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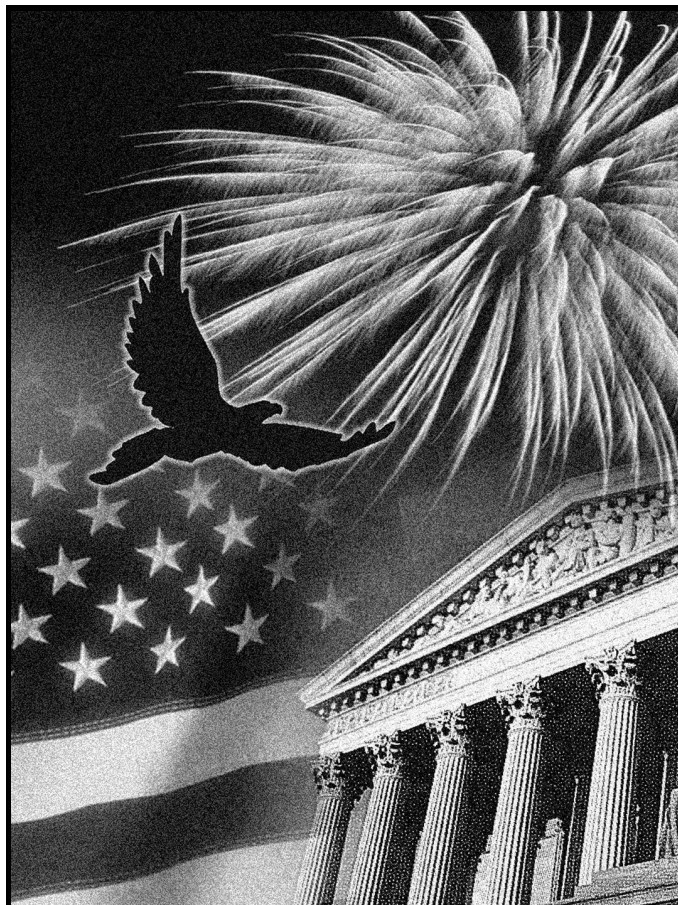
Internal
Revenue
Service

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Taxable and Nontaxable Income

For use in preparing
2008 Returns



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Contents

| | |
|---|----|
| What's New for 2008 | 1 |
| What's New for 2009 | 2 |
| Reminders | 2 |
| Introduction | 2 |
| Employee Compensation | 3 |
| Miscellaneous Compensation | 3 |
| Fringe Benefits | 4 |
| Retirement Plan Contributions | 9 |
| Stock Options | 11 |
| Restricted Property | 13 |
| Special Rules for Certain | |
| Employees | 14 |
| Clergy | 14 |
| Members of Religious Orders | 14 |
| Foreign Employer | 14 |
| Military | 15 |
| Volunteers | 15 |
| Business and Investment Income | 15 |
| Rents From Personal Property | 15 |
| Royalties | 16 |
| Partnership Income | 16 |
| S Corporation Income | 16 |
| Sickness and Injury Benefits | 17 |
| Disability Pensions | 17 |
| Long-Term Care Insurance | |
| Contracts | 17 |
| Workers' Compensation | 18 |
| Other Sickness and Injury | |
| Benefits | 18 |
| Miscellaneous Income | 19 |
| Bartering | 19 |
| Canceled Debts | 19 |
| Host or Hostess | 20 |
| Life Insurance Proceeds | 20 |
| Recoveries | 21 |
| Survivor Benefits | 29 |
| Unemployment Benefits | 29 |
| Welfare and Other Public | |
| Assistance Benefits | 29 |
| Other Income | 30 |
| Repayments | 36 |
| How To Get Tax Help | 36 |
| Index | 39 |

What's New for 2008

Economic stimulus payment. Any economic stimulus payment you received is not taxable. If your payment was directly deposited to a tax-favored account, such as an IRA, and you withdraw the payment by the due date (including extensions) of your 2008 tax return, the amount withdrawn will not be taxed and no additional tax or penalty will apply.

Retirement plans. Your employer, under a qualified automatic contribution arrangement, can treat you as having elected to have part of your compensation contributed (elective deferral) to a section 401(k) plan, unless you elect out of that arrangement.

Exclusion of income for volunteer firefighters and emergency medical responders. If you are a volunteer firefighter or emergency medical responder, you may be able to exclude from gross income certain rebates or reductions of state or local property or income taxes and up to \$30 per month provided by a state or local government. For more information, see *Volunteer firefighters and emergency medical responders* under *Volunteers*.

Retroactive VA determination. If you receive this type of determination, the period during which you can file a claim for refund has been extended until the end of the 1-year period beginning on the date of the determination. See the discussion under *Disability Pensions*.

Qualified military benefit. Any bonus payment by a state or political subdivision to an individual because of service in a combat zone is a qualified military benefit and is excluded from income. See *Military*.

Casualty loss caused by Hurricane Katrina, Rita, or Wilma. If you claimed a deduction in any tax year for a casualty loss to your home due to Hurricane Katrina, Rita, or Wilma and in a later tax year you receive a grant as reimbursement for that loss, you can report the grant as income in the year you receive it or you can choose to file an amended tax return for the year you claimed the deduction. See *Recoveries*.

Disaster relief provision. The Heartland Disaster Tax Relief Act of 2008 provides tax relief to persons affected by the severe storms, tornadoes, or flooding occurring in a Midwestern disaster area. Some of the provisions are covered in this publication. For information on other provisions, see Publication 4492-B, *Information for Affected Taxpayers in the Midwestern Disaster Areas*.

Qualified settlement income. If you receive qualified settlement income as a qualified taxpayer, report it on Form 1040, line 21, or Form 1040NR, line 21. Generally, this is interest and punitive damage awards received in connection with the civil action *In re Exxon Valdez*. You may be able to reduce the amount you report. See *Exxon Valdez settlement income* under *Other Income*.

What's New for 2009

Differential wage payments. Payments made after 2008 by an employer to an individual for any period during which the individual is an active duty member of the uniformed services are treated as wages.

Transportation fringe benefit to bicycle commuters. The qualified employer transportation fringe benefit is expanded to include any qualified bicycle commuting reimbursement made after 2008.

Nonqualified deferred compensation plans of nonqualified entities. Generally, for services performed after 2008, any compensation deferred under a nonqualified deferred compensation plan of a nonqualified entity is included in gross income when there is no substantial risk of

forfeiture of the rights to such compensation. For this purpose, a nonqualified entity is:

1. A foreign corporation unless substantially all of its income is:
 - a. Effectively connected with the conduct of a trade or business in the United States, or
 - b. Subject to a comprehensive foreign income tax.
2. A partnership unless substantially all of its income is allocated to persons other than:
 - a. Foreign persons for whom the income is not subject to a comprehensive foreign income tax, and
 - b. Tax-exempt organizations.

Reminders

Terrorist attacks. You can exclude from income certain disaster assistance, disability, and death payments received as a result of a terrorist or military action. For more information, see Publication 3920, *Tax Relief for Victims of Terrorist Attacks*.

Astronauts. You also can exclude death payments for astronauts dying in the line of duty after 2002.

Foreign income. If you are a U.S. citizen or resident alien, you must report income from sources outside the United States (foreign income) on your tax return unless it is exempt by U.S. law. This is true whether you reside inside or outside the United States and whether or not you receive a Form W-2, Wage and Tax Statement, or Form 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*.

Disaster mitigation payments. You can exclude from income grants you use to mitigate (reduce the severity of) potential damage from future natural disasters that are paid to you through state and local governments. For more information, see *Disaster mitigation payments* under *Welfare and Other Public Assistance Benefits*.

Nonqualified deferred compensation plans. Generally, all amounts deferred under a nonqualified deferred compensation plan for all tax years are included in gross income for the current year, unless certain requirements are met. See *Nonqualified deferred compensation plans* under *Employee Compensation*.

Health Savings Account (HSA). You can fund your HSA with a one-time direct transfer from your individual retirement plan, health reimbursement account, or health flexible spending

account and exclude the amount of the transfer from income. However, you must include the amount transferred in your income, as well as pay a 10% additional tax, if you do not remain an eligible individual for at least 12 months after the month of the transfer. See *Accident or Health Plan* under *Fringe Benefits*.

Qualified joint venture. A qualified joint venture conducted by you and your spouse may not be treated as a partnership if you file a joint return for the tax year. See *Partnership Income*.

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

Introduction

You can receive income in the form of money, property, or services. This publication discusses many kinds of income and explains whether they are taxable or nontaxable. It includes discussions on employee wages and fringe benefits, and income from bartering, partnerships, S corporations, and royalties. It also includes information on disability pensions, life insurance proceeds, and welfare and other public assistance benefits. Check the index for the location of a specific subject.

Generally, an amount included in your income is taxable unless it is specifically exempted by law. Income that is taxable must be reported on your return and is subject to tax. Income that is nontaxable may have to be shown on your tax return but is not taxable.

Constructively received income. You are generally taxed on income that is available to you, regardless of whether it is actually in your possession.

A valid check that you received or that was made available to you before the end of the tax year is considered income constructively received in that year, even if you do not cash the check or deposit it to your account until the next year. For example, if the postal service tries to deliver a check to you on the last day of the tax year but you are not at home to receive it, you must include the amount in your income for that tax year. If the check was mailed so that it could not possibly reach you until after the end of the tax year, and you otherwise could not get the funds before the end of the year, you include the amount in your income for the next tax year.

Assignment of income. Income received by an agent for you is income you constructively received in the year the agent received it. If you agree by contract that a third party is to receive income for you, you must include the amount in your income when the third party receives it.

Example. You and your employer agree that part of your salary is to be paid directly to your former spouse. You must include that amount in your income when your former spouse receives it.

Prepaid income. Prepaid income, such as compensation for future services, generally is included in your income in the year you receive it. However, if you use an accrual method of accounting, you can defer prepaid income you receive for services to be performed before the end of the next tax year. In this case, you include the payment in your income as you earn it by performing the services.

Comments and suggestions. We welcome your comments about this publication and your suggestions for future editions.

You can write to us at the following address:

Internal Revenue Service
Individual Forms and Publications Branch
SE:W:CAR:MP:T:I
1111 Constitution Ave. NW, IR-6526
Washington, DC 20224

We respond to many letters by telephone. Therefore, it would be helpful if you would include your daytime phone number, including the area code, in your correspondence.

You can email us at taxforms@irs.gov. (The asterisk must be included in the address.) Please put "Publications Comment" on the subject line. Although we cannot respond individually to each email, we do appreciate your feedback and will consider your comments as we revise our tax products.

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Bloomington, IL 61705-6613

Tax questions. If you have a tax question, check the information available on www.irs.gov or call 1-800-829-1040. We cannot answer tax questions sent to either of the above addresses.

Useful Items

You may want to see:

Publication

- 334 Tax Guide for Small Business (For Individuals Who Use Schedule C or C-EZ)
- 523 Selling Your Home
- 527 Residential Rental Property (Including Rental of Vacation Homes)
- 541 Partnerships
- 544 Sales and Other Dispositions of Assets
- 550 Investment Income and Expenses (Including Capital Gains and Losses)
- 559 Survivors, Executors, and Administrators
- 564 Mutual Fund Distributions
- 575 Pension and Annuity Income

915 Social Security and Equivalent Railroad Retirement Benefits

970 Tax Benefits for Education

See *How To Get Tax Help*, near the end of this publication, for information about getting these publications.

Employee Compensation

Generally, you must include in gross income everything you receive in payment for personal services. In addition to wages, salaries, commissions, fees, and tips, this includes other forms of compensation such as fringe benefits and stock options.

You should receive a Form W-2, Wage and Tax Statement, from your employer showing the pay you received for your services. Include your pay on line 7 of Form 1040 or Form 1040A or on line 1 of Form 1040EZ, even if you do not receive a Form W-2.

If you performed services, other than as an independent contractor, and your employer did not withhold social security and Medicare taxes from your pay, you must file Form 8919, Uncollected Social Security and Medicare Tax on Wages, with your Form 1040. These wages must be included on line 7 of Form 1040. See Form 8919 for more information.

Childcare providers. If you provide childcare, either in the child's home or in your home or other place of business, the pay you receive must be included in your income. If you are not an employee, you are probably self-employed and must include payments for your services on Schedule C (Form 1040), Profit or Loss From Business, or Schedule C-EZ (Form 1040), Net Profit From Business. You generally are not an employee unless you are subject to the will and control of the person who employs you as to what you are to do and how you are to do it.

Babysitting. If you babysit for relatives or neighborhood children, whether on a regular basis or only periodically, the rules for childcare providers apply to you.

Bankruptcy. If you filed for bankruptcy under Chapter 11 of the Bankruptcy Code, you must allocate your wages and withheld income tax. Your W-2 will show your total wages and withheld income tax for the year. On your tax return, you report the wages and withheld income tax for the period before you filed for bankruptcy. Your bankruptcy estate reports the wages and withheld income tax for the period after you filed for bankruptcy. If you receive other information returns (such as Form 1099-DIV or 1099-INT) that report gross income to you, rather than to the bankruptcy estate, you must allocate that income.

The only exception is for purposes of figuring your self-employment tax, if you are self-employed. For that purpose, you must take into account all your self-employment income for the year from services performed both before and after the beginning of the case.

You must file a statement with your income tax return stating that you filed a Chapter 11 bankruptcy case. The statement must show the allocation and describe the method used to

make the allocation. For a sample of this statement and other information, see Notice 2006-83, 2006-40 I.R.B. 596, available at www.irs.gov/irb/2006-40_IRB/ar12.html.

Miscellaneous Compensation

This section discusses many types of employee compensation. The subjects are arranged in alphabetical order.

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

If you repay unearned commissions or other amounts in the same year you receive them, reduce the amount included in your income by the repayment. If you repay them 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*, later.

Allowances and reimbursements. If you receive travel, transportation, or other business expense allowances or reimbursements from your employer, see Publication 463, Travel, Entertainment, Gift, and Car Expenses. If you are reimbursed for moving expenses, see Publication 521, Moving Expenses.

Back pay awards. Include in income amounts you are awarded in a settlement or judgment for back pay. These include payments made to you for damages, unpaid life insurance premiums, and unpaid health insurance premiums. They should be reported to you by your employer on Form W-2.

Bonuses and awards. Bonuses or awards you receive for outstanding work are included in your income and should be shown on your Form W-2. These include prizes such as vacation trips for meeting sales goals. If the prize or award you receive is goods or services, you must include the fair market value of the goods or services in your income. However, if your employer merely promises to pay you a bonus or award at some future time, it is not taxable until you receive it or it is made available to you.

Employee achievement award. If you receive tangible personal property (other than cash, a gift certificate, or an equivalent item) as an award for length-of-service or safety achievement, you generally can exclude its value from your income. However, the amount you can exclude is limited to your employer's cost and cannot be more than \$1,600 (\$400 for awards that are not qualified plan awards) for all such awards you receive during the year. Your employer can tell you whether your award is a qualified plan award. Your employer must make the award as part of a meaningful presentation, under conditions and circumstances that do not create a significant likelihood of it being disguised pay.

However, the exclusion does not apply to the following awards.

- A length-of-service award if you received it for less than 5 years of service or if you

received another length-of-service award during the year or the previous 4 years.

- A safety achievement award if you are a manager, administrator, clerical employee, or other professional employee or if more than 10% of eligible employees previously received safety achievement awards during the year.

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 income. However, because the \$1,750 total value of the awards is more than \$1,600, Ben must include \$150 (\$1,750 – \$1,600) in his income.

Government cost-of-living allowances. Cost-of-living allowances generally are included in your income. However, they are 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 income. For example, your compensation includes Foreign Post, Foreign Service, and Overseas Tropical differentials. For more information, see Publication 516, U.S. Government Civilian Employees Stationed Abroad.

Nonqualified deferred compensation plans. Your employer will report to you the total amount of deferrals for the year under a nonqualified deferred compensation plan. This amount is shown on Form W-2, box 12, using code Y. This amount is not included in your income.

However, if at any time during the tax year, the plan fails to meet certain requirements, or is not operated under those requirements, all amounts deferred under the plan for the tax year and all preceding tax years are included in your income for the current year. This amount is included in your wages shown on Form W-2, box 1. It also is shown on Form W-2, box 12, using code Z.

For information on the requirements and the amount to include in income, see Internal Revenue Code section 409A and Notice 2005-1. The notice is on page 274 of Internal Revenue Bulletin 2005-02 available at www.irs.gov/irb/2005-02_IRB/ar13.html.



For tax years beginning after 2008, portions of Notice 2005-1 are obsolete and replaced by final regulations issued under section 409A. For information on the applicability of the regulations, see the preamble to Treasury Decision 9321, 2007-19 I.R.B. 1123, available at www.irs.gov/irb/2007-19_IRB/ar07.html

Note received for services. If your employer gives you a secured note as payment for your services, you must include the fair market value (usually the discount value) of the note in your income for the year you receive it. When you later receive payments on the note, a proportionate part of each payment is the recovery of

the fair market value that you previously included in your income. Do not include that part again in your income. Include the rest of the payment in your income in the year of payment.

If your employer gives you a nonnegotiable 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.

Severance pay. You must include in income amounts you receive as severance pay and any payment for the cancellation of your employment contract.

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 as wages 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. Attach to your tax return a copy of the receipt or statement given to you by the agency you repaid to explain the difference between the wages on your return and the wages on your Forms W-2.

Outplacement services. If you choose to accept a reduced amount of severance pay so that you can receive outplacement services (such as training in résumé writing and interview techniques), you must include the unreduced amount of the severance pay in income.

However, you can deduct the value of these outplacement services (up to the difference between the severance pay included in income and the amount actually received) as a miscellaneous deduction (subject to the 2%-of-adjusted-gross-income (AGI) limit) on Schedule A (Form 1040).

Sick pay. Pay you receive from your employer while you are sick or injured is part of your salary or wages. In addition, you must include in your income sick pay benefits received from any of the following payers.

- A welfare fund.
- A state sickness or disability fund.
- An association of employers or employees.
- 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. For more information, see *Other Sickness and Injury Benefits* under *Sickness and Injury Benefits*, later.

Social security and Medicare taxes paid by employer. If you and your employer have an agreement that your employer pays your social security and Medicare taxes without deducting them from your gross wages, you must report the amount of tax paid for you as taxable wages on your tax return. The payment is also treated as wages for figuring your social security and Medicare taxes and your social security and Medicare benefits. However, these payments are not treated as social security and Medicare

wages if you are a household worker or a farm worker.

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

Fringe Benefits

Fringe benefits received in connection with the performance of your services are included in your income as compensation unless you pay fair market value for them or they are specifically excluded by law. Abstaining from the performance of services (for example, under a covenant not to compete) is treated as the performance of services for purposes of these rules.

See *Valuation of Fringe Benefits*, later in this discussion, for information on how to determine the amount to include in income.

Recipient of fringe benefit. You are the recipient of a fringe benefit if you perform the services for which the fringe benefit is provided. You are considered to be the recipient even if it is given to another person, such as a member of your family. An example is a car your employer gives to your spouse for services you perform. The car is considered to have been provided to you and not to your spouse.

You do not have to be an employee of the provider to be a recipient of a fringe benefit. If you are a partner, director, or independent contractor, you also can be the recipient of a fringe benefit.

Provider of benefit. Your employer or another person for whom you perform services is the provider of a fringe benefit regardless of whether that person actually provides the fringe benefit to you. The provider can be a client or customer of an independent contractor.

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 noncash fringe benefits by using either of the following rules.

- The general rule: benefits are reported for a full calendar year (January 1 – December 31).
- The special accounting period rule: benefits provided during the last 2 months of the calendar year (or any shorter period) are treated as paid during the following calendar year. For example, each year your employer reports the value of benefits provided during the last 2 months of the prior year and the first 10 months of the current year.

Your employer does not have to use the same accounting period for each fringe benefit, but must use the same period for all employees who receive a particular benefit.

You must use the same accounting period that you use to report the benefit to claim an employee business deduction (for use of a car, for example).

Form W-2. Your employer reports your taxable fringe benefits in box 1 (Wages, tips, other compensation) of Form W-2. The total value of your fringe benefits also may be noted in box 14. 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 14.

Accident or Health Plan

Generally, the value of accident or health plan coverage provided to you by your employer is not included in your income. Benefits you receive from the plan may be taxable, as explained, later, under *Sickness and Injury Benefits*.

For information on the items covered in this section, other than *Long-term care coverage*, see Publication 969, Health Savings Accounts and Other Tax-Favored Health Plans.

Long-term care coverage. Contributions by your employer to provide coverage for long-term care services generally are not included in your 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.

Archer MSA contributions. Contributions by your employer to your Archer MSA generally are not included in your income. Their total will be reported in box 12 of Form W-2, with code R. You must report this amount on Form 8853, Archer MSAs and Long-Term Care Insurance Contracts. File the form with your return.

Health flexible spending arrangement (health FSA). If your employer provides a health FSA that qualifies as an accident or health plan, the amount of your salary reduction, and reimbursements of your medical care expenses and those of your spouse and dependents, generally are not included in your income.

Qualified HSA distribution. A health FSA can make a qualified HSA distribution. This distribution is a direct transfer to your HSA trustee by your employer. Generally, the distribution is not included in your income and is not deductible. See Publication 969 for the requirements for these qualified HSA distributions.

Health reimbursement arrangement (HRA). If your employer provides an HRA that qualifies as an accident or health plan, coverage and reimbursements of your medical care expenses and those of your spouse and dependents generally are not included in your income.

Qualified HSA distribution. An HRA can make a qualified HSA distribution. This distribution is a direct transfer to your HSA trustee by your employer. Generally, the distribution is not included in your income and is not deductible. See Publication 969 for the requirements for these qualified HSA distributions.

Health savings accounts (HSA). If you are an eligible individual, you and any other person, including your employer or a family member, can make contributions to your HSA. Contributions, other than employer contributions, are deductible on your return whether or not you

itemize deductions. Contributions made by your employer are not included in your income. Distributions from your HSA that are used to pay qualified medical expenses are not included in your income. Distributions not used for qualified medical expenses are included in your income.

Contributions by a partnership to a *bona fide* partner's HSA are not contributions by an employer. The contributions are treated as a distribution of money and are not included in the partner's gross income. Contributions by a partnership to a partner's HSA for services rendered are treated as guaranteed payments that are includible in the partner's gross income. In both situations, the partner can deduct the contribution made to the partner's HSA.

Contributions by an S corporation to a 2% shareholder-employee's HSA for services rendered are treated as guaranteed payments and are includible in the shareholder-employee's gross income. The shareholder-employee can deduct the contribution made to the shareholder-employee's HSA.

Qualified HSA funding distribution. You can make a one-time distribution from your individual retirement account (IRA) to an HSA and you generally will not include any of the distribution in your income. See Publication 590, Individual Retirement Arrangements (IRAs), for the requirements for these qualified HSA funding distributions.

Failure to maintain eligibility. If your HSA received qualified HSA distributions from a health FSA or HRA (discussed earlier) or a qualified HSA funding distribution, you must be an eligible individual for HSA purposes for the period beginning with the month in which the qualified distribution was made and ending on the last day of the 12th month following that month. If you fail to be an eligible individual during this period, other than because of death or disability, you must include the distribution in your income for the tax year in which you become ineligible. This income is also subject to an additional 10% tax.

Adoption Assistance

You may be able to exclude from your income amounts paid or expenses incurred by your employer for qualified adoption expenses in connection with your adoption of an eligible child. See Instructions for Form 8839 (Qualified Adoption Expenses), for more information.

Adoption benefits are reported by your employer in box 12 of Form W-2 with code T. They also are included as social security and Medicare wages in boxes 3 and 5. However, they are not included as wages in box 1. To determine the taxable and nontaxable amounts, you must complete Part III of Form 8839, Qualified Adoption Expenses. File the form with your return.

Athletic Facilities

If your employer provides you with the free or low-cost use of an employer-operated gym or other athletic club on your employer's premises, the value is not included in your compensation. The gym must be used primarily by employees, their spouses, and their dependent children.

If your employer pays for a fitness program provided to you at an off-site resort hotel or athletic club, the value of the program is included in your compensation.

De Minimis (Minimal) Benefits

If your employer provides you with a product or service and the cost of it is so small that it would be unreasonable for the employer to account for it, the value is not included in your income. Generally, the value of benefits such as discounts at company cafeterias, cab fares home when working overtime, and company picnics are not included in your income. Also see *Employee Discounts*, later.

Holiday gifts. If your employer gives you a turkey, ham, or other item of nominal value at Christmas or other holidays, do not 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 easily can exchange for cash, you include the value of that gift as extra salary or wages regardless of the amount involved.

Dependent Care Benefits

If your employer provides dependent care benefits under a qualified plan, you may be able to exclude these benefits from your income. Dependent care benefits include:

- Amounts your employer pays directly to either you or your care provider for the care of your qualifying person while you work, and
- The fair market value of care in a daycare facility provided or sponsored by your employer.

The amount you can exclude is limited to the lesser of:

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

Your employer must show the total amount of dependent care benefits provided to you during the year under a qualified plan in box 10 of your Form W-2. Your employer also will include any dependent care benefits over \$5,000 in your wages shown in box 1 of your Form W-2.

To claim the exclusion, you must complete either Part III of Form 2441, Child and Dependent Care Expenses, or Part III of Schedule 2 (Form 1040A), Child and Dependent Care Expenses for Form 1040A Filers. (You cannot use Form 1040EZ.)

See the instructions for Form 2441 or Schedule 2 (Form 1040A) for more information.

Educational Assistance

You can exclude from your income up to \$5,250 of qualified employer-provided educational assistance. For more information, see Publication 970.

Employee Discounts

If your employer sells you property or services at a discount, you may be able to exclude the amount of the discount from your income. The exclusion applies to discounts on property or services offered to customers in the ordinary course of the line of business in which you work. However, it does not apply to discounts on real property or property commonly held for investment (such as stocks or bonds).

The exclusion is limited to the price charged nonemployee customers multiplied by the following percentage.

- For a discount on property, your employer's gross profit percentage (gross profit divided by gross sales) on all property sold during the employer's previous tax year. (Ask your employer for this percentage.)
- For a discount on services, 20%.

Financial Counseling Fees

Financial counseling fees paid for you by your employer are included in your income and must be reported as part of wages. If the fees are for tax or investment counseling, they can be deducted on Schedule A (Form 1040) as a miscellaneous deduction (subject to the 2%-of-AGI limit).

Qualified retirement planning services paid for you by your employer may be excluded from your income. For more information, see *Retirement Planning Services*, later.

Group-Term Life Insurance

Generally, the cost of up to \$50,000 of group-term life insurance coverage provided to you by your employer (or former employer) is not included in your income. However, you must include in income the cost of employer-provided insurance that is more than the cost of \$50,000 of coverage reduced by any amount you pay toward the purchase of the insurance.

For exceptions to this rule, see *Entire cost excluded*, and *Entire cost taxed*, later.

If your employer provided more than \$50,000 of coverage, the amount included in your income is reported as part of your wages in box 1 of your Form W-2. Also, it is shown separately in box 12 with code C.

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

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

Permanent benefits. If your group-term life insurance policy includes permanent benefits, such as a paid-up or cash surrender value, you must include in your income, as wages, the cost of the permanent benefits minus the amount you pay for them. Your employer should be able to tell you the amount to include in your income.

Accidental death benefits. Insurance that provides accidental or other death benefits but does not provide general death benefits (travel insurance, for example) is not group-term life insurance.

Former employer. If your former employer provided more than \$50,000 of group-term life insurance coverage during the year, the amount included in your income is reported as wages in box 1 of Form W-2. Also, it is shown separately in box 12 with code C. Box 12 also will show the amount of uncollected social security and Medicare taxes on the excess coverage, with codes M and N. You must pay these taxes with your income tax return. Include them in your total tax on line 61, Form 1040, and enter "UT" and the amount of the taxes on the dotted line next to line 61.

Two or more employers. Your exclusion for employer-provided group-term life insurance coverage cannot exceed the cost of \$50,000 of coverage, whether the insurance is provided by a single employer or multiple employers. If two or more employers provide insurance coverage that totals more than \$50,000, the amounts reported as wages on your Forms W-2 will not be correct. You must figure how much to include in your income. Reduce the amount you figure by any amount reported with code C in box 12 of your Forms W-2, add the result to the wages reported in box 1, and report the total on your return.

Figuring the taxable cost. Use the following worksheet to figure the amount to include in your income.

If you pay any part of the cost of the insurance, your entire payment reduces, dollar for dollar, the amount you otherwise would include in your income. However, you cannot reduce the amount to include in your income by:

- Payments for coverage in a different tax year,
- Payments for coverage through a cafeteria plan, unless the payments are after-tax contributions, or
- Payments for coverage not taxed to you because of the exceptions discussed later under *Entire cost excluded*.

Worksheet 1. Figuring the Cost of Group-Term Life Insurance To Include in Income

| | |
|--|------------------|
| 1. Enter the total amount of your insurance coverage from your employer(s) | 1. _____ |
| 2. Limit on exclusion for employer-provided group-term life insurance coverage | 2. <u>50,000</u> |
| 3. Subtract line 2 from line 1 | 3. _____ |
| 4. Divide line 3 by \$1,000. Figure to the nearest tenth | 4. _____ |
| 5. Go to Table 1. Using your age on the last day of the tax year, find your age group in the left column, and enter the cost from the column on the right for your age group | 5. _____ |
| 6. Multiply line 4 by line 5 | 6. _____ |
| 7. Enter the number of full months of coverage at this cost | 7. _____ |
| 8. Multiply line 6 by line 7 | 8. _____ |
| 9. Enter the premiums you paid per month | 9. _____ |
| 10. Enter the number of months you paid the premiums | 10. _____ |
| 11. Multiply line 9 by line 10. | 11. _____ |
| 12. Subtract line 11 from line 8. Include this amount in your income as wages | 12. _____ |

Table 1. Cost of \$1,000 of Group-Term Life Insurance for One Month

| Age | Cost |
|-------------------------|-------|
| Under 25 | \$.05 |
| 25 through 29 | .06 |
| 30 through 34 | .08 |
| 35 through 39 | .09 |
| 40 through 44 | .10 |
| 45 through 49 | .15 |
| 50 through 54 | .23 |
| 55 through 59 | .43 |
| 60 through 64 | .66 |
| 65 through 69 | 1.27 |
| 70 and older | 2.06 |

Example. You are 51 years old and work for employers A and B. Both employers provide group-term life insurance coverage for you for the entire year. Your coverage is \$35,000 with employer A and \$45,000 with employer B. You pay premiums of \$4.15 a month under the employer B group plan. You figure the amount to include in your income as follows.

Worksheet 1. Figuring the Cost of Group-Term Life Insurance To Include in Income—Illustrated

| | | |
|--|-----|---------------|
| 1. Enter the total amount of your insurance coverage from your employer(s) | 1. | <u>80,000</u> |
| 2. Limit on exclusion for employer-provided group-term life insurance coverage | 2. | <u>50,000</u> |
| 3. Subtract line 2 from line 1 | 3. | <u>30,000</u> |
| 4. Divide line 3 by \$1,000. Figure to the nearest tenth | 4. | <u>30.0</u> |
| 5. Go to Table 1. Using your age on the last day of the tax year, find your age group in the left column, and enter the cost from the column on the right for your age group | 5. | <u>.23</u> |
| 6. Multiply line 4 by line 5 | 6. | <u>6.90</u> |
| 7. Enter the number of full months of coverage at this cost. | 7. | <u>12</u> |
| 8. Multiply line 6 by line 7 | 8. | <u>82.80</u> |
| 9. Enter the premiums you paid per month | 9. | <u>4.15</u> |
| 10. Enter the number of months you paid the premiums | 10. | <u>12</u> |
| 11. Multiply line 9 by line 10. | 11. | <u>49.80</u> |
| 12. Subtract line 11 from line 8. Include this amount in your income as wages | 12. | <u>33.00</u> |

The total amount to include in income for the cost of excess group-term life insurance is \$33. Neither employer provided over \$50,000 insurance coverage, so the wages shown on your Forms W-2 do not include any part of that \$33. You must add it to the wages shown on your Forms W-2 and include the total on your return.

Entire cost excluded. You are not taxed on the cost of group-term life insurance if any of the following circumstances apply.

1. You are permanently and totally disabled and have ended your employment.
2. Your employer is the beneficiary of the policy for the entire period the insurance is in force during the tax year.
3. A charitable organization to which contributions are deductible is the only beneficiary of the policy for the entire period the insurance is in force during the tax year. (You are not entitled to a deduction for a charitable contribution for naming a charitable organization as the beneficiary of your policy.)
4. The plan existed on January 1, 1984, and:

- a. You retired before January 2, 1984, and were covered by the plan when you retired, or
- b. You reached age 55 before January 2, 1984, and were employed by the employer or its predecessor in 1983.

Entire cost taxed. You are taxed on the entire cost of group-term life insurance if either of the following circumstances apply.

- The insurance is provided by your employer through a qualified employees' trust, such as a pension trust or a qualified annuity plan.
- You are a key employee and your employer's plan discriminates in favor of key employees.

Meals and Lodging

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

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

You also do not include in your income the value of meals or meal money that qualifies as a *de minimis* fringe benefit. See *De Minimis (Minimal) Benefits*, earlier.

Lodging for employees affected by Midwestern disaster. If your employer provides in-kind lodging to you (or your spouse or dependents), you may be able to exclude from income part or all of the value of this lodging. The exclusion is equal to the value of lodging furnished from November 2008 through April 2009, up to a maximum of \$600 per month.

You can exclude the value only if you had your main home in a Midwestern disaster area on the applicable disaster date and you perform substantially all your work in a Midwestern disaster area for the employer furnishing the lodging. You cannot be a dependent of, or related to, your employer. For more information, see Publication 4492-B.

Faculty lodging. If you are an employee of an educational institution or an academic health center and you are provided with lodging that does not meet the three conditions above, you still may not have to include the value of the lodging in income. However, the lodging must be qualified campus lodging, and you must pay an adequate rent.

Academic health center. This is an organization that meets the following conditions.

- Its principal purpose or function is to provide medical or hospital care or medical education or research.
- It receives payments for graduate medical education under the Social Security Act.
- One of its principal purposes or functions is to provide and teach basic and clinical medical science and research using its own faculty.

Qualified campus lodging. Qualified campus lodging is lodging furnished to you, your spouse, or one of your dependents by, or on behalf of, the institution or center for use as a home. The lodging must be located on or near a campus of the educational institution or academic health center.

Adequate rent. The amount of rent you pay for the year for qualified campus lodging is considered adequate if it is at least equal to the lesser of:

- 5% of the appraised value of the lodging, or
- The average of rentals paid by individuals (other than employees or students) for comparable lodging held for rent by the educational institution.

If the amount you pay is less than the lesser of these amounts, you must include the difference in your income.

The lodging must be appraised by an independent appraiser and the appraisal must be reviewed on an annual basis.

Example. Carl Johnson, a sociology professor for State University, rents a home from the university that is qualified campus lodging. The house is appraised at \$200,000. The average rent paid for comparable university lodging by persons other than employees or students is \$14,000 a year. Carl pays an annual rent of \$11,000. Carl does not include in his income any rental value because the rent he pays equals at least 5% of the appraised value of the house ($5\% \times \$200,000 = \$10,000$). If Carl paid annual rent of only \$8,000, he would have to include \$2,000 in his income ($\$10,000 - \$8,000$).

Moving Expense Reimbursements

Generally, if your employer pays for your moving expenses (either directly or indirectly) and the expenses would have been deductible if you paid them yourself, the value is not included in your income. See Publication 521, Moving Expenses, for more information.

No-Additional-Cost Services

The value of services you receive from your employer for free, at cost, or for a reduced price is not included in your income if your employer:

- Offers the same service for sale to customers in the ordinary course of the line of business in which you work, and

- Does not have a substantial additional cost (including any sales income given up) to provide you with the service (regardless of what you paid for the service).

Generally, no-additional-cost services are excess capacity services, such as airline, bus, or train tickets, hotel rooms, and telephone services.

Example. You are employed as a flight attendant for a company that owns both an airline and a hotel chain. Your employer allows you to take personal flights (if there is an unoccupied seat) and stay in any one of their hotels (if there is an unoccupied room) at no cost to you. The value of the personal flight is not included in your income. However, the value of the hotel room is included in your income because you do not work in the hotel business.

Retirement Planning Services

If your employer has a qualified retirement plan, qualified retirement planning services provided to you (and your spouse) by your employer are not included in your income. Qualified services include retirement planning advice, information about your employer's retirement plan, and information about how the plan may fit into your overall individual retirement income plan. You cannot exclude the value of any tax preparation, accounting, legal, or brokerage services provided by your employer. Also, see *Financial Counseling Fees*, earlier.

Transportation

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

- Transportation in a commuter highway vehicle (such as a van) between your home and work place,
- A transit pass, or
- Qualified parking.

Cash reimbursement by your employer for these expenses under a *bona fide* reimbursement arrangement is also excludable. However, cash reimbursement for a transit pass is excludable only if a voucher or similar item that can be exchanged only for a transit pass is not readily available for direct distribution to you.

Exclusion limit. The exclusion for commuter highway vehicle transportation and transit pass fringe benefits cannot be more than a total of \$115 a month.

The exclusion for the qualified parking fringe benefit cannot be more than \$220 a month.

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:

- For transporting employees between their homes and work place, and
- 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 by mass transit, in a commuter highway vehicle, or by carpool. It does not include parking at or near the employee's home.

Tuition Reduction

You can exclude a qualified tuition reduction from your income. This is the amount of a reduction in tuition:

- For education (below graduate level) furnished by an educational institution to an employee, former employee who retired or became disabled, or his or her spouse and dependent children.
- For education furnished to a graduate student at an educational institution if the graduate student is engaged in teaching or research activities for that institution.
- Representing payment for teaching, research, or other services if you receive the amount under the National Health Service Corps Scholarship Program or the Armed Forces Health Professions Scholarship and Financial Assistance program.

For more information, see Publication 970.

Working Condition Benefits

If your employer provides you with a product or service and the cost of it would have been allowable as a business or depreciation deduction if you paid for it yourself, the cost is not included in your income.

Example. You work as an engineer and your employer provides you with a subscription to an engineering trade magazine. The cost of the subscription is not included in your income because the cost would have been allowable to you as a business deduction if you had paid for the subscription yourself.

Valuation of Fringe Benefits

If a fringe benefit is included in your income, the amount included is generally its value determined under the general valuation rule or under the special valuation rules. For an exception, see *Group-Term Life Insurance*, earlier.

General valuation rule. You must include in your income the amount by which the fair market value of the fringe benefit is more than the sum of:

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

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

Fair market value. The fair market value of a fringe benefit is determined by all the facts and circumstances. It is the amount you would have to pay a third party to buy or lease the benefit. This is determined without regard to:

- Your perceived value of the benefit, or
- The amount your employer paid for the benefit.

Employer-provided vehicles. If your employer provides a car (or other highway motor vehicle) to you, your personal use of the car is usually a taxable noncash fringe benefit.

Under the general valuation rules, the value of an employer-provided vehicle is the amount you would have to pay a third party to lease the same or a similar vehicle on the same or comparable terms in the same geographic area where you use the vehicle. An example of a comparable lease term is the amount of time the vehicle is available for your use, such as a 1-year period. The value cannot be determined by multiplying a cents-per-mile rate times the number of miles driven unless you prove the vehicle could have been leased on a cents-per-mile basis.

Flights on employer-provided aircraft. Under the general valuation rules, if your flight on an employer-provided piloted aircraft is primarily personal and you control the use of the aircraft for the flight, the value is the amount it would cost to charter the flight from a third party.

If there is more than one employee on the flight, the cost to charter the aircraft must be divided among those employees. The division must be based on all the facts, including which employee or employees control the use of the aircraft.

Special valuation rules. You generally can use a special valuation rule for a fringe benefit only if your employer uses the rule. If your employer uses a special valuation rule, you cannot use a different special rule to value that benefit. You always can use the general valuation rule discussed earlier, based on facts and circumstances, even if your employer uses a special rule.

If you and your employer use a special valuation rule, you must include in your income the amount your employer determines under the special rule minus the sum of:

1. Any amount you repaid your employer, plus
2. Any amount specifically excluded from income by law.

The special valuation rules are the following.

- The automobile lease rule.
- The vehicle cents-per-mile rule.
- The commuting rule.
- The unsafe conditions commuting rule.
- The employer-operated eating-facility rule.

For more information on these rules, see Publication 15-B, Employer's Tax Guide to Fringe Benefits.

For information on the non-commercial flight and commercial flight valuation rules, see sections 1.61-21(g) and 1.61-21(h) of the regulations.

Retirement Plan Contributions

Your employer's contributions to a qualified retirement plan for you are not included in income at the time contributed. (Your employer can tell you whether your retirement plan is qualified.) However, the cost of life insurance coverage included in the plan may have to be included. See *Group-Term Life Insurance*, earlier, under *Fringe Benefits*.

If your employer pays into a nonqualified plan for you, you generally must include the contributions in your income as wages for the tax year in which the contributions are made. However, if your interest in the plan is not transferable or is subject to a substantial risk of forfeiture (you have a good chance of losing it) at the time of the contribution, you do not have to include the value of your interest in your income until it is transferable or is no longer subject to a substantial risk of forfeiture.



For information on distributions from retirement plans, see Publication 575 (or Publication 721, *Tax Guide to U.S. Civil Service Retirement Benefits*, if you are a federal employee or retiree).

Elective Deferrals

If you are covered by certain kinds of retirement plans, you can choose to have part of your compensation contributed by your employer to a retirement fund, rather than have it paid to you. The amount you set aside (called an elective deferral) is treated as an employer contribution to a qualified plan. An elective deferral, other than a designated Roth contribution (discussed later), is not included in wages subject to income tax at the time contributed. However, it is included in wages subject to social security and Medicare taxes.

Elective deferrals include elective contributions to the following retirement plans.

1. Cash or deferred arrangements (section 401(k) plans).
2. The Thrift Savings Plan for federal employees.
3. Salary reduction simplified employee pension plans (SARSEP).
4. Savings incentive match plans for employees (SIMPLE plans).
5. Tax-sheltered annuity plans (403(b) plans).
6. Section 501(c)(18)(D) plans. (But see *Reporting by employer*, later.)
7. Section 457 plans.

Qualified automatic contribution arrangements. Under a qualified automatic contribution arrangement, your employer can treat you

as having elected to have a part of your compensation contributed to a section 401(k) plan. Before each plan year, your employer must give you a written notice of your rights under the arrangement. You can elect to change the amount of the contributions or elect out of the arrangement.

Overall limit on deferrals. For 2008, you generally should not have deferred more than a total of \$15,500 of contributions to the plans listed in (1) through (3) above. The specific plan limits for the plans listed in (4) through (7) above are discussed later.

Your employer or plan administrator should apply the proper annual limit when figuring your plan contributions. However, you are responsible for monitoring the total you defer to ensure that the deferrals are not more than the overall limit.

Catch-up contributions. You may be allowed catch-up contributions (additional elective deferrals) if you are age 50 or older by the end of your tax year. For more information about catch-up contributions to 403(b) plans, see chapter 6 of Publication 571, *Tax Sheltered Annuity Plans (403(b) Plans)*.

For more information about additional elective deferrals to:

- SEPs (SARSEPs), see *Salary Reduction Simplified Employee Pension* in Publication 560, *Retirement Plans for Small Business*.
- SIMPLE plans, see *How Much Can Be Contributed on Your Behalf?* in chapter 3 of Publication 590.
- Section 457 plans, see *Limit for deferrals under section 457 plans*, later.

Limit for deferrals under SIMPLE plans. If you are a participant in a SIMPLE plan, you generally should not have deferred more than \$10,500 in 2008. Amounts you defer under a SIMPLE plan count toward the overall limit (\$15,500 for 2008) and may affect the amount you can defer under other elective deferral plans.

Limit for tax-sheltered annuities. If you are a participant in a tax-sheltered annuity plan (403(b) plan), the limit on elective deferrals for 2008 generally is \$15,500. However, if you have at least 15 years of service with a public school system, a hospital, a home health service agency, a health and welfare service agency, a church, or a convention or association of churches (or associated organization), the limit on elective deferrals is increased by the least of the following amounts.

1. \$3,000.
2. \$15,000, reduced by increases to the overall limit that you were allowed in earlier years because of this years-of-service rule.
3. \$5,000 times your number of years of service for the organization, minus the total elective deferrals under the plan for earlier years.

For more information, see Publication 571.

Limit for deferral under section 501(c)(18) plans. If you are a participant in a section 501(c)(18) plan (a trust created before June 25,

1959, funded only by employee contributions), you should have deferred no more than the lesser of \$7,000 or 25% of your compensation.

Limit for deferrals under section 457 plans.

If you are a participant in a section 457 plan (a deferred compensation plan for employees of state or local governments or tax-exempt organizations), you should have deferred no more than the lesser of your includible compensation or \$15,500. However, if you are within 3 years of normal retirement age, you may be allowed an increased limit if the plan allows it. See *Increased limit*, later.

Includible compensation. This is the pay you received for the year from the employer who maintained the section 457 plan. It generally includes all the following payments.

1. Wages and salaries.
2. Fees for professional services.
3. The value of any employer-provided qualified transportation fringe benefit (defined under *Transportation*, earlier) that is not included in your income.
4. Other amounts received (cash or noncash) for personal services you performed, including, but not limited to, the following items.
 - a. Commissions and tips.
 - b. Fringe benefits.
 - c. Bonuses.
5. Employer contributions (elective deferrals) to:
 - a. The section 457 plan.
 - b. Qualified cash or deferred arrangements (section 401(k) plans) that are not included in your income.
 - c. A salary reduction simplified employee pension (SARSEP).
 - d. A tax-sheltered annuity (section 403(b) plan).
 - e. A savings incentive match plan for employees (SIMPLE plan).
 - f. A section 125 cafeteria plan.

Instead of using the amounts listed above to determine your includible compensation, your employer can use any of the following amounts.

- Your wages as defined for income tax withholding purposes.
- Your wages as reported in box 1 of Form W-2, Wage and Tax Statement.
- Your wages that are subject to social security withholding (including elective deferrals).

Increased limit. During any, or all, of the last 3 years ending before you reach normal retirement age under the plan, your plan may provide that your limit is the lesser of:

1. Twice the dollar limit for the year, or
2. The limit for prior years minus the amount you deferred in prior years plus the lesser of:

- a. Your includible compensation for the current year, or
- b. The dollar limit for the current year.

Catch-up contributions. You generally can have additional elective deferrals made to your governmental section 457 plan if:

- You reached age 50 by the end of the year, and
- No other elective deferrals can be made for you to the plan for the year because of limits or restrictions.

If you qualify, your limit can be the lesser of your includible compensation or \$15,500, plus \$5,000. However, if you are within 3 years of retirement age and your plan provides the increased limit, discussed earlier, that limit may be higher.

Designated Roth contributions. Employers with section 401(k) and section 403(b) plans can create qualified Roth contribution programs so that you may elect to have part or all of your elective deferrals to the plan designated as after-tax Roth contributions. Designated Roth contributions are treated as elective deferrals, except that they are included in income. Your retirement plan must maintain separate accounts and recordkeeping for the designated Roth contributions.

Qualified distributions from a Roth plan are not included in income. Generally, a distribution made before the end of the 5-tax-year period beginning with the first tax year for which you made a designated Roth contribution to the plan is not a qualified distribution.

Reporting by employer. Your employer generally should not include elective deferrals in your wages in box 1 of Form W-2. Instead, your employer should mark the Retirement plan checkbox in box 13 and show the total amount deferred in box 12.

Section 501(c)(18)(D) contributions. Wages shown in box 1 of your Form W-2 should not have been reduced for contributions you made to a section 501(c)(18)(D) retirement plan. The amount you contributed should be identified with code "H" in box 12. You may deduct the amount deferred subject to the limits that apply. Include your deduction in the total on Form 1040, line 36. Enter the amount and "501(c)(18)(D)" on the dotted line next to line 36.

Designated Roth contributions. These contributions are elective deferrals but are included in your wages in box 1 of Form W-2. Designated Roth contributions to a section 401(k) plan are reported using code AA in box 12, or, for section 403(b) plans, code BB in box 12.

Excess deferrals. If your deferrals exceed the limit, you must notify your plan by the date required by the plan. If the plan permits, the excess amount will be distributed to you. If you participate in more than one plan, you can have the excess paid out of any of the plans that permit these distributions. You must notify each plan by the date required by that plan of the amount to be paid from that particular plan. The

plan then must pay you the amount of the excess, along with any income earned on that amount, by April 15 of the following year.

You must include the excess deferral in your income for the year of the deferral unless you have an excess deferral of a designated Roth contribution. File Form 1040 to add the excess deferral amount to your wages on line 7. Do not use Form 1040A or Form 1040EZ to report excess deferral amounts.

Excess not distributed. If you do not take out the excess amount, you cannot include it in the cost of the contract even though you included it in your income. Therefore, you are taxed twice on the excess deferral left in the plan—once when you contribute it, and again when you receive it as a distribution.

Excess distributed to you. If you take out the excess after the year of the deferral and you receive the corrective distribution by April 15 of the following year, do not include it in income again in the year you receive it. If you receive it later, you must include it in income in both the year of the deferral and the year you receive it. Any income on the excess deferral taken out is taxable in the tax year in which you take it out. If you take out part of the excess deferral and the income on it, allocate the distribution proportionately between the excess deferral and the income.

You should receive a Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc., for the year in which the excess deferral is distributed to you. Use the following rules to report a corrective distribution shown on Form 1099-R for 2008.

- If the distribution was for a 2008 excess deferral, your Form 1099-R should have the code "8" in box 7. Add the excess deferral amount to your wages on your 2008 tax return.
- If the distribution was for a 2008 excess deferral to a designated Roth account, your Form 1099-R should have code "B" in box 7. Do not add this amount to your wages on your 2008 return.
- If the distribution was for a 2007 excess deferral, your Form 1099-R should have the code "P" in box 7. If you did not add the excess deferral amount to your wages on your 2007 tax return, you must file an amended return on Form 1040X, Amended U.S. Individual Income Tax Return. If you did not receive the distribution by April 15, 2008, you also must add it to your wages on your 2008 tax return.
- If the distribution was for a 2006 excess deferral, your Form 1099-R should have the code "D" in box 7. If you did not add the excess deferral amount to your wages on your 2006 tax return, you must file an amended return on Form 1040X. You also must add it to your wages on your 2008 income tax return.
- If the distribution was for the income earned on an excess deferral, your Form 1099-R should have the code "8" in box 7. Add the income amount to your wages on your 2008 income tax return, regardless of when the excess deferral was made.

Report a loss on a corrective distribution of an excess deferral in the year the excess amount (reduced by the loss) is distributed to you. Include the loss as a negative amount on Form 1040, line 21 and identify it as "Loss on Excess Deferral Distribution."



Even though a corrective distribution of excess deferrals is reported on Form 1099-R, it is not otherwise treated as a distribution from the plan. It cannot be rolled over into another plan, and it is not subject to the additional tax on early distributions.

Excess Contributions

If you are a highly compensated employee, the total of your elective deferrals and other contributions made for you for any year under a section 401(k) plan or SARSEP can be, as a percentage of pay, no more than 125% of the average deferral percentage (ADP) of all eligible non-highly compensated employees.

If the total contributed to the plan is more than the amount allowed under the ADP test, the excess contributions must be either distributed to you or recharacterized as after-tax employee contributions by treating them as distributed to you and then contributed by you to the plan. You must include the excess contributions in your income as wages on Form 1040, line 7. You cannot use Form 1040A or Form 1040EZ to report excess contribution amounts.

If you receive excess contributions from a 401(k) plan and any income earned on the contributions within 2½ months after the close of the plan year, you must include them in your income in the year of the contribution. If you receive them later, or receive less than \$100 excess contributions, include the excess contributions and earnings in your income in the year distributed. If the excess contributions are recharacterized, you must include them in income in the year a corrective distribution would have occurred. For a SARSEP, the employer must notify you by March 15 following the year in which excess contributions are made that you must withdraw the excess and earnings. You must include the excess contributions in your income in the year of the contribution (or the year of the notification if less than \$100) and include the earnings in your income in the year withdrawn.

You should receive a Form 1099-R for the year in which the excess contributions are distributed to you (or are recharacterized). Add excess contributions or earnings shown on Form 1099-R for 2008 to your wages on your 2008 tax return if code "8" is in box 7. If code "P" or "D" is in box 7, you may have to file an amended 2007 or 2006 return on Form 1040X to add the excess contributions or earnings to your wages in the year of the contribution.



Even though a corrective distribution of excess contributions is reported on Form 1099-R, it is not otherwise treated as a distribution from the plan. It cannot be rolled over into another plan, and it is not subject to the additional tax on early distributions.

Excess Annual Additions

The amount contributed in 2008 to a defined contribution plan is generally limited to the lesser of 100% of your compensation or \$46,000. Under certain circumstances, contributions that exceed these limits (excess annual additions) may be corrected by a distribution of your elective deferrals or a return of your after-tax contributions and earnings from these contributions.

A corrective payment of excess annual additions consisting of elective deferrals or earnings from your after-tax contributions is fully taxable in the year paid. A corrective payment consisting of your after-tax contributions is not taxable.

If you received a corrective payment of excess annual additions, you should receive a separate Form 1099-R for the year of the payment with the code "E" in box 7. Report the total payment shown in box 1 of Form 1099-R on line 16a of Form 1040 or line 12a of Form 1040A. Report the taxable amount shown in box 2a of Form 1099-R on line 16b of Form 1040 or line 12b of Form 1040A.



Even though a corrective distribution of excess annual additions is reported on Form 1099-R, it is not otherwise treated as a distribution from the plan. It cannot be rolled over into another plan, and it is not subject to the additional tax on early distributions.

Stock Options

If you receive an option to buy or sell stock or other property as payment for your services, you may have income when you receive the option (the grant), when you exercise the option (use it to buy or sell the stock or other property), or when you sell or otherwise dispose of the option or property acquired through exercise of the option. The timing, type, and amount of income inclusion depend on whether you receive a nonstatutory stock option or a statutory stock option. Your employer can tell you which kind of option you hold.

Nonstatutory Stock Options

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

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

- You can transfer the option.
- You can exercise the option immediately in full.
- The option or the property subject to the option is not subject to any condition or restriction (other than a condition to secure payment of the purchase price) that has a significant effect on the fair market value of the option.

- The fair market value of the option privilege can be readily determined.

The option privilege for an option to buy is the opportunity to benefit during the option's exercise period from any increase in the value of property subject to the option without risking any capital. For example, if during the exercise period the fair market value of stock subject to an option is greater than the option's exercise price, a profit may be realized by exercising the option and immediately selling the stock at its higher value. The option privilege for an option to sell is the opportunity to benefit during the exercise period from a decrease in the value of the property subject to the option.



If you or a member of your family is an officer, director, or more-than-10% owner of an expatriated corporation, you may owe an excise tax on the value of nonstatutory options and other stock-based compensation from that corporation. For more information on the excise tax, see Internal Revenue Code section 4985.

Option with readily determinable value. If you receive a nonstatutory stock option that has a readily determinable fair market value at the time it is granted to you, the option is treated like other property received as compensation. See *Restricted Property*, later, for rules on how much income to include and when to include it. However, the rule described in that discussion for choosing to include the value of property in your income for the year of the transfer does not apply to a nonstatutory option.

Option without readily determinable value. If the fair market value of the option is not readily determinable at the time it is granted to you (even if it is determined later), you do not have income until you exercise or transfer the option.

Exercise or transfer of option. When you exercise a nonstatutory stock option, the amount to include in your income depends on whether the option had a readily determinable value.

Option with readily determinable value. When you exercise a nonstatutory stock option that had a readily determinable value at the time the option was granted, you do not have to include any amount in income.

Option without readily determinable value. When you exercise a nonstatutory stock option that did not have a readily determinable value at the time the option was granted, the restricted property rules apply to the property received. The amount to include in your income is the difference between the amount you pay for the property and its fair market value when it becomes substantially vested. If it is not substantially vested at the time you exercise this nonstatutory stock option (so that you may have to give the stock back), you do not have to include any amount in income. You include the difference in income when the option becomes substantially vested. For more information on restricted property, see *Restricted Property*, later.

Transfer in arm's-length transaction. If you transfer a nonstatutory stock option without a readily determinable value in an arm's-length transaction to an unrelated person, you must

include in your income the money or other property you received for the transfer, as if you had exercised the option.

Transfer in non-arm's-length transaction. If you transfer a nonstatutory stock option without a readily determinable value in a non-arm's-length transaction (for example, a gift), the option is not treated as exercised or closed at that time. You must include in your income, as compensation, any money or property received. When the transferee exercises the option, you must include in your income, as compensation, the excess of the fair market value of the stock acquired by the transferee over the sum of the exercise price paid and any amount you included in income at the time you transferred the option. At the time of the exercise, the transferee recognizes no income and has a basis in the stock acquired equal to the fair market value of the stock.

Any transfer of this kind of option to a related person is treated as a non-arm's-length transaction. See Regulations section 1.83-7 for the definition of a related person.

Recourse note in satisfaction of the exercise price of an option. If you are an employee, and you issue a recourse note to your employer in satisfaction of the exercise price of an option to acquire your employer's stock, and your employer and you subsequently agree to reduce the stated principal amount of the note, you generally recognize compensation income at the time and in the amount of the reduction.

Tax form. If you receive compensation from employer-provided nonstatutory stock options, it is reported in box 1 of Form W-2. It also is reported in box 12 using code "V."

If you are a nonemployee spouse and you exercise nonstatutory stock options you received incident to a divorce, the income is reported to you on Form 1099-MISC, Miscellaneous Income, in box 3.

Sale of the stock. There are no special income rules for the sale of stock acquired through the exercise of a nonstatutory stock option. Report the sale on Schedule D (Form 1040), Capital Gains and Losses, for the year of the sale. You may receive a Form 1099-B, Proceeds from Broker and Barter Sale Transactions, reporting the sales proceeds.

Your basis in the property you acquire under the option is the amount you pay for it plus any amount you included in income upon grant or exercise of the option.

Your holding period begins as of the date you acquired the option, if it had a readily determinable value, or as of the date you exercised or transferred the option, if it had no readily determinable value.

Statutory Stock Options

There are two kinds of statutory stock options.

- Incentive stock options (ISOs), and
- Options granted under employee stock purchase plans.

For either kind of option, you must be an employee of the company granting the option, or a related company, at all times during the period beginning on the date the option is granted and

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

If you do not meet the employment requirements, or you receive a transferable option, your option is a nonstatutory stock option.

Grant of option. If you receive a statutory stock option, do not include any amount in your income when the option is granted.

Exercise of option. If you exercise a statutory stock option, do not include any amount in income when you exercise the option.

Alternative minimum tax (AMT). For the AMT, you must treat stock acquired through the exercise of an ISO as if no special treatment applied. This means that, when your rights in the stock are transferable or no longer subject to a substantial risk of forfeiture, you must include as an adjustment in figuring alternative minimum taxable income the amount by which the fair market value of the stock exceeds the option price. Enter this adjustment on line 14 of Form 6251, Alternative Minimum Tax—Individuals. Increase your AMT basis in any stock you acquire by exercising the ISO by the amount of the adjustment. However, no adjustment is required if you dispose of the stock in the same year you exercise the option.

See *Restricted Property*, later, for more information.



Your AMT basis in stock acquired through an ISO is likely to differ from your regular tax basis. Therefore, keep adequate records for both the AMT and regular tax so that you can figure your adjusted gain or loss.

Example. Your employer, M Company, granted you an incentive stock option on April 6, 2006, to buy 100 shares of M Company at \$9 a share, its fair market value at the time. You exercised the option on January 9, 2007, when the stock was selling on the open market for \$14 a share. On January 25, 2008, when the stock was selling on the open market for \$16 a share, your rights to the stock first became transferable. You include \$700 (\$1,600 value when your rights first became transferable minus \$900 option price) as an adjustment on Form 6251, line 14.

Sale of the stock. You have taxable income or a deductible loss when you sell the stock that you bought by exercising the option. Your income or loss is the difference between the amount you paid for the stock (the option price) and the amount you receive when you sell it. You generally treat this amount as capital gain or loss and report it on Schedule D (Form 1040) for the year of the sale.

However, you may have ordinary income for the year that you sell or otherwise dispose of the stock in either of the following situations.

- You do not satisfy the holding period requirement.
- You satisfy the conditions described under *Option granted at a discount*, under *Employee stock purchase plan*, later.

Report your ordinary income as wages on Form 1040, line 7, for the year of the sale.

Holding period requirement. You satisfy the holding period requirement if you do not sell the stock until the end of the later of the 1-year period after the stock was transferred to you or the 2-year period after the option was granted. However, you are considered to satisfy the holding period requirement if you sold the stock to comply with conflict-of-interest requirements.

Incentive stock options (ISOs). If you sell stock acquired by exercising an ISO, you need to determine if you satisfied the holding period requirement.

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

Holding period requirement not satisfied. If you sell stock acquired by exercising an ISO, do not satisfy the holding period requirement, and have a gain from the sale, the gain is ordinary income up to the amount by which the stock's fair market value when you exercised the option exceeded the option price. Any excess gain is capital gain. If you have a loss from the sale, it is a capital loss and you do not have any ordinary income.

Report the ordinary income as wages on line 7, Form 1040. Report the capital gain or loss on Schedule D (Form 1040). In determining capital gain or loss, your basis is the amount you paid when you exercised the option plus the amount reported as wages.

Example. Your employer, X Corporation, granted you an ISO on March 10, 2006, to buy 100 shares of X Corporation stock at \$10 a share, its fair market value at the time. You exercised the option on January 4, 2007, when the stock was selling on the open market for \$12 a share. On January 24, 2008, you sold the stock for \$15 a share. Although you held the stock for more than a year, less than 2 years had passed from the time you were granted the option. In 2008, you must report the difference between the option price (\$10) and the value of the stock when you exercised the option (\$12) as wages. The rest of your gain is capital gain, figured as follows:

| | |
|--|----------------------|
| Selling price (\$15 × 100 shares) | 1,500 |
| Purchase price (\$10 × 100 shares) | <u>–1,000</u> |
| Gain | \$ 500 |
| Amount reported as wages | |
| [((\$12 × 100 shares) – \$1,000)] | <u>– 200</u> |
| Amount reported as capital gain | <u>\$ 300</u> |

Employee stock purchase plan. If you sold stock acquired by exercising an option granted under an employee stock purchase plan, you need to determine if you satisfied the holding period requirement.

Holding period requirement satisfied. If you sold stock acquired by exercising an option granted under an employee stock purchase plan, and you satisfy the holding period requirement, determine your ordinary income as follows.

Your basis is equal to the option price at the time you exercised your option and acquired the

stock. The timing and amount of pay period deductions do not affect your basis.

Your holding period for the property you acquire when you exercise an option begins on the day after you exercise the option.

Example. XYZ Company has an employee stock purchase plan. The option price is the lower of the stock price at the time the option is granted or at the time the option is exercised. The value of the stock when the option was granted was \$25. XYZ deducts \$5 from A's pay every week for 48 weeks (total = \$240 (\$5 × 48)). The value of the stock when the option is exercised is \$20. A receives 12 shares of XYZ stock (\$240/\$20). A's holding period for all 12 shares begins the day after the option is exercised, even though the money used to purchase the shares was deducted from A's pay on 48 separate days. A's basis in each share is \$20.

Option granted at a discount. If, at the time the option was granted, the option price per share was less than 100% (but not less than 85%) of the fair market value of the share, and you dispose of the share after meeting the holding period requirement, or you die while owning the share, you must include in your income as compensation, the lesser of:

- The excess of the fair market value of the share at the time the option was granted over the option price, or
- The excess of the fair market value of the share at the time of the disposition or death over the amount paid for the share under the option.

For this purpose, if the option price was not fixed or determinable at the time the option was granted, the option price is figured as if the option had been exercised at the time it was granted.

Any excess gain is capital gain. If you have a loss from the sale, it is a capital loss, and you do not have any ordinary income.

Example. Your employer, Y Corporation, granted you an option under its employee stock purchase plan to buy 100 shares of stock of Y Corporation for \$20 a share at a time when the stock had a value of \$22 a share. Eighteen months later, when the value of the stock was \$23 a share, you exercised the option, and 14 months after that you sold your stock for \$30 a share. In the year of sale, you must report as wages the difference between the option price (\$20) and the value at the time the option was granted (\$22). The rest of your gain (\$8 per share) is capital gain, figured as follows:

| | |
|--|----------------------|
| Selling price (\$30 × 100 shares) | 3,000 |
| Purchase price (option price) | |
| (\$20 × 100 shares) | <u>–2,000</u> |
| Gain | \$ 1,000 |
| Amount reported as wages | |
| [((\$22 × 100 shares) – \$2,000)] | <u>– 200</u> |
| Amount reported as capital gain | <u>\$ 800</u> |

Holding period requirement not satisfied. If you do not satisfy the holding period requirement, your ordinary income is the amount by which the stock's fair market value when you exercised the option exceeded the option price. This ordinary income is not limited to your gain

from the sale of the stock. Increase your basis in the stock by the amount of this ordinary income. The difference between your increased basis and the selling price of the stock is a capital gain or loss.

Example. The facts are the same as in the previous example, except that you sold the stock only 6 months after you exercised the option. You did not satisfy the holding period requirement, so you must report \$300 as wages and \$700 as capital gain, figured as follows:

| | |
|---|---------------------|
| Selling price (\$30 × 100 shares) | \$3,000 |
| Purchase price (option price) (\$20 × 100 shares) | <u>-2,000</u> |
| Gain | \$1,000 |
| Amount reported as wages [(\$23 × 100 shares) – \$2,000] | <u>-300</u> |
| Amount reported as capital gain [\$3,000 – (\$2,000 + \$300)] | <u><u>\$700</u></u> |

Restricted Property

Generally, if you receive property for your services, you must include its fair market value in your income in the year you receive the property. However, if you receive stock or other property that has certain restrictions that affect its value, you do not include the value of the property in your income until it has been substantially vested. (You can choose to include the value of the property in your income in the year it is transferred to you, as discussed later, rather than the year it is substantially vested.)

Until the property becomes substantially vested, it is owned by the person who makes the transfer to you, usually your employer. However, any income from the property, or the right to use the property, is included in your income as additional compensation in the year you receive the income or have the right to use the property.

When the property becomes substantially vested, you must include its fair market value, minus any amount you paid for it, in your income for that year. Your holding period for this property begins when the property becomes substantially vested.

Example. Your employer, the RST Corporation, sells you 100 shares of its stock at \$10 a share. At the time of the sale the fair market value of the stock is \$100 a share. Under the terms of the sale, the stock is under a substantial risk of forfeiture (you have a good chance of losing it) for a 5-year period. Your stock is not substantially vested when it is transferred, so you do not include any amount in your income in the year you buy it. At the end of the 5-year period, the fair market value of the stock is \$200 a share. You must include \$19,000 in your income [100 shares × (\$200 fair market value – \$10 you paid)]. Dividends paid by the RST Corporation on your 100 shares of stock are taxable to you as additional compensation during the period the stock can be forfeited.

Substantially vested. Property is substantially vested when:


- It is transferable, or
- It is not subject to a substantial risk of forfeiture. (You do not have a good chance of losing it.)

Transferable property. Property is transferable if you can sell, assign, or pledge your interest in the property to any person (other than the transferor), and if the person receiving your interest in the property is not required to give up the property, or its value, if the substantial risk of forfeiture occurs.


Substantial risk of forfeiture. A substantial risk of forfeiture exists if the rights in the property transferred depend on performing (or not performing) substantial services, or on a condition related to the transfer, and the possibility of forfeiture is substantial if the condition is not satisfied.

Example. The Spin Corporation transfers to you as compensation for services 100 shares of its corporate stock for \$100 a share. Under the terms of the transfer, you must resell the stock to the corporation at \$100 a share if you leave your job for any reason within 3 years from the date of transfer. You must perform substantial services over a period of time and you must resell the stock to the corporation at \$100 a share (regardless of its value) if you do not perform the services, so your rights to the stock are subject to a substantial risk of forfeiture.

Choosing to include in income for year of transfer. You can choose to include the value of restricted property at the time of transfer (minus any amount you paid for the property) in your income for the year it is transferred. If you make this choice, the substantial vesting rules do not apply and, generally, any later appreciation in value is not included in your compensation when the property becomes substantially vested. Your basis for figuring gain or loss when you sell the property is the amount you paid for it plus the amount you included in income as compensation.

 *If you make this choice, you cannot revoke it without the consent of the Internal Revenue Service. Consent will be given only if you were under a mistake of fact as to the underlying transaction.*

If you forfeit the property after you have included its value in income, your loss is the amount you paid for the property minus any amount you realized on the forfeiture.

 *You cannot make this choice for a non-statutory stock option.*

How to make the choice. You make the choice by filing a written statement with the Internal Revenue Service Center where you file your return. You must file this statement no later than 30 days after the date the property was transferred. A copy of the statement must be attached to your tax return for the year the property was transferred. You also must give a copy of this statement to the person for whom you performed the services and, if someone other than you received the property, to that person.

You must sign the statement and indicate on it that you are making the choice under section 83(b) of the Internal Revenue Code. The statement must contain all of the following information.

- Your name, address, and taxpayer identification number.

- A description of each property for which you are making the choice.
- The date or dates on which the property was transferred and the tax year for which you are making the choice.
- The nature of any restrictions on the property.
- The fair market value at the time of transfer (ignoring restrictions except those that will never lapse) of each property for which you are making the choice.
- Any amount that you paid for the property.
- A statement that you have provided copies to the appropriate persons.

Dividends received on restricted stock.

Dividends you receive on restricted stock are treated as compensation and not as dividend income. Your employer should include these payments on your Form W-2. If they also are reported on a Form 1099-DIV, Dividends and Distributions, you should list them on Schedule B (Form 1040) or Schedule 1 (Form 1040A), Interest and Ordinary Dividends for Form 1040A Filers, with a statement that you have included them as wages. Do not include them in the total dividends received.

Stock you chose to include in your income. Dividends you receive on restricted stock you chose to include in your income in the year transferred are treated the same as any other dividends. You should receive a Form 1099-DIV showing these dividends. Do not include the dividends in your wages on your return. Report them as dividends.

Sale of property not substantially vested.

These rules apply to the sale or other disposition of property that you did not choose to include in your income in the year transferred and that is not substantially vested.

If you sell or otherwise dispose of the property in an arm's-length transaction, include in your income as compensation for the year of sale the amount realized minus the amount you paid for the property. If you exchange the property in an arm's-length transaction for other property that is not substantially vested, treat the new property as if it were substituted for the exchanged property.

The sale or other disposition of a nonstatutory stock option to a related person is not considered an arm's-length transaction. See Regulations section 1.83-7 for the definition of a related person.

If you sell the property in a transaction that is not at arm's length, include in your income as compensation for the year of sale the total of any money you received and the fair market value of any substantially vested property you received on the sale. In addition, you will have to report income when the original property becomes substantially vested, as if you still held it. Report as compensation its fair market value minus the total of the amount you paid for the property and the amount included in your income from the earlier sale.

Example. In 2005, you paid your employer \$50 for a share of stock that had a fair market value of \$100 and was subject to forfeiture until 2008. In 2007, you sold the stock to your spouse

for \$10 in a transaction not at arm's length. You had compensation of \$10 from this transaction. In 2008, when the stock had a fair market value of \$120, it became substantially vested. For 2008, you must report additional compensation of \$60, figured as follows:

| | |
|---|-------------|
| Fair market value of stock at time of substantial vesting | \$120 |
| Minus: Amount paid for stock . . . | \$50 |
| Minus: Compensation previously included in income from sale to spouse | 10 |
| Additional income | <u>\$60</u> |

Inherited property not substantially vested.

If you inherit property not substantially vested at the time of the decedent's death, any income you receive from the property is considered income in respect of a decedent and is taxed according to the rules for restricted property received for services. For information about income in respect of a decedent, see Publication 559.

Special Rules for Certain Employees

This part of the publication deals with special rules for people in certain types of employment: members of the clergy, members of religious orders, people working for foreign employers, military personnel, and 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 Publication 526. Also, see *Members of Religious Orders*, later.

Pension. A pension or retirement pay for a member of the clergy usually is treated as any other pension or annuity. It must be reported on lines 16a and 16b of Form 1040 or on lines 12a and 12b of Form 1040A.

Housing

Special rules for housing apply to members of the clergy. Under these rules, you do not include in your income the rental value of a home (including utilities) or a designated housing allowance provided to you as part of your pay. However, the exclusion cannot be more than the reasonable pay for your service. If you pay for the utilities, you can exclude any allowance designated for utility cost, up to your actual cost. The home or allowance must be provided as compensation for your services as an ordained, licensed, or commissioned minister. However, you must include the rental value of the home or

the housing allowance as earnings from self-employment on Schedule SE (Form 1040), Self-Employment Tax, if you are subject to the self-employment tax. For more information, see Publication 517, *Social Security and Other Information for Members of the Clergy and Religious Workers*.

Members of Religious Orders

If you are a member of a religious order who has taken a vow of poverty, how you treat earnings that you renounce and turn over to the order depends on whether your services are performed for the order.

Services performed for the order. If you are performing the services as an agent of the order in the exercise of duties required by the order, do not include in your income the amounts turned 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 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 income.

Services performed outside the order. If you are directed to work outside the order, your services are not an exercise of duties required by the order unless they meet both of the following requirements.

- They are the kind of services that are ordinarily the duties of members of the order.
- They are part of the duties that you must exercise for, or on behalf of, the religious order as its agent.

If you are an employee of a third party, the services you perform for the third party will not be considered directed or required of you by the order. Amounts you receive for these services are included in your income, even if you have taken a vow of poverty.

Example 1. 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 schoolteacher. 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 income.

Example 2. Gene Dennis is a member of a religious order who, as a condition of membership, has taken vows of poverty and obedience. All claims to his earnings are renounced. Gene received permission from the order to establish a private practice as a psychologist and counsels members of religious orders as well as nonmembers. Although the order reviews Gene's budget annually, Gene controls not only the details of his practice but also the means by which his work as a psychologist is accomplished.

Gene's private practice as a psychologist does not make him an agent of the religious order. The psychological services provided by Gene are not the type of services that are provided by the order. The income Gene earns as a psychologist is earned in his individual capacity. Gene must include in his income the earnings from his private practice.

Foreign Employer

Special rules apply if you work for a foreign employer.

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

Social security and Medicare taxes. You are exempt from social security and Medicare employee taxes if you are employed in the United States by an international organization or a foreign government. However, you must pay self-employment tax on your earnings from services performed in the United States, even though you are not self-employed. This rule also applies if you are an employee of a qualifying wholly owned instrumentality of a foreign government.

Employees of international organizations or foreign governments. Your compensation for official services to an international organization is exempt from federal income tax if you are not a citizen of the United States or you are a citizen of the Philippines (whether or not you are a citizen of the United States).

Your compensation for official services to a foreign government is exempt from federal income tax if all of the following are true.

- You are not a citizen of the United States or you are a citizen of the Philippines (whether or not you are a citizen of the United States).
- Your work is like the work done by employees of the United States in foreign countries.
- The foreign government gives an equal exemption to employees of the United States in its country.

Waiver of alien status. If you are an alien who works for a foreign government or international organization and you file a waiver under section 247(b) of the Immigration and Nationality Act to keep your immigrant status, any salary you receive after the date you file the waiver is not exempt under this rule. However, it may be exempt under a treaty or agreement. See Publication 519, *U.S. Tax Guide for Aliens*, for more information about treaties.

Nonwage income. This exemption applies only to employees' wages, salaries, and fees. Pensions and other income do not qualify for this exemption.

Employment abroad. For information on the tax treatment of income earned abroad, see Publication 54.

Military

Payments you receive as a member of a military service generally are taxed as wages except for retirement pay, which is taxed as a pension. Allowances generally are not taxed. For more information on the tax treatment of military allowances and benefits, see 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 income as a pension on lines 16a and 16b of Form 1040 or on lines 12a and 12b of Form 1040A. Do not include in your income the amount of any 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 a more detailed discussion of survivor annuities, see Publication 575.

Disability. If you are retired on disability, see *Military and Government Disability Pensions* under *Sickness and Injury Benefits*, later.

Veterans' benefits. Do not include in your income any veterans' benefits paid under any law, regulation, or administrative practice administered by the Department of Veterans Affairs (VA). The following amounts paid to veterans or their families are not taxable.

- Education, training, and subsistence allowances.
- Disability compensation and pension payments for disabilities paid either to veterans or their families.
- Grants for homes designed for wheelchair living.
- Grants for motor vehicles for veterans who lost their sight or the use of their limbs.
- Veterans' insurance proceeds and dividends paid either to veterans or their beneficiaries, including the proceeds of a veteran's endowment policy paid before death.
- Interest on insurance dividends left on deposit with the VA.
- Benefits under a dependent-care assistance program.
- The death gratuity paid to a survivor of a member of the Armed Forces who died after September 10, 2001.
- Payments made under the compensated work therapy program.
- Any bonus payment by a state or political subdivision because of service in a combat zone.

Note. If, in a previous year, you received a bonus payment by a state or political subdivision because of service in a combat zone that you

included in your income, you can file a claim for refund of the taxes on that income. Use Form 1040X, Amended U.S. Individual Income Tax Return, to file the claim. File a separate form for each tax year involved. Generally, you must file your claim 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. See the Instructions for Form 1040X for information on filing that form.

Volunteers

The tax treatment of amounts you receive as a volunteer is covered in the following discussions.

Mileage reimbursements to charitable volunteers providing relief relating to Midwestern disaster areas. You can exclude from income amounts you receive as mileage reimbursements from qualified charitable organizations. You cannot claim a deduction for reimbursed expenses that you paid in connection with services you performed for a charity (such as automobile expenses for which you received a mileage reimbursement).

The reimbursement must be for the use of a private passenger automobile for the benefit of the organization in providing relief related to a Midwestern disaster area during the period beginning on the applicable disaster date and ending on December 31, 2008. For more information, see Publication 4492-B.

You must keep records of miles driven, time, place (or use), and purpose of the mileage. The amount you can exclude from income can be up to the standard business mileage rate. For mileage incurred before July 1, 2008, the standard business mileage rate is 50.5 cents per mile. For mileage after June 30, 2008, the standard business mileage rate is 58.5 cents per mile.

Peace Corps. Living allowances you receive as a Peace Corps volunteer or volunteer leader for housing, utilities, household supplies, food, and clothing are exempt from tax.

Taxable allowances. The following allowances must be included in your income and reported as wages.

- Allowances paid to your spouse and minor children while you are a volunteer leader training in the United States.
- Living allowances designated by the Director of the Peace Corps as basic compensation. These are allowances for personal items such as domestic help, laundry and clothing maintenance, entertainment and recreation, transportation, and other miscellaneous expenses.
- Leave allowances.
- Readjustment allowances or termination payments. These are considered received by you when credited to your account.

Example. Gary Carpenter, a Peace Corps volunteer, gets \$175 a month as a readjustment allowance during his period of service, to be paid to him in a lump sum at the end of his tour of duty. Although the allowance is not available to him until the end of his service, Gary must include it in his income on a monthly basis as it is credited to his account.

Volunteers in Service to America (VISTA). If you are a VISTA volunteer, you must include meal and lodging allowances paid to you in your income as wages.

National Senior Service Corps programs. Do not include in your income amounts you receive for supportive services or reimbursements for out-of-pocket expenses from the following programs.

- Retired Senior Volunteer Program (RSVP).
- Foster Grandparent Program.
- Senior Companion Program.

Service Corps of Retired Executives (SCORE). If you receive amounts for supportive services or reimbursements for out-of-pocket expenses from SCORE, do not include these amounts in gross income.

Volunteer tax counseling. 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.

Volunteer firefighters and emergency medical responders. If you are a volunteer firefighter or emergency medical responder, do not include in your income the following benefits you receive from a state or local government.

- Rebates or reductions of property or income taxes you receive because of services you performed as a volunteer firefighter or emergency medical responder.
- Payments you receive because of services you performed as a volunteer firefighter or emergency medical responder, up to \$30 for each month you provided services.

The excluded income reduces any related tax or contribution deduction.

Business and Investment Income

This section provides information on the treatment of income from certain rents and royalties, and from interests in partnerships and S corporations.



Income from sales at auctions, including online auctions, may be business income. For more information, see Publication 334.

Rents From Personal Property

If you rent out personal property, such as equipment or vehicles, how you report your income and expenses is generally determined by:

- Whether or not the rental activity is a business, and
- 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, Business Expenses, 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 Schedule C-EZ (Form 1040). 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 Form 1040, line 21. List the type and amount of the income on the dotted line next to line 21.

Reporting nonbusiness expenses. If you rent personal property for profit, include your rental expenses in the total amount you enter on Form 1040, line 36. Also, enter the amount and "PPR" on the dotted line next to line 36.

If you do not rent personal property for profit, your deductions are limited and you cannot report a loss to offset other income. See *Activity not for profit under Other Income* in the discussion of *Miscellaneous Income*, later.

Royalties

Royalties from copyrights, patents, and oil, gas, and mineral properties are taxable as ordinary income.

You generally report royalties in Part I of Schedule E (Form 1040), Supplemental Income and Loss. 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 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 generally are 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 9 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, see Publication 544.

Sale of property interest. If you sell your complete interest in oil, gas, or mineral rights, the amount you receive is considered payment for the sale of section 1231 property, not royalty income. Under certain circumstances, the sale is subject to capital gain or loss treatment on Schedule D (Form 1040). For more information on selling section 1231 property, see chapter 3 of Publication 544.

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 of other interests in the property is ordinary income subject to a depletion allowance.

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.

Partnership Income

A partnership generally is not a taxable entity. The income, gains, losses, deductions, and credits of a partnership are passed through to the partners based on each partner's distributive share of these items. For more information, see Publication 541.

Partner's distributive share. Your distributive share of partnership income, gains, losses, deductions, or credits generally is based on the partnership agreement. You must report your distributive share of these items on your return whether or not they actually are distributed to you. However, your distributive share of the partnership losses is limited to the adjusted basis of your partnership interest at the end of the partnership year in which the losses took place.

Partnership agreement. The partnership agreement usually covers the distribution of profits, losses, and other items. However, if the agreement does not state how a specific item of gain or loss will be shared, or the allocation stated in the agreement does not have substantial economic effect, your distributive share is figured according to your interest in the partnership.

Partnership return. Although a partnership generally pays no tax, it must file an information return on Form 1065, U.S. Return of Partnership Income. This shows the result of the partnership's operations for its tax year and the items that must be passed through to the partners.

Schedule K-1 (Form 1065). You should receive from each partnership in which you are a member a copy of Schedule K-1 (Form 1065), Partner's Share of Income, Deductions, Credits, etc., showing your share of income, deductions, credits, and tax preference items of the partnership for the tax year. Keep Schedule K-1 for your records. Do not attach it to your Form 1040.

Partner's return. You generally must report partnership items on your individual return the same way as they are reported on the partnership return. That is, if the partnership had a capital gain, you report your share on Schedule D (Form 1040). You report your share of partnership ordinary income on Schedule E (Form 1040).



Generally, Schedule K-1 (Form 1065) will tell you where to report each item of income on your individual return.

Qualified joint venture. If you and your spouse each materially participate as the only members of a jointly owned and operated business, and you file a joint return for the tax year, you can make a joint election to be treated as a qualified joint venture instead of a partnership. To make this election, you must divide all items of income, gain, loss, deduction, and credit attributable to the business between you and your spouse in accordance with your respective interests in the venture. Each of you must file a separate Schedule C or Schedule C-EZ (Form 1040).

S Corporation Income

In general, an S corporation does not pay tax on its income. Instead, the income, losses, deductions, and credits of the corporation are passed through to the shareholders based on each shareholder's *pro rata* share. You must report your share of these items on your return. Generally, the items passed through to you will increase or decrease the basis of your S corporation stock as appropriate.

S corporation return. An S corporation must file a return on Form 1120S, U.S. Income Tax Return for an S Corporation. This shows the results of the corporation's operations for its tax year and the items of income, losses, deductions, or credits that affect the shareholders' individual income tax returns.

Schedule K-1 (Form 1120S). You should receive from the S corporation in which you are a shareholder a copy of Schedule K-1 (Form 1120S), Shareholder's Share of Income, Deductions, Credits, etc., showing your share of income, losses, deductions, and credits, of the S corporation for the tax year. Keep Schedule K-1 for your records. Do not attach it to your Form 1040.

Shareholder's return. Your distributive share of the items of income, losses, deductions, or credits of the S corporation must be shown separately on your Form 1040. The character of these items generally is the same as if you had realized or incurred them personally.



Generally, Schedule K-1 (Form 1120S) will tell you where to report each item of income on your individual return.

Distributions. Generally, S corporation distributions are a nontaxable return of your basis in the corporation stock. However, in certain cases, part of the distributions may be taxable as a dividend, or as a long-term or short-term capital gain, or as both. The corporation's distributions may be in the form of cash or property.

More information. For more information, see the Instructions for Form 1120S.

Sickness and Injury Benefits

Generally, you must report as income any amount you receive for personal injury or sickness through an accident or health plan that is paid for by your employer. If both you and your employer pay for the plan, only the amount you receive that is due to your employer's payments is reported as income. However, certain payments may not be taxable to you. For information on nontaxable payments, see *Military and Government Disability Pensions* and *Other Sickness and Injury Benefits*, later in this discussion.



Do not report as income any amounts paid to reimburse you for medical expenses you incurred after the plan was established.

Cost paid by you. If you pay the entire cost of an accident or health plan, do not include any amounts you receive from the plan for personal injury or sickness as income on your tax return. If your plan reimbursed you for medical expenses you deducted in an earlier year, you may have to include some, or all, of the reimbursement in your income. See *Recoveries* under *Miscellaneous Income*, later.

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

Disability Pensions

If you retired on disability, you must include in income any disability pension you receive under a plan that is paid for by your employer. You must report your taxable disability payments as wages on line 7 of Form 1040 or Form 1040A until you reach minimum retirement age. Minimum retirement age generally is the age at which you can first receive a pension or annuity if you are not disabled.



You may be entitled to a tax credit if you were permanently and totally disabled when you retired. For information on this credit, see Publication 524, Credit for the Elderly or the Disabled.

Beginning on the day after you reach minimum retirement age, payments you receive are taxable as a pension or annuity. Report the payments on lines 16a and 16b of Form 1040 or on lines 12a and 12b of Form 1040A. For more information on pensions and annuities, see Publication 575.

Retirement and profit-sharing plans. If you receive payments from a retirement or profit-sharing plan that does not provide for disability retirement, do not treat the payments as a disability pension. The payments must be reported as a pension or annuity.

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. Include it in your income in the tax year you receive it.

Military and Government Disability Pensions

Certain military and government disability pensions are not taxable.

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

- The armed forces of any country.
- The National Oceanic and Atmospheric Administration.
- The Public Health Service.
- The Foreign Service.

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

1. You were entitled to receive a disability payment before September 25, 1975.
2. You were a member of a listed government service or its reserve component, or were under a binding written commitment to become a member, on September 24, 1975.
3. You receive the disability payments for a combat-related injury. This is a personal injury or sickness that:
 - a. Results directly from armed conflict,
 - b. Takes place while you are engaged in extra-hazardous service,
 - c. Takes place under conditions simulating war, including training exercises such as maneuvers, or
 - d. Is caused by an instrumentality of war.
4. You would be entitled to receive disability compensation from the Department of Veterans Affairs (VA) if you filed an application for it. Your exclusion under this condition is equal to the amount you would be entitled to receive from the VA.

Pension based on years of service. If you receive a disability pension based on years of service, you generally must include it in your income. However, if the pension qualifies for the exclusion for a service-connected disability (discussed 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.

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

disability benefits you would have been entitled to receive. You can claim a refund of any tax paid on the excludable amount (subject to the statute of limitations) by filing an amended return on Form 1040X for each previous year during the retroactive period.

If you receive a lump-sum disability severance payment and are later awarded VA disability benefits, exclude 100% of the severance benefit from your income. However, you must include in your income any lump-sum readjustment or other nondisability severance payment you received on release from active duty, even if you are later given a retroactive disability rating by the VA.

Special statute of limitations. Generally, under the statute of limitations a claim for credit or refund must be filed within 3 years from the time a return was filed. However, if you receive a retroactive service-connected disability rating determination, the statute of limitations is extended by a 1-year period beginning on the date of the determination. This 1-year extended period applies to claims for credit or refund filed after June 17, 2008, and does not apply to any tax year that began more than 5 years before the date of the determination.

Example. You retired in 2003 and receive a pension based on your years of service. On August 6, 2008, you receive a determination of service-connected disability retroactive to 2003. Generally, you could claim a refund for the taxes paid on your pension for 2005, 2006, and 2007. However, under the special limitation period, you can also file a claim for 2004 as long as you file the claim by August 6, 2009. You cannot file a claim for 2003 because that tax year began more than 5 years before the determination.

Transition Rules. If you received a retroactive service-connected disability rating determination after December 31, 2000, and before June 17, 2008, you have 1 year from June 17, 2008, to file your claims. You cannot make any claims for tax years that began before 2001.

Terrorist attack or military action. Do not include in your income disability payments you receive for injuries resulting directly from a terrorist or military action.

A terrorist action is one that is directed against the United States or any of its allies (including a multinational force in which the United States is participating). A military action is one that involves the armed forces of the United States and is a result of actual or threatened violence or aggression against the United States or any of its allies, but does not include training exercises.

Long-Term Care Insurance Contracts

Long-term care insurance contracts generally are treated as accident and health insurance contracts. Amounts you receive from them (other than policyholder dividends or premium refunds) generally are excludable from income as amounts received for personal injury or sickness. To claim an exclusion for payments made on a *per diem* or other periodic basis under a long-term care insurance contract, you must file Form 8853 with your return.

A long-term care insurance contract is an insurance contract that only provides coverage for qualified long-term care services. The contract must:

- Be guaranteed renewable,
- Not provide for a cash surrender value or other money that can be paid, assigned, pledged, or borrowed,
- Provide that refunds, other than refunds on the death of the insured or complete surrender or cancellation of the contract, and dividends under the contract may be used only to reduce future premiums or increase future benefits, and
- Generally 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:

- Necessary diagnostic, preventive, therapeutic, curing, treating, mitigating, rehabilitative services, and maintenance and personal care services, and
- Required by a chronically ill individual and provided pursuant to a plan of care prescribed by a licensed health care practitioner.

Chronically ill individual. A chronically ill individual is one who has been certified by a licensed health care practitioner within the previous 12 months as one of the following.

- An individual who, for at least 90 days, is unable to perform at least two activities of daily living without substantial assistance due to a loss of functional capacity. Activities of daily living are eating, toileting, transferring, bathing, dressing, and continence.
- An individual who requires substantial supervision to be protected from threats to health and safety due to severe cognitive impairment.

Limit on exclusion. The exclusion for payments made on a *per diem* or other periodic basis under a long-term care insurance contract is subject to a limit. The limit applies to the total of these payments and any accelerated death benefits made on a *per diem* or other periodic basis under a life insurance contract because the insured is chronically ill. (For more information on accelerated death benefits, see *Life Insurance Proceeds* under *Miscellaneous Income*, later.)

Under this limit, the excludable amount for any period is figured by subtracting any reimbursement received (through insurance or otherwise) for the cost of qualified long-term care services during the period from the larger of the following amounts.

- The cost of qualified long-term care services during the period.

- The dollar amount for the period (\$270 per day for any period in 2008).

See Section C of Form 8853 and its instructions for more information.

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 survivors. The exemption, however, does not apply to retirement plan benefits you receive based on your age, length of service, or prior contributions to the plan, even if you retired because of an occupational sickness or injury.



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 a discussion of the taxability of these benefits, see Other Income under Miscellaneous Income, later.

Return to work. If you return to work after qualifying for workers' compensation, salary payments you receive for performing light duties are taxable as wages.

Disability pension. If your disability pension is paid under a statute that provides benefits only to employees with service-connected disabilities, part of it may be workers' compensation. That part is exempt from tax. The rest of your pension, based on years of service, is taxable as pension or annuity income. If you die, the part of your survivors' benefit that is a continuation of the workers' compensation is exempt from tax.

Other Sickness and Injury Benefits

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

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

Black lung benefit payments. These payments are similar to workers' compensation and generally are not taxable.

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.



If part of the payments you receive under FECA 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 a discussion of the taxability of these benefits, see Other Income under Miscellaneous Income, later.

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%-of-AGI limit on Schedule A (Form 1040). If you buy back sick leave in the same year you used it, the amount reduces your taxable sick leave pay. Do not deduct it separately.

Other compensation. Many other amounts you receive as compensation for sickness or injury are not taxable. These include the following amounts.

- Compensatory damages you receive for physical injury or physical sickness, whether paid in a lump sum or in periodic payments. See *Court awards and damages* under *Other Income*, later.
- 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 income.
- Disability benefits you receive for loss of income or earning capacity as a result of injuries under a no-fault car insurance policy.
- 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 not taxable even if your employer pays for the accident and health plan that provides these benefits.

Reimbursement for medical care. A reimbursement for medical care generally is not taxable. However, it may reduce your medical expense deduction. If you receive reimbursement for an expense you deducted in an earlier year, see *Recoveries*, later.

If you receive an "advance reimbursement" or "loan" for future medical expenses from your employer without regard to whether you suffered a personal injury or sickness or incurred medical expenses, that amount is included in your income, whether or not you incur uninsured medical expenses during the year.

Reimbursements received under your employer's plan for expenses incurred before the plan was established are included in income.

Amounts you receive under a reimbursement plan that provides for the payment of unused reimbursement amounts in cash or other benefits are included in your income. However, a qualified HSA distribution from a health flexible spending account or health reimbursement account can be made to a health savings account. For details, see Publication 969.

Reimbursements received under your employer's plan of the amount paid for nonprescription medicines and drugs (such as allergy medicine, pain reliever, and cold medicine) are not included in income. However, reimbursements of the amount paid for dietary supplements (such as vitamins) that are merely

beneficial to your general health are included in income.

Miscellaneous Income

This section discusses various types of income. You may have taxable income from certain transactions even if no money changes hands. For example, you may have taxable income if you lend money at a below-market interest rate or have a debt you owe canceled.

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). However, if the barter involves an exchange of something other than services, such as in *Example 4* below, you may have to use another form or schedule instead.

Example 1. You are a self-employed attorney who performs legal services for a client, a small corporation. The corporation gives you shares of its stock as payment for your services. You must include the fair market value of the shares in your income on Schedule C or Schedule C-EZ (Form 1040) in the year you receive them.

Example 2. You are a self-employed accountant. You and a house painter are members of a barter club. Members get in touch with each other directly and bargain for the value of the services to be performed. In return for accounting services you provided, the house painter painted your home. You must report as your income on Schedule C or Schedule C-EZ (Form 1040) the fair market value of the house painting services you received. The house painter must include in income the fair market value of the accounting services you provided.

Example 3. 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 or 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 your income the value of the 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 4. 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 she created. You must report as rental income on Schedule E (Form 1040) the fair market value

of the artwork, 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, Form 1099-B, Proceeds from Broker and Barter Exchange Transactions, or a similar statement from the barter exchange should be sent to you by February 17, 2009. It should show the value of cash, property, services, credits, or scrip you received from exchanges during 2008. The IRS also will receive a copy of Form 1099-B.

Backup withholding. The income you receive from bartering generally is not subject to regular income tax withholding. However, backup withholding will apply in certain circumstances to ensure that income tax is collected on this income.

Under backup withholding, the barter exchange must withhold, as income tax, 28% of the income if:

- You do not give the barter exchange your taxpayer identification number (generally a social security number or an employer identification number), or
- The IRS notifies the barter exchange that you gave it an incorrect identification number.

If you join a barter exchange, you must certify under penalties of perjury that your taxpayer identification number is correct and that you are not subject to backup withholding. If you do not make this certification, backup withholding may begin immediately. The barter exchange will give you a Form W-9, Request for Taxpayer Identification Number and Certification, or a similar form, for you to make this certification. The barter exchange will withhold tax only up to the amount of any cash paid to you or deposited in your account and any scrip or credit issued to you (and converted to cash).

TIP If tax is withheld from your barter income, the barter exchange will report the amount of tax withheld on Form 1099-B, or similar statement.

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 income. You have no income from the canceled debt if it is intended as a gift to you. A debt includes any indebtedness for which you are liable or which attaches to property you hold.

If the debt is a nonbusiness debt, report the canceled amount on Form 1040, line 21. If it is a business debt, report the amount on Schedule C or Schedule C-EZ (Form 1040) (or on Schedule F (Form 1040), Profit or Loss From Farming, if the debt is farm debt and 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 also will be shown in box 3. Whether or not you must include the interest portion of the canceled debt in your income depends on whether the interest would be deductible if you paid it. See *Deductible debt* under *Exceptions*, later.

If the interest would not be deductible (such as interest on a personal loan), include in your income the amount from Form 1099-C, box 2. If the interest would be deductible (such as on a business loan), include in your income the net amount of the canceled debt (the amount shown in box 2 less the interest amount shown in box 3).

Discounted mortgage loan. If your financial institution offers a discount for the early payment of your mortgage loan, the amount of the discount is canceled debt. You must include the canceled amount in your income.

Mortgage relief upon sale or other disposition. If you are personally liable for a mortgage (recourse debt), and you are relieved of the mortgage when you dispose of the property, you may realize gain or loss up to the fair market value of the property. To the extent the mortgage discharge exceeds the fair market value of the property, it is income from discharge of indebtedness unless it qualifies for exclusion under *Excluded debt*, later. Report any income from discharge of indebtedness on nonbusiness debt that does not qualify for exclusion as other income on Form 1040, line 21.

TIP You may be able to exclude part of the mortgage relief on your principal residence. See *Excluded debt*, later.

If you are not personally liable for a mortgage (nonrecourse debt), and you are relieved of the mortgage when you dispose of the property (such as through foreclosure or repossession), that relief is included in the amount you realize. You may have a taxable gain if the amount you realize exceeds your adjusted basis in the property. Report any gain on nonbusiness property as a capital gain.

See *Foreclosures and Repossessions* in Publication 544 for more information.

Stockholder debt. If you are a stockholder in a corporation and the corporation cancels or forgives your debt to it, the canceled debt is a constructive distribution that is generally dividend income to you. For more information, see Publication 542, Corporations.

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.

Repayment of canceled debt. If you included a canceled amount in your income and later pay the debt, you may be able to file a claim for refund for the year the amount was included in income. You can file a claim on Form 1040X if the statute of limitations for filing a claim is still open. The statute of limitations generally does not end until 3 years after the due date of your original return.

Exceptions

There are several exceptions to the inclusion of canceled debt in income. These are explained next.

Debt canceled as a result of a Midwestern disaster. If you qualify, you can exclude from income the amount of a canceled nonbusiness debt. The debt must be canceled by an applicable entity after the applicable disaster date and before January 1, 2010.

You may qualify for this relief if your main home on the applicable disaster date was located in a Midwestern disaster area. This exclusion does not apply to a canceled debt to the extent that real property, which was security for the debt, is located outside a Midwestern disaster area. For more information, see Publication 4492-B.

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 Federal Government, a state or local government, or an instrumentality, agency, or subdivision thereof,
2. A tax-exempt public benefit corporation that has assumed control of a state, county, or municipal hospital, and whose employees are considered public employees under state law, or
3. An educational institution:
 - a. Under an agreement with an entity described in (1) or (2) that provided the funds to the institution to make the loan, or
 - b. As part of a program of the institution designed to encourage students to serve in occupations or areas with unmet needs and under which the services provided are for or under the direction of a governmental unit or a tax-exempt section 501(c)(3) organization (defined later).

A loan to refinance a qualified student loan also will qualify if it was made by an educational institution or a tax-exempt section 501(a) organization under its program designed as described in (3)(b) above.

An educational institution is an organization with a regular faculty and curriculum and a regularly enrolled body of students in attendance at the place where the educational activities are carried on.

A section 501(c)(3) organization is any corporation, community chest, fund, or foundation organized and operated exclusively for one or more of the following purposes.

- Charitable.
- Educational.
- Fostering national or international amateur sports competition (but only if none of the

organization's activities involve providing athletic facilities or equipment).

- Literary.
- Preventing cruelty to children or animals.
- Religious.
- Scientific.
- Testing for public safety.

Exception. You do have income if your student loan was made by an educational institution and is canceled because of services you performed for the institution or other organization that provided the funds.

Education loan repayment assistance. Education loan repayments made to you by the National Health Service Corps Loan Repayment Program (NHSC Loan Repayment Program) or a state education loan repayment program eligible for funds under the Public Health Service Act are not taxable if you agree to provide primary health services in health professional shortage areas.

Deductible debt. You do not have income from the cancellation of a debt if your payment of the debt would be deductible. This exception applies only if you use the cash method of accounting. For more information, see chapter 5 of Publication 334.

Price reduced after purchase. Generally, if the seller reduces the amount of debt you owe for property you purchased, you do not have income from the reduction. The reduction of the debt is treated as a purchase price adjustment and reduces your basis in the property.

Excluded debt. Do not include a canceled debt in your gross income in the following situations.

- The debt is canceled in a bankruptcy case under title 11 of the U.S. Code. See Publication 908, Bankruptcy Tax Guide.
- The debt is canceled when you are insolvent. However, you cannot exclude any amount of canceled debt that is more than the amount by which you are insolvent. See Publication 908.
- The debt is qualified farm debt and is canceled by a qualified person. See chapter 3 of Publication 225, Farmer's Tax Guide.
- The debt is qualified real property business debt. See chapter 5 of Publication 334.
- The cancellation is intended as a gift.
- The debt is qualified principal residence indebtedness, discussed next.

Qualified principal residence indebtedness (QPRI). This is a mortgage secured by your principal residence that you took out to buy, build, or substantially improve your principal residence. QPRI cannot be more than the cost of your principal residence plus improvements.

You must reduce the basis of your principal residence by the amount excluded from gross income. To claim the exclusion, you must file Form 982, Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment), with your tax return.

Principal residence. Your principal residence is the home where you ordinarily live most of the time. You can have only one principal residence at any one time.

Amount eligible for exclusion. The maximum amount you can treat as QPRI is \$2 million (\$1 million if married filing separately). You cannot exclude debt canceled because of services performed for the lender or on account of any other factor not directly related to a decline in the value of your residence or to your financial condition.

Limitation. If only part of a loan is QPRI, the exclusion applies only to the extent the canceled amount is more than the amount of the loan immediately before the cancellation that is not QPRI.

Example. Your principal residence is secured by a debt of \$1 million, of which \$800,000 is QPRI. Your residence is sold for \$700,000 and \$300,000 of debt is canceled. Only \$100,000 of the canceled debt may be excluded from income (the \$300,000 that was discharged minus the \$200,000 of nonqualified debt).

Host or Hostess

If you host a party at which sales are made, any gift you receive for giving the party is a payment for helping a direct seller make sales. You must report it as income at its fair market value.

Your out-of-pocket party expenses are subject to the 50% limit for meal and entertainment expenses. These expenses are deductible as miscellaneous itemized deductions subject to the 2%-of-AGI limit on Schedule A (Form 1040), but only up to the amount of income you receive for giving the party.

For more information about the 50% limit for meal and entertainment expenses, see *50% Limit* in Publication 463.

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 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.

Example. The face amount of the policy is \$75,000 and, as beneficiary, you choose to receive 120 monthly installments of \$1,000 each. The excluded part of each installment is \$625 ($\$75,000 \div 120$), or \$7,500 for an entire year. The rest of each payment, \$375 a month (or \$4,500 for an entire year), is interest income to you.

Installments for life. If, as the beneficiary under an insurance contract, you are entitled to receive the proceeds in installments for the rest of your life without a refund or period-certain guarantee, you figure the excluded part of each installment by dividing the amount held by the insurance company by your life expectancy. If there is a refund or period-certain guarantee, the amount held by the insurance company for this purpose is reduced by the actuarial value of the guarantee.

Surviving spouse. If your spouse died before October 23, 1986, and insurance proceeds paid to you because of the death of your spouse are received in installments, you can exclude up to \$1,000 a year of the interest included in the installments. If you remarry, you can continue to take the exclusion.

Employer-owned life insurance contract. If you are the policyholder of an employer-owned life insurance contract, you must include in income any life insurance proceeds received that are more than the premiums and any other amounts you paid on the policy. You are subject to this rule if you have a trade or business, you own a life insurance contract on the life of your employee, and you (or a related person) are a beneficiary under the contract.

However, you may exclude the full amount of the life insurance proceeds if the following apply.

1. You provided written notice about the insurance to the employee and the employee agreed to be insured.
2. Either:
 - a. The employee was your employee within the 12-month period before death, or, at the time the contract was issued, was a director or highly compensated employee, or
 - b. The amount is paid to the family or designated beneficiary of the employee.

Interest option on insurance. If an insurance company pays you interest only on proceeds from life insurance left on deposit, the interest you are paid is taxable.

If your spouse died before October 23, 1986, and you chose to receive only the interest from your insurance proceeds, the \$1,000 interest exclusion for a surviving spouse does not apply. If you later decide to receive the proceeds from the policy in installments, you can take the interest exclusion from the time you begin to receive the installments.

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 of 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.

You should receive a Form 1099-R showing the total proceeds and the taxable part. Report these amounts on lines 16a and 16b of Form 1040 or on lines 12a and 12b of Form 1040A.



For information on when the proceeds are excluded from income, see Accelerated Death Benefits, later.

Split-dollar life insurance. Generally, a split-dollar life insurance arrangement is an arrangement between an owner and a non-owner of a life insurance contract under which either party to the arrangement pays all or part of the premiums, and one of the parties paying the premiums is entitled to recover all or part of those premiums from the proceeds of the contract. There are two mutually exclusive regimes to tax split-dollar life insurance arrangements.

1. Under the economic benefit regime, the owner of the life insurance contract is treated as providing current life insurance protection and other taxable economic benefits to the non-owner of the contract.
2. Under the loan regime, the non-owner of the life insurance contract is treated as loaning premium payments to the owner of the contract.

Only one of these regimes applies to any one policy. For more information, see sections 1.61-22 and 1.7872-15 of the regulations.

Endowment Contract Proceeds

An endowment contract is a policy under which you are paid a specified amount of money on a certain date unless you die before that date, in which case, the money is paid to your designated beneficiary. 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, subtract any amount that you previously received under the contract and excluded from your income from the total premiums (or other consideration) paid for the contract. Include the part of the lump-sum payment that is more than your cost in your income.

Endowment proceeds that you choose to receive in installments instead of a lump-sum payment at the maturity of the policy are taxed as an annuity. This is explained in Publication 575. For this treatment to apply, you must choose to receive the proceeds in installments before receiving any part of the lump sum. This election must be made within 60 days after the lump-sum payment first becomes payable to you.

Accelerated Death Benefits

Certain amounts paid as accelerated death benefits under a life insurance contract or viatical settlement before the insured's death are excluded from income if the insured is terminally or chronically ill.

Viatical settlement. This is the sale or assignment of any part of the death benefit under a life

insurance contract to a viatical settlement provider. A viatical settlement provider is a person 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 and who meets the requirements of section 101(g)(2)(B) of the Internal Revenue Code.

Exclusion for terminal illness. Accelerated death benefits are fully excludable if the insured is a terminally ill individual. This is a person 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.

Exclusion for chronic illness. If the insured is a chronically ill individual who is not terminally ill, accelerated death benefits paid on the basis of costs incurred for qualified long-term care services are fully excludable. Accelerated death benefits paid on a *per diem* or other periodic basis are excludable up to a limit. This limit applies to the total of the accelerated death benefits and any periodic payments received from long-term care insurance contracts. For information on the limit and the definitions of chronically ill individual, qualified long-term care services, and long-term care insurance contracts, see *Long-Term Care Insurance Contracts* under *Sickness and Injury Benefits*, earlier.

Exception. The exclusion does not apply to any amount paid to a person (other than the insured) who has an insurable interest in the life of the insured because the insured:

- Is a director, officer, or employee of the person, or
- Has a financial interest in the person's business.

Form 8853. To claim an exclusion for accelerated death benefits made on a *per diem* or other periodic basis, you must file Form 8853 with your return. You do not have to file Form 8853 to exclude accelerated death benefits paid on the basis of actual expenses incurred.

Recoveries

A recovery is a return of an amount you deducted or took a credit for in an earlier year. The most common recoveries are refunds, reimbursements, and rebates of itemized deductions. You also may have recoveries of non-itemized deductions (such as payments on previously deducted bad debts) and recoveries of items for which you previously claimed a tax credit.

Tax benefit rule. You must include a recovery in your income in the year you receive it up to the amount by which the deduction or credit you took for the recovered amount reduced your tax in the earlier year. For this purpose, any increase to an amount carried over to the current year that resulted from the deduction or credit is considered to have reduced your tax in the earlier year.

Federal income tax refund. Refunds of federal income taxes are not included in your income because they are never allowed as a deduction from income.

State tax refund. If you received a state or local income tax refund (or credit or offset) in 2008, you generally must include it in income if you deducted the tax in an earlier year. The payer should send Form 1099-G, Certain Government Payments, to you by February 2, 2009. The IRS also will receive a copy of the Form 1099-G. If you file Form 1040, use the worksheet in the 2008 Form 1040 instructions for line 10 to figure the amount (if any) to include in your income. See *Itemized Deduction Recoveries*, later, for when you must use Worksheet 2 on page 24 of this publication.

If you could choose to deduct for a tax year either:

- State and local income taxes, or
- State and local general sales taxes, then

the maximum refund that you may have to include in income is limited to the excess of the tax you chose to deduct for that year over the tax you did not choose to deduct for that year.

Example 1. For 2007 you can choose an \$11,000 state income tax deduction or a \$10,000 state general sales tax deduction. You choose to deduct the state income tax. In 2008 you receive a \$2,500 state income tax refund. The maximum refund that you may have to include in income is \$1,000, since you could have deducted \$10,000 in state general sales tax.

Example 2. For 2007 you can choose an \$11,500 state general sales tax deduction based on actual expenses or an \$11,200 state income tax deduction. You choose to deduct the general sales tax deduction. In 2008 you return an item you had purchased and receive a \$500 sales tax refund. In 2008 you also receive a \$1,500 state income tax refund. The maximum refund that you may have to include in income is \$500, since it is less than the excess of the tax deducted (\$11,500) over the tax you did not choose to deduct (\$11,200 – \$1,500 = \$9,700). Since you did not choose to deduct the state income tax, you do not include the state income tax refund in income.

Mortgage interest refund. If you received a refund or credit in 2008 of mortgage interest paid in an earlier year, the amount should be shown in box 3 of your Form 1098, Mortgage Interest Statement. Do not subtract the refund amount from the interest you paid in 2008. You may have to include it in your income under the rules explained in the following discussions.

Interest on recovery. Interest on any of the amounts you recover must be reported as interest income in the year received. For example, report any interest you received on state or local income tax refunds on Form 1040, line 8a or Form 1040NR, line 9a.

Recovery and expense in same year. If the refund or other recovery and the expense occur in the same year, the recovery reduces the deduction or credit and is not reported as income.

Recovery for 2 or more years. If you receive a refund or other recovery that is for amounts you paid in 2 or more separate years, you must allocate, on a *pro rata* basis, the recovered amount between the years in which you paid it. 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.

Example. You paid 2007 estimated state income tax of \$4,000 in four equal payments. You made your fourth payment in January 2008. You had no state income tax withheld during 2007. In 2008, you received a \$400 tax refund based on your 2007 state income tax return. You claimed itemized deductions each year on Schedule A (Form 1040).

You must allocate the \$400 refund between 2007 and 2008, the years in which you paid the tax on which the refund is based. You paid 75% ($\$3,000 \div \$4,000$) of the estimated tax in 2007, so 75% of the \$400 refund, or \$300, is for amounts you paid in 2007 and is a recovery item. If all of the \$300 is a taxable recovery item, you will include \$300 on Form 1040, line 10, for 2008, and attach a copy of your computation showing why that amount is less than the amount shown on the Form 1099-G you received from the state.

The balance (\$100) of the \$400 refund is for your January 2008 estimated tax payment. When you figure your deduction for state and local income taxes paid during 2008, you will reduce the \$1,000 paid in January by \$100. Your deduction for state and local income taxes paid during 2008 will include the January net amount of \$900 ($\$1,000 - \100), plus any estimated state income taxes paid in 2008 for 2008, and any state income tax withheld during 2008.

Deductions not itemized. If you did not itemize deductions for the year for which you received the recovery of an expense that was deductible only if you itemized, do not include any of the recovery amount in your income.

Example. You claimed the standard deduction on your 2007 federal income tax return. In 2008 you received a refund of your 2007 state income tax. Do not report any of the refund as income because you did not itemize deductions for 2007.

Casualty loss caused by Hurricane Katrina, Rita, or Wilma. Generally, if you recover an amount that you deducted in an earlier year, you must include the recovery (either in full or in part) in your income in the year you receive it. A special rule applies if you claimed a deduction in any tax year for a casualty loss to your main home due to Hurricane Katrina, Rita, or Wilma. If you receive a grant as reimbursement for that loss, you can report the grant as income in the year you receive it (using the rules discussed in the following sections of this publication) or you can choose to file an amended tax return for the year you claimed the deduction. To make this choice, you must file an amended return (Form 1040X) by the later of:

- The due date for filing the tax return for the tax year in which the grant was received, or
- July 30, 2009.

See the Instructions for Form 1040X for how to make this choice.

Itemized Deduction Recoveries

The following discussion explains how to determine the amount to include in your income from a recovery of an amount deducted in an earlier year as an itemized deduction. However, you generally do not need to use this discussion if you file Form 1040 and the recovery is for state or local income taxes paid in 2007. Instead, use the worksheet in the 2008 Form 1040 instructions for line 10 to figure the amount (if any) to include in your income.

You cannot use the Form 1040 worksheet and must use this discussion if you are a nonresident alien (discussed later) or any of the following statements are true.

1. The recovery is for a tax year other than 2007.
2. The recovery is for a deducted item other than state or local income taxes, such as a general sales tax or real property tax refund.
3. On your 2007 Form 1040, line 42 was more than line 41.
4. You received a refund of state and local income taxes in 2008 that was more than the excess of your 2007 state and local income tax deduction over the amount you could have deducted for your 2007 state and local general sales tax.
5. You made your last payment of 2007 state or local estimated tax in 2008.
6. You owed alternative minimum tax for 2007.
7. You could not deduct all your tax credits for 2007 because their total was more than the amount of tax shown on your 2007 Form 1040, line 46.
8. You could be claimed as a dependent by someone else in 2007.
9. You had to use the Itemized Deductions Worksheet in the 2007 Schedule A instructions because your 2007 adjusted gross income was over \$156,400 (\$78,200 if married filing separately) and both of the following apply.
 - a. You could not deduct all of the amount on the 2007 Itemized Deductions Worksheet, line 1.
 - b. The amount on line 8 of that 2007 worksheet would be more than the amount on line 4 of that worksheet if the amount on line 4 were reduced by 80% of the refund you received in 2008.



If you also recovered an amount deducted as a non-itemized deduction, figure the amount of that recovery to include in your income and add it to your adjusted gross income before applying the rules explained here. See Non-Itemized Deduction Recoveries, later.

Nonresident aliens. If you are a nonresident alien and file Form 1040NR or 1040NR-EZ, you cannot claim the standard deduction. If you recover an itemized deduction that you claimed in an earlier year, you generally must include the full amount of the recovery in your income in the

year you receive it. However, if you had no taxable income in that earlier year (see *Negative taxable income*, later), you should complete Worksheet 2 to determine the amount you must include in income. If any other statement under *Total recovery included in income* is not true, see the discussion referenced in the statement to determine the amount to include in income.

Total recovery included in income. If you recover any itemized deduction that you claimed in an earlier year, you generally must include the full amount of the recovery in your income in the year you receive it. This rule applies if, for the earlier year, all of the following statements are true.

1. Your itemized deductions exceeded the standard deduction by at least the amount of the recovery. (If your itemized deductions did not exceed the standard deduction by at least the amount of the recovery, see *Standard deduction limit*, later.)
2. You had taxable income. (If you had no taxable income, see *Negative taxable income*, later.)
3. Your deduction for the item recovered equals or exceeds the amount recovered. (If your deduction was less than the amount recovered, see *Recovery limited to deduction*, later.)
4. Your itemized deductions were not subject to the limit on itemized deductions. (If your deductions were limited, see *Itemized deductions limited*, later.)
5. You had no unused tax credits. (If you had unused tax credits, see *Unused tax credits*, later.)
6. You were not subject to alternative minimum tax. (If you were subject to alternative minimum tax, see *Subject to alternative minimum tax*, later.)

If any of the above statements is not true, see *Total recovery not included in income*, later.

State tax refund. In addition to the previous six items, you must include in your income the full amount of a refund of state or local income tax or general sales tax if the excess of the tax you deducted over the tax you did not deduct is more than the refund of the tax deducted.

If the refund is more than the excess, see *Total recovery not included in income*, later.

Where to report. Enter your state or local income tax refund on Form 1040, line 10, and the total of all other recoveries as other income on Form 1040, line 21. You cannot use Form 1040A or Form 1040EZ.

If you file Form 1040NR, enter your state or local income tax refund on line 11 and the total of all other recoveries on line 21. If you file Form 1040NR-EZ, enter your state or local income tax refund on line 4.

Example. For 2007, you filed a joint return on Form 1040. Your taxable income was \$60,000 and you were not entitled to any tax credits. Your standard deduction was \$10,700, and you had itemized deductions of \$12,000. In 2008, you received the following recoveries for amounts deducted on your 2007 return:

| | |
|---|--------------|
| Medical expenses | \$200 |
| State and local income tax refund | 400 |
| Refund of mortgage interest | <u>325</u> |
| Total recoveries | <u>\$925</u> |

None of the recoveries were more than the deductions taken for 2007. The difference between the state and local income tax you deducted and your local general sales tax was more than \$400.

Your total recoveries are less than the amount by which your itemized deductions exceeded the standard deduction (\$12,000 – \$10,700 = \$1,300), so you must include your total recoveries in your income for 2008. Report the state and local income tax refund of \$400 on Form 1040, line 10, and the balance of your recoveries, \$525, on Form 1040, line 21.

Total recovery not included in income. If one or more of the six statements listed in the preceding discussion is not true, you may be able to exclude at least part of the recovery from your income. See the discussion referenced to in the statement. You may be able to use Worksheet 2 on the next page to determine the part of your recovery to include in your income. You also can use Worksheet 2 to determine the part of a state tax refund (discussed earlier) to include in income.

Allocating the included part. If you are not required to include all of your recoveries in your

income, and you have both a state income tax refund and other itemized deduction recoveries, you must allocate the taxable recoveries between the state income tax refund you report on Form 1040, line 10 (Form 1040NR, line 11), and the amount you report as other income on Form 1040, line 21 (Form 1040NR, line 21). If you do not use Worksheet 2, make the allocation as follows.

1. Divide your state income tax refund by the total of all your itemized deduction recoveries.
2. Multiply the amount of taxable recoveries by the percentage in (1). This is the amount you report as a state income tax refund.
3. Subtract the result in (2) above from the amount of taxable recoveries. This is the amount you report as other income.

Example. In 2008 you recovered \$2,500 of your 2007 itemized deductions claimed on Schedule A (Form 1040), but the recoveries you must include in your 2008 income are only \$1,500. Of the \$2,500 you recovered, \$500 was due to your state income tax refund. Your state income tax was more than your state general sales tax by \$600. The amount you report as a state tax refund on Form 1040, line 10, is \$300 [(\$500 ÷ \$2,500) × \$1,500]. The balance of the taxable recoveries, \$1,200, is reported as other income on Form 1040, line 21.

Standard deduction limit. You generally are 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 lesser of:

- Your recoveries, or
- The amount by which your itemized deductions exceeded the standard deduction.

Worksheet 2. Recoveries of Itemized Deductions

To determine whether you should complete this worksheet to figure the part of a recovery amount to include in income on your 2008 tax return, see *Itemized Deduction Recoveries*. If you recovered amounts from more than one year, such as a state income tax refund from 2007 and a casualty loss reimbursement from 2006, complete a separate worksheet for each year. Use information from your tax return for the year the expense was deducted.

A recovery is included in income only to the extent of the deduction amount that reduced your tax in the prior year (year of the deduction). If you were subject to the alternative minimum tax or your tax credits reduced your tax to zero, see *Unused tax credits* and *Subject to alternative minimum tax* under *Itemized Deduction Recoveries*. If your recovery was for an itemized deduction that was limited, you should read *Itemized deductions limited* under *Itemized Deduction Recoveries*.

| | | | |
|-----|--|-----|-------|
| 1. | State/local income tax refund or credit ¹ | 1. | _____ |
| 2. | Enter the total of all other Schedule A refunds or reimbursements (excluding the amount you entered on line 1) ² | 2. | _____ |
| 3. | Add lines 1 and 2 | 3. | _____ |
| 4. | Itemized deductions for the prior year. For 2007, Form 1040, Schedule A, line 29 Form 1040NR, Schedule A, line 17 Form 1040NR-EZ, line 11 | 4. | _____ |
| 5. | Enter any amount previously refunded to you (do not enter an amount from line 1 or line 2) | 5. | _____ |
| 6. | Subtract line 5 from line 4 | 6. | _____ |
| 7. | Standard deduction for the prior year. (If you filed Form 1040, the standard deduction amounts for 2007, 2006, and 2005 are shown in Tables 2, 3, and 4. If you filed Form 1040NR or 1040NR-EZ, enter -0-.) | 7. | _____ |
| 8. | Subtract line 7 from line 6. If the result is zero or less, stop here. The amounts on lines 1 and 2 are not taxable | 8. | _____ |
| 9. | Enter the smaller of line 3 or line 8 | 9. | _____ |
| 10. | Taxable income for prior year ³ (2007 Form 1040, line 43; 2007 Form 1040NR, line 40; 2007 Form 1040NR-EZ, line 14) | 10. | _____ |
| 11. | Amount to include in income for 2008: • If line 10 is zero or more, enter the amount from line 9. • If line 10 is a negative amount, add lines 9 and 10 and enter the result (but not less than zero). ⁴ | 11. | _____ |

If line 11 equals line 3—

Enter the amount from line 1 on Form 1040, line 10; Form 1040NR, line 11; Form 1040NR-EZ, line 4.
Enter the amount from line 2 on Form 1040, line 21; Form 1040NR, line 21.

If line 11 is less than line 3 and either line 1 or line 2 is zero—

If there is an amount on line 1, enter the amount from line 11 on Form 1040, line 10; Form 1040NR, line 11; Form 1040NR-EZ, line 4.
If there is an amount on line 2, enter the amount from line 11 on Form 1040, line 21; Form 1040NR, line 21.

If line 11 is less than line 3, and there are amounts on both lines 1 and 2, complete the following worksheet.

| | | | |
|----|--|----|-------|
| A. | Divide the amount on line 1 by the amount on line 3. Enter the percentage | A. | _____ |
| B. | Multiply the amount on line 11 by the percentage on line A. Enter the result here and on Form 1040, line 10; Form 1040NR, line 11 | B. | _____ |
| C. | Subtract the amount on line B from the amount on line 11. Enter the result here and on Form 1040, line 21; Form 1040NR, line 21 | C. | _____ |

¹ Do not enter more than the amount deducted for the prior year. Do not enter more than the excess of your state and local income tax deduction over your state and local general sales taxes you could have deducted.

² Do not enter more than the amount deducted for the prior year. If you deducted state and local general sales taxes and received a refund of those taxes, include the amount on line 2, but do not enter more than the excess of your sales tax deduction over your state and local income tax you could have deducted.

³ If taxable income is a negative amount, enter that amount in brackets. Do not enter zero unless your taxable income is exactly zero. See *Negative taxable income*. Taxable income will have to be adjusted for any net operating loss carryover. For more information, see Publication 536, Net Operating Losses (NOLs) for Individuals, Estates, and Trusts.

⁴ For example, \$700 + (\$400) = \$300.

Table 2. 2007 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 born before January 2, 1943, or you are blind.

Table I. Standard Deduction Chart for Most People*

| IF your filing status is . . . | THEN your standard deduction is . . . |
|--|---------------------------------------|
| Single or Married filing separately | \$5,350 |
| Married filing joint return or Qualifying widow(er) with dependent child | 10,700 |
| Head of household | 7,850 |

* DO NOT use this chart if you were born before January 2, 1943, or you are blind, OR if someone else can claim an exemption for you (or your spouse if married filing jointly). Use Table II or III instead.

Table II. Standard Deduction Chart for People Who Were Born Before January 2, 1943, or Were Blind*

| Check the correct number of boxes below. Then go to the chart. | | |
|--|---|---|
| You | Born before January 2, 1943 | <input type="checkbox"/> Blind <input type="checkbox"/> |
| Your spouse, if claiming spouse's exemption | Born before January 2, 1943 | <input type="checkbox"/> Blind <input type="checkbox"/> |
| Total number of boxes you checked _____ | | |
| IF your filing status is . . . | AND the number on the line above is . . . | THEN your standard deduction is . . . |
| Single | 1 | 6,650 |
| | 2 | 7,950 |
| Married filing joint return or Qualifying widow(er) with dependent child | 1 | 11,750 |
| | 2 | 12,800 |
| | 3 | 13,850 |
| | 4 | 14,900 |
| Married filing separate return | 1 | 6,400 |
| | 2 | 7,450 |
| | 3 | 8,500 |
| | 4 | 9,550 |
| Head of household | 1 | 9,150 |
| | 2 | 10,450 |

*If someone else can claim an exemption for you (or your spouse if married filing jointly), use Table III instead.

Table III. Standard Deduction Worksheet for Dependents*

| | |
|---|---|
| If you were born before January 2, 1943, or you were blind, check the correct number of boxes below. Then go to the worksheet. | |
| You | Born before January 2, 1943 <input type="checkbox"/> Blind <input type="checkbox"/> |
| Your spouse, if claiming spouse's exemption | Born before January 2, 1943 <input type="checkbox"/> Blind <input type="checkbox"/> |
| Total number of boxes you checked _____ | |
| 1. Enter your earned income (defined below). If none, enter -0- | 1. _____ |
| 2. Additional amount | 2. <u>\$300</u> |
| 3. Add lines 1 and 2 | 3. _____ |
| 4. Minimum standard deduction | 4. <u>\$850</u> |
| 5. Enter the larger of line 3 or line 4 | 5. _____ |
| 6. Enter the amount shown below for your filing status. <ul style="list-style-type: none"> • Single or Married filing separately—\$5,350 • Married filing jointly—\$10,700 • Head of household—\$7,850 | 6. _____ |
| 7. Standard deduction. <p>a. Enter the smaller of line 5 or line 6. If born after January 1, 1943, and not blind, stop here. This is your standard deduction. Otherwise, go on to line 7b.</p> <p>b. If born before January 2, 1943, or blind, multiply \$1,300 (\$1,050 if married) by the number in the box above.</p> <p>c. Add lines 7a and 7b. This is your standard deduction for 2007.</p> | 7a. _____ 7b. _____ 7c. _____ |
| 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).

Table 3. 2006 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 born before January 2, 1942, or you are blind.

Table I. Standard Deduction Chart for Most People*

| IF your filing status is . . . | THEN your standard deduction is . . . |
|--|---------------------------------------|
| Single or Married filing separately | \$5,150 |
| Married filing joint return or Qualifying widow(er) with dependent child | 10,300 |
| Head of household | 7,550 |

* DO NOT use this chart if you were born before January 2, 1942, or you are blind, OR if someone else can claim an exemption for you (or your spouse if married filing jointly). Use Table II or III instead.

Table II. Standard Deduction Chart for People Who Were Born Before January 2, 1942, or Were Blind*

| Check the correct number of boxes below. Then go to the chart. | | |
|--|---|---|
| You | Born before January 2, 1942 | <input type="checkbox"/> Blind <input type="checkbox"/> |
| Your spouse, if claiming spouse's exemption | Born before January 2, 1942 | <input type="checkbox"/> Blind <input type="checkbox"/> |
| Total number of boxes you checked _____ | | |
| IF your filing status is . . . | AND the number on the line above is . . . | THEN your standard deduction is . . . |
| Single | 1 | \$ 6,400 |
| | 2 | 7,650 |
| Married filing joint return or Qualifying widow(er) with dependent child | 1 | 11,300 |
| | 2 | 12,300 |
| | 3 | 13,300 |
| | 4 | 14,300 |
| Married filing separate return | 1 | 6,150 |
| | 2 | 7,150 |
| | 3 | 8,150 |
| | 4 | 9,150 |
| Head of household | 1 | 8,800 |
| | 2 | 10,050 |

*If someone else can claim an exemption for you (or your spouse if married filing jointly), use Table III instead.

Table III. Standard Deduction Worksheet for Dependents*

| | |
|--|---|
| If you were born before January 2, 1942, or you were blind, check the correct number of boxes below. Then go to the worksheet. | |
| You | Born before January 2, 1942 <input type="checkbox"/> Blind <input type="checkbox"/> |
| Your spouse, if claiming spouse's exemption | Born before January 2, 1942 <input type="checkbox"/> Blind <input type="checkbox"/> |
| Total number of boxes you checked _____ | |
| 1. Enter your earned income (defined below). If none, enter -0- | 1. _____ |
| 2. Additional amount | 2. <u>\$300</u> |
| 3. Add lines 1 and 2 | 3. _____ |
| 4. Minimum standard deduction | 4. <u>\$850</u> |
| 5. Enter the larger of line 3 or line 4 | 5. _____ |
| 6. Enter the amount shown below for your filing status. <ul style="list-style-type: none"> • Single or Married filing separately—\$5,150 • Married filing jointly—\$10,300 • Head of household—\$7,550 | 6. _____ |
| 7. Standard deduction. <p>a. Enter the smaller of line 5 or line 6. If born after January 1, 1942, and not blind, stop here. This is your standard deduction. Otherwise, go on to line 7b.</p> <p>b. If born before January 2, 1942, or blind, multiply \$1,250 (\$1,000 if married) by the number in the box above.</p> <p>c. Add lines 7a and 7b. This is your standard deduction for 2006.</p> | 7a. _____ 7b. _____ 7c. _____ |
| 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).

Table 4. 2005 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 born before January 2, 1941, or you are blind.

Table I. Standard Deduction Chart for Most People*

| IF your filing status is . . . | THEN your standard deduction is . . . |
|--|---------------------------------------|
| Single or Married filing separately | \$5,000 |
| Married filing joint return or Qualifying widow(er) with dependent child | 10,000 |
| Head of household | 7,300 |

* DO NOT use this chart if you were born before January 2, 1941, or you are blind, OR if someone else can claim an exemption for you (or your spouse if married filing jointly). Use Table II or III instead.

Table II. Standard Deduction Chart for People Who Were Born Before January 2, 1941, or Were Blind*

| Check the correct number of boxes below. Then go to the chart. | | |
|--|---|---|
| You | Born before January 2, 1941 | <input type="checkbox"/> Blind <input type="checkbox"/> |
| Your spouse, if claiming spouse's exemption | Born before January 2, 1941 | <input type="checkbox"/> Blind <input type="checkbox"/> |
| Total number of boxes you checked _____ | | |
| IF your filing status is . . . | AND the number on the line above is . . . | THEN your standard deduction is . . . |
| Single | 1 | \$ 6,250 |
| | 2 | 7,500 |
| Married filing joint return or Qualifying widow(er) with dependent child | 1 | 11,000 |
| | 2 | 12,000 |
| | 3 | 13,000 |
| | 4 | 14,000 |
| Married filing separate return | 1 | 6,000 |
| | 2 | 7,000 |
| | 3 | 8,000 |
| | 4 | 9,000 |
| Head of household | 1 | 8,550 |
| | 2 | 9,800 |

*If someone else can claim an exemption for you (or your spouse if married filing jointly), use Table III instead.

Standard deduction for earlier years. To determine if amounts recovered in 2008 must be included in your income, you must know the standard deduction for your filing status for the year the deduction was claimed. If you filed Form 1040, the standard deduction tables for 2007, 2006, and 2005 are shown in Tables 2, 3, and 4. If you need the standard deduction amounts for years before 2005, see the copy of your return for that year. If you filed Form 1040NR or 1040NR-EZ, you could not claim the standard deduction.

Example. You filed a joint return on Form 1040 for 2007 with taxable income of \$45,000. Your itemized deductions were \$11,550. The standard deduction that you could have claimed was \$10,700. In 2008, you recovered \$2,100 of your 2007 itemized deductions. None of the recoveries were more than the actual deductions for 2007. Include \$850 of the recoveries in your 2008 income. This is the smaller of your recoveries (\$2,100) or the amount by which your itemized deductions were more than the standard deduction (\$11,550 – \$10,700 = \$850).

Negative taxable income. If your taxable income for the prior year (Worksheet 2, line 10) was a negative amount, the recovery you must include in income is reduced by that amount. You have a negative taxable income for 2007 if your:

- Form 1040, line 42 was more than line 41,
- Form 1040NR, line 39 was more than line 38, or
- Form 1040NR-EZ, line 13 was more than line 12.

Example. The facts are the same as in the previous example except line 42 was \$200 more than line 41 on your 2007 Form 1040 giving you a negative taxable income of \$200. You must include \$650 in your 2008 income, rather than \$850.

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:

- The amount deducted, or
- The amount recovered.

Example. During 2007, 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 2008, you received a \$500 reimbursement from your medical insurance for your 2007 expenses. The only amount of the \$500 reimbursement that must be included in your income for 2008 is \$200—the amount actually deducted.

Itemized deductions limited. You were subject to the limit on itemized deductions in the earlier year if your adjusted gross income (AGI) was more than a base amount. This amount was:

- For 2007, \$156,400 (\$78,200 if married filing separately),
- For 2006, \$150,500 (\$75,250 if married filing separately), and

Table III. Standard Deduction Worksheet for Dependents*

| | |
|---|---|
| If you were born before January 2, 1941, or you were blind, check the correct number of boxes below. Then go to the worksheet. | |
| You | Born before January 2, 1941 <input type="checkbox"/> Blind <input type="checkbox"/> |
| Your spouse, if claiming spouse's exemption | Born before January 2, 1941 <input type="checkbox"/> Blind <input type="checkbox"/> |
| Total number of boxes you checked _____ | |
| 1. Enter your earned income (defined below). If none, enter -0- | 1. _____ |
| 2. Additional amount | 2. <u>\$250</u> |
| 3. Add lines 1 and 2 | 3. _____ |
| 4. Minimum standard deduction | 4. <u>\$800</u> |
| 5. Enter the larger of line 3 or line 4 | 5. _____ |
| 6. Enter the amount shown below for your filing status. <ul style="list-style-type: none"> • Single or Married filing separately—\$5,000 • Married filing jointly—\$10,000 • Head of household—\$7,300 | 6. _____ |
| 7. Standard deduction. <p>a. Enter the smaller of line 5 or line 6. If born after January 1, 1941, and not blind, stop here. This is your standard deduction. Otherwise, go on to line 7b.</p> <p>b. If born before January 2, 1941, or blind, multiply \$1,250 (\$1,000 if married) by the number in the box above.</p> <p>c. Add lines 7a and 7b. This is your standard deduction for 2005.</p> | 7a. _____ 7b. _____ 7c. _____ |
| 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).

- For 2005, \$145,950 (\$72,975 if married filing separately).

If the limit applied, your itemized deductions were reduced by the smaller of the following amounts.

- 3% of the amount by which your AGI exceeded the base amount.
- 80% of your otherwise allowable deductions other than medical and dental expenses, investment interest expense, nonbusiness casualty and theft losses, and gambling losses.

In 2006 and 2007, your itemized deductions were reduced by only $\frac{2}{3}$ of the smaller amount.

If the amount you recovered was deducted in a year in which your itemized deductions were limited, you must include it in income up to the difference between the amount of itemized deductions actually allowed that year and the amount you would have been allowed (the greater of your itemized deductions or your standard deduction) if you had figured your deductions using only the net amount of the recovery item.

To determine the part of the recovery you must include in income, follow the two steps below.

1. Figure the greater of:
 - a. The standard deduction for the earlier year, or
 - b. The amount of itemized deductions you would have been allowed for the earlier year (after taking into account the limit on itemized deductions) if you had figured them using only the net amount of the recovery item. The net amount is the amount you actually paid reduced by the recovery amount.

Note. If you were required to itemize your deductions in the earlier year, use step 1(b) and not step 1(a).

2. Subtract the amount in step 1 from the amount of itemized deductions actually allowed in the earlier year after applying the limit on itemized deductions.

The result of step 2 is the amount of the recovery to include in your income for the year you receive the recovery. If your taxable income for the earlier year was a negative amount, reduce your recovery by the negative amount.

If you had unused tax credits in the earlier year, see *Unused tax credits*, later.

For more information on this computation, see Revenue Ruling 93-75. This ruling is in Cumulative Bulletin 1993-2.

Example. Eileen Martin is single. She had an AGI of \$1,156,400 and itemized her deductions on Schedule A (Form 1040) for 2007. She was not subject to alternative minimum tax and was not entitled to any credit against income tax. Her only allowable deduction was \$40,000 of state income taxes. Her state general sales tax was \$20,000. Eileen deducted only \$20,000 of her state income taxes in 2007 because her otherwise allowable deductions of \$40,000 were reduced by \$20,000. In 2008,

she received a \$5,000 refund of her state income taxes for 2007.

The following shows how Eileen figured the \$20,000 reduction and other amounts from the Itemized Deduction Worksheet in the 2007 Schedule A (Form 1040) instructions. These amounts are needed to figure the part of the \$5,000 refund that Eileen must include in her income for 2008.

| | |
|---|-------------|
| AGI for 2007 | \$1,156,400 |
| State income taxes paid in 2007 | \$40,000 |
| 3% reduction (amount on 2007 Itemized Deduction Worksheet, line 8) [((\$1,156,400 - \$156,400) × 3%)] | \$30,000 |
| 80% reduction (amount on 2007 Itemized Deduction Worksheet, line 4) (\$40,000 × 80%) | \$32,000 |
| Lesser of 3% reduction or 80% reduction | \$30,000 |
| Limit reduced ($\frac{2}{3}$) | -\$10,000 |
| 2007 deduction (amount on 2007 Itemized Deduction Worksheet, line 12) (\$40,000 - \$20,000) | \$20,000 |
| Refund received in 2008 of 2007 state income tax | \$ 5,000 |
| Net amount of 2007 state income tax (\$40,000 - \$5,000) | \$35,000 |

If Eileen had used the \$35,000 net amount of state income tax to figure her itemized deductions for 2007, the deduction allowed would have been \$16,333. This is her otherwise allowable deduction of \$35,000 reduced by \$18,667 ($(\$35,000 \times 80\% = \$28,000) - (\$28,000 \div 3.0)$). By deducting the full \$20,000 paid in 2007, she derived a tax benefit of \$3,667 ($\$20,000 - \$16,333$). Therefore, only \$3,667 of the \$5,000 refund is included in her income for 2008.

Unused tax credits. If you recover an item deducted in an earlier year in which you had unused tax credits, you must refigure the earlier year's tax to determine if you must include the recovery in your income. To do this, add the amount of the recovery to your earlier year's taxable income and refigure the tax and the credits on the recomputed amount. If the recomputed tax, after application of the credits, is more than the actual tax in the earlier year, include the recovery in your income up to the amount of the deduction that reduced the tax in the earlier year. For this purpose, any increase to a credit carried over to the current year that resulted from deducting the recovered amount in the earlier year is considered to have reduced your tax in the earlier year. If the recovery is for an itemized deduction claimed in a year in which the deductions were limited, see *Itemized deductions limited*, earlier.

If your tax, after application of the credits, does not change, you did not have a tax benefit from the deduction. Do not include the recovery in your income.

Example. In 2007, Jean Black filed as head of household and itemized her deductions on Schedule A (Form 1040). Her taxable income was \$5,260 and her tax was \$528. She claimed a child care credit of \$1,200. The credit reduced her tax to zero and she had an unused tax credit of \$672 ($\$1,200 - \528). In 2008,

Jean recovered \$1,000 of her itemized deductions. She reduces her 2007 itemized deductions by \$1,000 and recomputes that year's tax on taxable income of \$6,260. However, the child care credit exceeds the recomputed tax of \$628. Jean's tax liability for 2007 is not changed by reducing her deductions by the recovery. She did not have a tax benefit from the recovered deduction and does not include any of the recovery in her income for 2008.

Subject to alternative minimum tax. If you were subject to the alternative minimum tax in the year of the deduction, you will have to recompute your tax for the earlier year to determine if the recovery must be included in your income. This will require a recomputation of your regular tax, as shown in the preceding example, and a recomputation of your alternative minimum tax. If inclusion of the recovery does not change your total tax, you do not include the recovery in your income. However, if your total tax increases by any amount, you received a tax benefit from the deduction and you must include the recovery in your income up to the amount of the deduction that reduced your tax in the earlier year.

Non-Itemized Deduction Recoveries

This section discusses recovery of deductions other than itemized deductions.

Total recovery included in income. If you recover an amount that you deducted in an earlier year in figuring your adjusted gross income, you generally must include the full amount of the recovery in your income in the year received.

Total recovery not included in income. If any part of the deduction you took for the recovered amount did not reduce your tax, you may be able to exclude at least part of the recovery from your income. You must include the recovery in your income only up to the amount of the deduction that reduced your tax in the year of the deduction. (See *Tax benefit rule*, earlier.)

Negative taxable income. If your taxable income for the prior year was a negative amount, the recovery you must include in income is reduced by that amount. You have a negative taxable income for 2007 if you:

- Form 1040, line 42 was more than line 41,
- Form 1040NR, line 39 was more than line 38, or
- Form 1040NR-EZ, line 13 was more than line 12.

Unused tax credits. If you recover an item deducted in an earlier year in which you had unused tax credits, you must refigure the earlier year's tax to determine if you must include the recovery in your income. To do this, add the amount of the recovery to your earlier year's taxable income and refigure the tax and the credits on the recomputed amount. If the recomputed tax, after application of the credits, is more than the actual tax in the earlier year, include the recovery in your income up to the

amount of the deduction that reduced the tax in the earlier year. For this purpose, any increase to a credit carried over to the current year that resulted from deducting the recovered amount in the earlier year is considered to have reduced your tax in the earlier year.

If your tax, after application of the credits, does not change, you did not have a tax benefit from the deduction. Do not include the recovery in your income.

Amounts Recovered for Credits

If you received a recovery in 2008 for an item for which you claimed a tax credit in an earlier year, you must increase your 2008 tax by the amount of the recovery, up to the amount by which the credit reduced your tax in the earlier year. You had a recovery if there was a downward price adjustment or similar adjustment on the item for which you claimed a credit.

This rule does not apply to the investment credit or the foreign tax credit. Recoveries of these credits are covered by other provisions of the law. See Publication 514, Foreign Tax Credit for Individuals, or Form 4255, Recapture of Investment Credit, for details.

Survivor Benefits

Generally, payments made by or for an employer because of an employee's death must be included in income. The following discussions explain the tax treatment of certain payments made to survivors. For additional information, see Publication 559.

Lump-sum payments. Lump-sum payments you receive from a decedent's employer as the surviving spouse or beneficiary may be accrued salary payments; distributions from employee profit-sharing, pension, annuity, or stock bonus plans; or other items that should be treated separately for tax purposes. The tax treatment of these lump-sum payments depends on the type of payment.

Salary or wages. Salary or wages received after the death of the employee are usually ordinary income to you.

Qualified employee retirement plans. Lump-sum distributions from qualified employee retirement plans are subject to special tax treatment. For information on these distributions, see Publication 575 (or Publication 721, if you are the survivor of a federal employee or retiree).

Public safety officer killed in the line of duty. If you are a survivor of a public safety officer who was killed in the line of duty, you may be able to exclude from income certain amounts you receive. For this purpose, the term public safety officer includes law enforcement officers, firefighters, chaplains, and rescue squad and ambulance crew members. For more information, see Publication 559.

Unemployment Benefits

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

Unemployment compensation. You must include in your income all unemployment compensation you receive. You should receive a Form 1099-G showing the amount paid to you. Generally, you enter unemployment compensation on line 19 of Form 1040, line 13 of Form 1040A, or line 3 of Form 1040EZ.

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

- Benefits paid by a state or the District of Columbia from the Federal Unemployment Trust Fund.
- State unemployment insurance benefits.
- Railroad unemployment compensation benefits.
- Disability payments from a government program paid as a substitute for unemployment compensation. (Amounts received as workers' compensation for injuries or illness are not unemployment compensation. See *Workers' Compensation under Sickness and Injury Benefits*, earlier.)
- Trade readjustment allowances under the Trade Act of 1974.
- Unemployment assistance under the Disaster Relief and Emergency Assistance Act of 1974.

Governmental program. If you contribute to a governmental unemployment compensation program and your contributions are not deductible, amounts you receive under the program are not included as unemployment compensation until you recover your contributions. If you deducted all of your contributions to the program, the entire amount you receive under the program is included in your income.

Repayment of unemployment compensation. If you repaid in 2008 unemployment compensation you received in 2008, subtract the amount you repaid from the total amount you received and enter the difference on line 19 of Form 1040, line 13 of Form 1040A, or line 3 of Form 1040EZ. On the dotted line next to your entry, enter "Repaid" and the amount you repaid. If you repaid unemployment compensation in 2008 that you included in your income in an earlier year, you can deduct the amount repaid on Schedule A (Form 1040), line 23, if you itemize deductions. If the amount is more than \$3,000, see *Repayments*, later.

Tax withholding. You can choose to have federal income tax withheld from your unemployment compensation. To make this choice, complete Form W-4V, Voluntary Withholding Request, and give it to the paying office. Tax will be withheld at 10% of your payment.



If you do not choose to have tax withheld from your unemployment compensation, you may be liable for estimated tax. If you do not pay enough tax, either through withholding or estimated tax, or a combination of both, you may have to pay a penalty. For more information, see Publication 505, Tax Withholding and Estimated Tax.

Supplemental unemployment benefits.

Benefits received from an employer-financed fund (to which the employees did not contribute) are not unemployment compensation. They are taxable as wages and are subject to withholding for income tax. They may be subject to social security and Medicare taxes. For more information, see *Supplemental Unemployment Benefits* in Publication 15-A, section 5, Employer's Supplemental Tax Guide. Report these payments on line 7 of Form 1040 or Form 1040A or on line 1 of Form 1040EZ.

Repayment of benefits. 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 in your income for the year you received them.

Deduct the repayment in the later year as an adjustment to gross income on Form 1040. (You cannot use Form 1040A or Form 1040EZ.) Include the repayment on Form 1040, line 36, and enter "Sub-Pay TRA" and the amount on the dotted line next to line 36. 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 information on this, see *Repayments*, later.

Private unemployment fund. Unemployment benefit payments from a private (nonunion) 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 Form 1040, line 21.

Payments by a union. Benefits paid to you as an unemployed member of a union from regular union dues are included in your income on Form 1040, line 21. However, if you contribute to a special union fund and your payments to the fund are not deductible, the unemployment benefits you receive from the fund are includible in your income only to the extent they are more than your contributions.

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. Include them on line 7 of Form 1040 or Form 1040A or on line 1 of Form 1040EZ.

State employees. Payments similar to a state's unemployment compensation may be made by the state to its employees who are not covered by the state's unemployment compensation law. Although the payments are fully taxable, do not report them as unemployment compensation. Report these payments on Form 1040, line 21.

Welfare and Other Public Assistance Benefits

Do not include in your income governmental benefit payments from a public welfare fund based upon need, 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 payments that are compensation for services or that are obtained fraudulently.

Work-training program. Payments you receive from a state welfare agency for taking part in a work-training program are not included in your income, as long as the payments (exclusive of extra allowances for transportation or other costs) do not total more than the public welfare benefits you would have received otherwise. If the payments are more than the welfare benefits you would have received, the entire amount must be included in your income as wages.

Alternative trade adjustment assistance (ATAA) payments. Payments you receive from a state agency under the Demonstration Project for Alternative Trade Adjustment Assistance for Older Workers (ATAA) must be included in your income. The state must send you Form 1099-G to advise you of the amount you should include in income. The amount should be reported on Form 1040, line 21.

Persons with disabilities. If you have a disability, you must include in income compensation you receive for services you perform unless the compensation is otherwise excluded. However, you do not include in income the value of goods, services, and cash that you receive, not in return for your services, but for your training and rehabilitation because you have a disability. Excludable amounts include payments for transportation and attendant care, such as interpreter services for the deaf, reader services for the blind, and services to help mentally retarded persons do their work.

Disaster relief grants. Do not include post-disaster grants received under the Disaster Relief and Emergency Assistance Act in your income if the grant payments are made to help you meet necessary expenses or serious needs for medical, dental, housing, personal property, transportation, or funeral expenses. Do not deduct casualty losses or medical expenses that are specifically reimbursed by these disaster relief grants. If you have deducted a casualty loss for the loss of your personal residence and you later receive a disaster relief grant for the loss of the same residence, you may have to include part or all of the grant in your taxable income. See *Recoveries*, earlier. Unemployment assistance payments under the Act are taxable unemployment compensation. See *Unemployment compensation* under *Unemployment Benefits*, earlier.

Disaster relief payments. You can exclude from income any amount you receive that is a qualified disaster relief payment. A qualified disaster relief payment is an amount paid to you:

1. To reimburse or pay reasonable and necessary personal, family, living, or funeral expenses that result from a qualified disaster;
2. To reimburse or pay reasonable and necessary expenses incurred for the repair or

rehabilitation of your home or repair or replacement of its contents to the extent it is due to a qualified disaster;

3. By a person engaged in the furnishing or sale of transportation as a common carrier because of the death or personal physical injuries incurred as a result of a qualified disaster; or
4. By a federal, state, or local government, or agency or instrumentality in connection with a qualified disaster in order to promote the general welfare.

You can exclude this amount only to the extent any expense it pays for is not paid for by insurance or otherwise. The exclusion does not apply if you were a participant or conspirator in a terrorist action or his or her representative.

A qualified disaster is:

- A disaster which results from a terrorist or military action;
- A federally declared disaster; or
- A disaster which results from an accident involving a common carrier, or from any other event, which is determined to be catastrophic by the Secretary of the Treasury or his or her delegate.

For amounts paid under item (4), a disaster is qualified if it is determined by an applicable federal, state, or local authority to warrant assistance from the federal, state, or local government, agency, or instrumentality.

Disaster mitigation payments. You also can exclude from income any amount you receive that is a qualified disaster mitigation payment. Like qualified disaster relief payments, qualified disaster mitigation payments are also most commonly paid to you in the period immediately following damage to property as a result of a natural disaster. However, disaster mitigation payments are grants you use to mitigate (reduce the severity of) potential damage from future natural disasters. They are paid to you through state and local governments based on the provisions of the Robert T. Stafford Disaster Relief and Emergency Assistance Act or the National Flood Insurance Act.

You cannot increase the basis or adjusted basis of your property for improvements made with nontaxable disaster mitigation payments.

Mortgage assistance payments. Payments made under section 235 of the National Housing Act for mortgage assistance are not included in the homeowner's income. Interest paid for the homeowner under the mortgage assistance program cannot be deducted.

Replacement housing payments. Replacement housing payments made under the Uniform Relocation Assistance and Real Property Acquisition Policies Act for Federal and Federally Assisted Programs are not includible in gross income, but are includible in the basis of the newly acquired property.

Relocation payments and home rehabilitation grants. A relocation payment under section 105(a)(11) of the Housing and Community Development Act made by a local jurisdiction to a displaced individual moving from a flood-damaged residence to another residence

is not includible in gross income. Home rehabilitation grants received by low-income homeowners in a defined area under the same act are also not includible in gross income.

Indian financing grants. Nonreimbursable grants under title IV of the Indian Financing Act of 1974 to Indians to expand profit-making Indian-owned economic enterprises on or near reservations are not includible in gross income.

Medicare. Medicare benefits received under title XVIII of the Social Security Act are not includible in the gross income of the individuals for whom they are paid. This includes basic (part A (Hospital Insurance Benefits for the Aged)) and supplementary (part B (Supplementary Medical Insurance Benefits for the Aged)).

Old-age, survivors, and disability insurance benefits (OASDI). OASDI payments under section 202 of title II of the Social Security Act are not includible in the gross income of the individuals to whom they are paid. This applies to old-age insurance benefits, and insurance benefits for wives, husbands, children, widows, widowers, mothers and fathers, and parents, as well as the lump-sum death payment.

Nutrition Program for the Elderly. Food benefits you receive under the Nutrition Program for the Elderly are not taxable. If you prepare and serve free meals for the program, include in your income as wages the cash pay you receive, even if you are also eligible for food benefits.

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 Income

The following brief discussions are arranged in alphabetical order. Income items that are discussed in greater detail in another publication include a reference to that publication.

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 is a hobby or a farm you operate mostly for recreation and pleasure. Enter this income on Form 1040, line 21. 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 for information on whether an activity is considered carried on for a profit.

Alaska Permanent Fund dividend. If you received a payment from Alaska's mineral income fund (Alaska Permanent Fund dividend), report it as income on line 21 of Form 1040, line 13 of Form 1040A, or line 3 of Form 1040EZ. The state of Alaska sends each recipient a document that shows the amount of the payment with the check. The amount also is reported to the IRS.

Alimony. Include in your income on Form 1040, line 11, any alimony payments you receive. Amounts you receive for child support

are not income to you. For complete information, see Publication 504, *Divorced or Separated Individuals*.

Below-market loans. A below-market loan is a loan on which no interest is charged or on which the interest is charged at a rate below the applicable federal rate. If you make a below-market gift or demand loan, you must include the forgone interest (at the federal rate) as interest income on your return. These loans are considered a transaction in which you, the lender, are treated as having made:

- A loan to the borrower in exchange for a note that requires the payment of interest at the applicable federal rate, and
- An additional payment to the borrower, which the borrower transfers back to you as interest.

Depending on the transaction, the additional payment to the borrower is treated as a:

- Gift,
- Dividend,
- Contribution to capital,
- Payment of compensation, or
- Another type of payment.

The borrower may have to report this payment as income, depending on its classification.

For more information on below-market loans, see chapter 1 of Publication 550.

Bribes. If you receive a bribe, include it in your income.

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 realized 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 Form 1040, line 21, in the year transferred.

Canceled sales contract. If you sell property (such as land or a residence) under a contract, but the contract is canceled and you return the buyer's money in the same tax year as the original sale, you have no income from the sale. If the contract is canceled and you return the buyer's money in a later tax year, you must include your gain in your income for the year of the sale. When you return the money and take back the property in the later year, you treat the transaction as a purchase that gives you a new basis in the property equal to the funds you return to the buyer.

Special rules apply to the reacquisition of real property where a secured indebtedness (mortgage) to the original seller is involved. For further information, see *Repossession* in Publication 537, *Installment Sales*.

Car pools. Do not include in your income amounts you receive from the passengers for driving a car in a car pool to and from work.

These amounts are considered reimbursement for your expenses. However, this rule does not apply if you have developed car pool arrangements into a profit-making business of transporting workers for hire.

Cash rebates. A cash rebate you receive from a dealer or manufacturer of an item you buy is not income, but you must reduce your basis by the amount of the rebate.

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 basis in the car is \$8,600. This is the basis on which you figure gain or loss if you sell the car and depreciation if you use it for business.

Casualty insurance and other reimbursements. You generally should not report these reimbursements on your return unless you are figuring gain or loss from the casualty or theft. See Publication 547, *Casualties, Disasters, and Thefts*, for more information.

Charitable gift annuities. If you are the beneficiary of a charitable gift annuity, you must include the yearly annuity or fixed percentage payment in your income.

The payer will report the types of income you received on Form 1099-R. Report the gross distribution from box 1 on Form 1040, line 16a, or on Form 1040A, line 12a, and the part taxed as ordinary income (box 2a minus box 3) on Form 1040, line 16b, or on Form 1040A, line 12b. Report the portion taxed as capital gain (box 3) on Schedule D, line 8.

Child support payments. You should not report these payments on your return. See Publication 504 for more information.

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. The character of the income as ordinary income or capital gain depends on the nature of the underlying claim. 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, in most cases. It does not matter if they relate to a physical injury or physical sickness.
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.
7. Attorney fees and costs (including contingent fees) where the underlying recovery is included in gross income.

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. Emotional distress itself is not a physical injury or physical sickness, but damages you receive for emotional distress due to a physical injury or sickness are treated as received for the physical injury or sickness. Do not include them in your income.

If the emotional distress is due to a personal injury that is not due to a physical injury or sickness (for example, unlawful discrimination or injury to reputation), you must include the damages in your income, except for any damages you receive for medical care due to that emotional distress. Emotional distress includes physical symptoms that result from emotional distress, such as headaches, insomnia, and stomach disorders.

Deduction for costs involved in unlawful discrimination suits. You may be able to deduct attorney fees and court costs paid to recover a judgment or settlement for a claim of unlawful discrimination under various provisions of federal, state, and local law listed in Internal Revenue Code section 62(e), a claim against the United States government, or a claim under section 1862(b)(3)(A) of the Social Security Act. You can claim this deduction as an adjustment to income on Form 1040, line 36. The following rules apply.

- The attorney fees and court costs may be paid by you or on your behalf in connection with the claim for unlawful discrimination, the claim against the United States government, or the claim under section 1862(b)(3)(A) of the Social Security Act.
- The deduction you are claiming cannot be more than the amount of the judgment or settlement you are including in income for the tax year.
- The judgment or settlement to which your attorney fees and court costs apply must occur after October 22, 2004.

Pre-existing agreement. If you receive damages under a written binding agreement, court decree, or mediation award that was in effect (or issued on or before) September 13, 1995, do not include in income any of those damages received on account of personal injuries or sickness.

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 Form 1040, line 21, the amount of benefits you received during the year that is more than the amount of the premiums you paid during the year.

Down payment assistance. If you purchase a home and receive assistance from a non-profit corporation to make the down payment, that assistance is not included in your income. If the corporation qualifies as a tax-exempt charitable organization, the assistance is treated as a gift and is included in your basis of the house. If the corporation does not qualify,

the assistance is treated as a rebate or reduction of the purchase price and is not included in your basis.

Employment agency fees. If you get a job through an employment agency, and the fee is paid by your employer, the fee is not includible in your income if you are not liable for it. However, if you pay it and your employer reimburses you for it, it is includible in your 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.

Estate and trust income. An estate or trust, unlike a partnership, may have to pay federal income tax. If you are a beneficiary of an estate or trust, you may be taxed on your share of its income distributed or required to be distributed to you. However, there is never a double tax. Estates and trusts file their returns on Form 1041, U.S. Income Tax Return for Estates and Trusts, and your share of the income is reported to you on Schedule K-1 (Form 1041), Beneficiary's Share of Income, Deductions, Credits, etc.

Current income required to be distributed. If you are the beneficiary of an estate or trust that must distribute all of its current income, you must report your share of the distributable net income, whether or not you 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:

- All income that is required to be distributed to you, whether or not it is actually distributed, plus
- All other amounts actually paid or credited to you,

up to the amount of your share of distributable net income.

How to report. Treat each item of income the same way that the estate or trust would treat it. For example, if a trust's dividend income is distributed to you, you report the distribution as dividend income on your return. The same rule applies to distributions of tax-exempt interest and capital gains.

The fiduciary of the estate or trust must tell you the type of items making up your share of the estate or trust income and any credits you are allowed on your individual income tax return.

Losses. Losses of estates and trusts generally are not deductible by the beneficiaries.

Grantor trust. Income earned by a grantor trust is taxable to the grantor, not the beneficiary, if the grantor keeps certain control over the trust. (The grantor is the one who transferred property to 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.

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.

Expenses paid by another. If your personal expenses are paid for by another person, such as a corporation, the payment may be taxable to you depending upon your relationship with that person and the nature of the payment. But if the payment makes up for a loss caused by that person, and only restores you to the position you were in before the loss, the payment is not includible in your income.

Exxon Valdez settlement income. Include in your income on Form 1040, line 21, or Form 1040NR, line 21, any qualified settlement income you receive as a qualified taxpayer. See *Statement*, later. Qualified settlement income is any interest and punitive damage awards that are:

- Otherwise includible in taxable income, and
- Received in connection with the civil action *In re Exxon Valdez*, No. 89-095-CV (HRH) (Consolidated) (D. Alaska).

You are a qualified taxpayer if you were a plaintiff in the above mentioned civil action or you were a beneficiary of the estate of your spouse or a close relative who was such a plaintiff and from whom you acquired the right to receive qualified settlement income.

The income can be received as a lump sum or as periodic payments. You will receive a Form 1099-MISC showing the gross amount of the settlement income paid to you in the tax year.

Contributions to eligible retirement plan. If you are a qualified taxpayer you can contribute all or part of your qualified settlement income, up to \$100,000, to an eligible retirement plan, including an IRA. Contributions to eligible retirement plans, other than a Roth IRA or a designated Roth contribution, reduce the qualified settlement income that you must include in income. See *Statement*, later. For more information on these contributions, see Publication 560, Publication 575, and Publication 590.

Legal expenses. You may be able to deduct attorney fees and court costs paid in connection with the civil action. Depending on the facts and circumstances, these expenses are either claimed on Schedule A (Form 1040) or Form 1040NR (Schedule A), or deducted in figuring the income you report on Form 1040, line 21, or Form 1040NR, line 21. If the qualified settlement income was received in connection with your trade or business (other than as an employee), you can reduce the taxable amount of qualified settlement income by these expenses. In all other situations, you can only claim these expenses as a miscellaneous itemized deduction subject to the 2%-of-adjusted-gross-income limit on Schedule A (Form 1040),

line 23, or Form 1040NR (Schedule A), line 11. For example, an employee or the surviving spouse or beneficiary of a deceased plaintiff would claim the expenses as a miscellaneous itemized deduction subject to the 2% limit. See *Statement*, next.

Statement. If you report on Form 1040, line 21, or Form 1040NR, line 21, qualified settlement income that is less than the gross amount shown on the Form 1099-MISC, you must attach a statement to your tax return. The statement must identify and show the gross amount of the qualified settlement income, the reductions for the amount contributed to an eligible retirement plan or allowable as legal expenses not reported as a miscellaneous itemized deduction, and the net amount.

Income averaging. For purposes of the income averaging rules that apply to an individual engaged in a farming or fishing business, qualified settlement income is treated as attributable to a fishing business for the tax year in which it is received. See Schedule J (Form 1040) and its instructions for more information.

Fees for services. Include all fees for your services in your income. Examples of these fees are amounts you receive for services you perform as:

- A corporate director,
- An executor, administrator, or personal representative of an estate,
- A manager of a trade or business you operated before declaring Chapter 11 bankruptcy,
- A notary public, or
- An election precinct official.



If you are not an employee and the fees for your services from the same payor total \$600 or more for the year, you may receive a Form 1099-MISC.

Corporate director. Corporate director fees are self-employment income. Report these payments on Schedule C or Schedule C-EZ (Form 1040).

Personal representatives. All personal representatives must include in their gross income fees paid to them from an estate. If you are not in the trade or business of being an executor (for instance, you are the executor of a friend's or relative's estate), report these fees on Form 1040, line 21. If you are in the trade or business of being an executor, report these fees as self-employment income on Schedule C or Schedule C-EZ (Form 1040). The fee is not includible in income if it is waived.

Manager of trade or business for bankruptcy estate. Include in your income all payments received from your bankruptcy estate for managing or operating a trade or business that you operated before you filed for bankruptcy. Report this income on Form 1040, line 21.

Notary public. Report payments for these services on Schedule C or Schedule C-EZ (Form 1040). These payments are not subject

to self-employment tax. (See the separate instructions for Schedule SE (Form 1040) for details.)

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.

Food program payments to daycare providers. If you operate a daycare service and receive payments under the Child and Adult Care Food Program administered by the Department of Agriculture that are not for your services, the payments generally are not included in your income. However, you must include in your income any part of the payments you do not use to provide food to individuals eligible for help under the program.

Foreign currency transactions. If you have a gain on a personal foreign currency transaction because of changes in exchange rates, you do not have to include that gain in your income unless it is more than \$200. If the gain is more than \$200, report it as a capital gain.

Foster care providers. Payments you receive from a state, political subdivision, or a qualified foster care placement agency for providing care to qualified foster individuals in your home generally are not included in your income. However, 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. A qualified foster care placement agency.

Difficulty-of-care payments. These are additional payments that are designated by the payer as compensation for providing the additional care that is required for physically, mentally, or emotionally handicapped qualified foster individuals. A state must determine that the additional compensation is needed, and the care for which the payments are made must be provided in your home.

You must include in your income difficulty-of-care payments received for more than:

- 10 qualified foster individuals under age 19, or
- 5 qualified foster individuals age 19 or older.

Maintaining space in home. If you are paid to maintain space in your home for emergency foster care, you must include the payment in your income.

Reporting taxable payments. If you receive payments that you must include in your income, you are in business as a foster-care provider and you are self-employed. Report the payments on Schedule C or Schedule C-EZ (Form 1040). See Publication 587, Business

Use of Your Home (Including Use by Daycare Providers), to help you determine the amount you can deduct for the use of your home.

Found property. If you find and keep property that does not belong to you that has been lost or abandoned (treasure-trove), it is taxable to you at its fair market value in the first year it is your undisputed possession.

Free tour. If you received a free tour from a travel agency for organizing a group of tourists, you must include its value in your income. Report the fair market value of the tour on Form 1040, line 21, if you are not in the trade or business of organizing tours. You cannot deduct your expenses in serving as the voluntary leader of the group at the group's request. If you organize tours as a trade or business, report the tour's value on Schedule C or Schedule C-EZ (Form 1040).

Gambling winnings. You must include your gambling winnings in your income on Form 1040, line 21. If you itemize your deductions on Schedule A (Form 1040), you can deduct gambling losses you had during the year, but only up to the amount of your winnings.

Lotteries and raffles. Winnings from lotteries and raffles are gambling winnings. In addition to cash winnings, you must include in your income the fair market value of bonds, cars, houses, and other noncash prizes. However, the difference between the fair market value and the cost of an oil and gas lease obtained from the government through a lottery is not includible in income.

Installment payments. Generally, if you win a state lottery prize payable in installments, you must include in your gross income the annual payments and any amounts you receive designated as interest on the unpaid installments. If you sell future lottery payments for a lump sum, you must report the amount you receive from the sale as ordinary income (Form 1040, line 21) in the year you receive it.

Form W-2G. You may have received a Form W-2G, Certain Gambling Winnings, showing the amount of your gambling winnings and any tax taken out of them. Include the amount from box 1 on Form 1040, line 21. Include the amount shown in box 2 on Form 1040, line 62, as federal income tax withheld.

Gifts and inheritances. Generally, property you receive as a gift, bequest, or inheritance is not included in your income. However, if property you receive this way later produces income such as interest, dividends, or rents, that income is taxable to you. If property is given to a trust and the income from it is paid, credited, or distributed to you, that income is also taxable to you. If the gift, bequest, or inheritance is the income from the property, that income is taxable to you.

Inherited pension or IRA. If you inherited a pension or an individual retirement arrangement (IRA), you may have to include part of the inherited amount in your income. See *Survivors and Beneficiaries* in Publication 575, if you inherited a pension. See *What If You Inherit an IRA?* in Publication 590, if you inherited an IRA.

Expected inheritance. If you sell an interest in an expected inheritance from a living

person, include the entire amount you receive in gross income on Form 1040, line 21.

Bequest for services. If you receive cash or other property as a bequest for services you performed while the decedent was alive, the value is taxable compensation.

Historic preservation grants. Do not include in your income any payment you receive under the National Historic Preservation Act to preserve a historically significant property.

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, under *Other Income*.



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. However, if you sell items from your collection at a loss, you cannot deduct the loss.

Holocaust victims restitution. Restitution payments you receive as a Holocaust victim (or the heir of a Holocaust victim) and interest earned on the payments, including interest earned on amounts held in certain escrow accounts or funds, are not taxable. You also do not include them in any computations in which you ordinarily would add excludable income to your adjusted gross income, such as the computation to determine the taxable part of social security benefits. If the payments are made in property, your basis in the property is its fair market value when you receive it.

Excludable restitution payments are payments or distributions made by any country or any other entity because of persecution of an individual on the basis of race, religion, physical or mental disability, or sexual orientation by Nazi Germany, any other Axis regime, or any other Nazi-controlled or Nazi-allied country, whether the payments are made under a law or as a result of a legal action. They include compensation or reparation for property losses resulting from Nazi persecution, including proceeds under insurance policies issued before and during World War II by European insurance companies.

Illegal activities. Income from illegal activities, such as money from dealing illegal drugs, must be included in your income on Form 1040, line 21, 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.

Interest on frozen deposits. In general, you exclude from your income the amount of interest earned on a frozen deposit. A deposit is frozen if, at the end of the calendar year, you cannot withdraw any part of the deposit because:

- The financial institution is bankrupt or insolvent, or

- The state where the institution is located has placed limits on withdrawals because other financial institutions in the state are bankrupt or insolvent.

Excludable amount. The amount of interest you exclude from income for the year is the interest that was credited on the frozen deposit for that tax year minus the sum of:

1. The net amount withdrawn from the deposit during that year, and
2. The amount that could have been withdrawn at the end of that tax year (not reduced by any penalty for premature withdrawals of a time deposit).

The excluded part of the interest is included in your income in the tax year it becomes withdrawable.

Interest on qualified savings bonds. You may be able to exclude from income the interest from qualified U.S. savings bonds you redeem if you pay qualified higher educational expenses in the same year. Qualified higher educational expenses are those you pay for tuition and required fees at an eligible educational institution for you, your spouse, or your dependent. A qualified U.S. savings bond is a series EE bond issued after 1989 or a series I bond. The bond must have been issued to you when you were 24 years of age or older. For more information on this exclusion, see *Education Savings Bond Program* in chapter 1 of Publication 550.

Interest on state and local government obligations. This interest is usually exempt from federal tax. However, you must show the amount of any tax-exempt interest on your federal income tax return. For more information, see *State or Local Government Obligations* in chapter 1 of Publication 550.

Job interview expenses. If a prospective employer asks you to appear for an interview and either pays you an allowance or reimburses you for your transportation and other travel expenses, the amount you receive generally is not taxable. You include in income only the amount you receive that is more than your actual expenses.

Jury duty. Jury duty pay you receive must be included in your income on Form 1040, line 21. If you must give the pay to your employer because your employer continues to pay your salary while you serve on the jury, you can deduct the amount turned over to your employer as an adjustment to income. Enter the amount you repay your employer on Form 1040, line 36. Enter "Jury Pay" and the amount on the dotted line next to line 36.

Kickbacks. You must include kickbacks, side commissions, push money, or similar payments you receive in your income on Form 1040, line 21, or on Schedule C or Schedule C-EZ (Form 1040) if from your self-employment activity.

Example. You sell cars and help arrange car insurance for buyers. Insurance brokers pay back part of their commissions to you for referring customers to them. You must include the kickbacks in your income.

Manufacturer incentive payments. You must include as other income on Form 1040, line 21 (or Schedule C or Schedule C-EZ (Form 1040) if you are self-employed) incentive payments from a manufacturer that you receive as a salesperson. This is true whether you receive the payment directly from the manufacturer or through your employer.

Example. You sell cars for an automobile dealership and receive incentive payments from the automobile manufacturer every time you sell a particular model of car. You report the incentive payments on Form 1040, line 21.

Medical savings accounts (Archer MSAs and Medicare Advantage MSAs). You generally do not include in income amounts you withdraw from your Archer MSA or Medicare Advantage MSA if you use the money to pay for qualified medical expenses. Generally, qualified medical expenses are those you can deduct on Schedule A (Form 1040). For more information about Archer MSAs or Medicare Advantage MSAs, see Publication 969.

Moving expense reimbursements. You generally should not report these benefits on your return. See Publication 521 for more information.

Prizes and awards. If you win a prize in a lucky number drawing, television or radio quiz program, beauty contest, or other event, you must include it in your income. For example, if you win a \$50 prize in a photography contest, you must report this income on Form 1040, line 21. If you refuse to accept a prize, do not include its value in your income.

Prizes and awards in goods or services must be included in your income at their fair market value.

Employee awards or bonuses. Cash awards or bonuses given to you by your employer for good work or suggestions generally must be included in your income as wages. However, certain noncash employee achievement awards can be excluded from income. See *Bonuses and awards* under *Miscellaneous Compensation*, earlier.

Prize points. If you are a salesperson and receive prize points redeemable for merchandise, that are awarded by a distributor or manufacturer to employees of dealers, you must include their fair market value in your income. The prize points are taxable in the year they are paid or made available to you, rather than in the year you redeem them for merchandise.

Pulitzer, Nobel, and similar prizes. If you were awarded a prize in recognition of accomplishments in religious, charitable, scientific, artistic, educational, literary, or civic fields, you generally must include the value of the prize in your income. However, you do not include this prize in your income if you meet all of the following requirements.

1. You were selected without any action on your part to enter the contest or proceeding.
2. You are not required to perform substantial future services as a condition for receiving the prize or award.

3. The prize or award is transferred by the payer directly to a governmental unit or tax-exempt charitable organization as designated by you. The following conditions apply to the transfer.

- a. You cannot use the prize or award before it is transferred.
- b. You should provide the designation before the prize or award is presented to prevent a disqualifying use. The designation should contain:
 - i. The purpose of the designation by making a reference to section 74(b)(3) of the Internal Revenue Code,
 - ii. A description of the prize or award,
 - iii. The name and address of the organization to receive the prize or award,
 - iv. Your name, address, and taxpayer identification number, and
 - v. Your signature and the date signed.
- c. In the case of an unexpected presentation, you must return the prize or award before using it (or spending, depositing, investing it, etc., in the case of money) and then prepare the statement as described in (b).
- d. After the transfer, you should receive from the payer a written response stating when and to whom the designated amounts were transferred.

These rules do not apply to scholarship or fellowship awards. See *Scholarships and fellowships*, later.

Qualified tuition program (QTP). A qualified tuition program (also known as a 529 program) is a program set up to allow you to either prepay or contribute to an account established for paying a student's qualified higher education expenses at an eligible educational institution. A program can be established and maintained by a state, an agency or instrumentality of a state, or an eligible educational institution.

The part of a distribution representing the amount paid or contributed to a QTP is not included in income. This is a return of the investment in the program.

The beneficiary generally does not include in income any earnings distributed from a QTP if the total distribution is less than or equal to adjusted qualified higher education expenses. See Publication 970 for more information.

Railroad retirement annuities. The following types of payments are treated as pension or annuity income and are taxable under the rules explained in Publication 575.

- Tier 1 railroad retirement benefits that are more than the social security equivalent benefit.
- Tier 2 benefits.
- Vested dual benefits.

Rewards. If you receive a reward for providing information, include it in your income.

Sale of home. You may be able to exclude from income all or part of any gain from the sale or exchange of a personal residence. See Publication 523.

Sale of personal items. If you sold an item you owned for personal use, such as a car, refrigerator, furniture, stereo, jewelry, or silverware, your gain is taxable as a capital gain. Report it on Schedule D (Form 1040). You cannot deduct a loss.

However, if you sold an item you held for investment, such as gold or silver bullion, coins, or gems, any gain is taxable as a capital gain and any loss is deductible as a capital loss.

Example. You sold a painting on an online auction website for \$100. You bought the painting for \$20 at a garage sale years ago. Report your \$80 gain as a capital gain on Schedule D (Form 1040).

Scholarships and fellowships. A candidate for a degree can exclude amounts received as a qualified scholarship or fellowship. A qualified scholarship or fellowship is any amount you receive that is for:

- Tuition and fees to enroll at or attend an educational institution, or
- Fees, books, supplies, and equipment required for courses at the educational institution.

Amounts used for room and board do not qualify for the exclusion. See Publication 970 for more information on qualified scholarships and fellowship grants.

Payment for services. Generally, you must include in income the part of any scholarship or fellowship that represents payment for past, present, or future teaching, research, or other services. This applies even if all candidates for a degree must perform the services to receive the degree.

Do not include in income the part of any scholarship or fellowship representing payment for teaching, research, or other services if you receive the amount under the National Health Service Corps Scholarship Program or the Armed Forces Health Professions Scholarship and Financial Assistance program.

For information about the rules that apply to a tax-free qualified tuition reduction provided to employees and their families by an educational institution, see Publication 970.

VA payments. Allowances paid by the Department of Veterans Affairs are not included in your 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 income on Form 1040, line 21, whether or not you use the amounts for educational purposes.

Smallpox vaccine injuries. If you are an eligible individual who receives benefits under the Smallpox Emergency Personnel Protection Act of 2003 for a covered injury resulting from a

covered countermeasure, you can exclude the payment from your income (to the extent it is not allowed as a medical and dental expense deduction on Schedule A (Form 1040)). Eligible individuals include health care workers, emergency personnel, and first responders in a smallpox emergency, who have received a smallpox vaccination.

Social security and equivalent railroad retirement benefits. Social security or equivalent railroad retirement benefits, if taxable, must be included in the income of the person who has the legal right to receive the benefits. Whether any of your benefits are taxable, and the amount that is taxable, depends on the amount of the benefits and your other income.

Social security benefits include any monthly benefit under Title II of the Social Security Act and any part of a tier I railroad retirement benefit treated as a social security benefit. Social security benefits do not include any supplemental security income (SSI) payments.

Form SSA-1099. If you received social security benefits during the year, you will receive Form SSA-1099, Social Security Benefit Statement. An IRS Notice 703 will be enclosed with your Form SSA-1099. This notice includes a worksheet you can use to figure whether any of your benefits are taxable.

For an explanation of the information found on your Form SSA-1099, see Publication 915.

Form RRB-1099. If you received equivalent railroad retirement or special guaranty benefits during the year, you will receive Form RRB-1099, Payments by the Railroad Retirement Board.

For an explanation of the information found on your Form RRB-1099, see Publication 915.

If you received other railroad retirement benefits, see *Railroad retirement annuities*, earlier.

Joint return. If you are married and file a joint return, you and your spouse must combine your incomes and your social security and equivalent railroad retirement benefits when figuring 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 when figuring if any of your benefits are taxable.

Taxable amount. Use the worksheet in the Form 1040 or Form 1040A instruction package to determine the amount of your benefits to include in your income. Publication 915 also has worksheets you can use. However, you must use the worksheets in Publication 915 if any of the following situations apply.

- You received a lump-sum benefit payment during the year that is for one or more earlier years.
- You exclude employer-provided adoption benefits or interest from qualified U.S. savings bonds.
- You take the foreign earned income exclusion, the foreign housing exclusion or deduction, the exclusion of income from American Samoa, or the exclusion of income from Puerto Rico by *bona fide* residents of Puerto Rico.

Benefits may affect your IRA deduction.

You must use the special worksheets in appendix B of Publication 590 to figure your taxable benefits and your IRA deduction if all of the following conditions apply.

- You receive social security or equivalent railroad retirement benefits.
- You have taxable compensation.
- You contribute to your IRA.
- You or your spouse is covered by a retirement plan at work.

How to report. If any of your benefits are taxable, you must use either Form 1040 or Form 1040A to report the taxable part. You cannot use Form 1040EZ. Report your net benefits (the amount in box 5 of your Forms SSA-1099 and RRB-1099) on line 20a of Form 1040 or line 14a of Form 1040A. Report the taxable part (from the last line of the worksheet) on line 20b of Form 1040 or on line 14b of Form 1040A.

Stolen property. If you steal property, you must report its fair market value in your income in the year you steal it unless in the same year, you return it to its rightful owner.

Transporting school children. Do not include in your income a school board mileage allowance for taking children to and from school if you are not in the business of taking children to school. You cannot deduct expenses for providing this transportation.

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 income.

You may be able to deduct some of these payments as a miscellaneous deduction subject to the 2%-of-AGI limit if they are related to your job and if you itemize deductions on Schedule A (Form 1040). For more information, get Publication 529, Miscellaneous Deductions.

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, usually are included in your income as compensation. You can exclude these benefits from your income only when the facts clearly show that the union intended them as gifts to you.

Reimbursed union convention expenses. If you are a delegate of your local union chapter and you attend the annual convention of the international union, do not include in your income amounts you receive from the international union to reimburse you for expenses of traveling away from home to attend the convention. You cannot deduct the reimbursed expenses, even if you are reimbursed in a later year. If you are reimbursed for lost salary, you must include that reimbursement in your income.

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:

- A reduction in the purchase price of electricity furnished to you (rate reduction), or

- 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.

Repayments

If you had to repay an amount that you included in your income in an earlier year, you may be able to deduct the amount repaid from your income for the year in which you repaid it. Or, if the amount you repaid is more than \$3,000, you may be able to take a credit against your tax for the year in which you repaid it. Generally, you can claim a deduction or credit only if the repayment qualifies as an expense or loss incurred in your trade or business or in a for-profit transaction.

Type of deduction. The type of deduction you are allowed in the year of repayment depends on the type of income you included in the earlier year. You generally deduct the repayment on the same form or schedule on which you previously reported it as income. For example, if you reported it as self-employment income, deduct it as a business expense on Schedule C or Schedule C-EZ (Form 1040) or Schedule F (Form 1040). If you reported it as a capital gain, deduct it as a capital loss on Schedule D (Form 1040). If you reported it as wages, unemployment compensation, or other nonbusiness income, deduct it as a miscellaneous itemized deduction on Schedule A (Form 1040).

If you repaid social security or equivalent railroad retirement benefits, see Publication 915.

Repayment of \$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 must deduct it as a miscellaneous itemized deduction, enter it on Schedule A (Form 1040), line 23.

Repayment over \$3,000. If the amount you repaid was more than \$3,000, you can deduct the repayment (as explained earlier under *Type of deduction*). However, you can choose instead to take a tax credit for the year of repayment if you included the income under a claim of right. This means that at the time you included the income, it appeared that you had an unrestricted right to it. If you qualify for this choice, figure your tax under both methods and compare the results. Use the method (deduction or credit) that results in less tax.

Method 1. Figure your tax for 2008 claiming a deduction for the repaid amount. If you must deduct it as a miscellaneous itemized deduction, enter it on Schedule A (Form 1040), line 28.

Method 2. Figure your tax for 2008 claiming a credit for the repaid amount. Follow these steps.

1. Figure your tax for 2008 without deducting the repaid amount.
2. Refigure your tax from the earlier year without including in income the amount you repaid in 2008.

3. Subtract the tax in (2) from the tax shown on your return for the earlier year. This is the credit.
4. Subtract the answer in (3) from the tax for 2008 figured without the deduction (step 1).

If method 1 results in less tax, deduct the amount repaid. If method 2 results in less tax, claim the credit figured in (3) above on Form 1040, line 68, and enter "I.R.C. 1341" in the column to the right of line 68.

Example. For 2007 you filed a return and reported your income on the cash method. In 2008 you repaid \$5,000 included in your 2007 income under a claim of right. Your filing status in 2008 and 2007 is single. Your income and tax for both years are as follows:

| | 2007 | |
|----------------|-------------------|----------------|
| | With Income | Without Income |
| Taxable Income | \$15,000 | \$10,000 |
| Tax | \$ 1,863 | \$ 1,113 |
| | 2008 | |
| | Without Deduction | With Deduction |
| Taxable Income | \$49,950 | \$44,950 |
| Tax | \$ 8,838 | \$ 7,588 |

Your tax under method 1 is \$7,588. Your tax under method 2 is \$8,088, figured as follows:

| | |
|------------------------------------|---------|
| Tax previously determined for 2007 | \$1,863 |
| Less: Tax as refigured | - 1,113 |
| Decrease in 2007 tax | \$ 750 |
| Regular tax liability for 2008 | \$8,838 |
| Less: Decrease in 2007 tax | - 750 |
| Refigured tax for 2008 | \$8,088 |

You pay less tax using method 1, so you should take a deduction for the repayment in 2008.

Repayment rules do not apply. This discussion does not apply to:

- Deductions for bad debts;
- Deductions from sales to customers, such as returns and allowances, and similar items; or
- Deductions for legal and other expenses of contesting the repayment.

Year of deduction (or credit). If you use the cash method, you can take the deduction (or credit, if applicable) for the tax year in which you actually make the repayment. If you use any other accounting method, you can deduct the repayment or claim a credit for it only for the tax year in which it is a proper deduction under your accounting method. For example, if you use an accrual method, you are entitled to the deduction or credit in the tax year in which the obligation for the repayment accrues.

How To Get Tax Help

You can get help with unresolved tax issues, order free publications and forms, ask tax

questions, and get information from the IRS in several ways. By selecting the method that is best for you, you will have quick and easy access to tax help.

Contacting your Taxpayer Advocate. The Taxpayer Advocate Service (TAS) is an independent organization within the IRS whose employees assist taxpayers who are experiencing economic harm, who are seeking help in resolving tax problems that have not been resolved through normal channels, or who believe that an IRS system or procedure is not working as it should.

You can contact the TAS by calling the TAS toll-free case intake line at 1-877-777-4778 or TTY/TDD 1-800-829-4059 to see if you are eligible for assistance. You can also call or write your local taxpayer advocate, whose phone number and address are listed in your local telephone directory and in Publication 1546, Taxpayer Advocate Service—Your Voice at the IRS. You can file Form 911, Request for Taxpayer Advocate Service Assistance (And Application for Taxpayer Assistance Order), or ask an IRS employee to complete it on your behalf. For more information, go to www.irs.gov/advocate

Low Income Taxpayer Clinics (LITCs). LITCs are independent organizations that provide low income taxpayers with representation in federal tax controversies with the IRS for free or for a nominal charge. The clinics also provide tax education and outreach for taxpayers who speak English as a second language. Publication 4134, Low Income Taxpayer Clinic List, provides information on clinics in your area. It is available at www.irs.gov or your local IRS office.

Free tax services. To find out what services are available, get Publication 910, IRS Guide to Free Tax Services. It contains lists of free tax information sources, including publications, services, and free tax education and assistance programs. It also has an index of over 100 TeleTax topics (recorded tax information) you can listen to on your telephone.

Accessible versions of IRS published products are available on request in a variety of alternative formats for people with disabilities.

Free help with your return. Free help in preparing your return is available nationwide from IRS-trained volunteers. The Volunteer Income Tax Assistance (VITA) program is designed to help low-income taxpayers and the Tax Counseling for the Elderly (TCE) program is designed to assist taxpayers age 60 and older with their tax returns. Many VITA sites offer free electronic filing and all volunteers will let you know about credits and deductions you may be entitled to claim. To find the nearest VITA or TCE site, call 1-800-829-1040.

As part of the TCE program, AARP offers the Tax-Aide counseling program. To find the nearest AARP Tax-Aide site, call 1-888-227-7669 or visit AARP's website at www.aarp.org/money/taxaide.

For more information on these programs, go to www.irs.gov and enter keyword "VITA" in the upper right-hand corner.



Internet. You can access the IRS website at www.irs.gov 24 hours a day, 7 days a week to:

- *E-file* your return. Find out about commercial tax preparation and *e-file* services available free to eligible taxpayers.
- Check the status of your 2008 refund. Go to www.irs.gov and click on *Where's My Refund*. Wait at least 72 hours after the IRS acknowledges receipt of your e-filed return, or 3 to 4 weeks after mailing a paper return. If you filed Form 8379 with your return, wait 14 weeks (11 weeks if you filed electronically). Have your 2008 tax return available so you can provide your social security number, your filing status, and the exact whole dollar amount of your refund.
- Download forms, instructions, and publications.
- Order IRS products online.
- Research your tax questions online.
- Search publications online by topic or keyword.
- View Internal Revenue Bulletins (IRBs) published in the last few years.
- Figure your withholding allowances using the withholding calculator online at www.irs.gov/individuals.
- Determine if Form 6251 must be filed by using our Alternative Minimum Tax (AMT) Assistant.
- Sign up to receive local and national tax news by email.
- Get information on starting and operating a small business.



Phone. Many services are available by phone.

- *Ordering forms, instructions, and publications.* Call 1-800-829-3676 to order current-year forms, instructions, and publications, and prior-year forms and instructions. You should receive your order within 10 days.
- *Asking tax questions.* Call the IRS with your tax questions at 1-800-829-1040.
- *Solving problems.* You can get face-to-face help solving tax problems every business day in IRS Taxpayer Assistance Centers. An employee can explain IRS letters, request adjustments to your account, or help you set up a payment plan. Call your local Taxpayer Assistance Center for an appointment. To find the number, go to www.irs.gov/localcontacts or look in the phone book under *United States Government, Internal Revenue Service*.
- *TTY/TDD equipment.* If you have access to TTY/TDD equipment, call 1-800-829-4059 to ask tax questions or to order forms and publications.

- *TeleTax topics.* Call 1-800-829-4477 to listen to pre-recorded messages covering various tax topics.
- *Refund information.* To check the status of your 2008 refund, call 1-800-829-1954 during business hours or 1-800-829-4477 (automated refund information 24 hours a day, 7 days a week). Wait at least 72 hours after the IRS acknowledges receipt of your e-filed return, or 3 to 4 weeks after mailing a paper return. If you filed Form 8379 with your return, wait 14 weeks (11 weeks if you filed electronically). Have your 2008 tax return available so you can provide your social security number, your filing status, and the exact whole dollar amount of your refund. Refunds are sent out weekly on Fridays. If you check the status of your refund and are not given the date it will be issued, please wait until the next week before checking back.
- *Other refund information.* To check the status of a prior year refund or amended return refund, call 1-800-829-1954.

Evaluating the quality of our telephone services. To ensure IRS representatives give accurate, courteous, and professional answers, we use several methods to evaluate the quality of our telephone services. One method is for a second IRS representative to listen in on or record random telephone calls. Another is to ask some callers to complete a short survey at the end of the call.



Walk-in. Many products and services are available on a walk-in basis.

- *Products.* You can walk in to many post offices, libraries, and IRS offices to pick up certain forms, instructions, and publications. Some IRS offices, libraries, grocery stores, copy centers, city and county government offices, credit unions, and office supply stores have a collection of products available to print from a CD or photocopy from reproducible proofs. Also, some IRS offices and libraries have the Internal Revenue Code, regulations, Internal Revenue Bulletins, and Cumulative Bulletins available for research purposes.
- *Services.* You can walk in to your local Taxpayer Assistance Center every business day for personal, face-to-face tax help. An employee can explain IRS letters, request adjustments to your tax account, or help you set up a payment plan. If you need to resolve a tax problem, have questions about how the tax law applies to your individual tax return, or you are more comfortable talking with someone in person, visit your local Taxpayer Assistance Center where you can spread out your records and talk with an IRS representative face-to-face. No appointment is necessary—just walk in. If you prefer, you can call your local Center and leave a message requesting an appointment to resolve a tax account issue. A representative will call you back within 2 business days to schedule an in-person

appointment at your convenience. If you have an ongoing, complex tax account problem or a special need, such as a disability, an appointment can be requested. All other issues will be handled without an appointment. To find the number of your local office, go to www.irs.gov/localcontacts or look in the phone book under *United States Government, Internal Revenue Service*.



Mail. You can send your order for forms, instructions, and publications to the address below. You should receive a response within 10 days after your request is received.

Internal Revenue Service
1201 N. Mitsubishi Motorway
Bloomington, IL 61705-6613



DVD for tax products. You can order Publication 1796, IRS Tax Products DVD, and obtain:

- Current-year forms, instructions, and publications.
- Prior-year forms, instructions, and publications.
- Tax Map: an electronic research tool and finding aid.
- Tax law frequently asked questions.
- Tax Topics from the IRS telephone response system.
- Internal Revenue Code—Title 26 of the U.S. Code.
- Fill-in, print, and save features for most tax forms.
- Internal Revenue Bulletins.
- Toll-free and email technical support.
- Two releases during the year.
 - The first release will ship the beginning of January 2009.
 - The final release will ship the beginning of March 2009.

Purchase the DVD from National Technical Information Service (NTIS) at www.irs.gov/cdorders for \$30 (no handling fee) or call 1-877-233-6767 toll free to buy the DVD for \$30 (plus a \$6 handling fee). The price is discounted to \$25 for orders placed prior to December 1, 2008.



Small Business Resource Guide 2009. This online guide is a must for every small business owner or any taxpayer about to start a business. This year's guide includes:

- Helpful information, such as how to prepare a business plan, find financing for your business, and much more.
- All the business tax forms, instructions, and publications needed to successfully manage a business.
- Tax law changes for 2009.
- Tax Map: an electronic research tool and finding aid.

- Web links to various government agencies, business associations, and IRS organizations.
- “Rate the Product” survey—your opportunity to suggest changes for future editions.

- A site map of the guide to help you navigate the pages with ease.
- An interactive “Teens in Biz” module that gives practical tips for teens about starting their own business, creating a business plan, and filing taxes.

The information is updated during the year. Visit www.irs.gov and enter keyword “SBRG” in the upper right-hand corner for more information.

| | | | | | | |
|--------------------------------------|--------|---------------------------------------|----|----------------------------------|----------------------------------|------|
| Elective deferrals | 9 | Compensation Act (FECA) | 16 | Form 8839: | Adoption assistance | 5 |
| Catch-up contributions | 9 | payments | 18 | Form 1040A: | Recoveries | 23 |
| Excess annual additions | 11 | Cost-of-living allowances | 4 | Unemployment | Accelerated death | |
| Excess contributions | 10 | Disability pensions | 17 | compensation | benefits | 21 |
| Excess deferrals | 10 | Thrift Savings Plan for | 9 | Wages from Form W-2 | Archer MSAs and long-term | |
| Increased limit for last 3 years | | Federal income tax: | | Form 1040A, Schedule 1: | care insurance | |
| prior to retirement age | 9 | Refunds | 21 | Restricted stock | contracts | 5 |
| Limit on | 9 | Fees for services | 32 | dividends | Form 8919: | |
| Reporting by employer | 10 | Financial counseling fees | 6 | Form 1040A, Schedule 2: | Uncollected social security and | |
| Emotional distress | | Fellowships | 35 | Child and dependent care | Medicare tax on wages | 3 |
| damages | 31 | FICA withholding: | | expenses | Form RRB-1099: | |
| Employee achievement | | Foreign employers, U.S. | | Form 1040EZ: | Railroad retirement board | |
| awards | 3 | citizens working for in | | Recoveries | payments | 35 |
| Employee awards or | | U.S. | 14 | Unemployment | Form SSA-1099: | |
| bonuses | 34 | Paid by employer | 4 | compensation | Social security benefit | |
| Employee | | Fiduciaries: | | Wages from Form W-2 | statement | 35 |
| compensation | 3-14 | Fees for services | 32 | Form 1041: | Form W-2: | |
| Fringe benefits | 4-9 | Financial counseling fees (See | | Estates and trusts | 501(c)(18)(D) | |
| Restricted property | 13-14 | also Retirement planning | | Form 1041, Schedule K-1: | contributions | 10 |
| Retirement plan | | services) | 6 | Beneficiary's share of income, | Accrued leave payment at time | |
| contributions | 9 | Fitness programs: | | deductions, credits, | of retirement or | |
| Stock options | 11-13 | Flights: | | etc. | resignation | 4 |
| Employee discounts | 6 | Employer-provided | | Form 1065: | Back pay awards | 3 |
| Employee stock purchase | | aircraft | 8 | Partnership return | Bonuses or awards | 3 |
| plans | 11, 12 | No-additional-cost | | Form 1065, Schedule K-1: | Elective deferrals, reporting by | |
| Employer, foreign | 14 | services | 7 | Partner's share of | employer | 10 |
| Employer-owned life | | Food benefits: | | income | Failure to receive from | |
| insurance | 21 | Daycare providers, food | | Form 1098: | employer | 3 |
| Employer-provided: | | program payments to | 33 | Mortgage interest | Fringe benefits reported | |
| Educational assistance | 6 | Nutrition Program for the | | statement | on | 5 |
| Vehicles | 8 | Elderly | 30 | Form 1099-B: | Stock options from | |
| Employment: | | Foreign: | | Barter exchange | employers | 11 |
| Abroad | 15 | Currency transactions | 33 | transactions | Wage and tax statement | 3 |
| Agency fees | 32 | Employment | 14 | Form 1099-C: | Form W-2G: | |
| Contracts: | | Governments, employees | | Cancellation of debt | Gambling winnings | 33 |
| Severance pay for | | of | 14 | Form 1099-DIV: | Form W-4V: | |
| cancellation of | 4 | Income | 2 | Restricted stock | Unemployment compensation, | |
| Endowment proceeds | 21 | Service | 17 | dividends | voluntary withholding | |
| Energy: | | Form 1040: | | request | request | 29 |
| Assistance | 30 | Excess contributions to elective | | Form 1099-G: | Form W-9: | |
| Conservation: | | deferrals | 10 | State tax refunds | Request for taxpayer | |
| Subsidies | 32 | Recoveries | 23 | Unemployment | identification number | 19 |
| Utility rebates | 35 | Unemployment | | compensation | Foster care | 33 |
| Estate income | 32 | compensation | 29 | Form 1099-MISC: | Foster Grandparent | |
| Estimated tax: | | Wages from Form W-2 | 3 | Services totaling \$600 or | Program | 15 |
| Unemployment | | Form 1040, Schedule A: | | more | Found property | 33 |
| compensation | 29 | Outplacement services, | | Stock options exercised incident | Free tax services | 36 |
| Excess: | | deduction for | 4 | to divorce | Fringe benefits | 4-9 |
| Annual additions | 11 | Repayment of commissions | | Form 1099-R: | Accident and health | |
| Contributions | 10 | paid in advance | 3 | Charitable gift annuities | insurance | 5 |
| Deferrals | 10 | Form 1040, Schedule B: | | Excess annual additions | Adoption, employer | |
| Expected inheritance | 33 | Restricted stock | | Excess contribution | assistance | 5 |
| Expenses paid by | | dividends | 13 | amounts | Athletic facilities | 5 |
| another | 32 | Form 1040, Schedule C: | | Excess deferral | Bicycle commuters | 2 |
| Exxon Valdez settlement | 2, 32 | Bartering | 19 | amounts | Commuter highway | |
| Eligible retirement plan | 32 | Childcare providers to | | Surrender of life insurance | vehicles | 8 |
| Income averaging | 32 | use | 3 | policy for cash | <i>De minimis</i> benefits | 5, 7 |
| Legal expenses | 32 | Personal property rental, | | Form 1120-POL: | Dependent care benefits | 5 |
| Reporting | | reporting income from | 16 | Political organizations | Educational assistance | 6 |
| requirement-statement | 32 | Royalties | 16 | Form 1120S: | Employee discounts | 6 |
| F | | Form 1040, Schedule C-EZ: | | S corporation return | Faculty lodging | 7 |
| Faculty lodging | 7 | Bartering | 19 | Form 1120S, Schedule K-1: | Financial counseling fees | 6 |
| Fair market value (FMV) | 8 | Childcare providers to | | Shareholder's share of income, | Holiday gifts | 5 |
| Stock options | 11 | use | 3 | credits, deductions, | Meals and lodging | 7 |
| Farming: | | Personal property rental, | | etc. | Moving expenses (See Moving | |
| Qualified farm debt, cancellation | | reporting income from | 16 | Form 2441: | expenses) | |
| of | 20 | Royalties | 16 | Child and dependent care | No-additional-cost | |
| Federal employees: | | Form 1040, Schedule D: | | expenses | services | 7 |
| Accrued leave payment | 4 | Stock options | 12 | Form 4255: | Parking | 8 |
| | | Stock options reported | | Recapture of investment | Retirement planning (See | |
| | | on | 11 | credit | Retirement planning services) | |
| | | Form 1040, Schedule E: | | Form 6251: | Transit pass | 8 |
| | | Partner's return | 16 | Alternative minimum tax | Tuition reduction | 8 |

| | | | | | |
|---|--------|--|--|--|--|
| Fringe benefits (Cont.) | | | | | |
| Valuation of | 8-9 | | | | |
| Vehicle | 8 | | | | |
| Working condition benefits | 8 | | | | |
| Frozen deposits: | | | | | |
| Interest on | 33 | | | | |
| <hr/> | | | | | |
| G | | | | | |
| Gambling winnings and losses | 33 | | | | |
| Gas: | | | | | |
| Royalties from | 16 | | | | |
| Gifts | 33 | | | | |
| Holiday gifts from employer | 5 | | | | |
| Government employees (See Federal employees; State employees) | | | | | |
| Grantor trusts | 32 | | | | |
| Group-term life insurance: | | | | | |
| Worksheets | 6, 7 | | | | |
| <hr/> | | | | | |
| H | | | | | |
| Health: | | | | | |
| Flexible spending arrangement | 5 | | | | |
| Insurance | 5 | | | | |
| Reimbursement arrangement | 5 | | | | |
| Savings account | 2, 5 | | | | |
| Help (See Tax help) | | | | | |
| Highly compensated employees: | | | | | |
| Excess contributions to elective deferrals | 10 | | | | |
| Historic preservation grants | 33 | | | | |
| Hobby losses | 33 | | | | |
| Holding period requirement | 12 | | | | |
| Holiday gifts | 5 | | | | |
| Holocaust victims restitution | 33 | | | | |
| Home, sale of | 35 | | | | |
| Host or hostess | 20 | | | | |
| Hotels: | | | | | |
| No-additional-cost services | 7 | | | | |
| Housing (See Lodging) | | | | | |
| <hr/> | | | | | |
| I | | | | | |
| Illegal activities | 33 | | | | |
| Incentive stock options (ISOs) | 11, 12 | | | | |
| Income: | | | | | |
| Assigned | 2 | | | | |
| Business and investment | 15, 16 | | | | |
| Constructive receipt of | 2 | | | | |
| Estate and trust | 32 | | | | |
| Foreign employers | 14 | | | | |
| Illegal | 33 | | | | |
| Miscellaneous | 19 | | | | |
| Other | 30 | | | | |
| Partnership | 16 | | | | |
| Prepaid | 3 | | | | |
| S corporation | 16 | | | | |
| Indian fishing rights | 33 | | | | |
| Individual retirement arrangements (IRAs): | | | | | |
| Deduction | 35 | | | | |
| Inherited IRA | 33 | | | | |
| Inheritance | 33 | | | | |
| IRA | 33 | | | | |
| Property not substantially vested | 14 | | | | |
| Injury benefits | 17-18 | | | | |
| Insurance: | | | | | |
| Credit card | 31 | | | | |
| Health | 5 | | | | |
| Life (See Life insurance) | | | | | |
| Long-term care (See Long-term care insurance) | | | | | |
| Interest: | | | | | |
| Canceled debt including | 19 | | | | |
| Frozen deposits | 33 | | | | |
| Mortgage refunds | 22 | | | | |
| Option on insurance | 21 | | | | |
| Recovery amounts | 22 | | | | |
| Savings bond | 34 | | | | |
| State and local government obligations | 34 | | | | |
| Interference with business operations: | | | | | |
| Damages as income | 31 | | | | |
| International organizations, employees of | 14 | | | | |
| Interview expenses | 34 | | | | |
| Investment counseling fees (See also Retirement planning services) | 6 | | | | |
| Investment income | 15, 16 | | | | |
| IRAs (See Individual retirement arrangements (IRAs)) | | | | | |
| Iron ore | 16 | | | | |
| Itemized deductions: | | | | | |
| Limited | 27 | | | | |
| Recoveries | 21, 22 | | | | |
| <hr/> | | | | | |
| J | | | | | |
| Job interview expenses | 34 | | | | |
| Joint returns: | | | | | |
| Social security benefits or railroad retirement payments | 35 | | | | |
| Jury duty pay | 34 | | | | |
| <hr/> | | | | | |
| K | | | | | |
| Kickbacks | 34 | | | | |
| <hr/> | | | | | |
| L | | | | | |
| Labor unions: | | | | | |
| Convention expenses, reimbursed | 35 | | | | |
| Dues | 35 | | | | |
| Strike and lockout benefits | 35 | | | | |
| Unemployment benefits paid from | 29 | | | | |
| Last day of tax year, income received on | 2 | | | | |
| Leave (See Accrued leave payment) | | | | | |
| Length-of-service awards | 4 | | | | |
| Life insurance: | | | | | |
| Employer-owned | 21 | | | | |
| Proceeds | 20 | | | | |
| Surrender of policy for cash | 21 | | | | |
| Loans (See also Mortgage) | | | | | |
| Below-market | 31 | | | | |
| Student | 20 | | | | |
| Lockout benefits | 35 | | | | |
| Lodging: | | | | | |
| Campus lodging | 7 | | | | |
| Clergy | 14 | | | | |
| Employer-paid or reimbursed | 7 | | | | |
| Faculty lodging | 7 | | | | |
| Replacement housing payments | 30 | | | | |
| Long-term care insurance | 5, 17 | | | | |
| Lotteries and raffles | 33 | | | | |
| Lump-sum distributions: | | | | | |
| Survivor benefits | 29 | | | | |
| <hr/> | | | | | |
| M | | | | | |
| Manufacturer incentive payments | 34 | | | | |
| Meals: | | | | | |
| Employer-paid or reimbursed | 7 | | | | |
| Nutrition Program for the Elderly | 30 | | | | |
| Medical: | | | | | |
| Care reimbursements | 18 | | | | |
| Responders, emergency | 15 | | | | |
| Savings accounts | 34 | | | | |
| Medicare: | | | | | |
| Advantage MSAs | 34 | | | | |
| Benefits | 30 | | | | |
| Tax paid by employer | 4 | | | | |
| Medicare tax (See Social security and Medicare taxes) | | | | | |
| Military (See Armed forces) | | | | | |
| Minerals: | | | | | |
| Royalties from | 16 | | | | |
| Miscellaneous: | | | | | |
| Compensation | 3 | | | | |
| Income | 19 | | | | |
| Missing children, photographs of | 2 | | | | |
| More information (See Tax help) | | | | | |
| Mortgage: | | | | | |
| Assistance payment | 30 | | | | |
| Discounted loan | 19 | | | | |
| Interest refund | 22 | | | | |
| Qualified principal residence indebtedness | 20 | | | | |
| Relief | 19 | | | | |
| Motor vehicle, employer-provided | 8 | | | | |
| Moving expenses: | | | | | |
| Reimbursements | 3, 34 | | | | |
| MSAs (Medical savings accounts) | 34 | | | | |
| <hr/> | | | | | |
| N | | | | | |
| National Health Service Corps Scholarship Program | 8 | | | | |
| National Oceanic and Atmospheric Administration | 17 | | | | |
| National Senior Service Corps | 15 | | | | |
| No-additional-cost services | 7 | | | | |
| Nobel prize | 34 | | | | |
| No-fault car insurance: | | | | | |
| Disability benefits under | 18 | | | | |
| Nonrecourse debt | 19 | | | | |
| Nonstatutory stock options | 11 | | | | |
| Nontaxable income | 2 | | | | |
| Notary fees | 32 | | | | |
| Notes received for services | 4 | | | | |
| Not-for-profit activities | 30 | | | | |
| Nutrition Program for the Elderly | 30 | | | | |
| <hr/> | | | | | |
| O | | | | | |
| Oil: | | | | | |
| Royalties from | 16 | | | | |
| Old-age, survivors, and disability insurance benefits (OASDI) | 30 | | | | |
| Options, stock | 11, 13 | | | | |
| Outplacement services | 4 | | | | |
| Overseas work | 2 | | | | |
| <hr/> | | | | | |
| P | | | | | |
| Parking fees: | | | | | |
| Employer-paid or reimbursed | 8 | | | | |
| Partner and partnership income | 16 | | | | |
| Patents: | | | | | |
| Infringement damages | 31 | | | | |
| Royalties | 16 | | | | |
| Peace Corps | 15 | | | | |
| Pensions: | | | | | |
| Clergy | 14 | | | | |
| Disability pensions | 17 | | | | |
| Inherited pensions | 33 | | | | |
| Military | 15 | | | | |
| Personal property: | | | | | |
| Rental income and expense | 15 | | | | |
| Sale of | 35 | | | | |
| Personal representatives (See Fiduciaries) | | | | | |
| Prepaid income | 3 | | | | |
| Price reduced after purchase | 20 | | | | |
| Prizes and awards | 3, 34 | | | | |
| Achievement awards | 3 | | | | |
| Employee awards or bonuses | 34 | | | | |
| Length-of-service awards | 4 | | | | |
| Pulitzer, Nobel, and similar prizes | 34 | | | | |
| Safety achievement | 4 | | | | |
| Scholarship prizes | 35 | | | | |
| Profit-sharing plan | 17 | | | | |
| Public assistance benefits | 29 | | | | |
| Public Health Service | 17 | | | | |
| Public safety officers killed in line of duty | 29 | | | | |
| Public transportation passes, employer-provided | 8 | | | | |
| Publications (See Tax help) | | | | | |
| Pulitzer prize | 34 | | | | |
| Punitive damages | 31 | | | | |
| <hr/> | | | | | |
| Q | | | | | |
| Qualified Joint Venture | 2 | | | | |

| | | | | | | | |
|--|---------------|---|-------------------|--|-------------------|--|--------------|
| Qualified tuition program (QTP) | <u>34</u> | S | | Sale | <u>12</u> | Trusts: | |
| R | | S corporations | <u>16</u> | Stockholder debts | <u>19</u> | Grantor trusts | <u>32</u> |
| Raffles | <u>33</u> | Safety achievement awards | <u>4</u> | Stolen property | <u>35</u> | Income | <u>32</u> |
| Railroad: | | Salary reduction simplified employee pension plans (See SARSEPs) | | Strike benefits | <u>35</u> | TTY/TDD information | <u>36</u> |
| Retirement annuities | <u>34</u> | Sale of home | <u>35</u> | Student loans: | | Tuition program, qualified (QTP) | <u>34</u> |
| Retirement benefits | <u>35</u> | Sales contracts: | | Cancellation of debt | <u>20</u> | Tuition reduction | <u>8</u> |
| Sick pay | <u>18</u> | Cancellation of | <u>31</u> | Substantial risk of forfeiture | <u>13</u> | U | |
| Unemployment compensation benefits | <u>29</u> | SARSEPs | <u>9</u> | Substantially vested property | <u>13</u> | Unemployment compensation | <u>29</u> |
| Real estate: | | Excess contributions | <u>10</u> | Suggestions for publication | <u>3</u> | Unions (See Labor unions) | |
| Qualified real property business debt, cancellation of | <u>20</u> | Savings bonds | <u>34</u> | Supplemental security income (SSI) payments | <u>35</u> | Unlawful discrimination suits: | |
| Rebates: | | Savings incentive match plans for employees (See SIMPLE plans) | | Supplemental unemployment benefits | <u>29</u> | Deduction for costs | <u>31</u> |
| Cash | <u>31</u> | Scholarships and fellowships | <u>35</u> | Surviving spouse: | | V | |
| Utility | <u>35</u> | Self-employed persons: | | Life insurance proceeds paid to | <u>21</u> | VA payments | <u>35</u> |
| Recovery of amounts previously deducted | <u>21, 27</u> | U.S. citizens working for foreign employers in U.S. treated as | <u>14</u> | Survivor benefits | <u>29</u> | Valuation: | |
| Itemized deductions | <u>21, 22</u> | Senior Companion Program | <u>15</u> | T | | Fringe benefits | <u>8</u> |
| Non-itemized deductions | <u>28</u> | Service Corps of Retired Executives (SCORE) | <u>15</u> | Tables and figures: | | Stock options | <u>11</u> |
| Unused tax credits, refiguring of | <u>28</u> | Severance pay | <u>4</u> | Group-term life insurance (Table 1) | <u>6</u> | Vehicle: | |
| Worksheet of itemized deductions (Worksheet 2) | <u>24</u> | Outplacement services | <u>4</u> | Standard deduction (Tables 2-4) | <u>25, 26, 27</u> | Commuter highway | <u>8</u> |
| Refunds: | | Sick pay | <u>4</u> | Tax benefit rule | <u>21</u> | Employer-provided | <u>8</u> |
| Federal income tax | <u>21</u> | Sickness and injury benefits | <u>17, 18</u> | Tax Counseling for the Elderly | <u>15</u> | Veterans benefits | <u>15</u> |
| Mortgage interest | <u>22</u> | SIMPLE plans | <u>9</u> | Tax help | <u>36</u> | Disability compensation | <u>17</u> |
| State tax | <u>22</u> | Limit for deferrals under | <u>9</u> | Taxpayer Advocate | <u>36</u> | Retroactive VA determination | <u>2, 17</u> |
| Rehabilitative program payments | <u>15</u> | Smallpox vaccine injuries | <u>35</u> | Tax-sheltered annuity plans (403(b) plans) | <u>9</u> | Special statute of limitations | <u>17</u> |
| Reimbursements: | | Social security and Medicare taxes: | | Limit for | <u>9</u> | Viatical settlements | <u>21</u> |
| Business expenses | <u>3</u> | Foreign employers, U.S. citizens working for in U.S. | <u>14</u> | Terminal illness | <u>21</u> | Volunteer work | <u>15</u> |
| Casualty losses | <u>31</u> | Paid by employer | <u>4</u> | Terrorist attacks: | | Emergency medical responders | <u>15</u> |
| Meals and lodging | <u>7</u> | Social security benefits | <u>35</u> | Disability payments for injuries from | <u>17</u> | Firefighters | <u>15</u> |
| Medical expenses | <u>18</u> | Standard deduction: | | Victims of, tax relief | <u>2</u> | Tax counseling (Volunteer Income Tax Assistance Program) | <u>15</u> |
| Moving expenses | <u>3, 34</u> | Recoveries | <u>23, 27</u> | Thrift Savings Plan | <u>9</u> | Volunteers in Service to America (VISTA) | <u>15</u> |
| Related party transactions: | | Tables (2007-2005) | <u>25, 26, 27</u> | Title VII, Civil Rights Act of 1964: | | W | |
| Stock option transfer | <u>11</u> | State employees: | | Back pay and damages for emotional distress under | <u>31</u> | W-2 form (See Form W-2) | |
| Religious order members | <u>14</u> | Unemployment benefits paid to | <u>29</u> | Tour guides, free tours for | <u>33</u> | Welfare benefits | <u>29</u> |
| Rental income and expenses: | | State or local governments: | | Trade Act of 1974: | | Winter energy payments | <u>30</u> |
| Personal property rental | <u>15</u> | Interest on obligations of | <u>34</u> | Trade readjustment allowances under | <u>29</u> | Withholding: | |
| Reporting of | <u>16</u> | State or local taxes: | | Transferable property | <u>13</u> | Barter exchange transactions | <u>19</u> |
| Repayments | <u>36</u> | Refunds | <u>22</u> | Transit passes | <u>8</u> | Unemployment compensation | <u>29</u> |
| Repossession | <u>31</u> | Statutory stock option holding period | <u>12</u> | Travel agencies: | | Workers' compensation | <u>18</u> |
| Restricted property | <u>13, 14</u> | Stock appreciation rights | <u>4</u> | Free tour to organizer of group of tourists | <u>33</u> | Working condition benefits | <u>8</u> |
| Retired Senior Volunteer Program (RSVP) | <u>15</u> | Stock options | <u>11, 13</u> | Travel and transportation expenses: | | Worksheets: | |
| Retirement planning services | <u>6, 8</u> | Stock options, nonstatutory: | | Free tours from travel agencies | <u>33</u> | Group-term life insurance (Worksheet 1) | <u>6, 7</u> |
| Retirement plans (See also Pensions) | <u>15</u> | Exercise or transfer | <u>11</u> | Fringe benefits | <u>8</u> | Recoveries of itemized deductions (Worksheet 2) | <u>24</u> |
| Automatic contribution arrangements | <u>1, 9</u> | Grant | <u>11</u> | Reimbursements | <u>3</u> | Work-training programs | <u>30</u> |
| Contributions | <u>9, 11</u> | Sale | <u>11</u> | School children, transporting of | <u>35</u> | | |
| Elective deferrals (See Elective deferrals) | | Stock options, statutory: | | | | | |
| Rewards | <u>35</u> | Exercise | <u>12</u> | | | | |
| Roth contributions | <u>10</u> | Grant | <u>12</u> | | | | |
| Royalties | <u>16</u> | | | | | | |

Tax Publications for Individual Taxpayers

See *How To Get Tax Help* for a variety of ways to get publications, including by computer, phone, and mail.

General Guides

- 1 Your Rights as a Taxpayer
- 17 Your Federal Income Tax For Individuals
- 334 Tax Guide for Small Business (For Individuals Who Use Schedule C or C-EZ)
- 509 Tax Calendars for 2009
- 553 Highlights of 2008 Tax Changes
- 910 IRS Guide to Free Tax Services

Specialized Publications

- 3 Armed Forces' Tax Guide
- 54 Tax Guide for U.S. Citizens and Resident Aliens Abroad
- 225 Farmer's Tax Guide
- 463 Travel, Entertainment, Gift, and Car Expenses
- 501 Exemptions, Standard Deduction, and Filing Information
- 502 Medical and Dental Expenses (Including the Health Coverage Tax Credit)
- 503 Child and Dependent Care Expenses
- 504 Divorced or Separated Individuals
- 505 Tax Withholding and Estimated Tax
- 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
- 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 (Including Rental of Vacation Homes)
- 529 Miscellaneous Deductions
- 530 Tax Information for Homeowners

- 531 Reporting Tip Income
- 535 Business Expenses
- 536 Net Operating Losses (NOLs) for Individuals, Estates, and Trusts
- 537 Installment Sales
- 541 Partnerships
- 544 Sales and Other Dispositions of Assets
- 547 Casualties, Disasters, and Thefts
- 550 Investment Income and Expenses (Including Capital Gains and Losses)
- 551 Basis of Assets
- 552 Recordkeeping for Individuals
- 554 Tax Guide for Seniors
- 555 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
- 571 Tax-Sheltered Annuity Plans (403(b) Plans) For Employees of Public Schools and Certain Tax-Exempt Organizations
- 575 Pension and Annuity Income
- 584 Casualty, Disaster, and Theft Loss Workbook (Personal-Use Property)
- 587 Business Use of Your Home (Including Use by Daycare Providers)
- 590 Individual Retirement Arrangements (IRAs)
- 593 Tax Highlights for U.S. Citizens and Residents Going Abroad
- 594 The IRS Collection Process
- 596 Earned Income Credit (EIC)
- 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
- 915 Social Security and Equivalent Railroad Retirement Benefits
- 919 How Do I Adjust My Tax Withholding?
- 925 Passive Activity and At-Risk Rules
- 926 Household Employer's Tax Guide For Wages Paid in 2009
- 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 The IRS Will Figure Your Tax
- 969 Health Savings Accounts and Other Tax-Favored Health Plans
- 970 Tax Benefits for Education
- 971 Innocent Spouse Relief
- 972 Child Tax Credit
- 1542 Per Diem Rates (For Travel Within the Continental United States)
- 1544 Reporting Cash Payments of Over \$10,000 (Received in a Trade or Business)
- 1546 Taxpayer Advocate Service – Your Voice at the IRS

Spanish Language Publications

- 1SP Derechos del Contribuyente
- 17SP El Impuesto Federal sobre los Ingresos (Para Personas Físicas)
- 594SP El Proceso de Cobro del IRS
- 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

See *How To Get Tax Help* for a variety of ways to get forms, including by computer, phone, and mail.

| Form Number and Title |
|---|
| 1040 U.S. Individual Income Tax Return |
| Sch A&B Itemized Deductions & Interest and Ordinary Dividends |
| Sch C Profit or Loss From Business |
| Sch C-EZ Net Profit From Business |
| Sch D Capital Gains and Losses |
| Sch D-1 Continuation Sheet for Schedule D |
| Sch E Supplemental Income and Loss |
| Sch EIC Earned Income Credit |
| Sch F Profit or Loss From Farming |
| Sch H Household Employment Taxes |
| Sch J Income Averaging for Farmers and Fishermen |
| Sch R Credit for the Elderly or the Disabled |
| Sch SE Self-Employment Tax |
| 1040A U.S. Individual Income Tax Return |
| Sch 1 Interest and Ordinary Dividends 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 |
| 1040EZ Income Tax Return for Single and Joint Filers With No Dependents |
| 1040-ES Estimated Tax for Individuals |
| 1040X Amended U.S. Individual Income Tax Return |

| Form Number and Title |
|--|
| 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 |
| 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 on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts |
| 6251 Alternative Minimum Tax—Individuals |
| 8283 Noncash Charitable Contributions |
| 8582 Passive Activity Loss Limitations |
| 8606 Nondeductible IRAs |
| 8812 Additional Child Tax Credit |
| 8822 Change of Address |
| 8829 Expenses for Business Use of Your Home |
| 8863 Education Credits (Hope and Lifetime Learning Credits) |
| 9465 Installment Agreement Request |