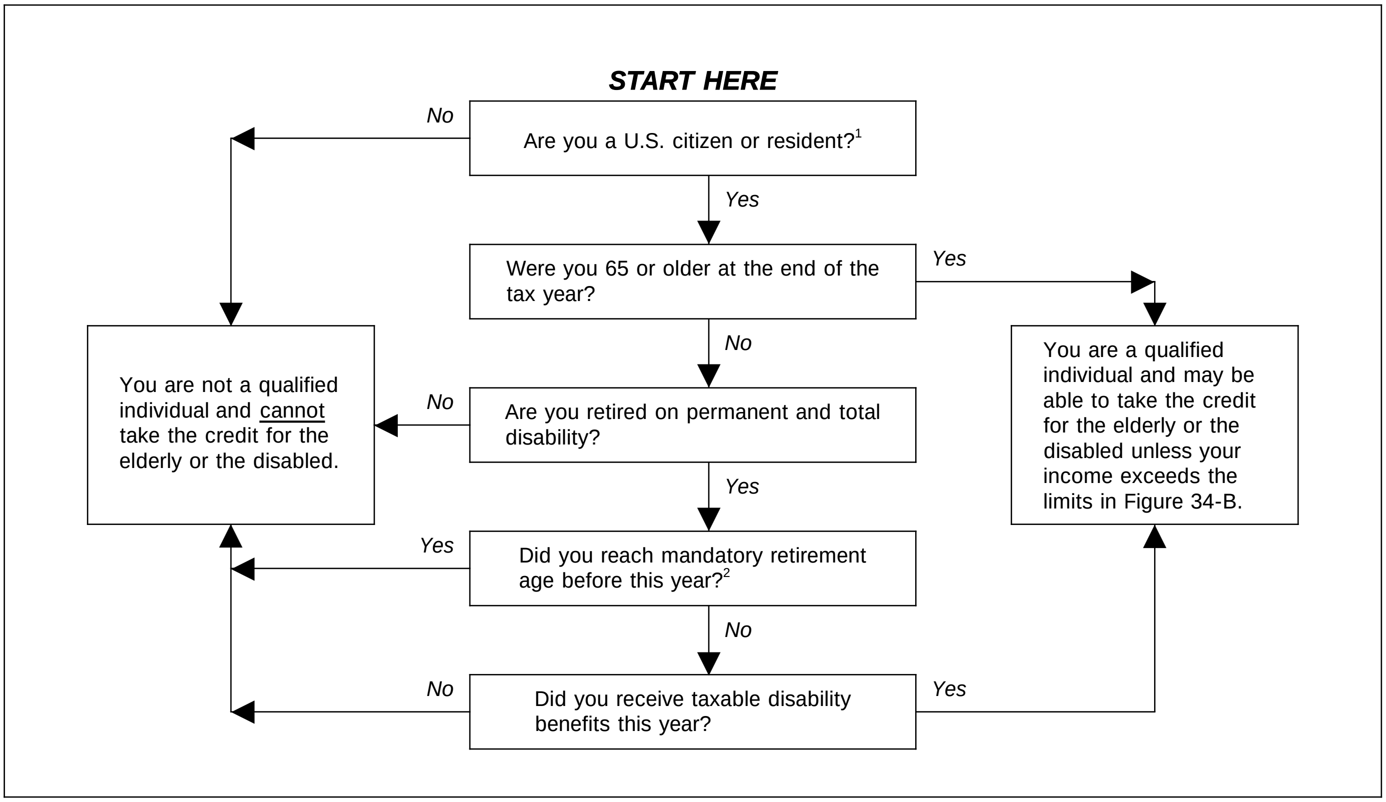
Example 1. Trisha, a sales clerk, retired on disability. She is 53 years old and now works as a full-time babysitter for the minimum wage. Even though Trisha is doing different work, she is able to do the duties of her new job in a full-time competitive work situation for the minimum wage. She cannot take the credit because she is able to engage in substantial gainful activity.

Example 2. Tom, a bookkeeper, retired on disability. He is 59 years old and now drives a truck for a charitable organization. He sets his own hours and is not paid. Duties of this nature generally are performed for pay or profit. Some weeks he works 10 hours, and some weeks he works 40 hours. Over the year he averages 20 hours a week. The kind of work and his average hours a week conclusively show that Tom is able to engage in substantial gainful activity. This is true even though Tom is not paid and he sets his own hours. He cannot take the credit.

Example 3. John, who retired on disability, took a job with a former employer on a trial basis. The purpose of the job was to see if John could do the work. The trial period lasted for 6 months during which John was paid the minimum wage. Because of John's disability, he was assigned only light duties of a nonproductive “make-work” nature. The activity was gainful because John was paid at least the minimum wage. But the activity was not substantial because his duties were nonproductive. These facts do not, by themselves, show that John is able to engage in substantial gainful activity.

Example 4. Joan, who retired on disability from employment as a bookkeeper, lives with her sister who manages several motel units. Joan assists her sister for one or two hours a day by performing duties

Figure 34-A. **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 is the age set by your employer at which you would have been required to retire, had you not become disabled.

Figure 34-B. **Income Limits**

Even if you qualify (see Figure A), you CANNOT take the credit IF:		
Your filing status is	**AND your adjusted gross income (AGI)* is equal to or more than**	**OR your nontaxable social security or other nontaxable pension(s) is equal to or more than**
Single, Head of household, or Qualifying widow(er) with dependent child	$17,500	$5,000
Married filing a joint return **and** both spouses qualify in *Figure A*	$25,500	$7,500
Married filing a joint return **and** only one spouse qualifies in *Figure A*	$20,000	$5,000
Married filing a separate return **and** you did not live with your spouse at any time during the year	$12,500	$3,750

*AGI is the amount on Form 1040A, line 17, or Form 1040, line 33 such as washing dishes, answering phones, registering guests, and bookkeeping. Joan can select the time of day when she feels most fit to perform the tasks undertaken. Work of this nature, performed off and on during the day at Joan's convenience, is not activity of a “substantial and gainful” nature even if she is paid for the work. The performance of these duties does not, of itself, show that Joan is able to engage in substantial gainful activity.

Sheltered employment. Certain work offered at qualified locations to physically or mentally impaired persons is considered sheltered employment. These locations are in sheltered workshops, hospitals and similar institutions, homebound programs, and Department of Veterans Affairs (VA) sponsored homes. Compared to commercial employment, pay is lower for sheltered employment. Therefore, one usually does not look for sheltered employment if he or she can get other employment. The fact that one has accepted sheltered employment is not proof of that person's ability to engage in substantial gainful activity.

Physician's statement. If you are under age 65, you must have your physician complete a statement certifying that you are permanently and totally disabled. Attach the statement to your return. You can use the physician's statement in Part II of either Schedule R (Form 1040) or Schedule 3 (Form 1040A). However, check the box on line 2 and do not attach a physician's statement if:

1) You filed a physician's statement for this disability for 1983 or an earlier year, or you filed 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 during the tax year.

If you checked box 4, 5, or 6 in Part I of either Schedule R or Schedule 3, print in the space above the box on line 2 in Part II, the name(s) of the spouse(s) for whom the box is checked.

If you have not filed a physician's statement in a previous year, or if the statement you filed did not meet these conditions, your physician must complete the statement.

If you file a joint return and you checked box 5 in Part I of either Schedule R or Schedule 3, you and your spouse must each file a physician's statement. Attach a separate Schedule R or Schedule 3 for your spouse with only Part II filled out.

Veterans. If the Department of Veterans Affairs (VA) certifies that you are permanently and totally disabled, you can file VA Form 21–0172, *Certification of Permanent Total Disability,* instead of the physician's statement. VA Form 21–0172 must be signed by a person authorized by the VA to do so. You can get this form from your local VA regional office.

Disability income. If you are under age 65, you can qualify for the credit only if you have taxable disability income.

Disability income must meet the following two requirements:

1) The income must be paid under your employer's accident or health plan or pension plan.

2) The income must be wages or payments in lieu of wages for the time you are absent from work because of permanent and total disability.

Any payment you receive from a plan that does not provide for disability retirement is not disability income. Any lump-sum payment for accrued annual leave that you receive when you retire on disability is a salary payment and is not disability income.

For purposes of the credit for the elderly or the disabled, disability income does **not** include amounts you receive after you reach mandatory retirement age. Mandatory retirement age is the age set by your employer at which you would have had to retire, had you not become disabled.

Income Limits

To determine if you can claim the credit, you must consider two income limits. The first limit is the amount of your adjusted gross income (AGI). The second limit is the amount of nontaxable social security or other nontaxable pensions you received. The limits are shown in *Figure 34-B.*

If the amount of your AGI and nontaxable pensions are less than the income limits, you may be able to claim the credit. See *Figuring the Credit,* next.

CAUTION *If the amount of your AGI **or** nontaxable pensions is equal to or more than the income limits, you cannot take the credit.*

Figuring the Credit

You can figure the credit yourself (see the explanation that follows), or the IRS will figure it for you. See *Credit Figured for You,* later.

Figuring the credit yourself. If you figure the credit yourself, fill out the front of either Schedule R (if you are filing Form 1040) or Schedule 3 (if you are filing Form 1040A). Next, fill out Part III of either Schedule R or Schedule 3.

There are four steps in Part III to determine the amount of your credit:

1) Determine your ***overall income limit*** (lines 10–12).

2) Total any ***nontaxable social security*** and certain other nontaxable pensions and disability benefits you received (lines 13a, 13b, and 13c).

3) Determine your ***excess adjusted gross income*** (lines 14–17).

4) Determine your credit (lines 18–20).

These steps are discussed in more detail next.

Step 1. Determine Overall Income Limit

To figure the credit, you must first determine your overall income limit. See *Table 34–1. Overall Income Limits.*

Overall income limit for persons under age 65. If you are a qualified individual under age 65, your overall income limit cannot be more than your taxable disability income. This limit affects you ***only if one of the following applies:***

1) Your filing status is single, head of household, or qualifying widow(er) with dependent child and your taxable disability income is less than $5,000,

2) Your filing status is married filing a joint return and:

   a) Your spouse is also a qualified individual under age 65 and your combined taxable disability income is less than $7,500,

   b) Your spouse is under age 65 and ***not*** a qualified individual and your taxable disability income is less than $5,000, or

   c) Your spouse is age 65 or older and your taxable disability income is less than $2,500, or

3) Your filing status is married filing separately and your taxable disability income is less than $3,750.

Step 2. Total Certain Nontaxable Pensions and Benefits

You must reduce your overall income limit by the total amount of nontaxable social security and certain other nontaxable payments (covered later) you receive during the year.

Enter these nontaxable payments on line 13a or 13b, and total them on line 13c. If you are married filing a joint return, you must enter the combined amount of nontaxable payments both you and your spouse receive.

TIP *Worksheets are provided in the Form 1040 or Form 1040A instructions to help you determine if any part of your social security benefits (or equivalent railroad retirement benefits) is taxable.*

Include the following nontaxable items in the amounts you enter on lines 13a and 13b.

- Nontaxable social security payments. This is the nontaxable part of the amount of benefits shown in box 5 of Form SSA–1099, which includes disability benefits, before deducting any amounts withheld to pay premiums on supplementary Medicare insurance, and before any reduction because of receipt of a benefit under worker's compensation.

  Do not include a lump-sum death benefit payment you may receive as a surviving spouse, or a surviving child's

Table 34-1. **Overall Income Limits**

If your filing status is:	Enter on line 10:
Single, head of household, or qualifying widow or widower and you are	
• 65 or older	$5,000
• under 65 and retired on permanent and total disability[1]	$5,000
Married filing a joint return and	
• both of you are 65 or older	$7,500
• both of you are under 65 and one of you retired on permanent and total disability[1]	$5,000
• both of you are under 65 and both of you retired on permanent and total disability[2]	$7,500
• one of you is 65 or older, and the other is under 65 and retired on permanent and total disability[3].	$7,500
• one of you is 65 or older, and the other is under 65 and ***not*** retired on permanent and total disability.	$5,000
Married filing a separate return and did not live with your spouse at any time during the year and	
• 65 or older	$3,750
• under 65 and retired on permanent and total disability[1]	$3,750

[1]Amount cannot be more than the taxable disability income.
[2]Amount cannot be more than your combined taxable disability income.
[3]Amount is $5,000 plus the taxable disability income of the spouse under age 65, but not more than $7,500.

insurance benefit payments you may receive as a guardian.

- Social security equivalent part of tier 1 railroad retirement pension payments that are not taxed. This is the nontaxable part of the amount of benefits shown in box 5 of Form RRB–1099.
- Nontaxable pension or annuity payments or disability benefits that are paid under a law administered by the Department of Veterans Affairs (VA).
  Do not include amounts received as a pension, annuity, or similar allowance for personal injuries or sickness resulting from active service in the armed forces of any country or in the National Oceanic and Atmospheric Administration or the Public Health Service, or as a disability annuity under section 808 of the Foreign Service Act of 1980.
- Pension or annuity payments or disability benefits that are excluded from income under any provision of federal law other than the Internal Revenue Code.
  Amounts that are a return of your cost of a pension or annuity do not reduce your overall income limit.

You should be sure to take into account all of the nontaxable amounts you receive. These amounts are verified by the IRS through information supplied by other government agencies.

Step 3. Determine Excess Adjusted Gross Income

You also must reduce your overall income limit by your excess adjusted gross income. Figure your excess adjusted gross income on lines 14 through 17.

You figure your excess adjusted gross income as follows:

1) Subtract from your adjusted gross income the amount shown for your filing status in the following list:
   a) **$7,500** if you are single, a head of household, or a qualifying widow(er) with a dependent child,
   b) **$10,000** if you are married filing a joint return, or
   c) **$5,000** if you are married filing a separate return and you and your spouse did not live in the same household at any time during the tax year.
2) Divide the result of (1) by 2.

Step 4. Determine Your Credit

To determine if you can take the credit, you must add the amounts in Step 2 and Step 3.

IF the total of Steps 2 and 3 is:	THEN
Equal to or more than the amount in Step 1	You **cannot** take the credit
Less than the amount in Step 1	You **can** take the credit

Figuring the credit amount. If you can take the credit, subtract the total of Step 2 and Step 3 from the amount in Step 1 and multiply the result by 15%. This is your credit.

In certain cases the amount of your credit may be limited. See *Limits on Credit*, later.

Example. You are 66 years old and your spouse is 64. Your spouse is not disabled. You file a joint return on Form 1040. Your adjusted gross income is $14,630. Together you received $3,200 from social security, which was nontaxable. You figure the credit as follows:

1) Overall income limit		$5,000
2) Subtract the total of:		
a) Social security and other nontaxable pensions	$3,200	
b) Excess adjusted gross income [($14,630 – $10,000) ÷ 2]	2,315	5,515
3) Balance (Not less than –0–)		–0–
4) **Credit**		–0–

You cannot take the credit since your nontaxable social security (line 2a) plus your excess adjusted gross income (line 2b) is more than your amount on line 1.

Limits on Credit

Your credit may be limited because of the alternative minimum tax.

The amount of your credit may be limited if:

1) You file Schedule C, C–EZ, D, E, or F (Form 1040), and
2) The amount on Form 1040, line 22, is more than:
   a) **$33,750** if single or head of household,
   b) **$45,000** if married filing jointly or qualifying widow(er) with a dependent child, or
   c) **$22,500** if married filing separately.

For purposes of (2) above, increase the amount on Form 1040, line 22, by any tax-exempt interest from private activity bonds issued after August 7, 1986, and any net operating loss deduction.

If both (1) and (2) do not apply, your credit is not subject to this limit. Enter the amount of the credit from Schedule R, line 20, on Form 1040, line 41.

If you meet both (1) and (2), get Form 6251, *Alternative Minimum Tax — Individuals,* and complete it through line 24. The limit on your credit will be the smaller of:

1) Your credit as computed, or
2) Your regular tax (line 39 of Form 1040) minus—
   a) Any credit for child and dependent care expenses, and
   b) Any amount shown on line 24, Form 6251.

Enter the smaller of (1) or (2) on Form 1040, line 41. If (2) is the smaller amount, also write "AMT" on the dotted line next to line 41, Form 1040, and replace the amount on Schedule R, line 20, with that amount.

Tax credit not refundable. Your credit for the elderly or the disabled cannot be more than the amount of your tax liability. Therefore, you cannot get a refund for any part of the credit that is more than your tax.

Credit Figured for You

If you choose to have the Internal Revenue Service (IRS) figure the credit for you, read the following discussions for filing Form 1040 or Form 1040A. If you want the IRS to figure your tax, see chapter 31.

Form 1040. If you want the IRS to figure your credit, see *Form 1040 Line Entries* under *Tax Figured by IRS* in chapter 31.

Form 1040A. If you want the IRS to figure your credit, see *Form 1040A Line Entries* under *Tax Figured by IRS* in chapter 31.

Examples

The following examples illustrate the credit for the elderly or the disabled. Assume that none of the taxpayers in these examples had to file a Form 6251. The overall income limits are taken from *Table 34–1,* shown earlier.

Example 1. Jerry Ash is 68 years old and single, and files Form 1040A. He received the following income for the year:

Nontaxable social security	$3,120
Interest (taxable)	215
Pension (all taxable)	3,600
Wages from a part-time job	4,245

Jerry's adjusted gross income is $8,060 ($4,245 + $3,600 + $215). Jerry figures the credit on Schedule 3 (Form 1040A) as follows:

1) Overall income limit		$5,000
2) Subtract the total of:		
a) Social security and other nontaxable pensions	$3,120	
b) Excess adjusted gross income [($8,060 – $7,500) ÷ 2]	280	3,400
3) Balance		$1,600
4) **Credit** (15% of $1,600)		$ 240

Jerry's credit is $240. He files Schedule 3 (Form 1040A) and shows this amount on line 24b of Form 1040A.

Example 2. James Davis is 58 years old and single, and files Form 1040A. Two years ago he retired on permanent and total disability, and he is still permanently and totally disabled. He filed the required physician's statement with his return for the year he retired on disability, so this year he checks the box in Part II of Schedule 3.

He received the following income for the year:

Nontaxable social security	$3,000
Interest (taxable)	100
Taxable disability pension	8,400

James' adjusted gross income is $8,500 ($8,400 + $100). He figures the credit on Schedule 3 as follows:

1) Overall income limit		$5,000
2) Taxable disability pension		$8,400
3) Smaller of (1) or (2)		$5,000
4) Subtract the total of:		
a) Nontaxable disability benefits (social security)	$3,000	
b) Excess adjusted gross income [($8,500 – $7,500) ÷ 2]	500	3,500
5) Balance (Not less than 0)		$1,500
6) **Credit** (15% of $1,500)		$ 225

His credit is $225. He enters $225 on line 24b of Form 1040A.

Example 3. William White is 53. His wife Helen is 49. William had a stroke 10 years ago and retired on permanent and total disability. He is still permanently and totally disabled because of the stroke. In November of last year, Helen was injured in an accident at work and retired on permanent and total disability.

William received nontaxable social security disability benefits of $3,000 during the year and a taxable disability pension of $6,000. Helen earned $9,200 from her job and received a taxable disability pension of $1,000. Their joint return on Form 1040 shows adjusted gross income of $16,200 ($6,000 + $9,200 + $1,000).

Helen got her doctor to complete Part II of Schedule R. William had filed a physician's statement with their return for the year he had the stroke. His doctor had signed on line B to certify that William was permanently and totally disabled. William does not have to file another physician's statement this year. He must fill out Part II of a separate Schedule R (not shown) and attach it to the joint return. He checks the box in Part II and writes his first name in the space above line 2.

William and Helen use Schedule R to figure their $135 credit for the elderly or the disabled. They enter this amount on line 41 of Form 1040. See their filled-in Schedule R on the next two pages.

Schedule R (Form 1040)

Department of the Treasury
Internal Revenue Service

Credit for the Elderly or the Disabled

► Attach to Form 1040. ► See separate instructions for Schedule R.

OMB No. 1545-0074

1997

Attachment Sequence No. **16**

Name(s) shown on Form 1040	Your social security number
William M. White and Helen A. White	220 00 3333

You may be able to take this credit and reduce your tax if by the end of 1997:

- You were age 65 or older, **OR**
- You were under age 65, you retired on **permanent and total** disability, and you received taxable disability income.

But you must also meet other tests. See the separate instructions for Schedule R.

TIP: In most cases, the IRS can figure the credit for you. See the instructions.

Part I Check the Box for Your Filing Status and Age

If your filing status is:	And by the end of 1997:	Check only one box:
Single, Head of household, or Qualifying widow(er) with dependent child	**1** You were 65 or older **1**	☐
	2 You were under 65 and you retired on permanent and total disability . . . **2**	☐
Married filing a joint return	**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 a separate return	**8** You were 65 or older and you lived apart from your spouse for all of 1997 . . **8**	☐
	9 You were under 65, you retired on permanent and total disability, and you lived apart from your spouse for all of 1997. . . . . . **9**	☐

Did you check box 1, 3, 7, or 8?

Yes ► Skip Part II and complete Part III on back.

No ► Complete Parts II and III.

Part II Statement of Permanent and Total Disability (Complete **only** if you checked box 2, 4, 5, 6, or 9 above.)

IF: 1 You filed a physician's statement for this disability for 1983 or an earlier year, or you filed 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 1997, check this box . . . . ► ☐

- If you checked this box, you do not have to file another statement for 1997.
- If you **did not** check this box, have your physician complete the statement below.

Physician's Statement (See instructions on back.)

I certify that Helen A. White
Name of disabled person

was permanently and totally disabled on January 1, 1976, or January 1, 1977, **OR** was permanently and totally disabled on the date he or she retired. If retired after 1976, enter the date retired. ► November 30, 1997

Physician: Sign your name on **either** line A or B below.

A The disability has lasted or can be expected to last continuously for at least a year . . . .

Physician's signature — Date

B There is no reasonable probability that the disabled condition will ever improve . . . . Juanita D. Doctor — 2/7/98

Physician's signature — Date

Physician's name	Physician's address
Juanita D. Doctor	1900 Green St., Hometown, MD 20000

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 11359K **Schedule R (Form 1040) 1997**

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**	7,500
	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:** • Box 6 in Part I, add $5,000 to the taxable disability income of the spouse who was under age 65. Enter the total. • Box 2, 4, or 9 in Part I, enter your taxable disability income. • Box 5 in Part I, 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**	7,000
12	If you completed line 11, enter the **smaller** of line 10 or line 11; **all others,** enter the amount from line 10	**12**	7,000
13	Enter the following pensions, annuities, or disability income that you (and your spouse if filing a joint return) received in 1997:		
a	Nontaxable part of social security benefits, and Nontaxable part of railroad retirement benefits treated as social security. See instructions. . . . **13a** 3,000		
b	Nontaxable veterans' pensions, and Any other pension, annuity, or disability benefit that is excluded from income under any other provision of law. See instructions. . . . **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** 3,000		
14	Enter the amount from Form 1040, line 33 . . . **14** 16,200		
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** 10,000		
16	Subtract line 15 from line 14. If zero or less, enter -0- **16** 6,200		
17	Enter one-half of line 16 . . . . . **17** 3,100		
18	Add lines 13c and 17	**18**	6,100
19	Subtract line 18 from line 12. If zero or less, **stop;** you **cannot** take the credit. Otherwise, go to line 20	**19**	900
20	Multiply line 19 by 15% (.15). Enter the result here and on Form 1040, line 41. **Caution:** *If you file Schedule C, C-EZ, D, E, or F (Form 1040), your credit may be limited. See the instructions for line 20 for the amount of credit you can claim*	**20**	135

Instructions for Physician's Statement

Taxpayer

If you retired after 1976, enter the date you retired in the space provided in Part II.

Physician

A person is permanently and totally disabled if **both** of the following apply:

1. He or she cannot engage in any substantial gainful activity because of a physical or mental condition, and

2. A physician determines that the disability has lasted or can be expected to last continuously for at least a year or can lead to death.

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35.

Earned Income Credit

Important Changes for 1997

Earned income credit is more. The amount of the credit has increased for 1997. The maximum you can receive is:

- $2,210 with one qualifying child,
- $3,656 with more than one qualifying child, or
- $332 without a qualifying child.

Earned income amount is more. The amount you can earn and still get the credit has increased for 1997. The amount you can earn must be less than:

- $25,760 with one qualifying child,
- $29,290 with more than one qualifying child, or
- $9,770 without a qualifying child.

Social security numbers. You must provide a correct and valid social security number (SSN) for yourself, your spouse, and any qualifying children. If an SSN is missing or incorrect, you may not get the credit. See rule A-4, *Social Security Number,* later.

Investment income amount is more. The maximum amount of investment income you can have and still get the credit has increased for 1997. You can have investment income up to $2,250. For most people, investment income is taxable interest and dividends, tax-exempt interest, and capital gain net income. To get more detailed information, see A-2, *Investment Income Limit,* later.

Earned income credit denied. Beginning in 1997, the earned income credit will be denied for a period of years if you improperly claim it because of reckless or intentional disregard of IRS rules or regulations, or fraud. Also, if you are denied the earned income credit as a result of deficiency procedures, you must recertify your eligibility before you can claim the credit again. See *Do You Qualify for the Credit?* later.

Important Change for 1998

Modified AGI (adjusted gross income). Beginning in 1998, your modified AGI used to limit your credit will expand to include:

1) Tax-exempt interest, and
2) Nontaxable distributions from a pension, annuity, or individual retirement arrangement (IRA), unless rolled over into a similar type of plan during the period allowed for rollovers.

Also, the amount of business losses that must be added back to AGI to figure modified AGI will increase from 50% to 75%.

If you qualify for the 1998 advance payment of the earned income credit, use these increases to figure your 1998 modified AGI.

See Publication 596, *Earned Income Credit,* for more detailed information on modified AGI.

Important Reminders

Advance payment of the earned income credit in your paycheck. If you qualify for the earned income credit in 1998, you can receive part of it in each paycheck throughout the year. See *Advance Earned Income Credit Payments,* later, for more information.

Credit has no effect on certain welfare benefits. The earned income credit and the advance earned income credit payments you receive will not be used to determine whether you are eligible for the following benefit programs or how much you can receive from the programs:

- Temporary assistance to needy families,
- Medicaid,
- Supplemental Security Income (SSI),
- Food stamps, and
- Low-income housing.

Introduction

The earned income credit is a special credit for certain people who work. The credit reduces the amount of income tax you owe (if any) and is intended to offset some of the increases in living expenses and social security taxes.

How do you get the earned income credit? To get the earned income credit, you must:

1) Qualify by meeting certain rules, and
2) File a tax return, even if you:
    a) Do not owe any tax,
    b) Did not earn enough money to file a return, or
    c) Did not have income taxes withheld from your pay.

When you complete your return, you can figure your earned income credit by using a worksheet in the instructions for the return. Or, if you prefer, you can let the IRS figure the credit for you.

How will this chapter help you? This chapter will explain the following:

- What rules you must meet to qualify for the credit,
- How to figure the credit, and
- How to get advance payment of the credit in your paycheck.

To learn about the rules you must meet, first read *Do You Qualify for the Credit?* later.

Useful Items

You may want to see:

Publication

- ☐ **504** Divorced or Separated Individuals
- ☐ **533** Self-Employment Tax
- ☐ **596** Earned Income Credit

Form (and Instructions)

- ☐ **Schedule EIC** Earned Income Credit (Qualifying Child Information)
- ☐ **Schedule SE (Form 1040)** Self-Employment Tax
- ☐ **W–5** Earned Income Credit Advance Payment Certificate

Do You Qualify for the Credit?

To qualify for the earned income credit, you must meet certain rules. These rules are explained in Part A, *Rules for Everyone,* Part B, *More Rules If you Have a Qualifying Child,* and Part C, *More Rules If You Do Not Have a Qualifying Child.* You qualify for the credit if you meet all the rules in each part that applies to you. For example:

- If you have a qualifying child, the rules in Parts A and B apply to you.
- If you do not have a qualifying child, the rules in Parts A and C apply to you.

Do you have a qualifying child? Basically, a qualifying child is a child who:

1) Is your son, daughter, adopted child, grandchild, stepchild, or eligible foster child, **and**
2) Was (at the end of 1997) under age 19, under age 24 and a full-time student, or aany age and permanently and totally disabled during the year, **and**
3) Lived with you in the United States for more than half of 1997 (for all of 1997 if the child is your eligible foster child).

See B-2, *Qualifying Child,* for more detailed information.

Table 35–1. Use Table 35–1, *Earned Income Credit at a Glance,* as a guide to Parts A, B, and C. The table is a summary list of all the rules in each part. Each rule listed has a rule number. Use this rule number to find a more detailed discussion of that rule in this chapter.

Table 35-1. **Earned Income Credit at a Glance**
(Use as a guide to Parts A, B, and C.)

Part A Rules for Everyone	**Part B More Rules If You Have a Qualifying Child**	**Part C More Rules If You Do Not Have a Qualifying Child**
☐ You must have earned income. (See **rule A-1**) ☐ Your investment income cannot be more than $2,250. (See **rule A-2**) ☐ Your filing status cannot be "Married Filing Separately." (See **rule A-3**) ☐ You must have a social security number. (See **rule A-4**) ☐ Neither you nor your spouse can be a qualifying child of another person. (See **rule A-5**) ☐ You cannot file a Form 2555, *Foreign Earned Income,* (or Form 2555-EZ, *Foreign Earned Income Exclusion).* (See **rule A-6**) ☐ You cannot be a nonresident alien for any part of the year. (See **rule A-7**)	☐ Your earned income and modified adjusted gross income (AGI) must each be less than: • $25,760 if you have one qualifying child, or • $29,290 if you have more than one qualifying child. (See **rule B-1**) ☐ You must have a qualifying child. (See **rule B-2**) ☐ Your qualifying child cannot be a qualifying child of another person whose modified AGI is higher than yours. (See **rule B-3**)	☐ Your earned income and modified AGI must each be less than $9,770. (See **rule C-1**) ☐ You (or your spouse, if filing a joint return) must be at least age 25 but under age 65. (See **rule C-2**) ☐ Neither you nor your spouse can be eligible to be claimed as a dependent on another person's return. (See **rule C-3**) ☐ Your main home must be in the United States for more than half of the year. (See **rule C-4**)

Earned Income Credit Denied

Beginning in 1997, if you improperly claim the earned income credit due to reckless or intentional disregard of IRS rules or regulations, you cannot claim the credit for the next 2 years. Also, if you fraudulently claim the earned income credit, you cannot claim the credit for the next 10 years. These sanctions are in addition to any other penalty imposed, such as the accuracy-related penalty or the fraud penalty.

Recertification after denial of credit. Beginning in 1997, if you improperly claim the earned income credit and the IRS denies it as the result of deficiency procedures, you cannot claim the credit again unless you provide information required by the IRS that shows you are eligible to claim the credit. The IRS will send you information about how to become recertified. If you claim the credit without first being recertified by the IRS, your claim will be automatically denied. The recertification procedures can apply if you are subject to the above described 2- or 10-year disallowance period.

More information. Get Publication 596 for more detailed information about the recertification and for an explanation of deficiency procedures.

Part A. Rules for Everyone

This part of the chapter discusses rules A-1 through A-7. You must meet all seven rules to qualify for the earned income credit. If you do not meet all seven rules, you cannot get the credit and you do not need to read the rest of the chapter.

If you meet all seven rules in this part, then read either Part B or Part C (whichever applies) for more rules you must meet.

A-1. Earned Income

This credit is called the "earned income credit" because, to qualify, you must work and have earned income. If you are married and file a joint return, you meet this rule if at least one spouse works and has earned income.

Figuring your total earned income. You can figure your total earned income on the **Earned Income Credit Worksheet** (EIC Worksheet) in your tax return instructions for:

- Lines 56a and 56b (Form 1040),
- Lines 29c and 29d (Form 1040A), or
- Lines 8a and 8b (Form 1040EZ).

If you file Form 1040, complete lines 1 through 6 of the EIC worksheet to figure your total earned income. If you file Form 1040A or Form 1040EZ, complete lines 1 through 5.

CAUTION *If the total of your taxable and nontaxable earned income is $25,760 or more (if you have one qualifying child), $29,290 or more (if you have more than one qualifying child), or $9,770 or more (if you do not have a qualifying child), print "No" directly to the right of line 56a (Form 1040) or line 29c (Form 1040A), or to the right of the word "below" on line 8b (Form 1040EZ).*

What Counts as Earned Income?

Earned income includes all the income you get from working—even if it is not taxable. Enter any nontaxable earned income on line 4 of the EIC Worksheet. If you claim the earned income credit, also enter that nontaxable earned income on line 56b (Form 1040), line 29d (Form 1040A), or line 8b (Form 1040EZ). (But see the "caution" under *Special procedures for a minister or a member of a religious order,* under *What Counts as Earnings from Self-Employment,* later.)

CAUTION *If you are married but filing as head of household (see rule A-3), and live in a state that has community property laws, your earned income for the credit does not include any amount earned by your spouse that is treated as belonging to you under those laws. That amount is not earned income for the credit even though* *you must include it in your gross income on your income tax return.*

For some examples of items that are included or not included in earned income, see Table 35–2, *Examples of Earned Income for the Earned Income Credit.* Some of the items listed are discussed in more detail later. Earnings from self-employment are discussed separately.

Special note for household employees. If you were a household employee who did not receive a Form W–2 because your employer paid you less than $1,000 in 1997, be sure to include the amount you were paid on line 7 (Form 1040 or 1040A) or line 1 (Form 1040EZ). Print “HSH” and the amount not reported on Form W–2 on the dotted line next to line 7 (Form 1040), or in the space to the left of line 7 (Form 1040A), or in the space to the right of the words “W–2 form(s)” on line 1 (Form 1040EZ).

U.S. military pay. Combat zone excluded pay, basic quarters and subsistence allowances, and the value of in-kind quarters and subsistence are all earned income that is not taxed but must be used when you figure the earned income credit. These amounts will be on your W–2 in box 13 under code “Q.” See Publication 3, *Armed Forces' Tax Guide,* for more detailed information.

Disability benefits. If you retired on disability, benefits you receive under your employer's disability retirement plan are considered earned income until you reach minimum retirement age. Minimum retirement age generally is the earliest age at which you could have received a pension or annuity if you were not disabled. You must report your taxable disability payments on line 7 of either Form 1040 or Form 1040A until you reach minimum retirement age.

Beginning on the day after you reach minimum retirement age, payments you receive are taxable as a pension and are not considered earned income. Report taxable pension payments on Form 1040, lines 16a and 16b (or Form 1040A, lines 11a and 11b).

Voluntary salary reductions under cafeteria plans. If your employer offers a benefit plan that allows you to choose among two or more benefits consisting of cash and benefits that are not taxed, you are probably participating in a cafeteria plan. If you choose a benefit that is not taxed (such as accident and health insurance), the amount of the voluntary salary reduction (because you did not choose cash) is earned income when figuring this credit.

Earnings while an inmate. Amounts paid to inmates in penal institutions for their work are not earned income when figuring the earned income credit. If the total on line 7 (Form 1040 or Form 1040A) or line 1 (Form 1040EZ) includes this income, do not enter that total on line 1 of the *Earned Income Credit Worksheet.* Instead, subtract that income from the total and enter the result on line 1 of the EIC worksheet. Also, print “PRI” and the amount subtracted on the dotted line next to line 7 (Form 1040), or in the space to the left of line 7 (Form 1040A), or in the space to the right of the words “W–2 form(s)” on line 1 (Form 1040EZ).

Native Americans. Income received by Native Americans that is exempt from federal income tax under the Internal Revenue Code or because of a treaty, agreement, Act of Congress, or other federal law is earned income for the credit if it is compensation for services performed as an employee. However, nontaxable income received for performing services as a self-employed individual is not earned income when figuring the earned income credit.

What Counts as Earnings from Self-Employment?

Your earnings from self-employment are earned income for the credit. You may have earnings from self-employment if:

- You own your business,
- You are a minister or member of a religious order, or
- You reported income and expenses on Schedule C or C-EZ (Form 1040) as a statutory employee.

Enter your earnings (or loss) from self-employment on line 5 of the EIC Worksheet. Figure the amount to enter on line 5 by completing the separate worksheet for that line in the Form 1040 instructions for lines 56a and 56b.

Statutory employee's earnings. If you reported income and expenses on Schedule C or C-EZ (Form 1040) as a statutory employee, your earnings from self-employment are the amount on line 1 of either schedule. Enter that amount on line 3 of the worksheet for line 5 of the EIC Worksheet.

Other earnings. Your earnings from self-employment in a business you own, or from your services as a minister or member of a religious order, are earned income for the credit. You must include these earnings in earned income even if your net earnings are less than $400. (But if you are a minister or member of a religious order, see *Approved Form 4361 or Approved Form 4029,* later.)

If you have a loss from self-employment, you must subtract the loss from your other earned income.

CAUTION *If your net earnings from self-employment are $400 or more, be sure to correctly fill out Schedule SE (Form 1040) and pay the proper amount of self-employment tax. If you do not, you may not get all the earned income credit you are entitled to.*

Schedule SE. If you are filing Schedule SE (Form 1040), your earnings from self-employment are the amount you get after you subtract one-half of your self-employment tax (Form 1040, line 26) from your net profit (Schedule SE, line 3 of either Section A or Section B, whichever applies). You figure this amount on lines 1a through 1e of the worksheet for line 5 of the EIC Worksheet.

TIP *Using the optional methods on Schedule SE to figure your net earnings from self-employment may qualify you for the earned income credit or give you a larger credit if your net earnings (determined without using the optional methods) are less than $1,600. If you use the optional methods, you increase your earnings from self-employment by adding the amount from line 4b of Section B, Schedule SE, to your net profit. See Publication 533 and the instructions for Schedule SE for details.*

If you do not have to file Schedule SE. If you do not have to file Schedule SE (for example, because your net earnings from self-employment are less than $400), your earnings (or loss) from self-employment is the net profit or loss from your self-employment activities. Enter this amount on line 2a or 2b of the worksheet for line 5 of the EIC Worksheet. (But if you are a minister or member of a religious order, see *Approved Form 4361 or Form 4029,* later.)

Special procedures for a minister or member of a religious order. If you file Schedule SE and the amount on line 2 of that schedule includes an amount that was also reported on Form 1040, line 7, follow these special procedures.

1) If you claim the credit, print “**Clergy**” directly to the right of line 56a, Form 1040.
2) Determine how much of the income reported on Form 1040, line 7, was also reported on Schedule SE, line 2.
3) Subtract that income from the amount on Form 1040, line 7. Enter only the result on line 1 of the EIC Worksheet.
4) Complete the worksheet for line 5 in the Form 1040 instructions for lines 56a and 56b.

CAUTION *If you received a housing allowance or were provided housing,* ***do not*** *include the allowance or rental value of the parsonage as nontaxable earned income on line 4 of the EIC Worksheet (or on line 56b, Form 1040) if it is required to be included on Schedule SE, line 2.*

Approved Form 4361 or Form 4029. This section is for persons who have an approved:

- Form 4361, *Application for Exemption from Self-Employment Tax for Use by Ministers, Members of Religious Orders and Christian Science Practitioners, or*
- Form 4029, *Application for Exemption from Social Security and Medicare Taxes and Waiver of Benefits.*

Each approved form exempts certain income from the self-employment tax. Each form is discussed in this section in terms of what is or is not earned income for purposes of the earned income credit.

Form 4361. If you have an approved Form 4361, amounts you received for performing ministerial duties as an employee are earned income. This includes wages, salaries, tips, and other employee compensation. Other employee compensation includes nontaxable compensation such as housing allowances or the rental value of a parsonage that you receive as part of your pay for services as an employee.

Amounts you received in the exercise of ministerial duties, but not as an employee, are not earned income. Examples include fees for performing marriages and honoraria for delivering speeches.

Any compensation you received from an undertaking unrelated to the ministry is earned income. This is so, whether you received the amounts as an employee or as a self-employed individual.

Form 4029. If you have an approved Form 4029, all wages, salaries, tips, and other employee compensation are earned income. Amounts you received as a self-employed individual are not earned income. Also, losses from Schedule C, C-EZ, or F cannot be subtracted from wages on line 7 of Form 1040.

A-2. Investment Income Limit

You cannot claim the earned income credit if your investment income is more than $2,250. For most people, investment income is the total of the following amounts.

- Taxable interest (line 8a of Form 1040 or 1040A).
- Tax-exempt interest (line 8b of Form 1040 or 1040A).
- Dividend income (line 9 of Form 1040 or 1040A).
- Capital gain net income (line 13 of Form 1040, if more than zero).

However, if you are reporting income from the rental of personal property on Form 1040, line 21, or are filing Schedule E (Form 1040) get Publication 596 for more information.

A-3. Married Person's Filing Status

If you are married, you usually must file a joint return to claim the earned income credit. Your filing status cannot be "Married Filing Separately."

Exception for head of household. You do not have to file a joint return if you can file as head of household. To file as head of household:

1) Your spouse must not have lived in your home at any time during the last 6 months of the year,
2) You must have paid more than half the cost to keep up your home for the entire year, and
3) Your home must have been, for more than half of the year, the main home of your child, adopted child, stepchild, or foster child for whom you are entitled to claim an exemption.

You will meet (3) even if you cannot claim an exemption for your child because:

- You released your claim in writing to the other parent by filling out **Form 8332,** *Release of Claim to Exemption for Child of Divorced or Separated Parents,* or a similar written statement, or
- There is a pre-1985 agreement (decree of divorce or separate maintenance or written agreement) granting the exemption to your child's other parent.

For more information about filing as head of household, see the instructions for Form 1040 or Form 1040A.

If a child who qualifies you for head of household status also meets the requirements of a qualifying child (described in rule B-2), you can take the credit under the rules in Parts A and B.

Example 1. You are married and lived apart from your spouse all year. You earned $8,000 and your 19-year-old son lived with you all year. You provided more than half the cost of maintaining your home. Your son had a part-time job and earned $2,000. He was not a full-time student or permanently and totally disabled. You qualify for the "head of household" filing status and claim your son as a dependent. You can get the earned income credit only if you meet all the rules in Parts A and C. You cannot use the rules in Part B because your son is not your qualifying child. He is not under age 19, is not a full-time student, and is not permanently and totally disabled. Even though your son is your dependent, he is not a qualifying child for the earned income credit.

Example 2. The facts are the same as in Example 1, except your son is 18. In this case, your son is your dependent and a qualifying child. You qualify for the credit if you meet the rules in Parts A and B.

Table 35-2. **Examples of Earned Income for the Earned Income Credit**

Earned Income — Includes:	Earned Income — Does not include:
TAXABLE EARNED INCOME (Enter on EIC Worksheet, line 1)	
Wages, salaries, and tips	Interest and dividends
Union strike benefits	Social security and railroad retirement benefits
Long-term disability benefits received prior to minimum retirement age	Welfare benefits
Earnings from self-employment (enter on line 5 of the Form 1040 EIC Worksheet)	Pensions or annuities
NONTAXABLE EARNED INCOME (Enter on EIC Worksheet, line 4)	Veterans' benefits (including VA rehabilitation payments)
Voluntary salary deferrals (for example: 401(k) plans or the Federal Thrift Savings Plan)	Workers' compensation benefits
Combat zone excluded pay (box 13, Code Q, of your W-2)	Alimony
Basic quarter and subsistence allowances and in-kind quarters and subsistence from the U.S. military (box 13, Code Q, of your W-2)	Child support
The value of meals or lodging provided by an employer for the convenience of the employer.	Unemployment compensation (insurance)
Housing allowance or rental value of a parsonage for the clergy (see "Ministers and members of religious orders")	Taxable scholarship or fellowship grants that were not reported on Form W-2
Excludable dependent care benefits (line 19 of either Form 2441 or Schedule 2)	Variable housing allowance for the military
Voluntary salary reductions such as under a cafeteria plan	Earnings for work performed while an inmate at a penal institution

A-4. Social Security Number (SSN)

To claim the earned income credit, you ***must*** have an SSN for you, your spouse (if filing a joint return), and your qualifying child. For more information about your qualifying child's SSN, see *Social Security Number Test* under rule B-2, *Qualifying Child.*

An SSN is a number issued by the Social Security Administration to a U.S. citizen or to a person who has permission from the Immigration and Naturalization Service to work in the United States. You cannot get the earned income credit if the SSN was issued solely for use in applying for or receiving federally funded benefits.

CAUTION *If an SSN on your income tax return for you, your spouse, or qualifying child, is missing or incorrect, you may not get the credit.*

Other taxpayer identification numbers. You cannot get the credit if, instead of an SSN, you, your spouse, or your qualifying child has:

- An Individual Taxpayer Identification Number (ITIN), which is issued to a noncitizen who cannot get an SSN, or
- An Adoption Taxpayer Identification Number (ATIN), which is issued for a child to adopting parents who cannot get an SSN for the child being adopted until the adoption is final.

Getting an SSN. If you, your spouse, or your child does not have an SSN, apply for one by filing **Form SS–5** with the Social Security Administration.

Filing deadline approaching and still no SSN. If the filing deadline is approaching and you still do not have an SSN, you have two choices.

1) Request an automatic 4–month extension (Form 4868). This extension does not give you extra time to pay any tax owed. You should pay any amount you expect to owe to avoid interest or penalty charges. (See the instructions for Form 4868, *Application for Automatic Extension of Time to File U.S. Individual Income Tax Return.)*
2) File the return on time without claiming the earned income credit. After receiving the SSN, file an amended return (Form 1040X) claiming the credit, and attach a filled-in Schedule EIC (if you have a qualifying child).

A-5. Qualifying Child of Another Person

If you (or your spouse if filing a joint return) are a qualifying child of another person, you cannot claim the earned income credit.

Are you a qualifying child? Basically, you are a qualifying child of another person (parent, guardian, foster parent, etc.) if:

- You are that person's son, daughter, adopted child, grandchild, or foster child,
- At the end of the year you were under age 19, under age 24 and a full-time student, or any age and permanently and totally disabled, **and**
- You lived with that person in the United States for more than half of the year (all year if you were a foster child). For the earned income credit, U.S. military personnel stationed outside the United States on extended active duty are considered to live in the United States during that duty period.

See rule B-2, *Qualifying Child,* if you need further information.

Example 1. You lived with your mother during the year and meet all the other rules in Parts A and C. You are age 26 and permanently and totally disabled. Your only income was from a community center where you went twice a week to answer telephones. You were paid a small fee of $1,500 for the year.

You are a qualifying child of your mother. She can claim the credit if she meets all the rules in Parts A and B. Because you are a qualifying child of your mother, you cannot claim the earned income credit.

Example 2. You and your daughter lived with your mother all year. Your daughter is your qualifying child and you meet all the other rules in Parts A and B. You are 22 years old and attended a trade school full time. You had a part-time job and earned $5,700. You had no other income.

Both you and your daughter are qualifying children of your mother. She can claim the earned income credit if she meets all the rules in Parts A and B. You cannot claim the earned income credit because you are your mother's qualifying child.

CAUTION *If you (or your spouse if filing a joint return) were a qualifying child of another person in 1997, print "No" directly to the right of line 56a (Form 1040) or 29c (Form 1040A), or to the right of the word "below" on line 8b (Form 1040EZ).*

A-6. Foreign Earned Income

You cannot claim the earned income credit if you file Form 2555, *Foreign Earned Income* or Form 2555–EZ, *Foreign Earned Income Exclusion.* You file these forms to exclude income earned in foreign countries from your gross income, or to deduct or exclude a foreign housing amount. U. S. possessions are not foreign countries. See Publication 54, *Tax Guide for U.S. Citizens and Resident Aliens Abroad,* for more detailed information.

A-7. Nonresident Alien

You cannot claim the earned income credit if you are a nonresident alien for any part of the year, unless:

1) You are married to a U.S. citizen or a resident alien, **and**
2) You choose to be treated as a resident for all of 1997.

For more information on making this choice, get Publication 519, *U.S. Tax Guide for Aliens.*

Part B. More Rules If You Have a Qualifying Child

Use this *Part B* if you:

1) Have a qualifying child, and
2) Have met all the rules in *Part A.*

This part of the chapter discusses rules B-1 through B-3. You must meet all three rules, in addition to the rules in Part A, to qualify for the earned income credit with a qualifying child.

If you meet all the rules in Part A and this part, you must file Form 1040 or Form 1040A to claim the credit. (You cannot file Form 1040EZ). You must also complete Schedule EIC and attach it to your return.

TIP *If you do not meet rule B-2, you do not have a qualifying child. Read Part C to find out if you can get the earned income credit.*

B-1. Earned Income and Modified AGI (Adjusted Gross Income) Limit

To claim the earned income credit your earned income and modified AGI must each be less than:

- $25,760 if you have one qualifying child, or
- $29,290 if you have two or more qualifying children.

Earned income. Earned income includes all the income you get from working—even if it is not taxable. For examples, see A-1, *Earned Income.*

CAUTION *If the total of your taxable and nontaxable earned income is $25,760 or more (if you have one qualifying child) or $29,290 or more (if you have more than one qualifying child), print "No" directly to the right of line 56a (Form 1040) or line 29c (Form 1040A).*

Modified AGI

Modified AGI for most people is the same as AGI. AGI includes items such as taxable social security benefits and unemployment benefits. AGI is the amount on line 32 (Form 1040), line 16 (Form 1040A), and line 4 (Form 1040EZ). But if you are filing Schedule C, C-EZ, D, E, or F, or if you claim a loss from the rental of personal property not used in a trade or business, get Publication 596 for more information.

B-2. Qualifying Child

You have a qualifying child if your child meets four tests. The four tests are:

1) Relationship,
2) Residency,
3) Age, and
4) Social security number.

If your child does not meet all four tests of a qualifying child, then you cannot claim the credit for persons with a qualifying child. However, you might qualify for the credit if you do not have a qualifying child and your earned income is under $9,770. See *Table 35–1. Earned Income Credit At A Glance,* earlier.

TIP *Your qualifying child does not necessarily have to be your dependent.*

Relationship Test

To meet the relationship test, the child must be your:

- Son, daughter, or adopted child (or a descendant of your son, daughter, or adopted child—for example, your grandchild),
- Stepson or stepdaughter, or

- Eligible foster child (this could include a niece, nephew, brother, sister, cousin, etc.).

Adopted child. Your adopted child includes a child placed with you for adoption by an authorized placement agency, even if the adoption is not final.

Eligible foster child. For the earned income credit, a person is your eligible foster child if:

1) The child lived with you and was a member of your household for the ***whole*** year, ***and***
2) You cared for that child as you would your own child.

As long as both (1) and (2) are met, any person can be your “eligible foster child.” The eligible foster child does not have to be related to you.

Qualifying child who is married. To meet the relationship test, you generally **must** claim an exemption for your married qualifying child. However, you do not have to claim an exemption, if you meet either of the following exceptions.

1) You cannot claim your child's exemption only because you gave that right to your child's other parent by filling out Form 8332 or a similar written statement.
2) You cannot claim your child's exemption only because you gave that right to your child's other parent in a pre-1985 agreement (such as a separation agreement or divorce decree).

CAUTION *If you need more information about either of these exceptions or when you can claim an exemption for your child, see Publication 501,* Exemptions, Standard Deduction, and Filing Information *or Publication 504.*

Residency Test

To meet the residency test, the child:

1) Must have lived with you for more than half the year (the whole year if the child is an eligible foster child), and
2) The home must be in the United States (one of the 50 states or the District of Columbia).

To meet the residency test, you do not need a traditional home. For example, if your child lived with you for more than half the year in a homeless shelter, the residency test is met.

Military personnel stationed outside the United States. U.S. military personnel stationed outside the United States on extended active duty are considered to live in the United States during that duty period for the earned income credit.

Extended active duty. Extended active duty means you are called or ordered to duty for an indefinite period or for a period of more than 90 days. Once you begin serving your extended active duty, you are still considered to have been on extended active duty even if you serve less than 90 days.

TIP *See Publication 3 for more information and examples on claiming the earned income credit.*

Birth or death of a child. The child is considered to have lived with you for all of 1997 if ***both*** of the following apply.

1) The child was born or died in 1997.
2) Your home was the child's home for the entire time he or she was alive during 1997.

Temporary absences. Count time that you or the qualifying child is away from home on a temporary absence due to a special circumstance as time lived at home. Examples of a special circumstance include:

- Illness,
- Attending school,
- Business,
- Vacation, and
- Military service.

Age Test

To meet the age test, your child must be:

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

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

Student defined. To qualify as a student your child must be, during some part of each of 5 calendar months during the calendar year:

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

TIP *The 5 calendar months need not be consecutive.*

School defined. The term “school” includes elementary schools, junior and senior high schools, colleges, universities, and technical, trade, and mechanical schools. It does ***not*** include on-the-job training courses, correspondence schools, and night schools. (But see *Night school,* later.)

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

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

Permanently and totally disabled. Your child is permanently and totally disabled if both the following apply:

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.

Social Security Number Test

To meet the social security number test, your child must have a social security number (SSN) issued by the Social Security Administration. See rule A-4, *Social Security Number (SSN),* earlier, for general information about required social security numbers.

Where to enter the child's SSN. Enter the SSN for your qualifying child on Schedule EIC, line 4. If your qualifying child is your dependent, also enter the SSN on line 6c of Form 1040 or Form 1040A.

Birth and death of your child. If your child was born and died in 1997 and did not have an SSN, you may attach a copy of the child's birth certificate and print “Died” on line 4 of Schedule EIC.

B-3. Qualifying Child for More Than One Person

If you and someone else have the same qualifying child, only the person with the higher modified AGI may be able to claim the credit. This is true even if the person with the higher modified AGI does not meet all the rules to claim the credit.

CAUTION *If you are filing Form 1040 or Form 1040A and cannot claim the earned income credit because of this rule, print “No” directly to the right of line 56a (Form 1040) or line 29c (Form 1040A).*

Example 1. You and your son lived with your mother all year. You are 25 years old. Your only income was $9,300 from a part-time job. Your mother's only income was $15,000 from her job.

Your son is a qualifying child of both you and your mother. However, because you both have the same qualifying child, only one of you can claim the credit. Because your mother's modified AGI ($15,000) is more than your modified AGI ($9,300), only your mother can claim the earned income credit. You cannot claim the credit either with or without a qualifying child.

Example 2. The facts are the same as in *Example 1,* except that your mother's modified AGI is $40,000.

Your mother cannot claim the earned income credit because her modified AGI is more than $25,760. (See rule B-1.) Even though your mother cannot claim the earned income credit, you cannot claim the credit either, because your mother's modified AGI is more than yours.

Example 3. You and your sister shared a household for the entire year. You have 3 young children who lived in the household. Your sister does not have any children. However, she cares for your children as if they were her own. You earn $15,000 and she earns $20,000.

The children meet the age and residency tests for both you and your sister. They meet the relationship test for you because they are your children. They also meet the relationship test for your sister because they lived with her in the same household for the whole year and she cared for them as if they were her own. Therefore, they qualify as her eligible foster children.

Your children are qualifying children for both you and your sister. However, because your sister's modified AGI is higher than yours, she is the only one who can claim the credit.

CAUTION *You and your sister cannot split the three qualifying children between you. You cannot claim the credit even though your sister enters the names of only two of the children on her Schedule EIC.*

Example 4. You, your spouse, and your son lived together until July 15, 1997, when your spouse moved out of the household. In November 1997, you and your spouse were divorced. Your modified AGI was $13,000. Your former spouse's modified AGI was $18,000. Your son is a qualifying child of both you and your former spouse, because your son lived with each of you for more than half the year. However, because your former spouse's modified AGI ($18,000) was more than your modified AGI ($13,000), only your former spouse can claim the earned income credit in 1997.

TIP *If the other person is your spouse and you file a joint return, rule B-3 does not apply.*

Unmarried couples living together. If an unmarried couple lives together with a qualifying child of both persons, only the person with the higher modified AGI may be eligible to claim the credit. The person with the lower modified AGI cannot claim the credit either with or without a qualifying child.

Part C. More Rules If You Do Not Have a Qualifying Child

Use this *Part C* if you:

1) Do not have a qualifying child, and

2) Have met all the rules in *Part A.*

This part of the chapter discusses rules C-1 through C-4. You must meet all four rules, in addition to the rules in Part A, to qualify for the earned income credit without a qualifying child.

CAUTION *If you have a qualifying child, the rules in this part do not apply to you. You can claim the credit only if you meet all the rules in Part A and Part B. See rule B-2 to find out if you have a qualifying child.*

C-1. Earned Income and Modified AGI (Adjusted Gross Income) Limit

To claim the earned income credit without a qualifying child, your earned income and modified AGI must each be less than $9,770.

Earned income. Earned income includes all the income you get from working—even if it is not taxable. For examples, see A-1, *Earned Income.*

CAUTION *If the total of your taxable and nontaxable earned income is $9,770 or more print "No" directly to the right of line 56a (Form 1040) or line 29c (Form 1040A), or to the right of the word "below" on line 8b (Form 1040EZ).*

Modified AGI

Modified AGI for most people is the same as AGI. AGI includes items such as taxable social security benefits and unemployment benefits. AGI is the amount on line 32 (Form 1040), line 16 (Form 1040A), or line 4 (Form 1040EZ). But if you are filing Schedule C, C-EZ, D, E, or F, or if you claim a loss from the rental of personal property not used in a trade or business, get Publication 596 for more information.

C-2. Age

You must be at least age 25 but under age 65 at the end of 1997. If you are married filing a joint return, either you or your spouse must be at least age 25 but under age 65 at the end of 1997. It does not matter which spouse meets the age rule, as long as one of the spouses does.

Example 1. You are age 28 and unmarried. You meet this rule.

Example 2. You are married and will file a joint return. You are age 23 and your spouse is age 27. You meet this rule because your spouse is at least age 25 but under age 65.

Example 3. You are married and will file a joint return. You are age 62 and your spouse is 66. You meet this rule because you are at least age 25 but under age 65.

CAUTION *If you (and your spouse if filing a joint return) are under age 25 or are age 65 or older, enter "No" directly to the right of line 56a (Form 1040) or line 29c (Form 1040A), or to the right of the word "below" on line 8b (Form 1040EZ).*

C-3. Dependent of Another Person

You must be able to claim an exemption for yourself (and your spouse if filing a joint return) on your tax return. If someone else can claim you (or your spouse if filing a joint return) as a dependent on their return, you cannot claim the earned income credit. If someone else can claim you (or your spouse if filing a joint return) as a dependent on their return but does not, you still cannot claim the credit.

Example 1. You are age 25, single, and living at home with your parents. You work and are not a student. You earned $7,500. Your parents cannot claim you as a dependent. When you file your return, you claim an exemption for yourself. Therefore, you meet this rule.

Example 2. You are age 25, single, and living at home with your parents. You work and earned $2,000. Your parents can claim you as a dependent but decide not to. You cannot claim the credit because your parents could have claimed you as a dependent.

Example 3. You file as head of household. Your mother is your dependent. You maintain your own home. You worked and earned $8,500. No one can claim you as a dependent. You claim an exemption for yourself when you file your return. You meet this rule.

C-4. Main Home

Your main home (and your spouse's if filing a joint return) must be in the United States for more than half the year. Your main home can be ***any location*** where you regularly live. For example, a homeless individual who lives in a shelter in the United States meets this rule. See *Military personnel stationed outside the United States,* under B-2 for a definition of "extended active duty."

U.S. military personnel stationed outside the U. S. on extended active duty are considered to live in the United States during that duty period for the earned income credit.

CAUTION *If your home (or your spouse's home if filing a joint return) was not in the United States for more than half of 1997, enter "No" directly to the right of line 56a (Form 1040) or line 29c (Form 1040A), or to the right of the word "below" on line 8b (Form 1040EZ).*

Figuring the Earned Income Credit

Use this section if you qualify for the earned income credit. You qualify if you have met all the rules in Parts A and B, or all the rules in Parts A and C.

This part of the chapter explains how to figure the amount of your credit. You have two choices.

1) Have the IRS figure the credit for you. If you want to do this, see *IRS Will Figure the Credit for You.*

2) Figure the credit yourself. If you want to do this, see *How To Figure the Credit Yourself.*

Qualifying child information (Schedule EIC). Whether the IRS figures your credit or you figure it yourself, you must give the IRS information about your qualifying child. To do this, complete Schedule EIC and attach it to your Form 1040 or Form 1040A.

The information you enter on Schedule EIC must show that the child meets all the tests for a qualifying child. (See rule B-2.) The schedule has space for information about only two qualifying children because the amount of your credit is the same whether you have two, three, or more qualifying children.

Do not file Form 1040EZ if you have a qualifying child and qualify for the credit. You must file Form 1040 or Form 1040A.

IRS Will Figure the Credit for You

The IRS will figure the amount of your earned income credit for you if you follow the steps explained in this section.

If you want the IRS to also figure the amount of your income tax, see Publication 967, The IRS Will Figure Your Tax.

Form 1040

If you file Form 1040 and want the IRS to figure your credit for you, follow these steps.

1) Print ***EIC*** directly to the right of line 56a. Also, if you have any earned income that is not taxed, enter the amount and type of that income on line 56b. See Table 35–2 for examples of earned income that is not taxed. Then, if you have any of the situations listed later under *Special Instructions,* follow those instructions.
2) Complete all other parts of your return that apply to you (including line 51), but do not fill in lines 60, 61, or 64. If you do not have a qualifying child, stop here.
3) If you have a qualifying child, complete Schedule EIC according to its instructions. Be sure to enter the child's social security number on line 4 of that schedule. If you do not, your credit may be reduced or disallowed. Attach Schedule EIC to your return.

Form 1040A

If you file Form 1040A and want the IRS to figure your credit for you, follow these steps.

1) Print ***EIC*** directly to the right of line 29c. Also, if you have earned income that is not taxed, enter the amount and type of income on line 29d. See Table 35–2 for examples of earned income that is not taxed. Then, if you have any of the situaitons listed later under *Special Instructions,* follow those instructions.
2) Complete all other parts of your return that apply to you (including line 26), but do not fill in lines 29e, 30, or 33. If you do not have a qualifying child, stop here.
3) If you have a qualifying child, complete Schedule EIC according to its instructions. Be sure to enter the child's social security number on line 4 of that schedule. If you do not, your credit may be reduced or disallowed. Attach Schedule EIC to your return.

Form 1040EZ

If you file Form 1040EZ and want the IRS to figure your credit for you, follow these steps.

1) Print ***EIC*** in the space to the right of the word “below” on line 8b. Also, if you have earned income that is not taxed, enter the amount and type in the spaces marked “Type” and “$” on line 8b. See Table 35–2 for examples of earned income that is not taxed. Then, if you have any of the situations listed later under *Special Instructions,* follow those instructions.
2) Complete all other parts of your return that apply to you, but do not fill in lines 9, 11a, or 12.

Special Instructions

Use the following special instructions, if the situation applies to you.

Member of the clergy. If you were a member of the clergy who is filing Schedule SE and line 2 of that schedule includes an amount that is also included on Form 1040, line 7, print “Clergy” directly to the right of line 56a, Form 1040. If you received a housing allowance or were provided housing and you were required to include the allowance or the rental value of the parsonage on Schedule SE, line 2, do not include it as nontaxable earned income on line 56b of Form 1040.

Household employee. If you were a household employee who did not receive a Form W-2 because your employer paid you less than $1,000 in 1997, print “HSH” and the amount not reported on a W-2 in the space to the right of the words “W-2 form(s)” on line 1 (Form 1040EZ), or on the dotted line next to line 7 (Form 1040), or in the space to the left of line 7 (Form 1040A). Also, be sure to include that amount in the total for line 1 of Form 1040EZ or line 7 of either Form 1040 or Form 1040A.

Inmates. If you were an inmate in a penal institution and the total on line 1 (Form 1040EZ) or line 7 (Form 1040 or Form 1040A), includes an amount paid for your work in the institution print “PRI” and the amount paid in the space to the right of the words “W-2 form(s)” on line 1 (Form 1040EZ), or on the dotted line next to line 7 (Form 1040), or in the space to the left of line 7 (Form 1040A).

How To Figure the Credit Yourself

To figure the amount of your earned income credit, you must use the Earned Income Credit Worksheet (EIC Worksheet) in the instruction booklet for Form 1040, Form 1040A, or Form 1040EZ, and the Earned Income Credit (EIC) Table in the tax form instruction booklet. This part of this chapter explains how to use the EIC Worksheet and how to report the credit on your return.

The amount of your earned income credit depends on:

- Whether you have no qualifying child, one qualifying child, or two or more qualifying children,
- The amount of your earned income (defined in rule A-1) and modified AGI (defined in rule B-1 or rule C-1), and
- Whether you owe alternative minimum tax.

Alternative minimum tax (AMT). The tax laws give special treatment to some kinds of income and expenses. This special treatment could substantially reduce or eliminate an individual's income tax. So that taxpayers who benefit from these laws will pay at least a minimum amount of tax, there is a special tax called the AMT.

You must reduce your earned income credit by the amount of any AMT you have for the tax year.

You may owe the AMT if you file Form 1040 or Form 1040A and your taxable income for regular tax purposes, combined with any of the adjustments and preference items that apply to you, totals more than:

- **$45,000** if you are married filing a joint return (or a qualifying widow(er) with a dependent child), or
- **$33,750** if your filing status is head of household or single.

See the instructions for line 48 (Form 1040) or line 28 (Form 1040A) for more information.

Form 1040 and EIC Worksheet. If you file Form 1040 and want to figure the credit yourself, follow these steps.

1) Go to your form instruction booklet and turn to the instructions for ***Lines 56a and 56b*** and look for the ***Earned Income Credit Worksheet—Line 56a.*** Use this worksheet to figure the credit amount. Do not attach this worksheet to your income tax return.
2) Complete the EIC Worksheet according to its instructions. If you have any of the situations listed later under *Special Instructions,* follow those instructions for the worksheet and Form 1040 where indicated. If you were self-employed or used Schedule C or C-EZ as a statutory employee, complete the separate worksheet in the Form 1040 instructions booklet for line 5 of the EIC Worksheet. Find the amount of your credit in the EIC Table in your instruction booklet.
3) Enter the amount of your earned income credit from line 10 of the EIC Worksheet on Form 1040, line 56a. But if you owe the alternative minimum tax (Form 1040, line 48), subtract it from the amount on line 10 of the EIC Worksheet and enter the result (if more than zero) on Form 1040, line 56a. Then replace the amount on line 10 of the EIC Worksheet with the amount entered on Form 1040, line 56a.
4) Enter the amount and type of any nontaxable earned income (from line 4 of the EIC Worksheet) on Form 1040, line 56b.
5) Keep the EIC Worksheet for your records. If you do not have a qualifying child, stop here.
6) If you have a qualifying child, complete Schedule EIC according to its instructions. Be sure to enter the child's social security number on line 4 of that schedule. If you do not, your credit may be reduced or disallowed. Attach Schedule EIC to your return.

Form 1040A and EIC Worksheet. If you file Form 1040A and want to figure the credit yourself, follow these steps.

1) Go to your form instruction booklet and turn to the instructions for ***Lines 29c and 29d*** and look for the ***Earned Income Credit Worksheet—Line 29c.*** Use this worksheet to figure the credit amount. Do not attach this worksheet to your income tax return.

2) Complete the EIC Worksheet according to its instructions. If you have any of the situations listed later under *Special Instructions,* follow those instructions for the worksheet and Form 1040A where indicated. Find the amount of your credit in the EIC Table in your form instruction booklet.

3) Enter the amount of your earned income credit from line 9 of the EIC Worksheet on Form 1040A, line 29c. But if you owe the alternative minimum tax (Form 1040A, line 28), subtract it from the amount on line 9 of the EIC Worksheet and enter the result (if more than zero) on Form 1040A, line 29c. Then replace the amount on line 9 of the EIC Worksheet with the amount entered on Form 1040A, line 29c.

4) Enter the amount and type of any nontaxable earned income (from line 4 of the EIC Worksheet) on Form 1040A, line 29d.

5) Keep the EIC Worksheet for your records. If you do not have a qualifying child, stop here.

6) If you have a qualifying child, complete Schedule EIC according to its instructions. Be sure to enter the child's social security number on line 4 of that schedule. If you do not, your credit may be reduced or disallowed. Attach Schedule EIC to your return.

Form 1040EZ and EIC Worksheet. If you file Form 1040EZ and want to figure the credit yourself, follow these steps.

1) Go to your form instruction booklet and turn to the instructions for ***Lines 8a and 8b*** and look for the ***Earned Income Credit Worksheet—Line 8a.*** Use this worksheet to figure the credit amount. Do not attach this worksheet to your income tax return.

2) Complete the EIC Worksheet according to its instructions. If you have any of the situations listed later under *Special Instructions,* follow those instructions for the worksheet and Form 1040EZ where indicated. Find the amount of your credit in the EIC Table in your form instructions booklet.

3) Enter the amount of your earned income credit from line 9 of the EIC Worksheet on Form 1040EZ, line 8a.

4) Enter the amount and type of any nontaxable earned income (line 4 of the EIC Worksheet) on Form 1040EZ, line 8b.

5) Keep the EIC Worksheet for your records.

Special Instructions

Use the following special instructions, if the situation applies to you.

Member of the clergy. If you were a member of the clergy who is filing Schedule SE and line 2 of that schedule includes an amount that is also included on Form 1040, line 7, print “Clergy” directly to the right of line 56a, Form 1040. Then determine how much of the income reported on Form 1040, line 7, was also reported on Schedule SE, line 2. Next, subtract that income from the amount on Form 1040, line 7. Then, enter only the result on line 1 of the EIC Worksheet. Last, be sure to complete the separate worksheet for line 5 of the EIC Worksheet in the Form 1040 instructions. Also, if you received a housing allowance or were provided housing and you were required to include the allowance or the rental value of the parsonage on Schedule SE, line 2, do not include it as nontaxable earned income on line 4 of the EIC Worksheet or line 56b of Form 1040.

Household employee. If you were a household employee who did not receive a Form W-2 because your employer paid you less than $1,000 in 1997, print “HSH” and the amount not reported on a W-2 in the space to the right of the words “W-2 form(s) ” on line 1 (Form 1040EZ), or on the dotted line next to line 7 (Form 1040), or in the space to the left of line 7 (Form 1040A). Also, be sure to include that amount in the total for line 1 of Form 1040EZ or line 7 of either Form 1040 or Form 1040A.

Inmates. If you were an inmate in a penal institution and the total on line 1 (Form 1040EZ) or line 7 (Form 1040 or Form 1040A), includes an amount paid for your work in the institution, print “PRI” and the amount paid in the space to the right of the words “W-2 form(s)” on line 1 (Form 1040EZ), or on the dotted line next to line 7 (Form 1040), or in the space to the left of line 7 (Form 1040A).

Examples

The following two comprehensive examples (complete with filled-in forms) may be helpful when figuring the earned income credit. The two examples are:

1) John and Janet Smith with one qualifying child and using Form 1040A, and

2) Kelly Green, age 30, a student, no qualifying child, and using Form 1040EZ.

Example 1. John and Janet Smith (Form 1040A)

John and Janet Smith are married and will file a joint return. They have one child—Amy, who is 2 years old. Amy lived with John and Janet for all of 1997. John worked and earned $9,500. Janet worked part of the year and earned $1,500. Their total earned income and modified AGI is $11,000. John and Janet qualify for the earned income credit and fill out the EIC Worksheet and Schedule EIC. The Smiths will attach Schedule EIC to Form 1040A when they send their completed return to the IRS.

They took the following steps to complete Schedule EIC and the EIC Worksheet.

Completing Schedule EIC

The Smiths complete Schedule EIC because they have a qualifying child. They enter “John and Janet Smith” and John's SSN (the SSN that appears first on their Form 1040A) on the line at the top of Schedule EIC. The Browns fill out *Information About Your Qualifying Child or Children* (lines 1–6).

Line 1. The Smiths enter the first name and last name for Amy in the column “Child 1. ”

Line 2. They enter the year of birth for Amy (1995).

Lines 3a and 3b. The Smiths skip these lines because Amy was born after 1978.

Line 4. They enter Amy's SSN. See rule A-4, *Social Security Number (SSN),* earlier.

Line 5. The Smiths enter “Daughter” for Amy. This column shows Amy's relationship to John and Janet.

Line 6. The Smiths enter “12” for Amy. This is how many months Amy lived with them in 1997.

Completing the EIC Worksheet

In Step 1 the Smiths completed Schedule EIC with information about their qualifying child. Next, they will complete the EIC Worksheet to figure their earned income credit amount.

Line 1. The Smiths enter $11,000 from Form 1040A, line 7.

Line 2. The Smiths leave this line blank because they did not have any taxable scholarships or fellowship grants.

Line 3. Because line 2 is blank, the Smiths enter the $11,000 from line 1.

Line 4. The Smiths leave this line blank because all their income is taxable.

Line 5. They add lines 3 and 4 together and enter $11,000.

Line 6. The Smiths are ready to see how much of a credit they can get. They go to the ***Earned Income Credit Table*** in the Form 1040A instructions. The Smiths find their income of $11,000 (from the EIC Worksheet, line 5) within the range of $9,800 to $11,950. They follow this line across to the column “One child” and find $2,210 and enter it on this line 6.

Line 7. The Smiths enter their modified AGI of $11,000. This amount is from Form 1040A, line 16.

TIP *Modified AGI for Form 1040A is the same as AGI.*

Line 8. Because their earned income of $11,000 is less than $11,950, they check the box for ***YES*** and got to line 9.

Line 9. The Smiths read the instructions for line 9. Because they checked ***YES*** on line 8, they enter the amount from line 6 on line 9 and also on Form 1040A, line 29c. The $2,210 is their earned income credit.

Filled-in Schedule EIC and Worksheet —John and Janet Smith

SCHEDULE EIC
(Form 1040A or 1040)
Department of the Treasury
Internal Revenue Service

Earned Income Credit
(Qualifying Child Information)
▶ Attach to Form 1040A or 1040.
▶ See instructions on back.

OMB No. 1545-0074
1997
Attachment Sequence No. **43**

Name(s) shown on return: First and initial(s)	Last	Your social security number
John and Janet	Smith	222-00-2222

Before you begin . . .

- See the instructions for Form 1040A, lines 29c and 29d, or Form 1040, lines 56a and 56b, to find out if you can take this credit.
- If you can take the credit, fill in the Earned Income Credit Worksheet in the Form 1040A or Form 1040 instructions to figure your credit. **But if you want the IRS to figure it for you, see instructions on back.**

Then, you **must** complete and attach Schedule EIC only if you have a qualifying child (see boxes on back).

Information About Your Qualifying Child or Children

If you have more than two qualifying children, you only have to list two to get the maximum credit.

Caution: *If you do not attach Schedule EIC and fill in all the lines that apply, it will take us longer to process your return and issue your refund.*	**Child 1**		**Child 2**	
	First name	Last name	First name	Last name
1 Child's name	Amy	Smith		
2 Child's year of birth	19 95		19	
3 If the child was born **before 1979** AND—				
a was **under age 24** at the end of 1997 **and** a student, check the "Yes" box, **OR** . . .	☐ **Yes**		☐ **Yes**	
b was permanently and totally disabled (see back), check the "Yes" box	☐ **Yes**		☐ **Yes**	
4 Enter the child's social security number	000-00-2224			
5 Child's relationship to you (for example, son, grandchild, etc.) . .	Daughter			
6 Number of months child lived with you in the United States in 1997 . .	12 **months**		**months**	

TIP: Do you want the earned income credit added to your take-home pay in 1998? To see if you qualify, get **Form W-5** from your employer or by calling the IRS at 1-800-TAX-FORM (1-800-829-3676).

For Paperwork Reduction Act Notice, see Form 1040A or 1040 instructions. Cat. No. 13339M **Schedule EIC (Form 1040A or 1040) 1997**

(Page references are to Form 1040A instructions)

Earned Income Credit Worksheet—Line 29c (keep for your records)

Caution: *If you were a household employee who did not receive a Form W-2 because your employer paid you less than $1,000 in 1997, see* ***Special Rules*** *on page 30 before completing this worksheet. Also, see* ***Special Rules*** *if Form 1040A, line 7, includes any amount paid to an inmate in a penal institution.*

1. Enter the amount from Form 1040A, line 7 . . . . . 1. 11,000

2. If you received a taxable scholarship or fellowship grant that was not reported on a W-2 form, enter that amount here . . . . . 2.

3. Subtract line 2 from line 1 . . . . . 3. 11,000

4. Enter any **nontaxable earned income** (see page 29). Types of nontaxable earned income include contributions to a 401(k) plan, and military housing and subsistence. These should be shown in box 13 of your W-2 form . . . . . 4.

5. Add lines 3 and 4 . . . . . 5. 11,000

6. Look up the amount on **line 5** above in the **EIC Table** on pages **31–32** to find your credit. Enter the credit here 6. 2,210

If line 6 is zero, **stop.** You **cannot** take the credit. Print "NO" directly to the right of line 29c of Form 1040A.

7. Enter the amount from Form 1040A, line 16 . . . . . 7. 11,000

8. **Is line 7 less than—**
- $5,450 if you do not have a qualifying child?
- $11,950 if you have at least one qualifying child?

☑ **Yes.** Go to line 9 now.
☐ **No.** Look up the amount on **line 7** above in the **EIC Table** on pages **31–32** to find your credit. Enter the credit here . . . . . 8.

9. **Earned income credit.**
- If you checked "Yes" on line 8, enter the amount from line 6.
- If you checked "No" on line 8, enter the **smaller** of line 6 or line 8.

. . . . . 9. 2,210

Next: Take the amount from line 9 above and enter it on Form 1040A, line 29c.

AND

If you had any nontaxable earned income (see line 4 above), enter the amount and type of that income on line 29d.

AND

Complete **Schedule EIC** and attach it to your return ONLY if you have a qualifying child.

Note: *If you included the alternative minimum tax on line 28, subtract it from the amount on line 9 above. Then, enter the result (if more than zero) on Form 1040A, line 29c. Also, replace the amount on line 9 above with the amount entered on Form 1040A, line 29c.*

Example 2. Kelly Green (Form 1040EZ)

Kelly Green is age 30 and a full-time student. She lived with her parents in the United States for all of 1997. She had a part-time job and earned $6,040. She earned $20 interest on a savings account. She is not eligible to be claimed as a dependent on her parents' return. Although she lived with her parents, she is not their qualifying child because she does not meet the age test. She does not have any children.

Kelly qualifies for the earned income credit. Kelly will file Form 1040EZ and complete the EIC Worksheet.

Completing the EIC Worksheet

Kelly figures the amount of her earned income credit on the *EIC Worksheet* as follows.

Line 1. She enters $6,040 from Form 1040EZ, line 1.

Line 2. Kelly leaves this line blank because she did not receive any taxable scholarships or fellowship grants.

Line 3. Kelly subtracts line 2 from line 1 and enters $6,040.

Line 4. Kelly leaves this line blank because all her income is taxable.

Line 5. She adds lines 3 and 4 and enters $6,040. This is her total earned income.

Line 6. To find her credit, Kelly goes to the *Earned Income Credit Table* in the forms instruction booklet. She finds her earned income of $6,040 (from the EIC Worksheet, line 5) in the range of $6,000 to $6,050. Kelly follows this line across to the column "No children" and finds $286. She enters $286 on line 6.

Line 7. She enters $6,060 ($6,040 plus $20) from Form 1040EZ, line 4. Modified AGI on Form 1040EZ is the same as AGI.

Line 8. Kelly checks the box for ***Yes*** and follows the instruction because her modified AGI of $6,060 is more than $5,450. Kelly again goes to the *Earned Income Credit Table* to find the amount of the credit based on her modified AGI. She finds $6,060 in the range of $6,050 to $6,100. Kelly follows this line across to the column "No children" and finds $283. Kelly enters $283 on line 8.

Line 9. Because Kelly checked the ***Yes*** box on line 8, she enters the smaller of $286 (line 6) or $283 (line 8). She enters $283 here and on Form 1040EZ, line 8a. The $283 is Kelly's earned income credit.

Filled-in Worksheet — Kelly Green
(Page references are to the Form 1040EZ instructions)

Earned Income Credit Worksheet—Line 8a (keep for your records)

Caution: *If you were a household employee who did not receive a Form W-2 because your employer paid you less than $1,000 in 1997, see **Special Rules** on page 10 before completing this worksheet. Also, see **Special Rules** if Form 1040EZ, line 1, includes any amount paid to an inmate in a penal institution.*

1. Enter the amount from Form 1040EZ, line 1 . . . . **1.** 6,040

2. If you received a taxable scholarship or fellowship grant that was not reported on a W-2 form, enter that amount here . . . . **2.** ______

3. Subtract line 2 from line 1 . . . . **3.** 6,040

4. Enter any **nontaxable earned income** (see page 9). Types of nontaxable earned income include contributions to a 401(k) plan, and military housing and subsistence. These should be shown in box 13 of your W-2 form . . . . **4.** ______

5. Add lines 3 and 4 . . . . **5.** 6,040

Caution: *If line 5 is $9,770 or more, you **cannot** take the credit. Print "No" to the right of the word "below" on line 8b of Form 1040EZ.*

6. Look up the amount on **line 5** above in the **EIC Table** on page 12 to find your credit. Enter the credit here **6.** 286

7. Enter the amount from Form 1040EZ, line 4 . . . . **7.** 6,060

8. Is line 7 $5,450 or more?

☑ **Yes.** Look up the amount on **line 7** above in the **EIC Table** on page 12 to find your credit. Enter the credit here **8.** 283

☐ **No.** Go to line 9.

9. Earned income credit.

- If you checked "Yes" on line 8, enter the **smaller** of line 6 or line 8.
- If you checked "No" on line 8, enter the amount from line 6 . . . . . . **9.** 283

Next: Take the amount from line 9 above and enter it on Form 1040EZ, line 8a.

AND

If you had any nontaxable earned income (see line 4 above), enter the type and amount of that income in the spaces marked "Type" and "$" on line 8b.

Advance Earned Income Credit Payments

Would you like to get part of your earned income credit now instead of waiting until after the end of the year? If you work for someone and expect to qualify for the earned income credit in 1998, you can choose to get part of the credit in advance. Give your employer a 1998 **Form W–5** and your employer will include part of the credit regularly in your pay. The advance payment is only available if you have at least one qualifying child.

Who can get the advance payment of the earned income credit? To get part of the earned income credit paid to you throughout the year in your paycheck, you must meet all the following rules.

1) You must expect that your earned income and modified AGI will each be less than a certain amount. The amount in 1997 was $25,760. The amount for 1998 will be higher. (See the 1998 Form W–5 for the 1998 amount.)
2) You must have a qualifying child.
3) You must expect to meet all the rules in Parts A and B of this chapter or in the instructions for Form W–5.

Persons who are not entitled to receive advance payments. Under certain circumstances, even if you meet these rules, you may not be entitled to get it. If your wages are not subject to federal income tax, social security tax, or Medicare tax withholding, you cannot get the advance payment of the earned income credit. If you are a farm worker and are paid on a daily basis, your employer is not required to pay you the advance amount of the credit.

How To Get Advance Payments for 1998

To get part of the credit in advance, you must fill out a 1998 Form W–5. After you have read the instructions and answered the questions on Form W–5, give the lower part of the form to your employer. Keep the top part for your records.

More than one employer. If you have more than one employer, give a certificate to only one of them. If you are married and both you and your spouse are employed and expect to qualify for the credit, you may give a Form W–5 to your employer and your spouse may give one to his or her employer.

CAUTION *If you receive advance earned income credit payments in 1998, you must file Form 1040 or Form 1040A for 1998. You must file a return to report what you already received and to take advantage of any additional earned income credit that you may qualify for.*

Receipt of advance payments you do not qualify for. If you receive advance payments and later find out that you do not qualify for the credit, you will have to pay back any advance payment you are not entitled to when you file your Form 1040 or Form 1040A.

When to give your employer a new Form W–5. The 1998 Form W–5 you give to your employer is valid until December 31, 1998. If you expect to qualify for the earned income credit in 1999 and you want to receive advance payments, you must give your employer a ***new*** Form W–5 in 1999. Do this each year you think you are eligible for the credit.

If you no longer want to get advance payments or if your situation changes and you no longer qualify for the earned income credit, you must give your employer a new Form W–5. Check the ***No*** box on line 1 of the new form.

If your spouse files a Form W–5 with his or her employer, you must file a new Form W–5 with your employer. Check the ***Yes*** box on line 4.

Advance Payments Received in 1997

If you received advance payments of the earned income credit in 1997, you must file a tax return to report the payments. Report the amount on line 51, Form 1040 (or line 26, Form 1040A). Your Form W–2, box 9, will show the amount you received.

CAUTION *You cannot use Form 1040EZ to report your advance payments.*

Table 35-3. **Earned Income Credit (EIC) Eligibility Checklist**

CAN YOU REALLY CLAIM THE EARNED INCOME CREDIT?
(For use in preparing 1997 tax returns)

*You may claim the earned income credit if you answer YES to all the following questions.**

CAUTION: You, your spouse, and your qualifying child must each have a social security number to claim the credit. (See **A-4. Social Security Number** earlier.)

YES **NO**

1. Is the total of your taxable and nontaxable earned income at least $1 but less than:
   - $ 9,770 if you do not have a qualifying child
   - $25,760 if you have one qualifying child
   - $29,290 if you have more than one qualifying child

2. Is your modified adjusted gross income less than:
   - $ 9,770 if you do not have a qualifying child
   - $25,760 if you have one qualifying child
   - $29,290 if you have more than one qualifying child

3. Is your investment income $2,250 or less?

4. Is your filing status married filing jointly, head of household, qualifying widow(er), or single?

   Caution: If you are a nonresident alien, your filing status must be married filing jointly to claim the credit. See rule A-7.

5. Answer **YES** if you (and your spouse if filing a joint return) are not a qualifying child of another person.

6. Answer **YES** if you are not filing Form 2555 or Form 2555-EZ to exclude from your gross income any income earned in foreign countries or to deduct or exclude a foreign housing amount.

STOP: If you have a qualifying child, answer question 7 and skip 8. If you do not have a qualifying child skip 7 and answer 8.*

7.
   - Does your child meet the age, relationship, residency, and social security number tests for a qualifying child? See rule B-2.
   - Answer **YES** if your qualifying child is also a qualifying child for another person and your modified AGI is higher than the other person's. Answer **YES** if your child is a qualifying child only for you.
   - If your qualifying child is married, did you claim the child as a dependent? (If your qualifying child is not married, answer **YES**.)

OR

8.
   - Was your main home (and your spouse's if filing a joint return) in the United States for more than half the year? Military personnel on extended active duty outside the United States are considered to be living in the United States.
   - Were you (or your spouse, if filing a joint return) at least age 25 but under 65 at the end of 1997?
   - No one can claim you (or your spouse if filing a joint return) as a dependent on their return. If you (and your spouse if filing a joint return) are not eligible to be a dependent on anyone else's return, answer **YES.** If you (or your spouse if filing a joint return) are eligible to be claimed as a dependent on someone else's return, answer **NO.**

* **PERSONS WITH A QUALIFYING CHILD:** If you answered **YES** to questions 1 through 7, you can claim the credit. Remember to fill out Schedule EIC and attach it to your Form 1040 or Form 1040A. You cannot use Form 1040EZ.

PERSONS WITHOUT A QUALIFYING CHILD: If you answered **YES** to questions 1 through 6 and 8, you can claim the credit.

IF YOU ANSWERED NO TO ANY QUESTION: You are not eligible for the credit.

36.

Other Credits

Important Changes

Excess withholding of social security tax and tier 1 railroad retirement tax. Social security and railroad retirement tax (RRTA) were both withheld at a rate of 6.2% on the first $65,400 of wages in 1997. If you had two or more employers and they withheld too much social security or RRTA tax during 1997, you may be entitled to a credit of the excess withholding. For more information about the credit and how to get it, see *Credit for Excess Social Security Tax or Railroad Retirement Tax Withheld.*

Credit on diesel-powered highway vehicles. The credit allowed to purchasers of diesel-powered highway vehicles has been repealed. If you purchased a diesel-powered highway vehicle after August 20, 1996, you are not entitled to the credit.

Adoption credit. Beginning in 1997, you may be able to claim a nonrefundable credit of up to $5,000 ($6,000 for certain special needs children) for expenses paid for adopting a child. For more information about this credit, see *Adoption Credit* under *Nonrefundable Credits.*

Introduction

In addition to the child and dependent care credit (chapter 33), the credit for the elderly or the disabled (chapter 34), and the earned income credit (chapter 35) you may be able to claim other tax credits. This chapter discusses seven other credits which you subtract directly from your tax to reduce your tax liability. It is divided into two parts, *Nonrefundable credits,* and *Refundable credits.*

Nonrefundable credits. The first part of the chapter, *Nonrefundable Credits,* covers five credits that you subtract directly from your tax. These credits may reduce your tax to zero. If these credits are more than your tax, the excess is not refunded to you.

Refundable credits. The second part of this chapter, *Refundable Credits,* covers two credits that are refundable to you and treated as payments. These credits are added to the federal income tax withheld and any estimated tax payments you made. If this total is more than your total tax, the excess will be refunded to you.

Useful Items

You may want to see:

Publication

- ☐ **514** Foreign Tax Credit for Individuals
- ☐ **564** Mutual Fund Distributions
- ☐ **936** Home Mortgage Interest Deduction
- ☐ **968** Tax Benefits for Adoption

Form (and Instructions)

- ☐ **1040** U.S. Individual Income Tax Return
- ☐ **1116** Foreign Tax Credit (Individual, Estate, Trust, or Nonresident Alien Individual)
- ☐ **8396** Mortgage Interest Credit
- ☐ **8801** Credit For Prior Year Minimum Tax—Individuals, Estates, and Trusts
- ☐ **8828** Recapture of Federal Mortgage Subsidy
- ☐ **8834** Qualified Electric Vehicle Credit
- ☐ **8839** Qualified Adoption Expenses

Nonrefundable Credits

The following credits are discussed in this part.

- Adoption credit.
- Credit for prior year minimum tax.
- Mortgage interest credit.
- Credit for electric vehicles.
- Foreign tax credit.

Adoption Credit

Beginning in 1997, you may be able to take a new tax credit of up to $5,000 for qualifying expenses paid to adopt an eligible child. The credit can be as much as $6,000 if the expenses are for the adoption of a child with special needs.

Qualifying expenses. Qualifying expenses are reasonable and necessary adoption fees, court costs, attorney fees, traveling expenses (including amounts spent for meals and lodging) while away from home, and other expenses directly related to, and whose principal purpose is for, the legal adoption of and eligible child.

Nonqualifying expenses. Qualifying adoption expenses do not include expenses:

- That violate state or federal law,
- For carrying out any surrogate parenting arrangement,
- For the adoption of your spouse's child,
- Paid using funds received from any federal, state, or local program,
- Allowed as a credit or deduction under any other federal income tax rule, or
- Paid or reimbursed by your employer or otherwise.

Eligible child. An eligible child must be:

1) Under 18 years old, or
2) Physically or mentally incapable of caring for himself or herself.

Child with special needs. An eligible child is a child with special needs if he or she is a citizen of the United States (including the District of Columbia and U.S. possessions) and a state determines that the child cannot or should not be returned to his or her parents' home and probably will not be adopted unless adoption assistance is provided to the adopted parents. A foreign child cannot be treated as a child with special needs. Factors used by states to determine if a child has special needs could include:

- The child's ethnic background,
- The child's age,
- Whether the child is a member of a minority or sibling group, or
- Whether the child has a medical condition or physical, mental, or emotional handicap.

How to claim the credit. To claim the credit you must complete Form 8839 and attach it to your Form 1040 or Form 1040A. Enter the credit on line 42, Form 1040 or line 24c Form 1040A. For more information, including income limits that may affect the credit, get Publication 968.

Credit for Prior Year Minimum Tax

The tax laws give special treatment to some kinds of income and allow special deductions and credits for some kinds of expenses. If you benefit from these laws, you may have to pay at least a minimum amount of tax. This is called the alternative minimum tax.

The special treatment of some items of income and expenses only allows you to postpone paying tax until a later year. It does not allow you to completely avoid the tax. In these situations, you may be able to claim a credit for prior year minimum tax against your current year's tax. The amount of the credit cannot reduce your current year's tax below your current year's tentative alternative minimum tax.

You may be able to take a credit against your regular tax if you:

1) Paid alternative minimum tax in 1996,
2) Had an unused minimum tax credit that you are carrying forward from 1996 to 1997, or
3) Had unallowed qualified electric vehicle credits in 1996.

How to claim the credit. Figure your 1997 credit and any carryforward to 1998 on **Form 8801,** and attach it to your Form 1040. Include the credit in your total for line 44, Form 1040, and check box c. You can carry forward any unused credit for prior year minimum tax to later years until it is completely used.

For additional information about the credit, see the instructions for Form 8801.

Mortgage Interest Credit

Mortgage credit certificates issued by state and local governments may entitle a certificate holder to a mortgage interest credit. The certificate must be used in connection with the purchase, qualified rehabilitation, or qualified home improvement of the certificate holder's main home.

Who qualifies. You may be able to claim a mortgage interest credit if you were issued a mortgage credit certificate (MCC) under a qualified MCC program. The MCC must relate to your main home.

Amount of credit. If your mortgage is equal to (or smaller than) the certified indebtedness amount (loan) shown on your MCC, you multiply the certified credit rate, shown on your MCC, by all the interest you paid on your mortgage during the year.

If your mortgage is larger than the certified indebtedness amount shown on your MCC, you multiply the certified credit rate, shown on your MCC, by only the interest allocated to the certified indebtedness amount shown on your MCC.

CAUTION **Limit.** *If the certificate credit rate is more than 20%, the credit cannot be more than $2,000.*

Carryforward. If your allowable credit is more than your tax liability reduced by certain credits, you can carry forward the unused portion of the credit to your next 3 tax years or until used, whichever comes first.

If you are subject to the $2,000 limit because your certificate credit rate is more than 20%, no amount over the $2,000 (or your prorated share of the $2,000 if you must allocate the credit) may be carried forward.

Reduced home mortgage interest deduction. If you itemize your deductions on Schedule A (Form 1040), reduce your home mortgage interest deduction by the amount on line 3 of Form 8396, even if part of that amount is to be carried forward to 1998. For more information about the home mortgage interest deduction, see chapter 25.

Recapture of Federal mortgage subsidy. If you closed on a mortgage from a qualified mortgage bond program and received a mortgage credit certificate after December 31, 1990, you may be subject to a recapture rule. The recapture would generally occur if you sold or disposed of your home during the first 9 years following the date of closing. See Publication 523, *Selling Your Home,* for more information.

How to claim the credit. Figure the credit and any carryforward to next year on **Form 8396,** and attach it to your Form 1040. Be sure to include any carryforward from 1994, 1995, and 1996. You cannot use a carryforward from 1994 on your tax return for any year after 1997.

Include the credit in your total for line 44 (Form 1040), and check box b.

Credit for Electric Vehicles

You may be allowed a 10% tax credit if you placed a qualified electric vehicle in service during the year.

Qualified electric vehicle. This is a motor vehicle that:

1) Has at least four wheels and is manufactured for use on public streets, roads, and highways.
2) Is powered ***primarily*** by an electric motor that draws its power from rechargeable batteries, fuel cells, or other portable sources of electrical current.
3) Is originally used by you.
4) Is acquired for your own use, not for resale.

Amount of credit. The credit is equal to 10% of the cost of the vehicle. However, if the vehicle is a depreciable business asset, you must reduce the cost by any section 179 deduction before figuring the credit. Get Publication 463, *Travel, Entertainment, Gift, and Car Expenses* for information on the section 179 deduction.

The credit is limited to $4,000 for each vehicle.

Special rules. You cannot take the credit if you use the vehicle predominately outside the United States.

The credit will be subject to recapture if, within 3 years after the date you place the vehicle in service, the vehicle is used predominately outside the United States or is modified so that it is no longer eligible for the credit.

How to claim the credit. To claim the credit, complete **Form 8834,** and attach it to your Form 1040. Include the credit in your total for line 44, check box d, and write “8834” on the line next to box d.

Foreign Tax Credit

You generally can choose to claim income taxes you paid or accrued during the year to a foreign country or U.S. possession as a credit against your U.S. income tax. Or, you can deduct them as an itemized deduction.

To take the foreign tax credit, complete **Form 1116** and attach it to your Form 1040. Enter the credit on line 43, Form 1040. For more information, get Publication 514.

Refundable Credits

The following credits are refundable and are treated as payments of tax:

- Credit for excess social security tax or railroad retirement tax withheld, and
- Credit from a regulated investment company.

Credit for Excess Social Security Tax or Railroad Retirement Tax Withheld

Most employers must withhold social security tax from your wages. Certain government employers (some federal, state, and local governments) do not have to withhold social security tax.

If you work for a railroad employer, that employer must withhold tier 1 railroad retirement (RRTA) tax and tier 2 RRTA tax.

If you worked for two or more employers in 1997, too much social security tax or RRTA may have been withheld from your pay. You can claim the excess as a credit against your income tax. The following table shows the maximum amount of wages subject to tax and the maximum amount of tax that should have been withheld in 1997.

Type of Tax	Maximum wages subject to tax	Maximum tax that should have been withheld
Social Security or RRTA tier 1	$65,400.00	$4,054.80
RRTA tier 2	$48,600.00	$2,381.40

CAUTION *All wages are subject to Medicare tax withholding.*

One employer. If any one employer withheld social security or RRTA tax that exceeded the amounts in the preceding table, you cannot claim the extra amount withheld by that employer as a credit against your income tax. Your employer must adjust this for you.

Joint return. If you are filing a joint return, you cannot add the social security or RRTA tax withheld from your spouse's wages to the amount withheld from your wages. Figure the credit separately for both you and your spouse to determine if either of you has excess withholding.

How to claim the credit. If you file Form 1040, enter the credit on line 58. If you file Form 1040A, include the credit in the total on line 29e. Write “Excess SST” and show the amount of the credit in the space to the left of the line.

CAUTION *You cannot claim the credit for excess social security or railroad retirement tax on Form 1040EZ.*

How to figure the credit if you did not work for a railroad. If you did not work for a railroad during 1997, figure the credit as follows:

1. Add all social security tax withheld (but not more than $4,054.80 for each employer). Enter the total here	______
2. Enter any uncollected social security tax on tips or group-term life insurance included in the total on Form 1040, line 53	______
3. Add lines 1 and 2. If $4,054.80 or less, stop here. You cannot claim the credit	______
4. Social security tax limit	4,054.80
5. Credit. Subtract line 4 from line 3. Enter the result here and on Form 1040, line 58 (or Form 1040A, line 29e)	______

Example. You are married and file a joint return with your spouse who had no gross income in 1997. During 1997 you worked for the Brown Shoe Company and earned $45,000 in wages. Social security tax of $2,790 was withheld. You also worked for another employer in 1997 and earned $35,000 in wages. $2,170 of social security tax was withheld from these wages. Because you worked for more than one employer and your total wages were more than $65,400, you can claim a credit of $905.20 for the excess social security tax withheld.

1. Add all social security tax withheld (but not more than $4,054.80 for each employer). Enter the total here	$4,960.00
2. Enter any uncollected social security tax on tips or group-term life insurance included in the total on Form 1040, line 53	–0–
3. Add lines 1 and 2. If $4,054.80 or less, stop here. You cannot claim the credit	4,960.00
4. Social security tax limit	4,054.80
5. Credit. Subtract line 4 from line 3. Enter the result here and on Form 1040, line 58 (or Form 1040A, line 29e)	$905.20

How to figure the credit if you worked for a railroad. If you were a railroad employee during 1997, figure the credit as follows:

1. Add all social security and tier 1 RRTA tax withheld (but not more than $4,054.80 for each employer). Enter the total here	
2. Enter any uncollected social security and tier 1 RRTA tax on tips or group-term life insurance included in the total on Form 1040, line 53	
3. Add lines 1 and 2. If $4,054.80 or less, enter –0– on line 5 and go to line 6	
4. Social security and tier 1 RRTA tax limit	4,054.80
5. Subtract line 4 from line 3	
6. Add all tier 2 RRTA tax withheld (but not more than $2,381.40 for each employer). Enter the total here	
7. Enter any uncollected tier 2 railroad retirement tax on tips or group-term life insurance included in the total on Form 1040, line 53	
8. Add lines 6 and 7. If $2,381.40 or less, enter –0– on line 10 and go to line 11	
9. RRTA tier 2 limit	2,381.40
10. Subtract line 9 from line 8	
11. Credit. Add lines 5 and 10. Enter the result here and on Form 1040, line 58 (or Form 1040A, line 29e)	

Credit from a Regulated Investment Company

You must include in your income any amounts that an investment company (for example, a mutual fund) allocated to you as capital gain distributions, even if you did not actually receive them. If the investment company paid a tax on the capital gain, you are allowed a credit for the tax since it is considered paid by you. The company will send you **Form 2439** showing the undistributed capital gains amount and the tax paid, if any. Claim the credit by entering the amount on line 59, Form 1040, and checking box a. Also attach Copy B of Form 2439 to your return. See *Capital Gain Distributions* in chapter 9 for more information on undistributed capital gains.

1997 Tax Table

Use if your taxable income is less than $100,000. If $100,000 or more, use the Tax Rate Schedules.

Example. Mr. and Mrs. Brown are filing a joint return. Their taxable income on line 38 of Form 1040 is $25,300. First, they find the $25,300–25,350 income line. Next, they find the column for married filing jointly and read down the column. The amount shown where the income line and filing status column meet is $3,799. This is the tax amount they should enter on line 39 of their Form 1040.

Sample Table

At least	But less than	Single	Married filing jointly *	Married filing sepa-rately	Head of a house-hold
		Your tax is—			
25,200	**25,250**	3,859	3,784	4,385	3,784
25,250	**25,300**	3,873	3,791	4,399	3,791
25,300	**25,350**	3,887	3,799	4,413	3,799
25,350	**25,400**	3,901	3,806	4,427	3,806

If line 6 (Form 1040EZ), line 22 (Form 1040A), or line 38 (Form 1040) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing sepa-rately	Head of a house-hold
		Your tax is—			
$0	**$5**	$0	$0	$0	$0
5	**15**	2	2	2	2
15	**25**	3	3	3	3
25	**50**	6	6	6	6
50	**75**	9	9	9	9
75	**100**	13	13	13	13
100	**125**	17	17	17	17
125	**150**	21	21	21	21
150	**175**	24	24	24	24
175	**200**	28	28	28	28
200	**225**	32	32	32	32
225	**250**	36	36	36	36
250	**275**	39	39	39	39
275	**300**	43	43	43	43
300	**325**	47	47	47	47
325	**350**	51	51	51	51
350	**375**	54	54	54	54
375	**400**	58	58	58	58
400	**425**	62	62	62	62
425	**450**	66	66	66	66
450	**475**	69	69	69	69
475	**500**	73	73	73	73
500	**525**	77	77	77	77
525	**550**	81	81	81	81
550	**575**	84	84	84	84
575	**600**	88	88	88	88
600	**625**	92	92	92	92
625	**650**	96	96	96	96
650	**675**	99	99	99	99
675	**700**	103	103	103	103
700	**725**	107	107	107	107
725	**750**	111	111	111	111
750	**775**	114	114	114	114
775	**800**	118	118	118	118
800	**825**	122	122	122	122
825	**850**	126	126	126	126
850	**875**	129	129	129	129
875	**900**	133	133	133	133
900	**925**	137	137	137	137
925	**950**	141	141	141	141
950	**975**	144	144	144	144
975	**1,000**	148	148	148	148
1,000					
1,000	**1,025**	152	152	152	152
1,025	**1,050**	156	156	156	156
1,050	**1,075**	159	159	159	159
1,075	**1,100**	163	163	163	163
1,100	**1,125**	167	167	167	167
1,125	**1,150**	171	171	171	171
1,150	**1,175**	174	174	174	174
1,175	**1,200**	178	178	178	178
1,200	**1,225**	182	182	182	182
1,225	**1,250**	186	186	186	186
1,250	**1,275**	189	189	189	189
1,275	**1,300**	193	193	193	193

If line 6 (Form 1040EZ), line 22 (Form 1040A), or line 38 (Form 1040) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing sepa-rately	Head of a house-hold
		Your tax is—			
1,300	**1,325**	197	197	197	197
1,325	**1,350**	201	201	201	201
1,350	**1,375**	204	204	204	204
1,375	**1,400**	208	208	208	208
1,400	**1,425**	212	212	212	212
1,425	**1,450**	216	216	216	216
1,450	**1,475**	219	219	219	219
1,475	**1,500**	223	223	223	223
1,500	**1,525**	227	227	227	227
1,525	**1,550**	231	231	231	231
1,550	**1,575**	234	234	234	234
1,575	**1,600**	238	238	238	238
1,600	**1,625**	242	242	242	242
1,625	**1,650**	246	246	246	246
1,650	**1,675**	249	249	249	249
1,675	**1,700**	253	253	253	253
1,700	**1,725**	257	257	257	257
1,725	**1,750**	261	261	261	261
1,750	**1,775**	264	264	264	264
1,775	**1,800**	268	268	268	268
1,800	**1,825**	272	272	272	272
1,825	**1,850**	276	276	276	276
1,850	**1,875**	279	279	279	279
1,875	**1,900**	283	283	283	283
1,900	**1,925**	287	287	287	287
1,925	**1,950**	291	291	291	291
1,950	**1,975**	294	294	294	294
1,975	**2,000**	298	298	298	298
2,000					
2,000	**2,025**	302	302	302	302
2,025	**2,050**	306	306	306	306
2,050	**2,075**	309	309	309	309
2,075	**2,100**	313	313	313	313
2,100	**2,125**	317	317	317	317
2,125	**2,150**	321	321	321	321
2,150	**2,175**	324	324	324	324
2,175	**2,200**	328	328	328	328
2,200	**2,225**	332	332	332	332
2,225	**2,250**	336	336	336	336
2,250	**2,275**	339	339	339	339
2,275	**2,300**	343	343	343	343
2,300	**2,325**	347	347	347	347
2,325	**2,350**	351	351	351	351
2,350	**2,375**	354	354	354	354
2,375	**2,400**	358	358	358	358
2,400	**2,425**	362	362	362	362
2,425	**2,450**	366	366	366	366
2,450	**2,475**	369	369	369	369
2,475	**2,500**	373	373	373	373
2,500	**2,525**	377	377	377	377
2,525	**2,550**	381	381	381	381
2,550	**2,575**	384	384	384	384
2,575	**2,600**	388	388	388	388
2,600	**2,625**	392	392	392	392
2,625	**2,650**	396	396	396	396
2,650	**2,675**	399	399	399	399
2,675	**2,700**	403	403	403	403

If line 6 (Form 1040EZ), line 22 (Form 1040A), or line 38 (Form 1040) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing sepa-rately	Head of a house-hold
		Your tax is—			
2,700	**2,725**	407	407	407	407
2,725	**2,750**	411	411	411	411
2,750	**2,775**	414	414	414	414
2,775	**2,800**	418	418	418	418
2,800	**2,825**	422	422	422	422
2,825	**2,850**	426	426	426	426
2,850	**2,875**	429	429	429	429
2,875	**2,900**	433	433	433	433
2,900	**2,925**	437	437	437	437
2,925	**2,950**	441	441	441	441
2,950	**2,975**	444	444	444	444
2,975	**3,000**	448	448	448	448
3,000					
3,000	**3,050**	454	454	454	454
3,050	**3,100**	461	461	461	461
3,100	**3,150**	469	469	469	469
3,150	**3,200**	476	476	476	476
3,200	**3,250**	484	484	484	484
3,250	**3,300**	491	491	491	491
3,300	**3,350**	499	499	499	499
3,350	**3,400**	506	506	506	506
3,400	**3,450**	514	514	514	514
3,450	**3,500**	521	521	521	521
3,500	**3,550**	529	529	529	529
3,550	**3,600**	536	536	536	536
3,600	**3,650**	544	544	544	544
3,650	**3,700**	551	551	551	551
3,700	**3,750**	559	559	559	559
3,750	**3,800**	566	566	566	566
3,800	**3,850**	574	574	574	574
3,850	**3,900**	581	581	581	581
3,900	**3,950**	589	589	589	589
3,950	**4,000**	596	596	596	596
4,000					
4,000	**4,050**	604	604	604	604
4,050	**4,100**	611	611	611	611
4,100	**4,150**	619	619	619	619
4,150	**4,200**	626	626	626	626
4,200	**4,250**	634	634	634	634
4,250	**4,300**	641	641	641	641
4,300	**4,350**	649	649	649	649
4,350	**4,400**	656	656	656	656
4,400	**4,450**	664	664	664	664
4,450	**4,500**	671	671	671	671
4,500	**4,550**	679	679	679	679
4,550	**4,600**	686	686	686	686
4,600	**4,650**	694	694	694	694
4,650	**4,700**	701	701	701	701
4,700	**4,750**	709	709	709	709
4,750	**4,800**	716	716	716	716
4,800	**4,850**	724	724	724	724
4,850	**4,900**	731	731	731	731
4,900	**4,950**	739	739	739	739
4,950	**5,000**	746	746	746	746

Continued on next page

* This column must also be used by a qualifying widow(er).

If line 6 (Form 1040EZ), line 22 (Form 1040A), or line 38 (Form 1040) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing sepa- rately	Head of a house- hold
		Your tax is—			
5,000					
5,000	**5,050**	754	754	754	754
5,050	**5,100**	761	761	761	761
5,100	**5,150**	769	769	769	769
5,150	**5,200**	776	776	776	776
5,200	**5,250**	784	784	784	784
5,250	**5,300**	791	791	791	791
5,300	**5,350**	799	799	799	799
5,350	**5,400**	806	806	806	806
5,400	**5,450**	814	814	814	814
5,450	**5,500**	821	821	821	821
5,500	**5,550**	829	829	829	829
5,550	**5,600**	836	836	836	836
5,600	**5,650**	844	844	844	844
5,650	**5,700**	851	851	851	851
5,700	**5,750**	859	859	859	859
5,750	**5,800**	866	866	866	866
5,800	**5,850**	874	874	874	874
5,850	**5,900**	881	881	881	881
5,900	**5,950**	889	889	889	889
5,950	**6,000**	896	896	896	896
6,000					
6,000	**6,050**	904	904	904	904
6,050	**6,100**	911	911	911	911
6,100	**6,150**	919	919	919	919
6,150	**6,200**	926	926	926	926
6,200	**6,250**	934	934	934	934
6,250	**6,300**	941	941	941	941
6,300	**6,350**	949	949	949	949
6,350	**6,400**	956	956	956	956
6,400	**6,450**	964	964	964	964
6,450	**6,500**	971	971	971	971
6,500	**6,550**	979	979	979	979
6,550	**6,600**	986	986	986	986
6,600	**6,650**	994	994	994	994
6,650	**6,700**	1,001	1,001	1,001	1,001
6,700	**6,750**	1,009	1,009	1,009	1,009
6,750	**6,800**	1,016	1,016	1,016	1,016
6,800	**6,850**	1,024	1,024	1,024	1,024
6,850	**6,900**	1,031	1,031	1,031	1,031
6,900	**6,950**	1,039	1,039	1,039	1,039
6,950	**7,000**	1,046	1,046	1,046	1,046
7,000					
7,000	**7,050**	1,054	1,054	1,054	1,054
7,050	**7,100**	1,061	1,061	1,061	1,061
7,100	**7,150**	1,069	1,069	1,069	1,069
7,150	**7,200**	1,076	1,076	1,076	1,076
7,200	**7,250**	1,084	1,084	1,084	1,084
7,250	**7,300**	1,091	1,091	1,091	1,091
7,300	**7,350**	1,099	1,099	1,099	1,099
7,350	**7,400**	1,106	1,106	1,106	1,106
7,400	**7,450**	1,114	1,114	1,114	1,114
7,450	**7,500**	1,121	1,121	1,121	1,121
7,500	**7,550**	1,129	1,129	1,129	1,129
7,550	**7,600**	1,136	1,136	1,136	1,136
7,600	**7,650**	1,144	1,144	1,144	1,144
7,650	**7,700**	1,151	1,151	1,151	1,151
7,700	**7,750**	1,159	1,159	1,159	1,159
7,750	**7,800**	1,166	1,166	1,166	1,166
7,800	**7,850**	1,174	1,174	1,174	1,174
7,850	**7,900**	1,181	1,181	1,181	1,181
7,900	**7,950**	1,189	1,189	1,189	1,189
7,950	**8,000**	1,196	1,196	1,196	1,196

If line 6 (Form 1040EZ), line 22 (Form 1040A), or line 38 (Form 1040) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing sepa- rately	Head of a house- hold
		Your tax is—			
8,000					
8,000	**8,050**	1,204	1,204	1,204	1,204
8,050	**8,100**	1,211	1,211	1,211	1,211
8,100	**8,150**	1,219	1,219	1,219	1,219
8,150	**8,200**	1,226	1,226	1,226	1,226
8,200	**8,250**	1,234	1,234	1,234	1,234
8,250	**8,300**	1,241	1,241	1,241	1,241
8,300	**8,350**	1,249	1,249	1,249	1,249
8,350	**8,400**	1,256	1,256	1,256	1,256
8,400	**8,450**	1,264	1,264	1,264	1,264
8,450	**8,500**	1,271	1,271	1,271	1,271
8,500	**8,550**	1,279	1,279	1,279	1,279
8,550	**8,600**	1,286	1,286	1,286	1,286
8,600	**8,650**	1,294	1,294	1,294	1,294
8,650	**8,700**	1,301	1,301	1,301	1,301
8,700	**8,750**	1,309	1,309	1,309	1,309
8,750	**8,800**	1,316	1,316	1,316	1,316
8,800	**8,850**	1,324	1,324	1,324	1,324
8,850	**8,900**	1,331	1,331	1,331	1,331
8,900	**8,950**	1,339	1,339	1,339	1,339
8,950	**9,000**	1,346	1,346	1,346	1,346
9,000					
9,000	**9,050**	1,354	1,354	1,354	1,354
9,050	**9,100**	1,361	1,361	1,361	1,361
9,100	**9,150**	1,369	1,369	1,369	1,369
9,150	**9,200**	1,376	1,376	1,376	1,376
9,200	**9,250**	1,384	1,384	1,384	1,384
9,250	**9,300**	1,391	1,391	1,391	1,391
9,300	**9,350**	1,399	1,399	1,399	1,399
9,350	**9,400**	1,406	1,406	1,406	1,406
9,400	**9,450**	1,414	1,414	1,414	1,414
9,450	**9,500**	1,421	1,421	1,421	1,421
9,500	**9,550**	1,429	1,429	1,429	1,429
9,550	**9,600**	1,436	1,436	1,436	1,436
9,600	**9,650**	1,444	1,444	1,444	1,444
9,650	**9,700**	1,451	1,451	1,451	1,451
9,700	**9,750**	1,459	1,459	1,459	1,459
9,750	**9,800**	1,466	1,466	1,466	1,466
9,800	**9,850**	1,474	1,474	1,474	1,474
9,850	**9,900**	1,481	1,481	1,481	1,481
9,900	**9,950**	1,489	1,489	1,489	1,489
9,950	**10,000**	1,496	1,496	1,496	1,496
10,000					
10,000	**10,050**	1,504	1,504	1,504	1,504
10,050	**10,100**	1,511	1,511	1,511	1,511
10,100	**10,150**	1,519	1,519	1,519	1,519
10,150	**10,200**	1,526	1,526	1,526	1,526
10,200	**10,250**	1,534	1,534	1,534	1,534
10,250	**10,300**	1,541	1,541	1,541	1,541
10,300	**10,350**	1,549	1,549	1,549	1,549
10,350	**10,400**	1,556	1,556	1,556	1,556
10,400	**10,450**	1,564	1,564	1,564	1,564
10,450	**10,500**	1,571	1,571	1,571	1,571
10,500	**10,550**	1,579	1,579	1,579	1,579
10,550	**10,600**	1,586	1,586	1,586	1,586
10,600	**10,650**	1,594	1,594	1,594	1,594
10,650	**10,700**	1,601	1,601	1,601	1,601
10,700	**10,750**	1,609	1,609	1,609	1,609
10,750	**10,800**	1,616	1,616	1,616	1,616
10,800	**10,850**	1,624	1,624	1,624	1,624
10,850	**10,900**	1,631	1,631	1,631	1,631
10,900	**10,950**	1,639	1,639	1,639	1,639
10,950	**11,000**	1,646	1,646	1,646	1,646

If line 6 (Form 1040EZ), line 22 (Form 1040A), or line 38 (Form 1040) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing sepa- rately	Head of a house- hold
		Your tax is—			
11,000					
11,000	**11,050**	1,654	1,654	1,654	1,654
11,050	**11,100**	1,661	1,661	1,661	1,661
11,100	**11,150**	1,669	1,669	1,669	1,669
11,150	**11,200**	1,676	1,676	1,676	1,676
11,200	**11,250**	1,684	1,684	1,684	1,684
11,250	**11,300**	1,691	1,691	1,691	1,691
11,300	**11,350**	1,699	1,699	1,699	1,699
11,350	**11,400**	1,706	1,706	1,706	1,706
11,400	**11,450**	1,714	1,714	1,714	1,714
11,450	**11,500**	1,721	1,721	1,721	1,721
11,500	**11,550**	1,729	1,729	1,729	1,729
11,550	**11,600**	1,736	1,736	1,736	1,736
11,600	**11,650**	1,744	1,744	1,744	1,744
11,650	**11,700**	1,751	1,751	1,751	1,751
11,700	**11,750**	1,759	1,759	1,759	1,759
11,750	**11,800**	1,766	1,766	1,766	1,766
11,800	**11,850**	1,774	1,774	1,774	1,774
11,850	**11,900**	1,781	1,781	1,781	1,781
11,900	**11,950**	1,789	1,789	1,789	1,789
11,950	**12,000**	1,796	1,796	1,796	1,796
12,000					
12,000	**12,050**	1,804	1,804	1,804	1,804
12,050	**12,100**	1,811	1,811	1,811	1,811
12,100	**12,150**	1,819	1,819	1,819	1,819
12,150	**12,200**	1,826	1,826	1,826	1,826
12,200	**12,250**	1,834	1,834	1,834	1,834
12,250	**12,300**	1,841	1,841	1,841	1,841
12,300	**12,350**	1,849	1,849	1,849	1,849
12,350	**12,400**	1,856	1,856	1,856	1,856
12,400	**12,450**	1,864	1,864	1,864	1,864
12,450	**12,500**	1,871	1,871	1,871	1,871
12,500	**12,550**	1,879	1,879	1,879	1,879
12,550	**12,600**	1,886	1,886	1,886	1,886
12,600	**12,650**	1,894	1,894	1,894	1,894
12,650	**12,700**	1,901	1,901	1,901	1,901
12,700	**12,750**	1,909	1,909	1,909	1,909
12,750	**12,800**	1,916	1,916	1,916	1,916
12,800	**12,850**	1,924	1,924	1,924	1,924
12,850	**12,900**	1,931	1,931	1,931	1,931
12,900	**12,950**	1,939	1,939	1,939	1,939
12,950	**13,000**	1,946	1,946	1,946	1,946
13,000					
13,000	**13,050**	1,954	1,954	1,954	1,954
13,050	**13,100**	1,961	1,961	1,961	1,961
13,100	**13,150**	1,969	1,969	1,969	1,969
13,150	**13,200**	1,976	1,976	1,976	1,976
13,200	**13,250**	1,984	1,984	1,984	1,984
13,250	**13,300**	1,991	1,991	1,991	1,991
13,300	**13,350**	1,999	1,999	1,999	1,999
13,350	**13,400**	2,006	2,006	2,006	2,006
13,400	**13,450**	2,014	2,014	2,014	2,014
13,450	**13,500**	2,021	2,021	2,021	2,021
13,500	**13,550**	2,029	2,029	2,029	2,029
13,550	**13,600**	2,036	2,036	2,036	2,036
13,600	**13,650**	2,044	2,044	2,044	2,044
13,650	**13,700**	2,051	2,051	2,051	2,051
13,700	**13,750**	2,059	2,059	2,059	2,059
13,750	**13,800**	2,066	2,066	2,066	2,066
13,800	**13,850**	2,074	2,074	2,074	2,074
13,850	**13,900**	2,081	2,081	2,081	2,081
13,900	**13,950**	2,089	2,089	2,089	2,089
13,950	**14,000**	2,096	2,096	2,096	2,096

* This column must also be used by a qualifying widow(er).

Continued on next page

If line 6 (Form 1040EZ), line 22 (Form 1040A), or line 38 (Form 1040) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing sepa-rately	Head of a house-hold
		Your tax is—			
14,000					
14,000	**14,050**	2,104	2,104	2,104	2,104
14,050	**14,100**	2,111	2,111	2,111	2,111
14,100	**14,150**	2,119	2,119	2,119	2,119
14,150	**14,200**	2,126	2,126	2,126	2,126
14,200	**14,250**	2,134	2,134	2,134	2,134
14,250	**14,300**	2,141	2,141	2,141	2,141
14,300	**14,350**	2,149	2,149	2,149	2,149
14,350	**14,400**	2,156	2,156	2,156	2,156
14,400	**14,450**	2,164	2,164	2,164	2,164
14,450	**14,500**	2,171	2,171	2,171	2,171
14,500	**14,550**	2,179	2,179	2,179	2,179
14,550	**14,600**	2,186	2,186	2,186	2,186
14,600	**14,650**	2,194	2,194	2,194	2,194
14,650	**14,700**	2,201	2,201	2,201	2,201
14,700	**14,750**	2,209	2,209	2,209	2,209
14,750	**14,800**	2,216	2,216	2,216	2,216
14,800	**14,850**	2,224	2,224	2,224	2,224
14,850	**14,900**	2,231	2,231	2,231	2,231
14,900	**14,950**	2,239	2,239	2,239	2,239
14,950	**15,000**	2,246	2,246	2,246	2,246
15,000					
15,000	**15,050**	2,254	2,254	2,254	2,254
15,050	**15,100**	2,261	2,261	2,261	2,261
15,100	**15,150**	2,269	2,269	2,269	2,269
15,150	**15,200**	2,276	2,276	2,276	2,276
15,200	**15,250**	2,284	2,284	2,284	2,284
15,250	**15,300**	2,291	2,291	2,291	2,291
15,300	**15,350**	2,299	2,299	2,299	2,299
15,350	**15,400**	2,306	2,306	2,306	2,306
15,400	**15,450**	2,314	2,314	2,314	2,314
15,450	**15,500**	2,321	2,321	2,321	2,321
15,500	**15,550**	2,329	2,329	2,329	2,329
15,550	**15,600**	2,336	2,336	2,336	2,336
15,600	**15,650**	2,344	2,344	2,344	2,344
15,650	**15,700**	2,351	2,351	2,351	2,351
15,700	**15,750**	2,359	2,359	2,359	2,359
15,750	**15,800**	2,366	2,366	2,366	2,366
15,800	**15,850**	2,374	2,374	2,374	2,374
15,850	**15,900**	2,381	2,381	2,381	2,381
15,900	**15,950**	2,389	2,389	2,389	2,389
15,950	**16,000**	2,396	2,396	2,396	2,396
16,000					
16,000	**16,050**	2,404	2,404	2,404	2,404
16,050	**16,100**	2,411	2,411	2,411	2,411
16,100	**16,150**	2,419	2,419	2,419	2,419
16,150	**16,200**	2,426	2,426	2,426	2,426
16,200	**16,250**	2,434	2,434	2,434	2,434
16,250	**16,300**	2,441	2,441	2,441	2,441
16,300	**16,350**	2,449	2,449	2,449	2,449
16,350	**16,400**	2,456	2,456	2,456	2,456
16,400	**16,450**	2,464	2,464	2,464	2,464
16,450	**16,500**	2,471	2,471	2,471	2,471
16,500	**16,550**	2,479	2,479	2,479	2,479
16,550	**16,600**	2,486	2,486	2,486	2,486
16,600	**16,650**	2,494	2,494	2,494	2,494
16,650	**16,700**	2,501	2,501	2,501	2,501
16,700	**16,750**	2,509	2,509	2,509	2,509
16,750	**16,800**	2,516	2,516	2,516	2,516
16,800	**16,850**	2,524	2,524	2,524	2,524
16,850	**16,900**	2,531	2,531	2,531	2,531
16,900	**16,950**	2,539	2,539	2,539	2,539
16,950	**17,000**	2,546	2,546	2,546	2,546

If line 6 (Form 1040EZ), line 22 (Form 1040A), or line 38 (Form 1040) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing sepa-rately	Head of a house-hold
		Your tax is—			
17,000					
17,000	**17,050**	2,554	2,554	2,554	2,554
17,050	**17,100**	2,561	2,561	2,561	2,561
17,100	**17,150**	2,569	2,569	2,569	2,569
17,150	**17,200**	2,576	2,576	2,576	2,576
17,200	**17,250**	2,584	2,584	2,584	2,584
17,250	**17,300**	2,591	2,591	2,591	2,591
17,300	**17,350**	2,599	2,599	2,599	2,599
17,350	**17,400**	2,606	2,606	2,606	2,606
17,400	**17,450**	2,614	2,614	2,614	2,614
17,450	**17,500**	2,621	2,621	2,621	2,621
17,500	**17,550**	2,629	2,629	2,629	2,629
17,550	**17,600**	2,636	2,636	2,636	2,636
17,600	**17,650**	2,644	2,644	2,644	2,644
17,650	**17,700**	2,651	2,651	2,651	2,651
17,700	**17,750**	2,659	2,659	2,659	2,659
17,750	**17,800**	2,666	2,666	2,666	2,666
17,800	**17,850**	2,674	2,674	2,674	2,674
17,850	**17,900**	2,681	2,681	2,681	2,681
17,900	**17,950**	2,689	2,689	2,689	2,689
17,950	**18,000**	2,696	2,696	2,696	2,696
18,000					
18,000	**18,050**	2,704	2,704	2,704	2,704
18,050	**18,100**	2,711	2,711	2,711	2,711
18,100	**18,150**	2,719	2,719	2,719	2,719
18,150	**18,200**	2,726	2,726	2,726	2,726
18,200	**18,250**	2,734	2,734	2,734	2,734
18,250	**18,300**	2,741	2,741	2,741	2,741
18,300	**18,350**	2,749	2,749	2,749	2,749
18,350	**18,400**	2,756	2,756	2,756	2,756
18,400	**18,450**	2,764	2,764	2,764	2,764
18,450	**18,500**	2,771	2,771	2,771	2,771
18,500	**18,550**	2,779	2,779	2,779	2,779
18,550	**18,600**	2,786	2,786	2,786	2,786
18,600	**18,650**	2,794	2,794	2,794	2,794
18,650	**18,700**	2,801	2,801	2,801	2,801
18,700	**18,750**	2,809	2,809	2,809	2,809
18,750	**18,800**	2,816	2,816	2,816	2,816
18,800	**18,850**	2,824	2,824	2,824	2,824
18,850	**18,900**	2,831	2,831	2,831	2,831
18,900	**18,950**	2,839	2,839	2,839	2,839
18,950	**19,000**	2,846	2,846	2,846	2,846
19,000					
19,000	**19,050**	2,854	2,854	2,854	2,854
19,050	**19,100**	2,861	2,861	2,861	2,861
19,100	**19,150**	2,869	2,869	2,869	2,869
19,150	**19,200**	2,876	2,876	2,876	2,876
19,200	**19,250**	2,884	2,884	2,884	2,884
19,250	**19,300**	2,891	2,891	2,891	2,891
19,300	**19,350**	2,899	2,899	2,899	2,899
19,350	**19,400**	2,906	2,906	2,906	2,906
19,400	**19,450**	2,914	2,914	2,914	2,914
19,450	**19,500**	2,921	2,921	2,921	2,921
19,500	**19,550**	2,929	2,929	2,929	2,929
19,550	**19,600**	2,936	2,936	2,936	2,936
19,600	**19,650**	2,944	2,944	2,944	2,944
19,650	**19,700**	2,951	2,951	2,951	2,951
19,700	**19,750**	2,959	2,959	2,959	2,959
19,750	**19,800**	2,966	2,966	2,966	2,966
19,800	**19,850**	2,974	2,974	2,974	2,974
19,850	**19,900**	2,981	2,981	2,981	2,981
19,900	**19,950**	2,989	2,989	2,989	2,989
19,950	**20,000**	2,996	2,996	2,996	2,996

If line 6 (Form 1040EZ), line 22 (Form 1040A), or line 38 (Form 1040) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing sepa-rately	Head of a house-hold
		Your tax is—			
20,000					
20,000	**20,050**	3,004	3,004	3,004	3,004
20,050	**20,100**	3,011	3,011	3,011	3,011
20,100	**20,150**	3,019	3,019	3,019	3,019
20,150	**20,200**	3,026	3,026	3,026	3,026
20,200	**20,250**	3,034	3,034	3,034	3,034
20,250	**20,300**	3,041	3,041	3,041	3,041
20,300	**20,350**	3,049	3,049	3,049	3,049
20,350	**20,400**	3,056	3,056	3,056	3,056
20,400	**20,450**	3,064	3,064	3,064	3,064
20,450	**20,500**	3,071	3,071	3,071	3,071
20,500	**20,550**	3,079	3,079	3,079	3,079
20,550	**20,600**	3,086	3,086	3,086	3,086
20,600	**20,650**	3,094	3,094	3,097	3,094
20,650	**20,700**	3,101	3,101	3,111	3,101
20,700	**20,750**	3,109	3,109	3,125	3,109
20,750	**20,800**	3,116	3,116	3,139	3,116
20,800	**20,850**	3,124	3,124	3,153	3,124
20,850	**20,900**	3,131	3,131	3,167	3,131
20,900	**20,950**	3,139	3,139	3,181	3,139
20,950	**21,000**	3,146	3,146	3,195	3,146
21,000					
21,000	**21,050**	3,154	3,154	3,209	3,154
21,050	**21,100**	3,161	3,161	3,223	3,161
21,100	**21,150**	3,169	3,169	3,237	3,169
21,150	**21,200**	3,176	3,176	3,251	3,176
21,200	**21,250**	3,184	3,184	3,265	3,184
21,250	**21,300**	3,191	3,191	3,279	3,191
21,300	**21,350**	3,199	3,199	3,293	3,199
21,350	**21,400**	3,206	3,206	3,307	3,206
21,400	**21,450**	3,214	3,214	3,321	3,214
21,450	**21,500**	3,221	3,221	3,335	3,221
21,500	**21,550**	3,229	3,229	3,349	3,229
21,550	**21,600**	3,236	3,236	3,363	3,236
21,600	**21,650**	3,244	3,244	3,377	3,244
21,650	**21,700**	3,251	3,251	3,391	3,251
21,700	**21,750**	3,259	3,259	3,405	3,259
21,750	**21,800**	3,266	3,266	3,419	3,266
21,800	**21,850**	3,274	3,274	3,433	3,274
21,850	**21,900**	3,281	3,281	3,447	3,281
21,900	**21,950**	3,289	3,289	3,461	3,289
21,950	**22,000**	3,296	3,296	3,475	3,296
22,000					
22,000	**22,050**	3,304	3,304	3,489	3,304
22,050	**22,100**	3,311	3,311	3,503	3,311
22,100	**22,150**	3,319	3,319	3,517	3,319
22,150	**22,200**	3,326	3,326	3,531	3,326
22,200	**22,250**	3,334	3,334	3,545	3,334
22,250	**22,300**	3,341	3,341	3,559	3,341
22,300	**22,350**	3,349	3,349	3,573	3,349
22,350	**22,400**	3,356	3,356	3,587	3,356
22,400	**22,450**	3,364	3,364	3,601	3,364
22,450	**22,500**	3,371	3,371	3,615	3,371
22,500	**22,550**	3,379	3,379	3,629	3,379
22,550	**22,600**	3,386	3,386	3,643	3,386
22,600	**22,650**	3,394	3,394	3,657	3,394
22,650	**22,700**	3,401	3,401	3,671	3,401
22,700	**22,750**	3,409	3,409	3,685	3,409
22,750	**22,800**	3,416	3,416	3,699	3,416
22,800	**22,850**	3,424	3,424	3,713	3,424
22,850	**22,900**	3,431	3,431	3,727	3,431
22,900	**22,950**	3,439	3,439	3,741	3,439
22,950	**23,000**	3,446	3,446	3,755	3,446

* This column must also be used by a qualifying widow(er).

Continued on next page

If line 6 (Form 1040EZ), line 22 (Form 1040A), or line 38 (Form 1040) is— At least	But less than	And you are— Single	Married filing jointly *	Married filing sepa-rately	Head of a house-hold
		Your tax is—			
23,000					
23,000	**23,050**	3,454	3,454	3,769	3,454
23,050	**23,100**	3,461	3,461	3,783	3,461
23,100	**23,150**	3,469	3,469	3,797	3,469
23,150	**23,200**	3,476	3,476	3,811	3,476
23,200	**23,250**	3,484	3,484	3,825	3,484
23,250	**23,300**	3,491	3,491	3,839	3,491
23,300	**23,350**	3,499	3,499	3,853	3,499
23,350	**23,400**	3,506	3,506	3,867	3,506
23,400	**23,450**	3,514	3,514	3,881	3,514
23,450	**23,500**	3,521	3,521	3,895	3,521
23,500	**23,550**	3,529	3,529	3,909	3,529
23,550	**23,600**	3,536	3,536	3,923	3,536
23,600	**23,650**	3,544	3,544	3,937	3,544
23,650	**23,700**	3,551	3,551	3,951	3,551
23,700	**23,750**	3,559	3,559	3,965	3,559
23,750	**23,800**	3,566	3,566	3,979	3,566
23,800	**23,850**	3,574	3,574	3,993	3,574
23,850	**23,900**	3,581	3,581	4,007	3,581
23,900	**23,950**	3,589	3,589	4,021	3,589
23,950	**24,000**	3,596	3,596	4,035	3,596
24,000					
24,000	**24,050**	3,604	3,604	4,049	3,604
24,050	**24,100**	3,611	3,611	4,063	3,611
24,100	**24,150**	3,619	3,619	4,077	3,619
24,150	**24,200**	3,626	3,626	4,091	3,626
24,200	**24,250**	3,634	3,634	4,105	3,634
24,250	**24,300**	3,641	3,641	4,119	3,641
24,300	**24,350**	3,649	3,649	4,133	3,649
24,350	**24,400**	3,656	3,656	4,147	3,656
24,400	**24,450**	3,664	3,664	4,161	3,664
24,450	**24,500**	3,671	3,671	4,175	3,671
24,500	**24,550**	3,679	3,679	4,189	3,679
24,550	**24,600**	3,686	3,686	4,203	3,686
24,600	**24,650**	3,694	3,694	4,217	3,694
24,650	**24,700**	3,705	3,701	4,231	3,701
24,700	**24,750**	3,719	3,709	4,245	3,709
24,750	**24,800**	3,733	3,716	4,259	3,716
24,800	**24,850**	3,747	3,724	4,273	3,724
24,850	**24,900**	3,761	3,731	4,287	3,731
24,900	**24,950**	3,775	3,739	4,301	3,739
24,950	**25,000**	3,789	3,746	4,315	3,746
25,000					
25,000	**25,050**	3,803	3,754	4,329	3,754
25,050	**25,100**	3,817	3,761	4,343	3,761
25,100	**25,150**	3,831	3,769	4,357	3,769
25,150	**25,200**	3,845	3,776	4,371	3,776
25,200	**25,250**	3,859	3,784	4,385	3,784
25,250	**25,300**	3,873	3,791	4,399	3,791
25,300	**25,350**	3,887	3,799	4,413	3,799
25,350	**25,400**	3,901	3,806	4,427	3,806
25,400	**25,450**	3,915	3,814	4,441	3,814
25,450	**25,500**	3,929	3,821	4,455	3,821
25,500	**25,550**	3,943	3,829	4,469	3,829
25,550	**25,600**	3,957	3,836	4,483	3,836
25,600	**25,650**	3,971	3,844	4,497	3,844
25,650	**25,700**	3,985	3,851	4,511	3,851
25,700	**25,750**	3,999	3,859	4,525	3,859
25,750	**25,800**	4,013	3,866	4,539	3,866
25,800	**25,850**	4,027	3,874	4,553	3,874
25,850	**25,900**	4,041	3,881	4,567	3,881
25,900	**25,950**	4,055	3,889	4,581	3,889
25,950	**26,000**	4,069	3,896	4,595	3,896

If line 6 (Form 1040EZ), line 22 (Form 1040A), or line 38 (Form 1040) is— At least	But less than	And you are— Single	Married filing jointly *	Married filing sepa-rately	Head of a house-hold
		Your tax is—			
26,000					
26,000	**26,050**	4,083	3,904	4,609	3,904
26,050	**26,100**	4,097	3,911	4,623	3,911
26,100	**26,150**	4,111	3,919	4,637	3,919
26,150	**26,200**	4,125	3,926	4,651	3,926
26,200	**26,250**	4,139	3,934	4,665	3,934
26,250	**26,300**	4,153	3,941	4,679	3,941
26,300	**26,350**	4,167	3,949	4,693	3,949
26,350	**26,400**	4,181	3,956	4,707	3,956
26,400	**26,450**	4,195	3,964	4,721	3,964
26,450	**26,500**	4,209	3,971	4,735	3,971
26,500	**26,550**	4,223	3,979	4,749	3,979
26,550	**26,600**	4,237	3,986	4,763	3,986
26,600	**26,650**	4,251	3,994	4,777	3,994
26,650	**26,700**	4,265	4,001	4,791	4,001
26,700	**26,750**	4,279	4,009	4,805	4,009
26,750	**26,800**	4,293	4,016	4,819	4,016
26,800	**26,850**	4,307	4,024	4,833	4,024
26,850	**26,900**	4,321	4,031	4,847	4,031
26,900	**26,950**	4,335	4,039	4,861	4,039
26,950	**27,000**	4,349	4,046	4,875	4,046
27,000					
27,000	**27,050**	4,363	4,054	4,889	4,054
27,050	**27,100**	4,377	4,061	4,903	4,061
27,100	**27,150**	4,391	4,069	4,917	4,069
27,150	**27,200**	4,405	4,076	4,931	4,076
27,200	**27,250**	4,419	4,084	4,945	4,084
27,250	**27,300**	4,433	4,091	4,959	4,091
27,300	**27,350**	4,447	4,099	4,973	4,099
27,350	**27,400**	4,461	4,106	4,987	4,106
27,400	**27,450**	4,475	4,114	5,001	4,114
27,450	**27,500**	4,489	4,121	5,015	4,121
27,500	**27,550**	4,503	4,129	5,029	4,129
27,550	**27,600**	4,517	4,136	5,043	4,136
27,600	**27,650**	4,531	4,144	5,057	4,144
27,650	**27,700**	4,545	4,151	5,071	4,151
27,700	**27,750**	4,559	4,159	5,085	4,159
27,750	**27,800**	4,573	4,166	5,099	4,166
27,800	**27,850**	4,587	4,174	5,113	4,174
27,850	**27,900**	4,601	4,181	5,127	4,181
27,900	**27,950**	4,615	4,189	5,141	4,189
27,950	**28,000**	4,629	4,196	5,155	4,196
28,000					
28,000	**28,050**	4,643	4,204	5,169	4,204
28,050	**28,100**	4,657	4,211	5,183	4,211
28,100	**28,150**	4,671	4,219	5,197	4,219
28,150	**28,200**	4,685	4,226	5,211	4,226
28,200	**28,250**	4,699	4,234	5,225	4,234
28,250	**28,300**	4,713	4,241	5,239	4,241
28,300	**28,350**	4,727	4,249	5,253	4,249
28,350	**28,400**	4,741	4,256	5,267	4,256
28,400	**28,450**	4,755	4,264	5,281	4,264
28,450	**28,500**	4,769	4,271	5,295	4,271
28,500	**28,550**	4,783	4,279	5,309	4,279
28,550	**28,600**	4,797	4,286	5,323	4,286
28,600	**28,650**	4,811	4,294	5,337	4,294
28,650	**28,700**	4,825	4,301	5,351	4,301
28,700	**28,750**	4,839	4,309	5,365	4,309
28,750	**28,800**	4,853	4,316	5,379	4,316
28,800	**28,850**	4,867	4,324	5,393	4,324
28,850	**28,900**	4,881	4,331	5,407	4,331
28,900	**28,950**	4,895	4,339	5,421	4,339
28,950	**29,000**	4,909	4,346	5,435	4,346

If line 6 (Form 1040EZ), line 22 (Form 1040A), or line 38 (Form 1040) is— At least	But less than	And you are— Single	Married filing jointly *	Married filing sepa-rately	Head of a house-hold
		Your tax is—			
29,000					
29,000	**29,050**	4,923	4,354	5,449	4,354
29,050	**29,100**	4,937	4,361	5,463	4,361
29,100	**29,150**	4,951	4,369	5,477	4,369
29,150	**29,200**	4,965	4,376	5,491	4,376
29,200	**29,250**	4,979	4,384	5,505	4,384
29,250	**29,300**	4,993	4,391	5,519	4,391
29,300	**29,350**	5,007	4,399	5,533	4,399
29,350	**29,400**	5,021	4,406	5,547	4,406
29,400	**29,450**	5,035	4,414	5,561	4,414
29,450	**29,500**	5,049	4,421	5,575	4,421
29,500	**29,550**	5,063	4,429	5,589	4,429
29,550	**29,600**	5,077	4,436	5,603	4,436
29,600	**29,650**	5,091	4,444	5,617	4,444
29,650	**29,700**	5,105	4,451	5,631	4,451
29,700	**29,750**	5,119	4,459	5,645	4,459
29,750	**29,800**	5,133	4,466	5,659	4,466
29,800	**29,850**	5,147	4,474	5,673	4,474
29,850	**29,900**	5,161	4,481	5,687	4,481
29,900	**29,950**	5,175	4,489	5,701	4,489
29,950	**30,000**	5,189	4,496	5,715	4,496
30,000					
30,000	**30,050**	5,203	4,504	5,729	4,504
30,050	**30,100**	5,217	4,511	5,743	4,511
30,100	**30,150**	5,231	4,519	5,757	4,519
30,150	**30,200**	5,245	4,526	5,771	4,526
30,200	**30,250**	5,259	4,534	5,785	4,534
30,250	**30,300**	5,273	4,541	5,799	4,541
30,300	**30,350**	5,287	4,549	5,813	4,549
30,350	**30,400**	5,301	4,556	5,827	4,556
30,400	**30,450**	5,315	4,564	5,841	4,564
30,450	**30,500**	5,329	4,571	5,855	4,571
30,500	**30,550**	5,343	4,579	5,869	4,579
30,550	**30,600**	5,357	4,586	5,883	4,586
30,600	**30,650**	5,371	4,594	5,897	4,594
30,650	**30,700**	5,385	4,601	5,911	4,601
30,700	**30,750**	5,399	4,609	5,925	4,609
30,750	**30,800**	5,413	4,616	5,939	4,616
30,800	**30,850**	5,427	4,624	5,953	4,624
30,850	**30,900**	5,441	4,631	5,967	4,631
30,900	**30,950**	5,455	4,639	5,981	4,639
30,950	**31,000**	5,469	4,646	5,995	4,646
31,000					
31,000	**31,050**	5,483	4,654	6,009	4,654
31,050	**31,100**	5,497	4,661	6,023	4,661
31,100	**31,150**	5,511	4,669	6,037	4,669
31,150	**31,200**	5,525	4,676	6,051	4,676
31,200	**31,250**	5,539	4,684	6,065	4,684
31,250	**31,300**	5,553	4,691	6,079	4,691
31,300	**31,350**	5,567	4,699	6,093	4,699
31,350	**31,400**	5,581	4,706	6,107	4,706
31,400	**31,450**	5,595	4,714	6,121	4,714
31,450	**31,500**	5,609	4,721	6,135	4,721
31,500	**31,550**	5,623	4,729	6,149	4,729
31,550	**31,600**	5,637	4,736	6,163	4,736
31,600	**31,650**	5,651	4,744	6,177	4,744
31,650	**31,700**	5,665	4,751	6,191	4,751
31,700	**31,750**	5,679	4,759	6,205	4,759
31,750	**31,800**	5,693	4,766	6,219	4,766
31,800	**31,850**	5,707	4,774	6,233	4,774
31,850	**31,900**	5,721	4,781	6,247	4,781
31,900	**31,950**	5,735	4,789	6,261	4,789
31,950	**32,000**	5,749	4,796	6,275	4,796

* This column must also be used by a qualifying widow(er).

Continued on next page

If line 6 (Form 1040EZ), line 22 (Form 1040A), or line 38 (Form 1040) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing sepa-rately	Head of a house-hold
		Your tax is—			
32,000					
32,000	**32,050**	5,763	4,804	6,289	4,804
32,050	**32,100**	5,777	4,811	6,303	4,811
32,100	**32,150**	5,791	4,819	6,317	4,819
32,150	**32,200**	5,805	4,826	6,331	4,826
32,200	**32,250**	5,819	4,834	6,345	4,834
32,250	**32,300**	5,833	4,841	6,359	4,841
32,300	**32,350**	5,847	4,849	6,373	4,849
32,350	**32,400**	5,861	4,856	6,387	4,856
32,400	**32,450**	5,875	4,864	6,401	4,864
32,450	**32,500**	5,889	4,871	6,415	4,871
32,500	**32,550**	5,903	4,879	6,429	4,879
32,550	**32,600**	5,917	4,886	6,443	4,886
32,600	**32,650**	5,931	4,894	6,457	4,894
32,650	**32,700**	5,945	4,901	6,471	4,901
32,700	**32,750**	5,959	4,909	6,485	4,909
32,750	**32,800**	5,973	4,916	6,499	4,916
32,800	**32,850**	5,987	4,924	6,513	4,924
32,850	**32,900**	6,001	4,931	6,527	4,931
32,900	**32,950**	6,015	4,939	6,541	4,939
32,950	**33,000**	6,029	4,946	6,555	4,946
33,000					
33,000	**33,050**	6,043	4,954	6,569	4,954
33,050	**33,100**	6,057	4,961	6,583	4,965
33,100	**33,150**	6,071	4,969	6,597	4,979
33,150	**33,200**	6,085	4,976	6,611	4,993
33,200	**33,250**	6,099	4,984	6,625	5,007
33,250	**33,300**	6,113	4,991	6,639	5,021
33,300	**33,350**	6,127	4,999	6,653	5,035
33,350	**33,400**	6,141	5,006	6,667	5,049
33,400	**33,450**	6,155	5,014	6,681	5,063
33,450	**33,500**	6,169	5,021	6,695	5,077
33,500	**33,550**	6,183	5,029	6,709	5,091
33,550	**33,600**	6,197	5,036	6,723	5,105
33,600	**33,650**	6,211	5,044	6,737	5,119
33,650	**33,700**	6,225	5,051	6,751	5,133
33,700	**33,750**	6,239	5,059	6,765	5,147
33,750	**33,800**	6,253	5,066	6,779	5,161
33,800	**33,850**	6,267	5,074	6,793	5,175
33,850	**33,900**	6,281	5,081	6,807	5,189
33,900	**33,950**	6,295	5,089	6,821	5,203
33,950	**34,000**	6,309	5,096	6,835	5,217
34,000					
34,000	**34,050**	6,323	5,104	6,849	5,231
34,050	**34,100**	6,337	5,111	6,863	5,245
34,100	**34,150**	6,351	5,119	6,877	5,259
34,150	**34,200**	6,365	5,126	6,891	5,273
34,200	**34,250**	6,379	5,134	6,905	5,287
34,250	**34,300**	6,393	5,141	6,919	5,301
34,300	**34,350**	6,407	5,149	6,933	5,315
34,350	**34,400**	6,421	5,156	6,947	5,329
34,400	**34,450**	6,435	5,164	6,961	5,343
34,450	**34,500**	6,449	5,171	6,975	5,357
34,500	**34,550**	6,463	5,179	6,989	5,371
34,550	**34,600**	6,477	5,186	7,003	5,385
34,600	**34,650**	6,491	5,194	7,017	5,399
34,650	**34,700**	6,505	5,201	7,031	5,413
34,700	**34,750**	6,519	5,209	7,045	5,427
34,750	**34,800**	6,533	5,216	7,059	5,441
34,800	**34,850**	6,547	5,224	7,073	5,455
34,850	**34,900**	6,561	5,231	7,087	5,469
34,900	**34,950**	6,575	5,239	7,101	5,483
34,950	**35,000**	6,589	5,246	7,115	5,497

If line 6 (Form 1040EZ), line 22 (Form 1040A), or line 38 (Form 1040) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing sepa-rately	Head of a house-hold
		Your tax is—			
35,000					
35,000	**35,050**	6,603	5,254	7,129	5,511
35,050	**35,100**	6,617	5,261	7,143	5,525
35,100	**35,150**	6,631	5,269	7,157	5,539
35,150	**35,200**	6,645	5,276	7,171	5,553
35,200	**35,250**	6,659	5,284	7,185	5,567
35,250	**35,300**	6,673	5,291	7,199	5,581
35,300	**35,350**	6,687	5,299	7,213	5,595
35,350	**35,400**	6,701	5,306	7,227	5,609
35,400	**35,450**	6,715	5,314	7,241	5,623
35,450	**35,500**	6,729	5,321	7,255	5,637
35,500	**35,550**	6,743	5,329	7,269	5,651
35,550	**35,600**	6,757	5,336	7,283	5,665
35,600	**35,650**	6,771	5,344	7,297	5,679
35,650	**35,700**	6,785	5,351	7,311	5,693
35,700	**35,750**	6,799	5,359	7,325	5,707
35,750	**35,800**	6,813	5,366	7,339	5,721
35,800	**35,850**	6,827	5,374	7,353	5,735
35,850	**35,900**	6,841	5,381	7,367	5,749
35,900	**35,950**	6,855	5,389	7,381	5,763
35,950	**36,000**	6,869	5,396	7,395	5,777
36,000					
36,000	**36,050**	6,883	5,404	7,409	5,791
36,050	**36,100**	6,897	5,411	7,423	5,805
36,100	**36,150**	6,911	5,419	7,437	5,819
36,150	**36,200**	6,925	5,426	7,451	5,833
36,200	**36,250**	6,939	5,434	7,465	5,847
36,250	**36,300**	6,953	5,441	7,479	5,861
36,300	**36,350**	6,967	5,449	7,493	5,875
36,350	**36,400**	6,981	5,456	7,507	5,889
36,400	**36,450**	6,995	5,464	7,521	5,903
36,450	**36,500**	7,009	5,471	7,535	5,917
36,500	**36,550**	7,023	5,479	7,549	5,931
36,550	**36,600**	7,037	5,486	7,563	5,945
36,600	**36,650**	7,051	5,494	7,577	5,959
36,650	**36,700**	7,065	5,501	7,591	5,973
36,700	**36,750**	7,079	5,509	7,605	5,987
36,750	**36,800**	7,093	5,516	7,619	6,001
36,800	**36,850**	7,107	5,524	7,633	6,015
36,850	**36,900**	7,121	5,531	7,647	6,029
36,900	**36,950**	7,135	5,539	7,661	6,043
36,950	**37,000**	7,149	5,546	7,675	6,057
37,000					
37,000	**37,050**	7,163	5,554	7,689	6,071
37,050	**37,100**	7,177	5,561	7,703	6,085
37,100	**37,150**	7,191	5,569	7,717	6,099
37,150	**37,200**	7,205	5,576	7,731	6,113
37,200	**37,250**	7,219	5,584	7,745	6,127
37,250	**37,300**	7,233	5,591	7,759	6,141
37,300	**37,350**	7,247	5,599	7,773	6,155
37,350	**37,400**	7,261	5,606	7,787	6,169
37,400	**37,450**	7,275	5,614	7,801	6,183
37,450	**37,500**	7,289	5,621	7,815	6,197
37,500	**37,550**	7,303	5,629	7,829	6,211
37,550	**37,600**	7,317	5,636	7,843	6,225
37,600	**37,650**	7,331	5,644	7,857	6,239
37,650	**37,700**	7,345	5,651	7,871	6,253
37,700	**37,750**	7,359	5,659	7,885	6,267
37,750	**37,800**	7,373	5,666	7,899	6,281
37,800	**37,850**	7,387	5,674	7,913	6,295
37,850	**37,900**	7,401	5,681	7,927	6,309
37,900	**37,950**	7,415	5,689	7,941	6,323
37,950	**38,000**	7,429	5,696	7,955	6,337

If line 6 (Form 1040EZ), line 22 (Form 1040A), or line 38 (Form 1040) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing sepa-rately	Head of a house-hold
		Your tax is—			
38,000					
38,000	**38,050**	7,443	5,704	7,969	6,351
38,050	**38,100**	7,457	5,711	7,983	6,365
38,100	**38,150**	7,471	5,719	7,997	6,379
38,150	**38,200**	7,485	5,726	8,011	6,393
38,200	**38,250**	7,499	5,734	8,025	6,407
38,250	**38,300**	7,513	5,741	8,039	6,421
38,300	**38,350**	7,527	5,749	8,053	6,435
38,350	**38,400**	7,541	5,756	8,067	6,449
38,400	**38,450**	7,555	5,764	8,081	6,463
38,450	**38,500**	7,569	5,771	8,095	6,477
38,500	**38,550**	7,583	5,779	8,109	6,491
38,550	**38,600**	7,597	5,786	8,123	6,505
38,600	**38,650**	7,611	5,794	8,137	6,519
38,650	**38,700**	7,625	5,801	8,151	6,533
38,700	**38,750**	7,639	5,809	8,165	6,547
38,750	**38,800**	7,653	5,816	8,179	6,561
38,800	**38,850**	7,667	5,824	8,193	6,575
38,850	**38,900**	7,681	5,831	8,207	6,589
38,900	**38,950**	7,695	5,839	8,221	6,603
38,950	**39,000**	7,709	5,846	8,235	6,617
39,000					
39,000	**39,050**	7,723	5,854	8,249	6,631
39,050	**39,100**	7,737	5,861	8,263	6,645
39,100	**39,150**	7,751	5,869	8,277	6,659
39,150	**39,200**	7,765	5,876	8,291	6,673
39,200	**39,250**	7,779	5,884	8,305	6,687
39,250	**39,300**	7,793	5,891	8,319	6,701
39,300	**39,350**	7,807	5,899	8,333	6,715
39,350	**39,400**	7,821	5,906	8,347	6,729
39,400	**39,450**	7,835	5,914	8,361	6,743
39,450	**39,500**	7,849	5,921	8,375	6,757
39,500	**39,550**	7,863	5,929	8,389	6,771
39,550	**39,600**	7,877	5,936	8,403	6,785
39,600	**39,650**	7,891	5,944	8,417	6,799
39,650	**39,700**	7,905	5,951	8,431	6,813
39,700	**39,750**	7,919	5,959	8,445	6,827
39,750	**39,800**	7,933	5,966	8,459	6,841
39,800	**39,850**	7,947	5,974	8,473	6,855
39,850	**39,900**	7,961	5,981	8,487	6,869
39,900	**39,950**	7,975	5,989	8,501	6,883
39,950	**40,000**	7,989	5,996	8,515	6,897
40,000					
40,000	**40,050**	8,003	6,004	8,529	6,911
40,050	**40,100**	8,017	6,011	8,543	6,925
40,100	**40,150**	8,031	6,019	8,557	6,939
40,150	**40,200**	8,045	6,026	8,571	6,953
40,200	**40,250**	8,059	6,034	8,585	6,967
40,250	**40,300**	8,073	6,041	8,599	6,981
40,300	**40,350**	8,087	6,049	8,613	6,995
40,350	**40,400**	8,101	6,056	8,627	7,009
40,400	**40,450**	8,115	6,064	8,641	7,023
40,450	**40,500**	8,129	6,071	8,655	7,037
40,500	**40,550**	8,143	6,079	8,669	7,051
40,550	**40,600**	8,157	6,086	8,683	7,065
40,600	**40,650**	8,171	6,094	8,697	7,079
40,650	**40,700**	8,185	6,101	8,711	7,093
40,700	**40,750**	8,199	6,109	8,725	7,107
40,750	**40,800**	8,213	6,116	8,739	7,121
40,800	**40,850**	8,227	6,124	8,753	7,135
40,850	**40,900**	8,241	6,131	8,767	7,149
40,900	**40,950**	8,255	6,139	8,781	7,163
40,950	**41,000**	8,269	6,146	8,795	7,177

* This column must also be used by a qualifying widow(er).

Continued on next page

If line 6 (Form 1040EZ), line 22 (Form 1040A), or line 38 (Form 1040) is— At least	But less than	And you are— Single	Married filing jointly *	Married filing sepa-rately	Head of a house-hold
		Your tax is—			
41,000					
41,000	**41,050**	8,283	6,154	8,809	7,191
41,050	**41,100**	8,297	6,161	8,823	7,205
41,100	**41,150**	8,311	6,169	8,837	7,219
41,150	**41,200**	8,325	6,176	8,851	7,233
41,200	**41,250**	8,339	6,187	8,865	7,247
41,250	**41,300**	8,353	6,201	8,879	7,261
41,300	**41,350**	8,367	6,215	8,893	7,275
41,350	**41,400**	8,381	6,229	8,907	7,289
41,400	**41,450**	8,395	6,243	8,921	7,303
41,450	**41,500**	8,409	6,257	8,935	7,317
41,500	**41,550**	8,423	6,271	8,949	7,331
41,550	**41,600**	8,437	6,285	8,963	7,345
41,600	**41,650**	8,451	6,299	8,977	7,359
41,650	**41,700**	8,465	6,313	8,991	7,373
41,700	**41,750**	8,479	6,327	9,005	7,387
41,750	**41,800**	8,493	6,341	9,019	7,401
41,800	**41,850**	8,507	6,355	9,033	7,415
41,850	**41,900**	8,521	6,369	9,047	7,429
41,900	**41,950**	8,535	6,383	9,061	7,443
41,950	**42,000**	8,549	6,397	9,075	7,457
42,000					
42,000	**42,050**	8,563	6,411	9,089	7,471
42,050	**42,100**	8,577	6,425	9,103	7,485
42,100	**42,150**	8,591	6,439	9,117	7,499
42,150	**42,200**	8,605	6,453	9,131	7,513
42,200	**42,250**	8,619	6,467	9,145	7,527
42,250	**42,300**	8,633	6,481	9,159	7,541
42,300	**42,350**	8,647	6,495	9,173	7,555
42,350	**42,400**	8,661	6,509	9,187	7,569
42,400	**42,450**	8,675	6,523	9,201	7,583
42,450	**42,500**	8,689	6,537	9,215	7,597
42,500	**42,550**	8,703	6,551	9,229	7,611
42,550	**42,600**	8,717	6,565	9,243	7,625
42,600	**42,650**	8,731	6,579	9,257	7,639
42,650	**42,700**	8,745	6,593	9,271	7,653
42,700	**42,750**	8,759	6,607	9,285	7,667
42,750	**42,800**	8,773	6,621	9,299	7,681
42,800	**42,850**	8,787	6,635	9,313	7,695
42,850	**42,900**	8,801	6,649	9,327	7,709
42,900	**42,950**	8,815	6,663	9,341	7,723
42,950	**43,000**	8,829	6,677	9,355	7,737
43,000					
43,000	**43,050**	8,843	6,691	9,369	7,751
43,050	**43,100**	8,857	6,705	9,383	7,765
43,100	**43,150**	8,871	6,719	9,397	7,779
43,150	**43,200**	8,885	6,733	9,411	7,793
43,200	**43,250**	8,899	6,747	9,425	7,807
43,250	**43,300**	8,913	6,761	9,439	7,821
43,300	**43,350**	8,927	6,775	9,453	7,835
43,350	**43,400**	8,941	6,789	9,467	7,849
43,400	**43,450**	8,955	6,803	9,481	7,863
43,450	**43,500**	8,969	6,817	9,495	7,877
43,500	**43,550**	8,983	6,831	9,509	7,891
43,550	**43,600**	8,997	6,845	9,523	7,905
43,600	**43,650**	9,011	6,859	9,537	7,919
43,650	**43,700**	9,025	6,873	9,551	7,933
43,700	**43,750**	9,039	6,887	9,565	7,947
43,750	**43,800**	9,053	6,901	9,579	7,961
43,800	**43,850**	9,067	6,915	9,593	7,975
43,850	**43,900**	9,081	6,929	9,607	7,989
43,900	**43,950**	9,095	6,943	9,621	8,003
43,950	**44,000**	9,109	6,957	9,635	8,017
44,000					
44,000	**44,050**	9,123	6,971	9,649	8,031
44,050	**44,100**	9,137	6,985	9,663	8,045
44,100	**44,150**	9,151	6,999	9,677	8,059
44,150	**44,200**	9,165	7,013	9,691	8,073
44,200	**44,250**	9,179	7,027	9,705	8,087
44,250	**44,300**	9,193	7,041	9,719	8,101
44,300	**44,350**	9,207	7,055	9,733	8,115
44,350	**44,400**	9,221	7,069	9,747	8,129
44,400	**44,450**	9,235	7,083	9,761	8,143
44,450	**44,500**	9,249	7,097	9,775	8,157
44,500	**44,550**	9,263	7,111	9,789	8,171
44,550	**44,600**	9,277	7,125	9,803	8,185
44,600	**44,650**	9,291	7,139	9,817	8,199
44,650	**44,700**	9,305	7,153	9,831	8,213
44,700	**44,750**	9,319	7,167	9,845	8,227
44,750	**44,800**	9,333	7,181	9,859	8,241
44,800	**44,850**	9,347	7,195	9,873	8,255
44,850	**44,900**	9,361	7,209	9,887	8,269
44,900	**44,950**	9,375	7,223	9,901	8,283
44,950	**45,000**	9,389	7,237	9,915	8,297
45,000					
45,000	**45,050**	9,403	7,251	9,929	8,311
45,050	**45,100**	9,417	7,265	9,943	8,325
45,100	**45,150**	9,431	7,279	9,957	8,339
45,150	**45,200**	9,445	7,293	9,971	8,353
45,200	**45,250**	9,459	7,307	9,985	8,367
45,250	**45,300**	9,473	7,321	9,999	8,381
45,300	**45,350**	9,487	7,335	10,013	8,395
45,350	**45,400**	9,501	7,349	10,027	8,409
45,400	**45,450**	9,515	7,363	10,041	8,423
45,450	**45,500**	9,529	7,377	10,055	8,437
45,500	**45,550**	9,543	7,391	10,069	8,451
45,550	**45,600**	9,557	7,405	10,083	8,465
45,600	**45,650**	9,571	7,419	10,097	8,479
45,650	**45,700**	9,585	7,433	10,111	8,493
45,700	**45,750**	9,599	7,447	10,125	8,507
45,750	**45,800**	9,613	7,461	10,139	8,521
45,800	**45,850**	9,627	7,475	10,153	8,535
45,850	**45,900**	9,641	7,489	10,167	8,549
45,900	**45,950**	9,655	7,503	10,181	8,563
45,950	**46,000**	9,669	7,517	10,195	8,577
46,000					
46,000	**46,050**	9,683	7,531	10,209	8,591
46,050	**46,100**	9,697	7,545	10,223	8,605
46,100	**46,150**	9,711	7,559	10,237	8,619
46,150	**46,200**	9,725	7,573	10,251	8,633
46,200	**46,250**	9,739	7,587	10,265	8,647
46,250	**46,300**	9,753	7,601	10,279	8,661
46,300	**46,350**	9,767	7,615	10,293	8,675
46,350	**46,400**	9,781	7,629	10,307	8,689
46,400	**46,450**	9,795	7,643	10,321	8,703
46,450	**46,500**	9,809	7,657	10,335	8,717
46,500	**46,550**	9,823	7,671	10,349	8,731
46,550	**46,600**	9,837	7,685	10,363	8,745
46,600	**46,650**	9,851	7,699	10,377	8,759
46,650	**46,700**	9,865	7,713	10,391	8,773
46,700	**46,750**	9,879	7,727	10,405	8,787
46,750	**46,800**	9,893	7,741	10,419	8,801
46,800	**46,850**	9,907	7,755	10,433	8,815
46,850	**46,900**	9,921	7,769	10,447	8,829
46,900	**46,950**	9,935	7,783	10,461	8,843
46,950	**47,000**	9,949	7,797	10,475	8,857
47,000					
47,000	**47,050**	9,963	7,811	10,489	8,871
47,050	**47,100**	9,977	7,825	10,503	8,885
47,100	**47,150**	9,991	7,839	10,517	8,899
47,150	**47,200**	10,005	7,853	10,531	8,913
47,200	**47,250**	10,019	7,867	10,545	8,927
47,250	**47,300**	10,033	7,881	10,559	8,941
47,300	**47,350**	10,047	7,895	10,573	8,955
47,350	**47,400**	10,061	7,909	10,587	8,969
47,400	**47,450**	10,075	7,923	10,601	8,983
47,450	**47,500**	10,089	7,937	10,615	8,997
47,500	**47,550**	10,103	7,951	10,629	9,011
47,550	**47,600**	10,117	7,965	10,643	9,025
47,600	**47,650**	10,131	7,979	10,657	9,039
47,650	**47,700**	10,145	7,993	10,671	9,053
47,700	**47,750**	10,159	8,007	10,685	9,067
47,750	**47,800**	10,173	8,021	10,699	9,081
47,800	**47,850**	10,187	8,035	10,713	9,095
47,850	**47,900**	10,201	8,049	10,727	9,109
47,900	**47,950**	10,215	8,063	10,741	9,123
47,950	**48,000**	10,229	8,077	10,755	9,137
48,000					
48,000	**48,050**	10,243	8,091	10,769	9,151
48,050	**48,100**	10,257	8,105	10,783	9,165
48,100	**48,150**	10,271	8,119	10,797	9,179
48,150	**48,200**	10,285	8,133	10,811	9,193
48,200	**48,250**	10,299	8,147	10,825	9,207
48,250	**48,300**	10,313	8,161	10,839	9,221
48,300	**48,350**	10,327	8,175	10,853	9,235
48,350	**48,400**	10,341	8,189	10,867	9,249
48,400	**48,450**	10,355	8,203	10,881	9,263
48,450	**48,500**	10,369	8,217	10,895	9,277
48,500	**48,550**	10,383	8,231	10,909	9,291
48,550	**48,600**	10,397	8,245	10,923	9,305
48,600	**48,650**	10,411	8,259	10,937	9,319
48,650	**48,700**	10,425	8,273	10,951	9,333
48,700	**48,750**	10,439	8,287	10,965	9,347
48,750	**48,800**	10,453	8,301	10,979	9,361
48,800	**48,850**	10,467	8,315	10,993	9,375
48,850	**48,900**	10,481	8,329	11,007	9,389
48,900	**48,950**	10,495	8,343	11,021	9,403
48,950	**49,000**	10,509	8,357	11,035	9,417
49,000					
49,000	**49,050**	10,523	8,371	11,049	9,431
49,050	**49,100**	10,537	8,385	11,063	9,445
49,100	**49,150**	10,551	8,399	11,077	9,459
49,150	**49,200**	10,565	8,413	11,091	9,473
49,200	**49,250**	10,579	8,427	11,105	9,487
49,250	**49,300**	10,593	8,441	11,119	9,501
49,300	**49,350**	10,607	8,455	11,133	9,515
49,350	**49,400**	10,621	8,469	11,147	9,529
49,400	**49,450**	10,635	8,483	11,161	9,543
49,450	**49,500**	10,649	8,497	11,175	9,557
49,500	**49,550**	10,663	8,511	11,189	9,571
49,550	**49,600**	10,677	8,525	11,203	9,585
49,600	**49,650**	10,691	8,539	11,217	9,599
49,650	**49,700**	10,705	8,553	11,231	9,613
49,700	**49,750**	10,719	8,567	11,245	9,627
49,750	**49,800**	10,733	8,581	11,259	9,641
49,800	**49,850**	10,747	8,595	11,274	9,655
49,850	**49,900**	10,761	8,609	11,289	9,669
49,900	**49,950**	10,775	8,623	11,305	9,683
49,950	**50,000**	10,789	8,637	11,320	9,697

* This column must also be used by a qualifying widow(er).

Continued on next page

If line 38 (taxable income) is— At least	But less than	And you are— Single	Married filing jointly *	Married filing sepa-rately	Head of a house-hold
		Your tax is—			
50,000					
50,000	**50,050**	10,803	8,651	11,336	9,711
50,050	**50,100**	10,817	8,665	11,351	9,725
50,100	**50,150**	10,831	8,679	11,367	9,739
50,150	**50,200**	10,845	8,693	11,382	9,753
50,200	**50,250**	10,859	8,707	11,398	9,767
50,250	**50,300**	10,873	8,721	11,413	9,781
50,300	**50,350**	10,887	8,735	11,429	9,795
50,350	**50,400**	10,901	8,749	11,444	9,809
50,400	**50,450**	10,915	8,763	11,460	9,823
50,450	**50,500**	10,929	8,777	11,475	9,837
50,500	**50,550**	10,943	8,791	11,491	9,851
50,550	**50,600**	10,957	8,805	11,506	9,865
50,600	**50,650**	10,971	8,819	11,522	9,879
50,650	**50,700**	10,985	8,833	11,537	9,893
50,700	**50,750**	10,999	8,847	11,553	9,907
50,750	**50,800**	11,013	8,861	11,568	9,921
50,800	**50,850**	11,027	8,875	11,584	9,935
50,850	**50,900**	11,041	8,889	11,599	9,949
50,900	**50,950**	11,055	8,903	11,615	9,963
50,950	**51,000**	11,069	8,917	11,630	9,977
51,000					
51,000	**51,050**	11,083	8,931	11,646	9,991
51,050	**51,100**	11,097	8,945	11,661	10,005
51,100	**51,150**	11,111	8,959	11,677	10,019
51,150	**51,200**	11,125	8,973	11,692	10,033
51,200	**51,250**	11,139	8,987	11,708	10,047
51,250	**51,300**	11,153	9,001	11,723	10,061
51,300	**51,350**	11,167	9,015	11,739	10,075
51,350	**51,400**	11,181	9,029	11,754	10,089
51,400	**51,450**	11,195	9,043	11,770	10,103
51,450	**51,500**	11,209	9,057	11,785	10,117
51,500	**51,550**	11,223	9,071	11,801	10,131
51,550	**51,600**	11,237	9,085	11,816	10,145
51,600	**51,650**	11,251	9,099	11,832	10,159
51,650	**51,700**	11,265	9,113	11,847	10,173
51,700	**51,750**	11,279	9,127	11,863	10,187
51,750	**51,800**	11,293	9,141	11,878	10,201
51,800	**51,850**	11,307	9,155	11,894	10,215
51,850	**51,900**	11,321	9,169	11,909	10,229
51,900	**51,950**	11,335	9,183	11,925	10,243
51,950	**52,000**	11,349	9,197	11,940	10,257
52,000					
52,000	**52,050**	11,363	9,211	11,956	10,271
52,050	**52,100**	11,377	9,225	11,971	10,285
52,100	**52,150**	11,391	9,239	11,987	10,299
52,150	**52,200**	11,405	9,253	12,002	10,313
52,200	**52,250**	11,419	9,267	12,018	10,327
52,250	**52,300**	11,433	9,281	12,033	10,341
52,300	**52,350**	11,447	9,295	12,049	10,355
52,350	**52,400**	11,461	9,309	12,064	10,369
52,400	**52,450**	11,475	9,323	12,080	10,383
52,450	**52,500**	11,489	9,337	12,095	10,397
52,500	**52,550**	11,503	9,351	12,111	10,411
52,550	**52,600**	11,517	9,365	12,126	10,425
52,600	**52,650**	11,531	9,379	12,142	10,439
52,650	**52,700**	11,545	9,393	12,157	10,453
52,700	**52,750**	11,559	9,407	12,173	10,467
52,750	**52,800**	11,573	9,421	12,188	10,481
52,800	**52,850**	11,587	9,435	12,204	10,495
52,850	**52,900**	11,601	9,449	12,219	10,509
52,900	**52,950**	11,615	9,463	12,235	10,523
52,950	**53,000**	11,629	9,477	12,250	10,537

If line 38 (taxable income) is— At least	But less than	And you are— Single	Married filing jointly *	Married filing sepa-rately	Head of a house-hold
		Your tax is—			
53,000					
53,000	**53,050**	11,643	9,491	12,266	10,551
53,050	**53,100**	11,657	9,505	12,281	10,565
53,100	**53,150**	11,671	9,519	12,297	10,579
53,150	**53,200**	11,685	9,533	12,312	10,593
53,200	**53,250**	11,699	9,547	12,328	10,607
53,250	**53,300**	11,713	9,561	12,343	10,621
53,300	**53,350**	11,727	9,575	12,359	10,635
53,350	**53,400**	11,741	9,589	12,374	10,649
53,400	**53,450**	11,755	9,603	12,390	10,663
53,450	**53,500**	11,769	9,617	12,405	10,677
53,500	**53,550**	11,783	9,631	12,421	10,691
53,550	**53,600**	11,797	9,645	12,436	10,705
53,600	**53,650**	11,811	9,659	12,452	10,719
53,650	**53,700**	11,825	9,673	12,467	10,733
53,700	**53,750**	11,839	9,687	12,483	10,747
53,750	**53,800**	11,853	9,701	12,498	10,761
53,800	**53,850**	11,867	9,715	12,514	10,775
53,850	**53,900**	11,881	9,729	12,529	10,789
53,900	**53,950**	11,895	9,743	12,545	10,803
53,950	**54,000**	11,909	9,757	12,560	10,817
54,000					
54,000	**54,050**	11,923	9,771	12,576	10,831
54,050	**54,100**	11,937	9,785	12,591	10,845
54,100	**54,150**	11,951	9,799	12,607	10,859
54,150	**54,200**	11,965	9,813	12,622	10,873
54,200	**54,250**	11,979	9,827	12,638	10,887
54,250	**54,300**	11,993	9,841	12,653	10,901
54,300	**54,350**	12,007	9,855	12,669	10,915
54,350	**54,400**	12,021	9,869	12,684	10,929
54,400	**54,450**	12,035	9,883	12,700	10,943
54,450	**54,500**	12,049	9,897	12,715	10,957
54,500	**54,550**	12,063	9,911	12,731	10,971
54,550	**54,600**	12,077	9,925	12,746	10,985
54,600	**54,650**	12,091	9,939	12,762	10,999
54,650	**54,700**	12,105	9,953	12,777	11,013
54,700	**54,750**	12,119	9,967	12,793	11,027
54,750	**54,800**	12,133	9,981	12,808	11,041
54,800	**54,850**	12,147	9,995	12,824	11,055
54,850	**54,900**	12,161	10,009	12,839	11,069
54,900	**54,950**	12,175	10,023	12,855	11,083
54,950	**55,000**	12,189	10,037	12,870	11,097
55,000					
55,000	**55,050**	12,203	10,051	12,886	11,111
55,050	**55,100**	12,217	10,065	12,901	11,125
55,100	**55,150**	12,231	10,079	12,917	11,139
55,150	**55,200**	12,245	10,093	12,932	11,153
55,200	**55,250**	12,259	10,107	12,948	11,167
55,250	**55,300**	12,273	10,121	12,963	11,181
55,300	**55,350**	12,287	10,135	12,979	11,195
55,350	**55,400**	12,301	10,149	12,994	11,209
55,400	**55,450**	12,315	10,163	13,010	11,223
55,450	**55,500**	12,329	10,177	13,025	11,237
55,500	**55,550**	12,343	10,191	13,041	11,251
55,550	**55,600**	12,357	10,205	13,056	11,265
55,600	**55,650**	12,371	10,219	13,072	11,279
55,650	**55,700**	12,385	10,233	13,087	11,293
55,700	**55,750**	12,399	10,247	13,103	11,307
55,750	**55,800**	12,413	10,261	13,118	11,321
55,800	**55,850**	12,427	10,275	13,134	11,335
55,850	**55,900**	12,441	10,289	13,149	11,349
55,900	**55,950**	12,455	10,303	13,165	11,363
55,950	**56,000**	12,469	10,317	13,180	11,377

If line 38 (taxable income) is— At least	But less than	And you are— Single	Married filing jointly *	Married filing sepa-rately	Head of a house-hold
		Your tax is—			
56,000					
56,000	**56,050**	12,483	10,331	13,196	11,391
56,050	**56,100**	12,497	10,345	13,211	11,405
56,100	**56,150**	12,511	10,359	13,227	11,419
56,150	**56,200**	12,525	10,373	13,242	11,433
56,200	**56,250**	12,539	10,387	13,258	11,447
56,250	**56,300**	12,553	10,401	13,273	11,461
56,300	**56,350**	12,567	10,415	13,289	11,475
56,350	**56,400**	12,581	10,429	13,304	11,489
56,400	**56,450**	12,595	10,443	13,320	11,503
56,450	**56,500**	12,609	10,457	13,335	11,517
56,500	**56,550**	12,623	10,471	13,351	11,531
56,550	**56,600**	12,637	10,485	13,366	11,545
56,600	**56,650**	12,651	10,499	13,382	11,559
56,650	**56,700**	12,665	10,513	13,397	11,573
56,700	**56,750**	12,679	10,527	13,413	11,587
56,750	**56,800**	12,693	10,541	13,428	11,601
56,800	**56,850**	12,707	10,555	13,444	11,615
56,850	**56,900**	12,721	10,569	13,459	11,629
56,900	**56,950**	12,735	10,583	13,475	11,643
56,950	**57,000**	12,749	10,597	13,490	11,657
57,000					
57,000	**57,050**	12,763	10,611	13,506	11,671
57,050	**57,100**	12,777	10,625	13,521	11,685
57,100	**57,150**	12,791	10,639	13,537	11,699
57,150	**57,200**	12,805	10,653	13,552	11,713
57,200	**57,250**	12,819	10,667	13,568	11,727
57,250	**57,300**	12,833	10,681	13,583	11,741
57,300	**57,350**	12,847	10,695	13,599	11,755
57,350	**57,400**	12,861	10,709	13,614	11,769
57,400	**57,450**	12,875	10,723	13,630	11,783
57,450	**57,500**	12,889	10,737	13,645	11,797
57,500	**57,550**	12,903	10,751	13,661	11,811
57,550	**57,600**	12,917	10,765	13,676	11,825
57,600	**57,650**	12,931	10,779	13,692	11,839
57,650	**57,700**	12,945	10,793	13,707	11,853
57,700	**57,750**	12,959	10,807	13,723	11,867
57,750	**57,800**	12,973	10,821	13,738	11,881
57,800	**57,850**	12,987	10,835	13,754	11,895
57,850	**57,900**	13,001	10,849	13,769	11,909
57,900	**57,950**	13,015	10,863	13,785	11,923
57,950	**58,000**	13,029	10,877	13,800	11,937
58,000					
58,000	**58,050**	13,043	10,891	13,816	11,951
58,050	**58,100**	13,057	10,905	13,831	11,965
58,100	**58,150**	13,071	10,919	13,847	11,979
58,150	**58,200**	13,085	10,933	13,862	11,993
58,200	**58,250**	13,099	10,947	13,878	12,007
58,250	**58,300**	13,113	10,961	13,893	12,021
58,300	**58,350**	13,127	10,975	13,909	12,035
58,350	**58,400**	13,141	10,989	13,924	12,049
58,400	**58,450**	13,155	11,003	13,940	12,063
58,450	**58,500**	13,169	11,017	13,955	12,077
58,500	**58,550**	13,183	11,031	13,971	12,091
58,550	**58,600**	13,197	11,045	13,986	12,105
58,600	**58,650**	13,211	11,059	14,002	12,119
58,650	**58,700**	13,225	11,073	14,017	12,133
58,700	**58,750**	13,239	11,087	14,033	12,147
58,750	**58,800**	13,253	11,101	14,048	12,161
58,800	**58,850**	13,267	11,115	14,064	12,175
58,850	**58,900**	13,281	11,129	14,079	12,189
58,900	**58,950**	13,295	11,143	14,095	12,203
58,950	**59,000**	13,309	11,157	14,110	12,217

* This column must also be used by a qualifying widow(er).

Continued on next page

If line 38 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing sepa-rately	Head of a house-hold
		Your tax is—			
59,000					
59,000	**59,050**	13,323	11,171	14,126	12,231
59,050	**59,100**	13,337	11,185	14,141	12,245
59,100	**59,150**	13,351	11,199	14,157	12,259
59,150	**59,200**	13,365	11,213	14,172	12,273
59,200	**59,250**	13,379	11,227	14,188	12,287
59,250	**59,300**	13,393	11,241	14,203	12,301
59,300	**59,350**	13,407	11,255	14,219	12,315
59,350	**59,400**	13,421	11,269	14,234	12,329
59,400	**59,450**	13,435	11,283	14,250	12,343
59,450	**59,500**	13,449	11,297	14,265	12,357
59,500	**59,550**	13,463	11,311	14,281	12,371
59,550	**59,600**	13,477	11,325	14,296	12,385
59,600	**59,650**	13,491	11,339	14,312	12,399
59,650	**59,700**	13,505	11,353	14,327	12,413
59,700	**59,750**	13,519	11,367	14,343	12,427
59,750	**59,800**	13,533	11,381	14,358	12,441
59,800	**59,850**	13,549	11,395	14,374	12,455
59,850	**59,900**	13,564	11,409	14,389	12,469
59,900	**59,950**	13,580	11,423	14,405	12,483
59,950	**60,000**	13,595	11,437	14,420	12,497
60,000					
60,000	**60,050**	13,611	11,451	14,436	12,511
60,050	**60,100**	13,626	11,465	14,451	12,525
60,100	**60,150**	13,642	11,479	14,467	12,539
60,150	**60,200**	13,657	11,493	14,482	12,553
60,200	**60,250**	13,673	11,507	14,498	12,567
60,250	**60,300**	13,688	11,521	14,513	12,581
60,300	**60,350**	13,704	11,535	14,529	12,595
60,350	**60,400**	13,719	11,549	14,544	12,609
60,400	**60,450**	13,735	11,563	14,560	12,623
60,450	**60,500**	13,750	11,577	14,575	12,637
60,500	**60,550**	13,766	11,591	14,591	12,651
60,550	**60,600**	13,781	11,605	14,606	12,665
60,600	**60,650**	13,797	11,619	14,622	12,679
60,650	**60,700**	13,812	11,633	14,637	12,693
60,700	**60,750**	13,828	11,647	14,653	12,707
60,750	**60,800**	13,843	11,661	14,668	12,721
60,800	**60,850**	13,859	11,675	14,684	12,735
60,850	**60,900**	13,874	11,689	14,699	12,749
60,900	**60,950**	13,890	11,703	14,715	12,763
60,950	**61,000**	13,905	11,717	14,730	12,777
61,000					
61,000	**61,050**	13,921	11,731	14,746	12,791
61,050	**61,100**	13,936	11,745	14,761	12,805
61,100	**61,150**	13,952	11,759	14,777	12,819
61,150	**61,200**	13,967	11,773	14,792	12,833
61,200	**61,250**	13,983	11,787	14,808	12,847
61,250	**61,300**	13,998	11,801	14,823	12,861
61,300	**61,350**	14,014	11,815	14,839	12,875
61,350	**61,400**	14,029	11,829	14,854	12,889
61,400	**61,450**	14,045	11,843	14,870	12,903
61,450	**61,500**	14,060	11,857	14,885	12,917
61,500	**61,550**	14,076	11,871	14,901	12,931
61,550	**61,600**	14,091	11,885	14,916	12,945
61,600	**61,650**	14,107	11,899	14,932	12,959
61,650	**61,700**	14,122	11,913	14,947	12,973
61,700	**61,750**	14,138	11,927	14,963	12,987
61,750	**61,800**	14,153	11,941	14,978	13,001
61,800	**61,850**	14,169	11,955	14,994	13,015
61,850	**61,900**	14,184	11,969	15,009	13,029
61,900	**61,950**	14,200	11,983	15,025	13,043
61,950	**62,000**	14,215	11,997	15,040	13,057
62,000					
62,000	**62,050**	14,231	12,011	15,056	13,071
62,050	**62,100**	14,246	12,025	15,071	13,085
62,100	**62,150**	14,262	12,039	15,087	13,099
62,150	**62,200**	14,277	12,053	15,102	13,113
62,200	**62,250**	14,293	12,067	15,118	13,127
62,250	**62,300**	14,308	12,081	15,133	13,141
62,300	**62,350**	14,324	12,095	15,149	13,155
62,350	**62,400**	14,339	12,109	15,164	13,169
62,400	**62,450**	14,355	12,123	15,180	13,183
62,450	**62,500**	14,370	12,137	15,195	13,197
62,500	**62,550**	14,386	12,151	15,211	13,211
62,550	**62,600**	14,401	12,165	15,226	13,225
62,600	**62,650**	14,417	12,179	15,242	13,239
62,650	**62,700**	14,432	12,193	15,257	13,253
62,700	**62,750**	14,448	12,207	15,273	13,267
62,750	**62,800**	14,463	12,221	15,288	13,281
62,800	**62,850**	14,479	12,235	15,304	13,295
62,850	**62,900**	14,494	12,249	15,319	13,309
62,900	**62,950**	14,510	12,263	15,335	13,323
62,950	**63,000**	14,525	12,277	15,350	13,337
63,000					
63,000	**63,050**	14,541	12,291	15,366	13,351
63,050	**63,100**	14,556	12,305	15,381	13,365
63,100	**63,150**	14,572	12,319	15,397	13,379
63,150	**63,200**	14,587	12,333	15,412	13,393
63,200	**63,250**	14,603	12,347	15,428	13,407
63,250	**63,300**	14,618	12,361	15,443	13,421
63,300	**63,350**	14,634	12,375	15,459	13,435
63,350	**63,400**	14,649	12,389	15,474	13,449
63,400	**63,450**	14,665	12,403	15,490	13,463
63,450	**63,500**	14,680	12,417	15,505	13,477
63,500	**63,550**	14,696	12,431	15,521	13,491
63,550	**63,600**	14,711	12,445	15,536	13,505
63,600	**63,650**	14,727	12,459	15,552	13,519
63,650	**63,700**	14,742	12,473	15,567	13,533
63,700	**63,750**	14,758	12,487	15,583	13,547
63,750	**63,800**	14,773	12,501	15,598	13,561
63,800	**63,850**	14,789	12,515	15,614	13,575
63,850	**63,900**	14,804	12,529	15,629	13,589
63,900	**63,950**	14,820	12,543	15,645	13,603
63,950	**64,000**	14,835	12,557	15,660	13,617
64,000					
64,000	**64,050**	14,851	12,571	15,676	13,631
64,050	**64,100**	14,866	12,585	15,691	13,645
64,100	**64,150**	14,882	12,599	15,707	13,659
64,150	**64,200**	14,897	12,613	15,722	13,673
64,200	**64,250**	14,913	12,627	15,738	13,687
64,250	**64,300**	14,928	12,641	15,753	13,701
64,300	**64,350**	14,944	12,655	15,769	13,715
64,350	**64,400**	14,959	12,669	15,784	13,729
64,400	**64,450**	14,975	12,683	15,800	13,743
64,450	**64,500**	14,990	12,697	15,815	13,757
64,500	**64,550**	15,006	12,711	15,831	13,771
64,550	**64,600**	15,021	12,725	15,846	13,785
64,600	**64,650**	15,037	12,739	15,862	13,799
64,650	**64,700**	15,052	12,753	15,877	13,813
64,700	**64,750**	15,068	12,767	15,893	13,827
64,750	**64,800**	15,083	12,781	15,908	13,841
64,800	**64,850**	15,099	12,795	15,924	13,855
64,850	**64,900**	15,114	12,809	15,939	13,869
64,900	**64,950**	15,130	12,823	15,955	13,883
64,950	**65,000**	15,145	12,837	15,970	13,897
65,000					
65,000	**65,050**	15,161	12,851	15,986	13,911
65,050	**65,100**	15,176	12,865	16,001	13,925
65,100	**65,150**	15,192	12,879	16,017	13,939
65,150	**65,200**	15,207	12,893	16,032	13,953
65,200	**65,250**	15,223	12,907	16,048	13,967
65,250	**65,300**	15,238	12,921	16,063	13,981
65,300	**65,350**	15,254	12,935	16,079	13,995
65,350	**65,400**	15,269	12,949	16,094	14,009
65,400	**65,450**	15,285	12,963	16,110	14,023
65,450	**65,500**	15,300	12,977	16,125	14,037
65,500	**65,550**	15,316	12,991	16,141	14,051
65,550	**65,600**	15,331	13,005	16,156	14,065
65,600	**65,650**	15,347	13,019	16,172	14,079
65,650	**65,700**	15,362	13,033	16,187	14,093
65,700	**65,750**	15,378	13,047	16,203	14,107
65,750	**65,800**	15,393	13,061	16,218	14,121
65,800	**65,850**	15,409	13,075	16,234	14,135
65,850	**65,900**	15,424	13,089	16,249	14,149
65,900	**65,950**	15,440	13,103	16,265	14,163
65,950	**66,000**	15,455	13,117	16,280	14,177
66,000					
66,000	**66,050**	15,471	13,131	16,296	14,191
66,050	**66,100**	15,486	13,145	16,311	14,205
66,100	**66,150**	15,502	13,159	16,327	14,219
66,150	**66,200**	15,517	13,173	16,342	14,233
66,200	**66,250**	15,533	13,187	16,358	14,247
66,250	**66,300**	15,548	13,201	16,373	14,261
66,300	**66,350**	15,564	13,215	16,389	14,275
66,350	**66,400**	15,579	13,229	16,404	14,289
66,400	**66,450**	15,595	13,243	16,420	14,303
66,450	**66,500**	15,610	13,257	16,435	14,317
66,500	**66,550**	15,626	13,271	16,451	14,331
66,550	**66,600**	15,641	13,285	16,466	14,345
66,600	**66,650**	15,657	13,299	16,482	14,359
66,650	**66,700**	15,672	13,313	16,497	14,373
66,700	**66,750**	15,688	13,327	16,513	14,387
66,750	**66,800**	15,703	13,341	16,528	14,401
66,800	**66,850**	15,719	13,355	16,544	14,415
66,850	**66,900**	15,734	13,369	16,559	14,429
66,900	**66,950**	15,750	13,383	16,575	14,443
66,950	**67,000**	15,765	13,397	16,590	14,457
67,000					
67,000	**67,050**	15,781	13,411	16,606	14,471
67,050	**67,100**	15,796	13,425	16,621	14,485
67,100	**67,150**	15,812	13,439	16,637	14,499
67,150	**67,200**	15,827	13,453	16,652	14,513
67,200	**67,250**	15,843	13,467	16,668	14,527
67,250	**67,300**	15,858	13,481	16,683	14,541
67,300	**67,350**	15,874	13,495	16,699	14,555
67,350	**67,400**	15,889	13,509	16,714	14,569
67,400	**67,450**	15,905	13,523	16,730	14,583
67,450	**67,500**	15,920	13,537	16,745	14,597
67,500	**67,550**	15,936	13,551	16,761	14,611
67,550	**67,600**	15,951	13,565	16,776	14,625
67,600	**67,650**	15,967	13,579	16,792	14,639
67,650	**67,700**	15,982	13,593	16,807	14,653
67,700	**67,750**	15,998	13,607	16,823	14,667
67,750	**67,800**	16,013	13,621	16,838	14,681
67,800	**67,850**	16,029	13,635	16,854	14,695
67,850	**67,900**	16,044	13,649	16,869	14,709
67,900	**67,950**	16,060	13,663	16,885	14,723
67,950	**68,000**	16,075	13,677	16,900	14,737

* This column must also be used by a qualifying widow(er).

Continued on next page

If line 38 (taxable income) is— At least	But less than	And you are— Single	Married filing jointly *	Married filing sepa-rately	Head of a house-hold
		Your tax is—			
68,000					
68,000	**68,050**	16,091	13,691	16,916	14,751
68,050	**68,100**	16,106	13,705	16,931	14,765
68,100	**68,150**	16,122	13,719	16,947	14,779
68,150	**68,200**	16,137	13,733	16,962	14,793
68,200	**68,250**	16,153	13,747	16,978	14,807
68,250	**68,300**	16,168	13,761	16,993	14,821
68,300	**68,350**	16,184	13,775	17,009	14,835
68,350	**68,400**	16,199	13,789	17,024	14,849
68,400	**68,450**	16,215	13,803	17,040	14,863
68,450	**68,500**	16,230	13,817	17,055	14,877
68,500	**68,550**	16,246	13,831	17,071	14,891
68,550	**68,600**	16,261	13,845	17,086	14,905
68,600	**68,650**	16,277	13,859	17,102	14,919
68,650	**68,700**	16,292	13,873	17,117	14,933
68,700	**68,750**	16,308	13,887	17,133	14,947
68,750	**68,800**	16,323	13,901	17,148	14,961
68,800	**68,850**	16,339	13,915	17,164	14,975
68,850	**68,900**	16,354	13,929	17,179	14,989
68,900	**68,950**	16,370	13,943	17,195	15,003
68,950	**69,000**	16,385	13,957	17,210	15,017
69,000					
69,000	**69,050**	16,401	13,971	17,226	15,031
69,050	**69,100**	16,416	13,985	17,241	15,045
69,100	**69,150**	16,432	13,999	17,257	15,059
69,150	**69,200**	16,447	14,013	17,272	15,073
69,200	**69,250**	16,463	14,027	17,288	15,087
69,250	**69,300**	16,478	14,041	17,303	15,101
69,300	**69,350**	16,494	14,055	17,319	15,115
69,350	**69,400**	16,509	14,069	17,334	15,129
69,400	**69,450**	16,525	14,083	17,350	15,143
69,450	**69,500**	16,540	14,097	17,365	15,157
69,500	**69,550**	16,556	14,111	17,381	15,171
69,550	**69,600**	16,571	14,125	17,396	15,185
69,600	**69,650**	16,587	14,139	17,412	15,199
69,650	**69,700**	16,602	14,153	17,427	15,213
69,700	**69,750**	16,618	14,167	17,443	15,227
69,750	**69,800**	16,633	14,181	17,458	15,241
69,800	**69,850**	16,649	14,195	17,474	15,255
69,850	**69,900**	16,664	14,209	17,489	15,269
69,900	**69,950**	16,680	14,223	17,505	15,283
69,950	**70,000**	16,695	14,237	17,520	15,297
70,000					
70,000	**70,050**	16,711	14,251	17,536	15,311
70,050	**70,100**	16,726	14,265	17,551	15,325
70,100	**70,150**	16,742	14,279	17,567	15,339
70,150	**70,200**	16,757	14,293	17,582	15,353
70,200	**70,250**	16,773	14,307	17,598	15,367
70,250	**70,300**	16,788	14,321	17,613	15,381
70,300	**70,350**	16,804	14,335	17,629	15,395
70,350	**70,400**	16,819	14,349	17,644	15,409
70,400	**70,450**	16,835	14,363	17,660	15,423
70,450	**70,500**	16,850	14,377	17,675	15,437
70,500	**70,550**	16,866	14,391	17,691	15,451
70,550	**70,600**	16,881	14,405	17,706	15,465
70,600	**70,650**	16,897	14,419	17,722	15,479
70,650	**70,700**	16,912	14,433	17,737	15,493
70,700	**70,750**	16,928	14,447	17,753	15,507
70,750	**70,800**	16,943	14,461	17,768	15,521
70,800	**70,850**	16,959	14,475	17,784	15,535
70,850	**70,900**	16,974	14,489	17,799	15,549
70,900	**70,950**	16,990	14,503	17,815	15,563
70,950	**71,000**	17,005	14,517	17,830	15,577

If line 38 (taxable income) is— At least	But less than	And you are— Single	Married filing jointly *	Married filing sepa-rately	Head of a house-hold
		Your tax is—			
71,000					
71,000	**71,050**	17,021	14,531	17,846	15,591
71,050	**71,100**	17,036	14,545	17,861	15,605
71,100	**71,150**	17,052	14,559	17,877	15,619
71,150	**71,200**	17,067	14,573	17,892	15,633
71,200	**71,250**	17,083	14,587	17,908	15,647
71,250	**71,300**	17,098	14,601	17,923	15,661
71,300	**71,350**	17,114	14,615	17,939	15,675
71,350	**71,400**	17,129	14,629	17,954	15,689
71,400	**71,450**	17,145	14,643	17,970	15,703
71,450	**71,500**	17,160	14,657	17,985	15,717
71,500	**71,550**	17,176	14,671	18,001	15,731
71,550	**71,600**	17,191	14,685	18,016	15,745
71,600	**71,650**	17,207	14,699	18,032	15,759
71,650	**71,700**	17,222	14,713	18,047	15,773
71,700	**71,750**	17,238	14,727	18,063	15,787
71,750	**71,800**	17,253	14,741	18,078	15,801
71,800	**71,850**	17,269	14,755	18,094	15,815
71,850	**71,900**	17,284	14,769	18,109	15,829
71,900	**71,950**	17,300	14,783	18,125	15,843
71,950	**72,000**	17,315	14,797	18,140	15,857
72,000					
72,000	**72,050**	17,331	14,811	18,156	15,871
72,050	**72,100**	17,346	14,825	18,171	15,885
72,100	**72,150**	17,362	14,839	18,187	15,899
72,150	**72,200**	17,377	14,853	18,202	15,913
72,200	**72,250**	17,393	14,867	18,218	15,927
72,250	**72,300**	17,408	14,881	18,233	15,941
72,300	**72,350**	17,424	14,895	18,249	15,955
72,350	**72,400**	17,439	14,909	18,264	15,969
72,400	**72,450**	17,455	14,923	18,280	15,983
72,450	**72,500**	17,470	14,937	18,295	15,997
72,500	**72,550**	17,486	14,951	18,311	16,011
72,550	**72,600**	17,501	14,965	18,326	16,025
72,600	**72,650**	17,517	14,979	18,342	16,039
72,650	**72,700**	17,532	14,993	18,357	16,053
72,700	**72,750**	17,548	15,007	18,373	16,067
72,750	**72,800**	17,563	15,021	18,388	16,081
72,800	**72,850**	17,579	15,035	18,404	16,095
72,850	**72,900**	17,594	15,049	18,419	16,109
72,900	**72,950**	17,610	15,063	18,435	16,123
72,950	**73,000**	17,625	15,077	18,450	16,137
73,000					
73,000	**73,050**	17,641	15,091	18,466	16,151
73,050	**73,100**	17,656	15,105	18,481	16,165
73,100	**73,150**	17,672	15,119	18,497	16,179
73,150	**73,200**	17,687	15,133	18,512	16,193
73,200	**73,250**	17,703	15,147	18,528	16,207
73,250	**73,300**	17,718	15,161	18,543	16,221
73,300	**73,350**	17,734	15,175	18,559	16,235
73,350	**73,400**	17,749	15,189	18,574	16,249
73,400	**73,450**	17,765	15,203	18,590	16,263
73,450	**73,500**	17,780	15,217	18,605	16,277
73,500	**73,550**	17,796	15,231	18,621	16,291
73,550	**73,600**	17,811	15,245	18,636	16,305
73,600	**73,650**	17,827	15,259	18,652	16,319
73,650	**73,700**	17,842	15,273	18,667	16,333
73,700	**73,750**	17,858	15,287	18,683	16,347
73,750	**73,800**	17,873	15,301	18,698	16,361
73,800	**73,850**	17,889	15,315	18,714	16,375
73,850	**73,900**	17,904	15,329	18,729	16,389
73,900	**73,950**	17,920	15,343	18,745	16,403
73,950	**74,000**	17,935	15,357	18,760	16,417

If line 38 (taxable income) is— At least	But less than	And you are— Single	Married filing jointly *	Married filing sepa-rately	Head of a house-hold
		Your tax is—			
74,000					
74,000	**74,050**	17,951	15,371	18,776	16,431
74,050	**74,100**	17,966	15,385	18,791	16,445
74,100	**74,150**	17,982	15,399	18,807	16,459
74,150	**74,200**	17,997	15,413	18,822	16,473
74,200	**74,250**	18,013	15,427	18,838	16,487
74,250	**74,300**	18,028	15,441	18,853	16,501
74,300	**74,350**	18,044	15,455	18,869	16,515
74,350	**74,400**	18,059	15,469	18,884	16,529
74,400	**74,450**	18,075	15,483	18,900	16,543
74,450	**74,500**	18,090	15,497	18,915	16,557
74,500	**74,550**	18,106	15,511	18,931	16,571
74,550	**74,600**	18,121	15,525	18,946	16,585
74,600	**74,650**	18,137	15,539	18,962	16,599
74,650	**74,700**	18,152	15,553	18,977	16,613
74,700	**74,750**	18,168	15,567	18,993	16,627
74,750	**74,800**	18,183	15,581	19,008	16,641
74,800	**74,850**	18,199	15,595	19,024	16,655
74,850	**74,900**	18,214	15,609	19,039	16,669
74,900	**74,950**	18,230	15,623	19,055	16,683
74,950	**75,000**	18,245	15,637	19,070	16,697
75,000					
75,000	**75,050**	18,261	15,651	19,086	16,711
75,050	**75,100**	18,276	15,665	19,101	16,725
75,100	**75,150**	18,292	15,679	19,117	16,739
75,150	**75,200**	18,307	15,693	19,132	16,753
75,200	**75,250**	18,323	15,707	19,148	16,767
75,250	**75,300**	18,338	15,721	19,163	16,781
75,300	**75,350**	18,354	15,735	19,179	16,795
75,350	**75,400**	18,369	15,749	19,194	16,809
75,400	**75,450**	18,385	15,763	19,210	16,823
75,450	**75,500**	18,400	15,777	19,225	16,837
75,500	**75,550**	18,416	15,791	19,241	16,851
75,550	**75,600**	18,431	15,805	19,256	16,865
75,600	**75,650**	18,447	15,819	19,272	16,879
75,650	**75,700**	18,462	15,833	19,287	16,893
75,700	**75,750**	18,478	15,847	19,303	16,907
75,750	**75,800**	18,493	15,861	19,318	16,921
75,800	**75,850**	18,509	15,875	19,334	16,935
75,850	**75,900**	18,524	15,889	19,349	16,949
75,900	**75,950**	18,540	15,903	19,367	16,963
75,950	**76,000**	18,555	15,917	19,385	16,977
76,000					
76,000	**76,050**	18,571	15,931	19,403	16,991
76,050	**76,100**	18,586	15,945	19,421	17,005
76,100	**76,150**	18,602	15,959	19,439	17,019
76,150	**76,200**	18,617	15,973	19,457	17,033
76,200	**76,250**	18,633	15,987	19,475	17,047
76,250	**76,300**	18,648	16,001	19,493	17,061
76,300	**76,350**	18,664	16,015	19,511	17,075
76,350	**76,400**	18,679	16,029	19,529	17,089
76,400	**76,450**	18,695	16,043	19,547	17,103
76,450	**76,500**	18,710	16,057	19,565	17,117
76,500	**76,550**	18,726	16,071	19,583	17,131
76,550	**76,600**	18,741	16,085	19,601	17,145
76,600	**76,650**	18,757	16,099	19,619	17,159
76,650	**76,700**	18,772	16,113	19,637	17,173
76,700	**76,750**	18,788	16,127	19,655	17,187
76,750	**76,800**	18,803	16,141	19,673	17,201
76,800	**76,850**	18,819	16,155	19,691	17,215
76,850	**76,900**	18,834	16,169	19,709	17,229
76,900	**76,950**	18,850	16,183	19,727	17,243
76,950	**77,000**	18,865	16,197	19,745	17,257

* This column must also be used by a qualifying widow(er).

Continued on next page

If line 38 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing sepa-rately	Head of a house-hold
		Your tax is—			
77,000					
77,000	**77,050**	18,881	16,211	19,763	17,271
77,050	**77,100**	18,896	16,225	19,781	17,285
77,100	**77,150**	18,912	16,239	19,799	17,299
77,150	**77,200**	18,927	16,253	19,817	17,313
77,200	**77,250**	18,943	16,267	19,835	17,327
77,250	**77,300**	18,958	16,281	19,853	17,341
77,300	**77,350**	18,974	16,295	19,871	17,355
77,350	**77,400**	18,989	16,309	19,889	17,369
77,400	**77,450**	19,005	16,323	19,907	17,383
77,450	**77,500**	19,020	16,337	19,925	17,397
77,500	**77,550**	19,036	16,351	19,943	17,411
77,550	**77,600**	19,051	16,365	19,961	17,425
77,600	**77,650**	19,067	16,379	19,979	17,439
77,650	**77,700**	19,082	16,393	19,997	17,453
77,700	**77,750**	19,098	16,407	20,015	17,467
77,750	**77,800**	19,113	16,421	20,033	17,481
77,800	**77,850**	19,129	16,435	20,051	17,495
77,850	**77,900**	19,144	16,449	20,069	17,509
77,900	**77,950**	19,160	16,463	20,087	17,523
77,950	**78,000**	19,175	16,477	20,105	17,537
78,000					
78,000	**78,050**	19,191	16,491	20,123	17,551
78,050	**78,100**	19,206	16,505	20,141	17,565
78,100	**78,150**	19,222	16,519	20,159	17,579
78,150	**78,200**	19,237	16,533	20,177	17,593
78,200	**78,250**	19,253	16,547	20,195	17,607
78,250	**78,300**	19,268	16,561	20,213	17,621
78,300	**78,350**	19,284	16,575	20,231	17,635
78,350	**78,400**	19,299	16,589	20,249	17,649
78,400	**78,450**	19,315	16,603	20,267	17,663
78,450	**78,500**	19,330	16,617	20,285	17,677
78,500	**78,550**	19,346	16,631	20,303	17,691
78,550	**78,600**	19,361	16,645	20,321	17,705
78,600	**78,650**	19,377	16,659	20,339	17,719
78,650	**78,700**	19,392	16,673	20,357	17,733
78,700	**78,750**	19,408	16,687	20,375	17,747
78,750	**78,800**	19,423	16,701	20,393	17,761
78,800	**78,850**	19,439	16,715	20,411	17,775
78,850	**78,900**	19,454	16,729	20,429	17,789
78,900	**78,950**	19,470	16,743	20,447	17,803
78,950	**79,000**	19,485	16,757	20,465	17,817
79,000					
79,000	**79,050**	19,501	16,771	20,483	17,831
79,050	**79,100**	19,516	16,785	20,501	17,845
79,100	**79,150**	19,532	16,799	20,519	17,859
79,150	**79,200**	19,547	16,813	20,537	17,873
79,200	**79,250**	19,563	16,827	20,555	17,887
79,250	**79,300**	19,578	16,841	20,573	17,901
79,300	**79,350**	19,594	16,855	20,591	17,915
79,350	**79,400**	19,609	16,869	20,609	17,929
79,400	**79,450**	19,625	16,883	20,627	17,943
79,450	**79,500**	19,640	16,897	20,645	17,957
79,500	**79,550**	19,656	16,911	20,663	17,971
79,550	**79,600**	19,671	16,925	20,681	17,985
79,600	**79,650**	19,687	16,939	20,699	17,999
79,650	**79,700**	19,702	16,953	20,717	18,013
79,700	**79,750**	19,718	16,967	20,735	18,027
79,750	**79,800**	19,733	16,981	20,753	18,041
79,800	**79,850**	19,749	16,995	20,771	18,055
79,850	**79,900**	19,764	17,009	20,789	18,069
79,900	**79,950**	19,780	17,023	20,807	18,083
79,950	**80,000**	19,795	17,037	20,825	18,097
80,000					
80,000	**80,050**	19,811	17,051	20,843	18,111
80,050	**80,100**	19,826	17,065	20,861	18,125
80,100	**80,150**	19,842	17,079	20,879	18,139
80,150	**80,200**	19,857	17,093	20,897	18,153
80,200	**80,250**	19,873	17,107	20,915	18,167
80,250	**80,300**	19,888	17,121	20,933	18,181
80,300	**80,350**	19,904	17,135	20,951	18,195
80,350	**80,400**	19,919	17,149	20,969	18,209
80,400	**80,450**	19,935	17,163	20,987	18,223
80,450	**80,500**	19,950	17,177	21,005	18,237
80,500	**80,550**	19,966	17,191	21,023	18,251
80,550	**80,600**	19,981	17,205	21,041	18,265
80,600	**80,650**	19,997	17,219	21,059	18,279
80,650	**80,700**	20,012	17,233	21,077	18,293
80,700	**80,750**	20,028	17,247	21,095	18,307
80,750	**80,800**	20,043	17,261	21,113	18,321
80,800	**80,850**	20,059	17,275	21,131	18,335
80,850	**80,900**	20,074	17,289	21,149	18,349
80,900	**80,950**	20,090	17,303	21,167	18,363
80,950	**81,000**	20,105	17,317	21,185	18,377
81,000					
81,000	**81,050**	20,121	17,331	21,203	18,391
81,050	**81,100**	20,136	17,345	21,221	18,405
81,100	**81,150**	20,152	17,359	21,239	18,419
81,150	**81,200**	20,167	17,373	21,257	18,433
81,200	**81,250**	20,183	17,387	21,275	18,447
81,250	**81,300**	20,198	17,401	21,293	18,461
81,300	**81,350**	20,214	17,415	21,311	18,475
81,350	**81,400**	20,229	17,429	21,329	18,489
81,400	**81,450**	20,245	17,443	21,347	18,503
81,450	**81,500**	20,260	17,457	21,365	18,517
81,500	**81,550**	20,276	17,471	21,383	18,531
81,550	**81,600**	20,291	17,485	21,401	18,545
81,600	**81,650**	20,307	17,499	21,419	18,559
81,650	**81,700**	20,322	17,513	21,437	18,573
81,700	**81,750**	20,338	17,527	21,455	18,587
81,750	**81,800**	20,353	17,541	21,473	18,601
81,800	**81,850**	20,369	17,555	21,491	18,615
81,850	**81,900**	20,384	17,569	21,509	18,629
81,900	**81,950**	20,400	17,583	21,527	18,643
81,950	**82,000**	20,415	17,597	21,545	18,657
82,000					
82,000	**82,050**	20,431	17,611	21,563	18,671
82,050	**82,100**	20,446	17,625	21,581	18,685
82,100	**82,150**	20,462	17,639	21,599	18,699
82,150	**82,200**	20,477	17,653	21,617	18,713
82,200	**82,250**	20,493	17,667	21,635	18,727
82,250	**82,300**	20,508	17,681	21,653	18,741
82,300	**82,350**	20,524	17,695	21,671	18,755
82,350	**82,400**	20,539	17,709	21,689	18,769
82,400	**82,450**	20,555	17,723	21,707	18,783
82,450	**82,500**	20,570	17,737	21,725	18,797
82,500	**82,550**	20,586	17,751	21,743	18,811
82,550	**82,600**	20,601	17,765	21,761	18,825
82,600	**82,650**	20,617	17,779	21,779	18,839
82,650	**82,700**	20,632	17,793	21,797	18,853
82,700	**82,750**	20,648	17,807	21,815	18,867
82,750	**82,800**	20,663	17,821	21,833	18,881
82,800	**82,850**	20,679	17,835	21,851	18,895
82,850	**82,900**	20,694	17,849	21,869	18,909
82,900	**82,950**	20,710	17,863	21,887	18,923
82,950	**83,000**	20,725	17,877	21,905	18,937
83,000					
83,000	**83,050**	20,741	17,891	21,923	18,951
83,050	**83,100**	20,756	17,905	21,941	18,965
83,100	**83,150**	20,772	17,919	21,959	18,979
83,150	**83,200**	20,787	17,933	21,977	18,993
83,200	**83,250**	20,803	17,947	21,995	19,007
83,250	**83,300**	20,818	17,961	22,013	19,021
83,300	**83,350**	20,834	17,975	22,031	19,035
83,350	**83,400**	20,849	17,989	22,049	19,049
83,400	**83,450**	20,865	18,003	22,067	19,063
83,450	**83,500**	20,880	18,017	22,085	19,077
83,500	**83,550**	20,896	18,031	22,103	19,091
83,550	**83,600**	20,911	18,045	22,121	19,105
83,600	**83,650**	20,927	18,059	22,139	19,119
83,650	**83,700**	20,942	18,073	22,157	19,133
83,700	**83,750**	20,958	18,087	22,175	19,147
83,750	**83,800**	20,973	18,101	22,193	19,161
83,800	**83,850**	20,989	18,115	22,211	19,175
83,850	**83,900**	21,004	18,129	22,229	19,189
83,900	**83,950**	21,020	18,143	22,247	19,203
83,950	**84,000**	21,035	18,157	22,265	19,217
84,000					
84,000	**84,050**	21,051	18,171	22,283	19,231
84,050	**84,100**	21,066	18,185	22,301	19,245
84,100	**84,150**	21,082	18,199	22,319	19,259
84,150	**84,200**	21,097	18,213	22,337	19,273
84,200	**84,250**	21,113	18,227	22,355	19,287
84,250	**84,300**	21,128	18,241	22,373	19,301
84,300	**84,350**	21,144	18,255	22,391	19,315
84,350	**84,400**	21,159	18,269	22,409	19,329
84,400	**84,450**	21,175	18,283	22,427	19,343
84,450	**84,500**	21,190	18,297	22,445	19,357
84,500	**84,550**	21,206	18,311	22,463	19,371
84,550	**84,600**	21,221	18,325	22,481	19,385
84,600	**84,650**	21,237	18,339	22,499	19,399
84,650	**84,700**	21,252	18,353	22,517	19,413
84,700	**84,750**	21,268	18,367	22,535	19,427
84,750	**84,800**	21,283	18,381	22,553	19,441
84,800	**84,850**	21,299	18,395	22,571	19,455
84,850	**84,900**	21,314	18,409	22,589	19,469
84,900	**84,950**	21,330	18,423	22,607	19,483
84,950	**85,000**	21,345	18,437	22,625	19,497
85,000					
85,000	**85,050**	21,361	18,451	22,643	19,511
85,050	**85,100**	21,376	18,465	22,661	19,525
85,100	**85,150**	21,392	18,479	22,679	19,539
85,150	**85,200**	21,407	18,493	22,697	19,553
85,200	**85,250**	21,423	18,507	22,715	19,567
85,250	**85,300**	21,438	18,521	22,733	19,581
85,300	**85,350**	21,454	18,535	22,751	19,595
85,350	**85,400**	21,469	18,549	22,769	19,609
85,400	**85,450**	21,485	18,563	22,787	19,625
85,450	**85,500**	21,500	18,577	22,805	19,640
85,500	**85,550**	21,516	18,591	22,823	19,656
85,550	**85,600**	21,531	18,605	22,841	19,671
85,600	**85,650**	21,547	18,619	22,859	19,687
85,650	**85,700**	21,562	18,633	22,877	19,702
85,700	**85,750**	21,578	18,647	22,895	19,718
85,750	**85,800**	21,593	18,661	22,913	19,733
85,800	**85,850**	21,609	18,675	22,931	19,749
85,850	**85,900**	21,624	18,689	22,949	19,764
85,900	**85,950**	21,640	18,703	22,967	19,780
85,950	**86,000**	21,655	18,717	22,985	19,795

* This column must also be used by a qualifying widow(er).

Continued on next page

If line 38 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing sepa-rately	Head of a house-hold
		Your tax is—			
86,000					
86,000	**86,050**	21,671	18,731	23,003	19,811
86,050	**86,100**	21,686	18,745	23,021	19,826
86,100	**86,150**	21,702	18,759	23,039	19,842
86,150	**86,200**	21,717	18,773	23,057	19,857
86,200	**86,250**	21,733	18,787	23,075	19,873
86,250	**86,300**	21,748	18,801	23,093	19,888
86,300	**86,350**	21,764	18,815	23,111	19,904
86,350	**86,400**	21,779	18,829	23,129	19,919
86,400	**86,450**	21,795	18,843	23,147	19,935
86,450	**86,500**	21,810	18,857	23,165	19,950
86,500	**86,550**	21,826	18,871	23,183	19,966
86,550	**86,600**	21,841	18,885	23,201	19,981
86,600	**86,650**	21,857	18,899	23,219	19,997
86,650	**86,700**	21,872	18,913	23,237	20,012
86,700	**86,750**	21,888	18,927	23,255	20,028
86,750	**86,800**	21,903	18,941	23,273	20,043
86,800	**86,850**	21,919	18,955	23,291	20,059
86,850	**86,900**	21,934	18,969	23,309	20,074
86,900	**86,950**	21,950	18,983	23,327	20,090
86,950	**87,000**	21,965	18,997	23,345	20,105
87,000					
87,000	**87,050**	21,981	19,011	23,363	20,121
87,050	**87,100**	21,996	19,025	23,381	20,136
87,100	**87,150**	22,012	19,039	23,399	20,152
87,150	**87,200**	22,027	19,053	23,417	20,167
87,200	**87,250**	22,043	19,067	23,435	20,183
87,250	**87,300**	22,058	19,081	23,453	20,198
87,300	**87,350**	22,074	19,095	23,471	20,214
87,350	**87,400**	22,089	19,109	23,489	20,229
87,400	**87,450**	22,105	19,123	23,507	20,245
87,450	**87,500**	22,120	19,137	23,525	20,260
87,500	**87,550**	22,136	19,151	23,543	20,276
87,550	**87,600**	22,151	19,165	23,561	20,291
87,600	**87,650**	22,167	19,179	23,579	20,307
87,650	**87,700**	22,182	19,193	23,597	20,322
87,700	**87,750**	22,198	19,207	23,615	20,338
87,750	**87,800**	22,213	19,221	23,633	20,353
87,800	**87,850**	22,229	19,235	23,651	20,369
87,850	**87,900**	22,244	19,249	23,669	20,384
87,900	**87,950**	22,260	19,263	23,687	20,400
87,950	**88,000**	22,275	19,277	23,705	20,415
88,000					
88,000	**88,050**	22,291	19,291	23,723	20,431
88,050	**88,100**	22,306	19,305	23,741	20,446
88,100	**88,150**	22,322	19,319	23,759	20,462
88,150	**88,200**	22,337	19,333	23,777	20,477
88,200	**88,250**	22,353	19,347	23,795	20,493
88,250	**88,300**	22,368	19,361	23,813	20,508
88,300	**88,350**	22,384	19,375	23,831	20,524
88,350	**88,400**	22,399	19,389	23,849	20,539
88,400	**88,450**	22,415	19,403	23,867	20,555
88,450	**88,500**	22,430	19,417	23,885	20,570
88,500	**88,550**	22,446	19,431	23,903	20,586
88,550	**88,600**	22,461	19,445	23,921	20,601
88,600	**88,650**	22,477	19,459	23,939	20,617
88,650	**88,700**	22,492	19,473	23,957	20,632
88,700	**88,750**	22,508	19,487	23,975	20,648
88,750	**88,800**	22,523	19,501	23,993	20,663
88,800	**88,850**	22,539	19,515	24,011	20,679
88,850	**88,900**	22,554	19,529	24,029	20,694
88,900	**88,950**	22,570	19,543	24,047	20,710
88,950	**89,000**	22,585	19,557	24,065	20,725
89,000					
89,000	**89,050**	22,601	19,571	24,083	20,741
89,050	**89,100**	22,616	19,585	24,101	20,756
89,100	**89,150**	22,632	19,599	24,119	20,772
89,150	**89,200**	22,647	19,613	24,137	20,787
89,200	**89,250**	22,663	19,627	24,155	20,803
89,250	**89,300**	22,678	19,641	24,173	20,818
89,300	**89,350**	22,694	19,655	24,191	20,834
89,350	**89,400**	22,709	19,669	24,209	20,849
89,400	**89,450**	22,725	19,683	24,227	20,865
89,450	**89,500**	22,740	19,697	24,245	20,880
89,500	**89,550**	22,756	19,711	24,263	20,896
89,550	**89,600**	22,771	19,725	24,281	20,911
89,600	**89,650**	22,787	19,739	24,299	20,927
89,650	**89,700**	22,802	19,753	24,317	20,942
89,700	**89,750**	22,818	19,767	24,335	20,958
89,750	**89,800**	22,833	19,781	24,353	20,973
89,800	**89,850**	22,849	19,795	24,371	20,989
89,850	**89,900**	22,864	19,809	24,389	21,004
89,900	**89,950**	22,880	19,823	24,407	21,020
89,950	**90,000**	22,895	19,837	24,425	21,035
90,000					
90,000	**90,050**	22,911	19,851	24,443	21,051
90,050	**90,100**	22,926	19,865	24,461	21,066
90,100	**90,150**	22,942	19,879	24,479	21,082
90,150	**90,200**	22,957	19,893	24,497	21,097
90,200	**90,250**	22,973	19,907	24,515	21,113
90,250	**90,300**	22,988	19,921	24,533	21,128
90,300	**90,350**	23,004	19,935	24,551	21,144
90,350	**90,400**	23,019	19,949	24,569	21,159
90,400	**90,450**	23,035	19,963	24,587	21,175
90,450	**90,500**	23,050	19,977	24,605	21,190
90,500	**90,550**	23,066	19,991	24,623	21,206
90,550	**90,600**	23,081	20,005	24,641	21,221
90,600	**90,650**	23,097	20,019	24,659	21,237
90,650	**90,700**	23,112	20,033	24,677	21,252
90,700	**90,750**	23,128	20,047	24,695	21,268
90,750	**90,800**	23,143	20,061	24,713	21,283
90,800	**90,850**	23,159	20,075	24,731	21,299
90,850	**90,900**	23,174	20,089	24,749	21,314
90,900	**90,950**	23,190	20,103	24,767	21,330
90,950	**91,000**	23,205	20,117	24,785	21,345
91,000					
91,000	**91,050**	23,221	20,131	24,803	21,361
91,050	**91,100**	23,236	20,145	24,821	21,376
91,100	**91,150**	23,252	20,159	24,839	21,392
91,150	**91,200**	23,267	20,173	24,857	21,407
91,200	**91,250**	23,283	20,187	24,875	21,423
91,250	**91,300**	23,298	20,201	24,893	21,438
91,300	**91,350**	23,314	20,215	24,911	21,454
91,350	**91,400**	23,329	20,229	24,929	21,469
91,400	**91,450**	23,345	20,243	24,947	21,485
91,450	**91,500**	23,360	20,257	24,965	21,500
91,500	**91,550**	23,376	20,271	24,983	21,516
91,550	**91,600**	23,391	20,285	25,001	21,531
91,600	**91,650**	23,407	20,299	25,019	21,547
91,650	**91,700**	23,422	20,313	25,037	21,562
91,700	**91,750**	23,438	20,327	25,055	21,578
91,750	**91,800**	23,453	20,341	25,073	21,593
91,800	**91,850**	23,469	20,355	25,091	21,609
91,850	**91,900**	23,484	20,369	25,109	21,624
91,900	**91,950**	23,500	20,383	25,127	21,640
91,950	**92,000**	23,515	20,397	25,145	21,655
92,000					
92,000	**92,050**	23,531	20,411	25,163	21,671
92,050	**92,100**	23,546	20,425	25,181	21,686
92,100	**92,150**	23,562	20,439	25,199	21,702
92,150	**92,200**	23,577	20,453	25,217	21,717
92,200	**92,250**	23,593	20,467	25,235	21,733
92,250	**92,300**	23,608	20,481	25,253	21,748
92,300	**92,350**	23,624	20,495	25,271	21,764
92,350	**92,400**	23,639	20,509	25,289	21,779
92,400	**92,450**	23,655	20,523	25,307	21,795
92,450	**92,500**	23,670	20,537	25,325	21,810
92,500	**92,550**	23,686	20,551	25,343	21,826
92,550	**92,600**	23,701	20,565	25,361	21,841
92,600	**92,650**	23,717	20,579	25,379	21,857
92,650	**92,700**	23,732	20,593	25,397	21,872
92,700	**92,750**	23,748	20,607	25,415	21,888
92,750	**92,800**	23,763	20,621	25,433	21,903
92,800	**92,850**	23,779	20,635	25,451	21,919
92,850	**92,900**	23,794	20,649	25,469	21,934
92,900	**92,950**	23,810	20,663	25,487	21,950
92,950	**93,000**	23,825	20,677	25,505	21,965
93,000					
93,000	**93,050**	23,841	20,691	25,523	21,981
93,050	**93,100**	23,856	20,705	25,541	21,996
93,100	**93,150**	23,872	20,719	25,559	22,012
93,150	**93,200**	23,887	20,733	25,577	22,027
93,200	**93,250**	23,903	20,747	25,595	22,043
93,250	**93,300**	23,918	20,761	25,613	22,058
93,300	**93,350**	23,934	20,775	25,631	22,074
93,350	**93,400**	23,949	20,789	25,649	22,089
93,400	**93,450**	23,965	20,803	25,667	22,105
93,450	**93,500**	23,980	20,817	25,685	22,120
93,500	**93,550**	23,996	20,831	25,703	22,136
93,550	**93,600**	24,011	20,845	25,721	22,151
93,600	**93,650**	24,027	20,859	25,739	22,167
93,650	**93,700**	24,042	20,873	25,757	22,182
93,700	**93,750**	24,058	20,887	25,775	22,198
93,750	**93,800**	24,073	20,901	25,793	22,213
93,800	**93,850**	24,089	20,915	25,811	22,229
93,850	**93,900**	24,104	20,929	25,829	22,244
93,900	**93,950**	24,120	20,943	25,847	22,260
93,950	**94,000**	24,135	20,957	25,865	22,275
94,000					
94,000	**94,050**	24,151	20,971	25,883	22,291
94,050	**94,100**	24,166	20,985	25,901	22,306
94,100	**94,150**	24,182	20,999	25,919	22,322
94,150	**94,200**	24,197	21,013	25,937	22,337
94,200	**94,250**	24,213	21,027	25,955	22,353
94,250	**94,300**	24,228	21,041	25,973	22,368
94,300	**94,350**	24,244	21,055	25,991	22,384
94,350	**94,400**	24,259	21,069	26,009	22,399
94,400	**94,450**	24,275	21,083	26,027	22,415
94,450	**94,500**	24,290	21,097	26,045	22,430
94,500	**94,550**	24,306	21,111	26,063	22,446
94,550	**94,600**	24,321	21,125	26,081	22,461
94,600	**94,650**	24,337	21,139	26,099	22,477
94,650	**94,700**	24,352	21,153	26,117	22,492
94,700	**94,750**	24,368	21,167	26,135	22,508
94,750	**94,800**	24,383	21,181	26,153	22,523
94,800	**94,850**	24,399	21,195	26,171	22,539
94,850	**94,900**	24,414	21,209	26,189	22,554
94,900	**94,950**	24,430	21,223	26,207	22,570
94,950	**95,000**	24,445	21,237	26,225	22,585

* This column must also be used by a qualifying widow(er).

Continued on next page

1997 Tax Table—*Continued*

If line 38 (taxable income) is— At least	But less than	And you are— Single	Married filing jointly *	Married filing sepa-rately	Head of a house-hold
		Your tax is—			
95,000					
95,000	**95,050**	24,461	21,251	26,243	22,601
95,050	**95,100**	24,476	21,265	26,261	22,616
95,100	**95,150**	24,492	21,279	26,279	22,632
95,150	**95,200**	24,507	21,293	26,297	22,647
95,200	**95,250**	24,523	21,307	26,315	22,663
95,250	**95,300**	24,538	21,321	26,333	22,678
95,300	**95,350**	24,554	21,335	26,351	22,694
95,350	**95,400**	24,569	21,349	26,369	22,709
95,400	**95,450**	24,585	21,363	26,387	22,725
95,450	**95,500**	24,600	21,377	26,405	22,740
95,500	**95,550**	24,616	21,391	26,423	22,756
95,550	**95,600**	24,631	21,405	26,441	22,771
95,600	**95,650**	24,647	21,419	26,459	22,787
95,650	**95,700**	24,662	21,433	26,477	22,802
95,700	**95,750**	24,678	21,447	26,495	22,818
95,750	**95,800**	24,693	21,461	26,513	22,833
95,800	**95,850**	24,709	21,475	26,531	22,849
95,850	**95,900**	24,724	21,489	26,549	22,864
95,900	**95,950**	24,740	21,503	26,567	22,880
95,950	**96,000**	24,755	21,517	26,585	22,895
96,000					
96,000	**96,050**	24,771	21,531	26,603	22,911
96,050	**96,100**	24,786	21,545	26,621	22,926
96,100	**96,150**	24,802	21,559	26,639	22,942
96,150	**96,200**	24,817	21,573	26,657	22,957
96,200	**96,250**	24,833	21,587	26,675	22,973
96,250	**96,300**	24,848	21,601	26,693	22,988
96,300	**96,350**	24,864	21,615	26,711	23,004
96,350	**96,400**	24,879	21,629	26,729	23,019
96,400	**96,450**	24,895	21,643	26,747	23,035
96,450	**96,500**	24,910	21,657	26,765	23,050
96,500	**96,550**	24,926	21,671	26,783	23,066
96,550	**96,600**	24,941	21,685	26,801	23,081
96,600	**96,650**	24,957	21,699	26,819	23,097
96,650	**96,700**	24,972	21,713	26,837	23,112
96,700	**96,750**	24,988	21,727	26,855	23,128
96,750	**96,800**	25,003	21,741	26,873	23,143
96,800	**96,850**	25,019	21,755	26,891	23,159
96,850	**96,900**	25,034	21,769	26,909	23,174
96,900	**96,950**	25,050	21,783	26,927	23,190
96,950	**97,000**	25,065	21,797	26,945	23,205
97,000					
97,000	**97,050**	25,081	21,811	26,963	23,221
97,050	**97,100**	25,096	21,825	26,981	23,236
97,100	**97,150**	25,112	21,839	26,999	23,252
97,150	**97,200**	25,127	21,853	27,017	23,267
97,200	**97,250**	25,143	21,867	27,035	23,283
97,250	**97,300**	25,158	21,881	27,053	23,298
97,300	**97,350**	25,174	21,895	27,071	23,314
97,350	**97,400**	25,189	21,909	27,089	23,329
97,400	**97,450**	25,205	21,923	27,107	23,345
97,450	**97,500**	25,220	21,937	27,125	23,360
97,500	**97,550**	25,236	21,951	27,143	23,376
97,550	**97,600**	25,251	21,965	27,161	23,391
97,600	**97,650**	25,267	21,979	27,179	23,407
97,650	**97,700**	25,282	21,993	27,197	23,422
97,700	**97,750**	25,298	22,007	27,215	23,438
97,750	**97,800**	25,313	22,021	27,233	23,453
97,800	**97,850**	25,329	22,035	27,251	23,469
97,850	**97,900**	25,344	22,049	27,269	23,484
97,900	**97,950**	25,360	22,063	27,287	23,500
97,950	**98,000**	25,375	22,077	27,305	23,515
98,000					
98,000	**98,050**	25,391	22,091	27,323	23,531
98,050	**98,100**	25,406	22,105	27,341	23,546
98,100	**98,150**	25,422	22,119	27,359	23,562
98,150	**98,200**	25,437	22,133	27,377	23,577
98,200	**98,250**	25,453	22,147	27,395	23,593
98,250	**98,300**	25,468	22,161	27,413	23,608
98,300	**98,350**	25,484	22,175	27,431	23,624
98,350	**98,400**	25,499	22,189	27,449	23,639
98,400	**98,450**	25,515	22,203	27,467	23,655
98,450	**98,500**	25,530	22,217	27,485	23,670
98,500	**98,550**	25,546	22,231	27,503	23,686
98,550	**98,600**	25,561	22,245	27,521	23,701
98,600	**98,650**	25,577	22,259	27,539	23,717
98,650	**98,700**	25,592	22,273	27,557	23,732
98,700	**98,750**	25,608	22,287	27,575	23,748
98,750	**98,800**	25,623	22,301	27,593	23,763
98,800	**98,850**	25,639	22,315	27,611	23,779
98,850	**98,900**	25,654	22,329	27,629	23,794
98,900	**98,950**	25,670	22,343	27,647	23,810
98,950	**99,000**	25,685	22,357	27,665	23,825
99,000					
99,000	**99,050**	25,701	22,371	27,683	23,841
99,050	**99,100**	25,716	22,385	27,701	23,856
99,100	**99,150**	25,732	22,399	27,719	23,872
99,150	**99,200**	25,747	22,413	27,737	23,887
99,200	**99,250**	25,763	22,427	27,755	23,903
99,250	**99,300**	25,778	22,441	27,773	23,918
99,300	**99,350**	25,794	22,455	27,791	23,934
99,350	**99,400**	25,809	22,469	27,809	23,949
99,400	**99,450**	25,825	22,483	27,827	23,965
99,450	**99,500**	25,840	22,497	27,845	23,980
99,500	**99,550**	25,856	22,511	27,863	23,996
99,550	**99,600**	25,871	22,525	27,881	24,011
99,600	**99,650**	25,887	22,540	27,899	24,027
99,650	**99,700**	25,902	22,555	27,917	24,042
99,700	**99,750**	25,918	22,571	27,935	24,058
99,750	**99,800**	25,933	22,586	27,953	24,073
99,800	**99,850**	25,949	22,602	27,971	24,089
99,850	**99,900**	25,964	22,617	27,989	24,104
99,900	**99,950**	25,980	22,633	28,007	24,120
99,950	**100,000**	25,995	22,648	28,025	24,135

$100,000 or over — use the Tax Rate Schedules

* This column must also be used by a qualifying widow(er).

1997 Tax Rate Schedules

Caution: *Use **only** if your taxable income (Form 1040, line 38) is $100,000 or more. If less, use the **Tax Table.** Even though you cannot use the Tax Rate Schedules below if your taxable income is less than $100,000, all levels of taxable income are shown so taxpayers can see the tax rate that applies to each level.*

Schedule X—Use if your filing status is **Single**

If the amount on Form 1040, line 38, is: *Over—*	*But not over—*	Enter on Form 1040, line 39		*of the amount over—*
$0	$24,650	--------	**15%**	**$0**
24,650	59,750	**$3,697.50 +**	**28%**	**24,650**
59,750	124,650	**13,525.50 +**	**31%**	**59,750**
124,650	271,050	**33,644.50 +**	**36%**	**124,650**
271,050	--------	**86,348.50 +**	**39.6%**	**271,050**

Schedule Y-1—Use if your filing status is **Married filing jointly** or **Qualifying widow(er)**

If the amount on Form 1040, line 38, is: *Over—*	*But not over—*	Enter on Form 1040, line 39		*of the amount over—*
$0	$41,200	--------	**15%**	**$0**
41,200	99,600	**$6,180.00 +**	**28%**	**41,200**
99,600	151,750	**22,532.00 +**	**31%**	**99,600**
151,750	271,050	**38,698.50 +**	**36%**	**151,750**
271,050	--------	**81,646.50 +**	**39.6%**	**271,050**

Schedule Y-2—Use if your filing status is **Married filing separately**

If the amount on Form 1040, line 38, is: *Over—*	*But not over—*	Enter on Form 1040, line 39		*of the amount over—*
$0	$20,600	--------	**15%**	**$0**
20,600	49,800	**$3,090.00 +**	**28%**	**20,600**
49,800	75,875	**11,266.00 +**	**31%**	**49,800**
75,875	135,525	**19,349.25 +**	**36%**	**75,875**
135,525	--------	**40,823.25 +**	**39.6%**	**135,525**

Schedule Z—Use if your filing status is **Head of household**

If the amount on Form 1040, line 38, is: *Over—*	*But not over—*	Enter on Form 1040, line 39		*of the amount over—*
$0	$33,050	--------	**15%**	**$0**
33,050	85,350	**$4,957.50 +**	**28%**	**33,050**
85,350	138,200	**19,601.50 +**	**31%**	**85,350**
138,200	271,050	**35,985.00 +**	**36%**	**138,200**
271,050	--------	**83,811.00 +**	**39.6%**	**271,050**

The first part of this section explains some of your most important rights as a taxpayer.

The second part explains the examination, appeal, collection, and refund processes.

I. Declaration of Taxpayer Rights

Protection of your rights —

IRS employees will explain and protect your rights as a taxpayer throughout your contact with us.

Privacy and confidentiality —

The IRS will not disclose to anyone the information you give us, except as authorized by law. You have the right to know why we are asking you for information, how we will use it, and what happens if you do not provide requested information.

Professional and courteous service —

If you believe that an IRS employee has not treated you in a professional manner, you should tell that employee's supervisor. If the supervisor's response is not satisfactory, you should write to your IRS District Director or Service Center Director.

Representation —

You may either represent yourself, or with proper written authorization, have someone else represent you in your place. You can have someone accompany you at an interview. You may make sound recordings of any meetings with our examination or collection personnel, provided you tell us in writing 10 days before the meeting.

Payment of only the correct amount of tax —

You are responsible for paying only the correct amount of tax due under the law — no more, no less.

Help from the Problem Resolution Program —

The Problem Resolution Program (administered by the **Taxpayer Advocate**) can help you with unresolved tax problems and can offer you special help if you have a significant hardship as a result of a tax problem. For more information, write to the Taxpayer Advocate at the District Office or Service Center where you have the problem, or call 1–800–829–1040 (1–800–829–4059 for TTY/TDD users).

Appeals and judicial review —

If you disagree with us about the amount of your tax liability or certain collection actions, you have the right to ask the IRS Appeals Office to review your case. You may also ask a court to review your case.

Relief from certain penalties —

The IRS will waive penalties when allowed by law if you can show you acted reasonably and in good faith or relied on the incorrect advice of an IRS employee.

II. Examinations, Appeals, Collections, and Refunds

Examinations (Audits)

We accept most taxpayers' returns as filed. If we inquire about your return or select it for examination, it does not suggest that you are dishonest. The inquiry or examination may or may not result in more tax. We may close your case without change; or, you may receive a refund.

By mail. We handle many examinations and inquiries by mail. We will send you a letter with either a request for more information or a reason why we believe a change to your return may be needed. If you give us the requested information or provide an explanation, we may or may not agree with you, and we will explain the reasons for any changes. Please do not hesitate to write us about anything you do not understand. If you cannot resolve a question through the mail, you can request a personal interview with an examiner.

By interview. If we notify you that we will conduct your examination through a personal interview, or you request such an interview, you have the right to ask that the examination take place at a reasonable time and place that is convenient for both you and the IRS. At the end of your examination, the examiner will give you a report if there are any proposed changes to your tax return. If you do not agree with the report, you may meet with the examiner's supervisor.

Repeat examinations. If we examined your tax return for the same items in either of the 2 previous years and proposed no change to your tax liability, please contact us as soon as possible so we can determine if we should discontinue the repeat examination. Publication 556, *Examination of Returns, Appeal Rights, and Claims for Refund,* will give you more information about the rules and procedures of an IRS examination.

Appeals

If you do not agree with the examiner's findings, you can appeal them to an Appeals Office. Most differences can be settled without expensive and time-consuming court trials. Your appeal rights are explained in detail in Publication 5, *Appeal Rights and Preparation of Protests for Unagreed Cases.* If you do not wish to use our Appeals Office or disagree with its findings, you can take your case to the U.S. Tax Court, U.S. Court of Federal Claims, or the U.S. District Court where you live. If the court agrees with you on most issues in your case, and finds that our position was largely unjustified, you may be able to recover some of your administrative and litigation costs. You will not be eligible to recover these costs unless you tried to resolve your case administratively, including going through our Appeals system, and you gave us all the information necessary to resolve the case.

Collections

Publication 594, *Understanding The Collection Process,* explains your rights and responsibilities regarding payment of federal taxes. It is divided into several sections that explain the procedures in plain language. The sections include:

1) *When you have not paid enough tax.* This section describes tax bills and explains what to do if you think your bill is wrong.
2) *Making arrangements to pay your bill.* This covers making installment payments, delaying collection action, and submitting an offer in compromise.
3) *What happens when you take no action to pay.* This covers liens, releasing a lien, levies, releasing a levy, seizures and sales, and release of property. Publication 1660, *Collection Appeal Rights (for Liens, Levies and Seizures),* explains your rights to appeal liens, levies and seizures and how to request these appeals.

Refunds

You may file a claim for refund if you think you paid too much tax. You must generally file the claim within 3 years from the date you filed your return or 2 years from the date you paid the tax, whichever is later. The law generally provides for interest on your refund if it is not paid within 45 days of the date you filed your return or claim for refund. Publication 556, *Examination of Returns, Appeals Rights, and Claims for Refund,* has more information on refunds.

Where To Go for Help

The IRS provides free tax information and services throughout the year. This section describes several ways you can get free tax help from the IRS and from community volunteers (during the regular filing season).

Free publications and forms. To order free publications and forms, call 1–800– TAX–FORM (1–800–829–3676). You can also write to the IRS Forms Distribution Center nearest you. Check your tax form instruction booklet for the address. Your local library or post office also may have the items you need.

For a list of free tax publications, order Publication 910, *Guide to Free Tax Services.* It contains an index of tax topics and related publications and describes other free tax information services available from IRS, including tax education and assistance programs.

If you have access to a personal computer and modem, you also can get many forms and publications electronically. For details, see *Quick and Easy Access to Tax Help and Forms* in your tax form instruction booklet. Also see the front cover of this publication for information on using your computer or fax machine to get forms.

Telephone help. IRS representatives are available to answer your tax questions by telephone. If, after reading the tax form instructions and IRS tax publications, you are not sure how to fill out your return, or you have a question about an IRS notice, you can call the IRS number for your area. These numbers are listed in your tax form instruction booklet, which also gives the hours of operation. You will not be charged for the call unless your phone company charges you for local calls.

TTY/TDD equipment. If you have access to TTY/TDD equipment, you can call 1–800–829–4059 to ask tax questions or to order forms and publications. See your tax form instruction booklet for the hours of operation.

Evaluating the quality of our telephone services. To ensure that IRS representatives give accurate, courteous, and professional answers, we evaluate the quality of our "800 number" telephone services in several ways.

- A second IRS representative sometimes monitors live telephone calls. That person only evaluates the IRS assistor and does not keep a record of any taxpayer's name or tax identification number.
- We sometimes record telephone calls to evaluate IRS assistors objectively. We hold these recordings no longer than one week and use them only to measure the quality of assistance.
- We value our customers' opinions. Throughout this year, we will be surveying our customers for their opinions on our service.

TeleTax. This telephone service provides recorded tax information on about 150 topics. You can also get these topics by using a fax machine or a personal computer and modem. For details on how to use this service, see *What Is TeleTax?* in your tax form instruction booklet.

Refund information. You can also check on the status of your 1997 refund using TeleTax's Refund Information service.

Written tax questions. You can send your written tax questions to your IRS District Director. You should get an answer in about 30 days. If you do not have the address, you can get it by calling the IRS number for your area that is listed in your tax form instruction booklet.

Braille tax materials. Braille tax materials are available for review from Regional Libraries for the Visually Impaired in conjunction with the National Library Service for the Blind and Physically Handicapped. To locate your nearest library, write to:

National Library Service for
the Blind and Physically
Handicapped
Library of Congress
1291 Taylor St., NW
Washington, DC 20542

Braille materials currently available for review include this publication, Publication 334, *Tax Guide for Small Business,* and Forms 1040, 1040A, and 1040EZ and their instructions.

Assistance with your return. Assistors are available in many IRS offices throughout the country to help you prepare your own return. To find the location and the hours of the IRS office nearest you, call the IRS telephone number for your area. These phone numbers are in your tax form instruction booklet. If you want help with your tax return, you should bring in your tax package, Forms W–2 and 1099, and any other information (such as a copy of last year's return) that will help the assister to help you.

At most IRS offices you can also get tax forms, publications, and help with questions about IRS notices or bills.

Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE). Free help from volunteers is available in most communities. After completing IRS training, these volunteers help prepare basic tax returns for taxpayers with special needs, including low-income people, persons with disabilities, the elderly, and non-English-speaking people. At many of these offices, you can file your tax return electronically. See *IRS **e-file*** in chapter 1 for information on electronic filing.

Call the IRS telephone number for your area for the location of the volunteer assistance site near you. Or, for the location of an American Association of Retired Persons (AARP) Tax-Aide site in your community, you can use their Internet site locator at www.aarp.org/taxaide/home.htm.

Unresolved tax problems. The Problem Resolution Program (PRP) is administered by the Taxpayer Advocate. This program is for people who have been unable to resolve problems with IRS. If you have a tax problem you cannot clear up through normal channels, you can call the IRS at 1–800– 829–1040 for PRP assistance. If you prefer, you can write to the office that last contacted you (or your local District Director) and ask for Problem Resolution assistance. People who have access to TTY/TDD equipment can call 1–800–829–4059 to obtain this assistance.

While the PRP cannot change the tax law or a technical tax decision, it can clear up problems that resulted from previous contacts and ensure that your case is given a complete and impartial review. For more information about the PRP, get Publication 1546, *The Problem Resolution Program of the Internal Revenue Service.*

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334 Tax Guide for Small Business
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553 Highlights of 1997 Tax Changes
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594 Understanding the Collection Process
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901 U.S. Tax Treaties
908 Bankruptcy Tax Guide
911 Direct Sellers
925 Passive Activity and At-Risk Rules
946 How To Depreciate Property
947 Practice Before the IRS and Power of Attorney
953 International Tax Information for Businesses
1544 Reporting Cash Payments of Over $10,000
1546 The Problem Resolution Program of the Internal Revenue Service

Spanish Language Publications

1SP Derechos del Contribuyente
579SP Cómo Preparar la Declaración de Impuesto Federal
594SP Comprendiendo el Proceso de Cobro
850 English-Spanish Glossary of Words and Phrases Used in Publications Issued by the Internal Revenue Service
1544SP Informe de Pagos en Efectivo en Exceso de $10,000 (Recibidos en una Ocupación o Negocio)

Commonly Used Tax Forms

W-2 Wage and Tax Statement
W-4 Employee's Withholding Allowance Certificate
940 Employer's Annual Federal Unemployment (FUTA) Tax Return
940EZ Employer's Annual Federal Unemployment (FUTA) Tax Return
1040 U.S. Individual Income Tax Return
- **Sch A** Itemized Deductions
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1040-ES Estimated Tax for Individuals
1040X Amended U.S. Individual Income Tax Return
1065 U.S. Partnership Return of Income
- **Sch D** Capital Gains and Losses
- **Sch K-1** Partner's Share of Income, Credits, Deductions, etc.

1120 U.S. Corporation Income Tax Return
1120-A U.S. Corporation Short-Form Income Tax Return
1120S U.S. Income Tax Return for an S Corporation
- **Sch D** Capital Gains and Losses and Built-In Gains
- **Sch K-1** Shareholder's Share of Income, Credits, Deductions, etc.

2106 Employee Business Expenses
2106-EZ Unreimbursed Employee Business Expenses
2210 Underpayment of Estimated Tax by Individuals, Estates, and Trusts
2441 Child and Dependent Care Expenses
2848 Power of Attorney and Declaration of Representative
3800 General Business Credit
3903 Moving Expenses
4562 Depreciation and Amortization
4797 Sales of Business Property
4868 Application for Automatic Extension of Time To File U.S. Individual Income Tax Return
5329 Additional Taxes Attributable to Qualified Retirement Plans (Including IRAs), Annuities, and Modified Endowment Contracts
6252 Installment Sale Income
8283 Noncash Charitable Contributions
8300 Report of Cash Payments Over $10,000 Received in a Trade or Business
8582 Passive Activity Loss Limitations
8606 Nondeductible IRAs (Contributions, Distributions, and Basis)
8822 Change of Address
8829 Expenses for Business Use of Your Home

Tax Publications for Individual Taxpayers

General Guides

1 Your Rights as a Taxpayer
17 Your Federal Income Tax (For Individuals)
225 Farmer's Tax Guide
334 Tax Guide for Small Business
509 Tax Calendars for 1998
553 Highlights of 1997 Tax Changes
595 Tax Highlights for Commercial Fishermen
910 Guide to Free Tax Services

Specialized Publications

3 Armed Forces' Tax Guide
378 Fuel Tax Credits and Refunds
463 Travel, Entertainment, Gift, and Car Expenses
501 Exemptions, Standard Deduction, and Filing Information
502 Medical and Dental Expenses
503 Child and Dependent Care Expenses
504 Divorced or Separated Individuals
505 Tax Withholding and Estimated Tax
508 Educational Expenses
514 Foreign Tax Credit for Individuals
516 U.S. Government Civilian Employees Stationed Abroad
517 Social Security and Other Information for Members of the Clergy and Religious Workers
519 U.S. Tax Guide for Aliens
520 Scholarships and Fellowships
521 Moving Expenses
523 Selling Your Home
524 Credit for the Elderly or the Disabled
525 Taxable and Nontaxable Income
526 Charitable Contributions
527 Residential Rental Property
529 Miscellaneous Deductions
530 Tax Information for First-Time Homeowners
531 Reporting Tip Income
533 Self-Employment Tax
534 Depreciating Property Placed in Service Before 1987
537 Installment Sales
541 Partnerships
544 Sales and Other Dispositions of Assets
547 Casualties, Disasters, and Thefts (Business and Nonbusiness)
550 Investment Income and Expenses
551 Basis of Assets
552 Recordkeeping for Individuals
554 Older Americans' Tax Guide
555 Federal Tax Information on Community Property
556 Examination of Returns, Appeal Rights, and Claims for Refund
559 Survivors, Executors, and Administrators
561 Determining the Value of Donated Property
564 Mutual Fund Distributions
570 Tax Guide for Individuals With Income From U.S. Possessions
575 Pension and Annuity Income
584 Nonbusiness Disaster, Casualty, and Theft Loss Workbook
587 Business Use of Your Home (Including Use by Day-Care Providers)
590 Individual Retirement Arrangements (IRAs) (Including SEP-IRAs and SIMPLE IRAs)
593 Tax Highlights for U.S. Citizens and Residents Going Abroad
594 Understanding the Collection Process
596 Earned Income Credit
721 Tax Guide to U.S. Civil Service Retirement Benefits
901 U.S. Tax Treaties
907 Tax Highlights for Persons with Disabilities
908 Bankruptcy Tax Guide
911 Direct Sellers
915 Social Security and Equivalent Railroad Retirement Benefits
919 Is My Withholding Correct for 1998?
925 Passive Activity and At-Risk Rules
926 Household Employer's Tax Guide
929 Tax Rules for Children and Dependents
936 Home Mortgage Interest Deduction
946 How To Depreciate Property
947 Practice Before the IRS and Power of Attorney
950 Introduction to Estate and Gift Taxes
967 IRS Will Figure Your Tax
968 Tax Benefits for Adoption
1542 Per Diem Rates
1544 Reporting Cash Payments of Over $10,000
1546 The Problem Resolution Program of the Internal Revenue Service

Spanish Language Publications

1SP Derechos del Contribuyente
579SP Cómo Preparar la Declaración de Impuesto Federal
594SP Comprendiendo el Proceso de Cobro
596SP Crédito por Ingreso del Trabajo
850 English-Spanish Glossary of Words and Phrases Used in Publications Issued by the Internal Revenue Service
1544SP Informe de Pagos en Efectivo en Exceso de $10,000 (Recibidos en una Ocupación o Negocio)

Commonly Used Tax Forms

1040 U.S. Individual Income Tax Return
- **Sch A** Itemized Deductions
- **Sch B** Interest and Dividend Income
- **Sch C** Profit or Loss From Business
- **Sch C-EZ** Net Profit From Business
- **Sch D** Capital Gains and Losses
- **Sch E** Supplemental Income and Loss
- **Sch EIC** Earned Income Credit
- **Sch F** Profit or Loss From Farming
- **Sch H** Household Employment Taxes
- **Sch R** Credit for the Elderly or the Disabled
- **Sch SE** Self-Employment Tax

1040EZ Income Tax Return for Single and Joint Filers With No Dependents
1040A U.S. Individual Income Tax Return
- **Sch 1** Interest and Dividend Income for Form 1040A Filers
- **Sch 2** Child and Dependent Care Expenses for Form 1040A Filers
- **Sch 3** Credit for the Elderly or the Disabled for Form 1040A Filers

1040-ES Estimated Tax for Individuals
1040X Amended U.S. Individual Income Tax Return
2106 Employee Business Expenses
2106-EZ Unreimbursed Employee Business Expenses
2119 Sale of Your Home
2210 Underpayment of Estimated Tax by Individuals, Estates and Trusts
2441 Child and Dependent Care Expenses
2848 Power of Attorney and Declaration of Representative
3903 Moving Expenses
4562 Depreciation and Amortization
4868 Application for Automatic Extension of Time To File U.S. Individual Income Tax Return
4952 Investment Interest Expense Deduction
5329 Additional Taxes Attributable to Qualified Retirement Plans (Including IRAs), Annuities, and Modified Endowment Contracts
6251 Alternative Minimum Tax–Individuals
8283 Noncash Charitable Contributions
8582 Passive Activity Loss Limitations
8606 Nondeductible IRAs (Contributions, Distributions, and Basis)
8822 Change of Address
8829 Expenses for Business Use of Your Home