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IRS

4491

VITA/TCE Training Guide

2022

Volunteer Income Tax Assistance (VITA) / Tax Counseling for the Elderly (TCE)

Link & Learn Taxes

Take your VITA/TCE training online at: apps.irs.gov/app/vita/ (keyword: Link & Learn Taxes). Link to the Practice Lab to gain experience using tax software and take the certification test online, with immediate scoring and feedback.

Publication 4491 (Rev. 10-2022) Catalog Number 47499R Department of the Treasury **Internal Revenue Service** www.irs.gov

How to Get Technical Updates?

Updates to the volunteer training materials will be contained in Publication 4491-X, VITA/TCE Training Supplement. The most recent version can be downloaded at: **www.irs.gov/pub/irs-pdf/p4491x.pdf**

Volunteer Standards of Conduct

VITA/TCE Programs

The mission of the VITA/TCE return preparation programs is to assist eligible taxpayers in satisfying their tax responsibilities by providing free tax return preparation. To establish the greatest degree of public trust, volunteers are required to maintain the highest standards of ethical conduct and provide quality service.

Annually all VITA/TCE volunteers (whether paid or unpaid) must pass the Volunteer Standards of Conduct (VSC) certification test and agree that they will adhere to the VSC by signing and dating Form 13615, Volunteer Standards of Conduct Agreement, prior to volunteering at a VITA/TCE site. In addition, return preparers, quality reviewers, coordinators, and tax law instructors must certify in Intake/Interview & Quality Review. Volunteers who answer tax law questions, instruct tax law classes, prepare or correct tax returns, or conduct quality reviews of completed returns must also certify in tax law prior to signing the form. Form 13615 is not valid until the sponsoring partner's approving official (coordinator, instructor, administrator, etc.) or IRS contact confirms the volunteer's identity with a government-issued photo identification (ID) and signs and dates the form.

As a volunteer in the VITA/TCE Programs, you must adhere to the following Volunteer Standards of Conduct:

VSC 1 - Follow the Quality Site Requirements (QSR).

VSC 2 - Do not accept payment, ask for donations, or accept refund payments for federal or state tax return preparation from customers.

VSC 3 - Do not solicit business from taxpayers you assist or use the information you gained about them (their information) for any direct or indirect personal benefit for yourself or any other specific individual.

VSC 4 - Do not knowingly prepare false returns.

VSC 5 - Do not engage in criminal, infamous, dishonest, notoriously disgraceful conduct, or any other conduct considered to have a negative effect on the VITA/TCE programs.

VSC 6 - Treat all taxpayers in a professional, courteous, and respectful manner.

Failure to comply with these standards could result in, but is not limited to, the following:

- Your removal from all VITA/TCE programs;
- Inclusion in the IRS Volunteer Registry to bar future VITA/TCE activity indefinitely;
- Deactivation of your sponsoring partner's site VITA/TCE EFIN (electronic filing ID number);
- Removal of all IRS products, supplies, loaned equipment, and taxpayer information from your site;
- Termination of your sponsoring organization's partnership with the IRS;
- Termination of grant funds from the IRS to your sponsoring partner; and

Referral of your conduct for potential TIGTA and criminal investigations.

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Confidentiality Statement:

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

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Director's Letter

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308

WAGE AND INVESTMENT DIVISION

October 1, 2022

Greetings Volunteers,

I am excited to welcome you to another Tax Filing Season! ***Thank you*** for supporting the Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE) programs. Your service continues to be needed to help taxpayers and enhance their federal tax return experience through these programs.

As returning volunteers, your ongoing dedication to the VITA and TCE programs is appreciated. You've shown extraordinary fortitude, perseverance, kindness and dedication this past year in carrying out our cause despite the challenges due to COVID-19.

As new volunteers, I encourage you to embrace each opportunity to help taxpayers through these vital programs. The success of each filing season is attributed to your continued commitment to the VITA and TCE programs.

Each year offers unique challenges and opportunities to help many taxpayers. To ensure that all volunteers are equipped and prepared for the filing season, we have taken extensive steps to provide the training materials and software you will need.

As we continue through this filing season, I look forward to hearing good news stories on how volunteers have embraced our cause to serve more taxpayers and touch more lives. I welcome your suggestions for improving your experience, as well as that of the taxpayers you serve. Feel free to email your feedback to specdirect@irs.gov.

Your support is sincerely appreciated. I look forward to another successful filing season.

Best regards,

Frank Nolden
Director, Stakeholder Partnerships,
Education and Communication

Important Changes for 2022

Due Date of Return

Taxpayers will have until Tuesday, April 18, 2023 to file their 2022 return because the Emancipation Day holiday in Washington, D.C. falls on Sunday, April 16, 2023 and will be celebrated on Monday, April 17, 2023.

Tax Form Changes

Form 1040 has an updated digital asset statement and new lines 1a through 1z to decrease the number of write-ins:

- 1a Amounts from Form(s) W-2, box 1 (see instructions)
- 1b Household employee wages not reported on Form(s) W-2
- 1c Tip income not reported on line 1a
- 1d Medicaid waiver payments not reported on Form(s) W-2 (see instructions)
- 1e Taxable dependent care benefits from Form 2441, line 26
- 1f Employer-provided adoption benefits from Form 8839, line 29
- 1g Wages from Form 8919, line 6
- 1h Other earned income (see instructions)
- 1i Nontaxable combat pay election. This entry was moved from line 27b to line 1i because nontaxable combat pay can be used to figure earned income for the EIC and ACTC
- 1z Add lines 1a through 1h

In addition, Line 6c is an added new line with a checkbox for taxpayers who use the lump-sum election method when figuring taxable Social Security benefits and eliminates the need for the write-in “LSE.”

Form 1040, Schedule 1 expanded line 8 to add lines for the following entries:

- Scholarships and fellowship grants not reported on Form W-2
- Nontaxable amount of Medicaid waiver payments included on Form 1040, line 1a or 1d
- Pension or annuity from a nonqualified deferred compensation plan or a nongovernmental section 457 plan
- Certain wages from penal institutions

Form 1040, Schedule 2 added a checkbox for taxpayers who are not required to file Form 5329.

The reporting requirement for Form 1099-K, Payment Card and Third Party Network Transactions, is reduced. As a result, sites may encounter more of these forms. See the Volunteer Resource Guide, Tab D, Income, for details.

Form W-4P is split into two forms.

- Form W-4P, Withholding Certificate for Periodic Pension or Annuity Payments, which is to be used only for periodic pension and annuity payments that are treated similarly to wages
- New Form W-4R, Withholding Certificate for Nonperiodic Payments and Eligible Rollover Distributions, which is to be used only for nonperiodic payments and eligible rollover distributions

The following forms and their instructions change from annual to continuous use:

- Form 1098, Mortgage Interest Statement
- Form 1098-Q, Qualifying Longevity Annuity Contract Information
- Form 1099-A, Acquisition or Abandonment of Secured Property
- Form 1099-C, Cancellation of Debt
- Form 1099-CAP, Changes in Corporate Control and Capital Structure
- Form 1099-DIV, Dividends and Distributions
- Form 1099-G, Certain Government Payments
- Form 1099-INT, Interest Income
- Form 1099-K, Payment Card and Third Party Network Transactions
- Form 1099-LTC, Long Term Care and Accelerated Death Benefits
- Form 1099-OID, Original Issue Discount
- Form 1099-Q, Payments from Qualified Education Programs (Under Sections 529 and 530)
- Form 1099-S, Proceeds From Real Estate Transactions
- Form 1099-SA, Distributions From an HSA, Archer MSA, or Medicare Advantage MSA

Tax Form Changes For TY2023

New Form 1099-DA, Digital Asset Proceeds from Broker Transactions, will be used to report proceeds of digital asset transactions. The form will be issued by broker exchanges to the IRS and the seller.

Tax Law Changes

- What provisions have expired?
  - Child tax credit (CTC) expansion
  - Recovery Rebate Credit
  - Increased amount of the child and dependent care credit (CDCC) and eligible expenses, modified phase-out of the credit for higher earners, and refundability.
  - Earned income tax credit (EITC) expired provisions:
    - Higher income limits and credit for taxpayers with no qualifying children
    - Ability to figure credit based on 2019 income
    - Elimination of upper age limit; minimum age of 19; minimum age of 18 for qualified homeless youth and qualified former foster youth
  - Private mortgage insurance premiums (PMI) deducted as home mortgage interest (through 2021)
  - Temporary deduction for charitable contributions for taxpayers who do not itemize (through 2021)
  - A taxpayer who received, or was approved to receive, unemployment for any week in 2021 was considered to be an applicable taxpayer and to have household income at 133 percent of the FPL if his or her household income was at or above 133 percent of the FPL (through 2021).
  - The provision for qualified sick and family leave credits expired on 09/30/21.
- What temporary provisions are still in effect?
  - Exclusion from gross income is available for student loan forgiveness after 2020 and before 2026 for most forgiven student loans. See Publication 970 for details.
  - The temporary 100% deduction for food or beverages from restaurants. Beginning January 1, 2021, through December 31, 2022.

- An employer may contribute up to $5,250 annually toward an employee's student loans, and such payment is excluded from the employee's income through 2025. The $5,250 cap applies to both the student loan repayment benefit as well as other educational assistance (e.g., tuition, fees, books) provided by the employer.
- Exclusion from gross income of canceled qualified principal residence indebtedness (through 2025).
- For most years, only taxpayers and families whose household income for the year is between 100 percent and 400 percent of the FPL for their family size may be eligible for the PTC. For 2021 and 2022, however, taxpayers with household income of 100 percent or more of the FPL may be eligible for a PTC. See the Premium Tax Credit lesson and Instructions for Form 8962, Premium Tax Credit, for details.
- The nonbusiness energy property credit is extended for 2022 and the name has been changed to energy efficient home improvement credit.

What changes from last year are permanent?

- Earned Income Credit changes:
  - Individuals and couples who have Social Security numbers can claim the credit, even if their children don't have SSNs. In this instance, they would get the smaller credit available to taxpayers without qualifying children. In the past, these filers didn't qualify for the credit.
  - More taxpayers who also have investment income can get the credit. Starting in 2021, the limit on investment income is increased to $10,000. After 2021, the $10,000 limit is indexed for inflation. See EIC updates below for the 2022 amount.
  - Special rule for separated spouses. Taxpayers can claim the EIC if they are married, not filing a joint return, had a qualifying child who lived with them for more than half of the tax year and either:
    - lived apart from their spouse for the last 6 months of the year or
    - are legally separated according to state law under a written separation agreement or a decree of separate maintenance and didn't live in the same household as their spouse at the end of the year.

Individual Taxpayer Identification Numbers (ITINs)

ITINs not used in the last three consecutive tax years: Any ITIN that is not used on a federal tax return for at least three consecutive tax years will expire on December 31 of the third consecutive tax year of non-use. ITINs with middle digits (the fourth and fifth positions) "70," "71," "72," "73," "74," "75," "76," "77," "78," "79," "80," "81," "82," "83," "84," "85," "86," "87" or "88" have expired. In addition, ITINS with middle digits "90," "91," "92," "94," "95," "96," "97," "98," or "99" **if assigned before 2013, have expired.**

Personal Exemption Amount

The deduction for all personal exemptions is suspended (reduced to zero), effective for tax years 2018 through 2025. For 2022, the gross income limitation for a qualifying relative is $4,400 ($100 increase).

Certain Expenses of Elementary and Secondary School Teachers

The amount of the deduction allowed that consists of expenses paid or incurred by an eligible educator for use in the classroom is $300 ($50 increase).

Qualified expenses include amounts paid or incurred after March 12, 2021, for personal protective equipment, disinfectant, and other supplies used for the prevention of the spread of coronavirus.

Standard Deduction

The standard deduction for taxpayers who do not itemize deductions on Schedule A (Form 1040) has increased. The standard deduction amounts for 2022 are:

- $25,900 – Married Filing Jointly or Qualifying Surviving Spouse (increase of $800)
- $19,400 – Head of Household (increase of $600)
- $12,950 – Single or Married Filing Separately (increase of $400)

Taxpayers who are 65 and Older or are Blind

For 2022, the additional standard deduction amounts for taxpayers who are 65 and older or blind are:

- $1,750 for Single or Head of Household (increase of $50)
- $1,400 for married taxpayers or Qualifying Surviving Spouse (increase of $50)

Kiddie Tax

To be subject to the kiddie tax, the individual must have unearned income of at least $2,300 in 2022.

Standard Mileage Rate

From **1/1/2022 through 6/30/2022**, the following rates are in effect:

- 58.5 cents per mile for business miles driven
- 18 cents per mile driven for medical or moving purposes
- 14 cents per mile driven in service of charitable organizations

From **7/1/2022 through 12/31/2022**, the following rates are in effect:

- 62.5 cents per mile for business miles driven
- 22 cents per mile driven for medical or moving purposes
- 14 cents per mile driven in service of charitable organizations

The standard mileage rate for business cannot be used to claim an itemized deduction for unreimbursed employee travel expenses during the suspension of miscellaneous itemized deductions that are subject to the 2% of AGI floor.

The moving expense deduction is not allowed through 2025 and the exclusion from income of moving expense reimbursements from an employer is also suspended. The only exception is for active military service members who move pursuant to a military order to a new permanent duty station.

Deduction for Qualified Business Income

For 2022, the threshold amount is $340,100 for married filing joint returns and $170,050 for all other returns.

Retirement Savings Contribution Credit

To claim this credit, the taxpayer's modified adjusted gross income (MAGI) must not be more than $34,000 for Single, Married Filing Separately, or Qualifying Surviving Spouse (increase of $1,000). MAGI must not be more than $51,000 (increase of $1,500) for Head of Household, and $68,000 (increase of $2,000) for Married Filing Jointly.

Earned Income Credit (EIC)

For 2022, the maximum credit increased to:

- $6,935 with three or more children
- $6,164 with two children

- $3,733 with one child
- $560 with no children

Earned Income and AGI Amounts Increased

To be eligible for a full or partial credit, the taxpayer must have earned income and AGI of at least $1 but less than:

- $53,057 ($59,187 if Married Filing Jointly) with three or more qualifying children
- $49,399 ($55,529 if Married Filing Jointly) with two qualifying children
- $43,492 ($49,622 if Married Filing Jointly) with one qualifying child
- $16,480 ($22,610 if Married Filing Jointly) with no qualifying child

Investment Income

Taxpayers whose investment income is more than $10,300 cannot claim the EIC.

Child Tax Credit/Additional Child Tax Credit

- The increased age allowance has expired. A child must not have attained age 17 by the end of 2022 to be a qualifying child.
- The initial amount of the CTC is $2,000 including a maximum additional child tax credit (ACTC) of $1,500 for each qualifying child.
- Bona fide residents of Puerto Rico are no longer required to have three or more qualifying children to be eligible to claim the ACTC.

Education Benefits

American opportunity credit for 2022 is gradually reduced (phased out) if taxpayers' MAGI is between $80,000 and $90,000 ($160,000 and $180,000 if Married Filing Jointly). Taxpayers cannot claim a credit if their MAGI is $90,000 or more ($180,000 or more if Married Filing Jointly). These MAGI limits will not be indexed for inflation for 2021 or later.

Lifetime learning credit for 2022 is gradually reduced (phased out) if taxpayers' MAGI is between $80,000 and $90,000 ($160,000 and $180,000 if Married Filing Jointly). Taxpayers cannot claim a credit if their MAGI is $90,000 or more ($180,000 or more if Married Filing Jointly). These MAGI limits will not be indexed for inflation for 2021 or later.

Student loan interest deduction begins to phase out for taxpayers with MAGI in excess of $70,000 ($145,000 for joint returns) and is completely phased out for taxpayers with MAGI of $85,000 or more ($175,000 or more for joint returns).

Eligible Long-Term Care Premium Limits

For 2022, the maximum amount of qualified long-term care premiums includible as medical expenses has increased. Qualified long-term care premiums up to the amounts shown below can be included as medical expenses on Schedule A (Form 1040), Itemized Deductions, or in calculating the self-employed health insurance deduction.

- Age 40 or under: $450
- Age 41 to 50: $850
- Age 51 to 60: $1,690

- Age 61 to 70: $4,510
- Age 71 and over: $5,640

The limit on premiums is for each person.

Foreign Earned Income Exclusion

For 2022, the maximum foreign earned income exclusion is $112,000.

IRA Deduction Amount and Modified AGI (MAGI) Limits for Traditional and Roth IRA Contributions

For 2022, the maximum combined traditional IRA deduction or Roth contribution is $6,000 ($7,000 if age 50 or older). For taxpayers who are covered by a retirement plan at work, the deduction for contributions to a traditional IRA is reduced (phased out) if the MAGI is:

- More than $109,000 but less than $129,000 for a married couple filing a joint return or a qualifying surviving spouse
- More than $68,000 but less than $78,000 for an individual filing as single, head of household, or married filing separately and did not live with the spouse at any time during 2022
- Less than $10,000 for a married individual filing a separate return who lived with the spouse at any time during 2022

For an IRA contributor who is not covered by a workplace retirement plan and is married to someone who is covered (and the spouses live together or file a joint return), the deduction is phased out if the couple's MAGI is between $204,000 and $214,000.

For 2022, maximum Roth IRA contributions phase out based on MAGI as follows:

- Married filing jointly or qualifying surviving spouse with MAGI between $204,000 and $214,000
- Single, head of household, or married filing separately and didn't live with the spouse at any time in 2022 with MAGI between $129,000 and $144,000
- Married filing separately, lived with the spouse at any time during the year, and MAGI is between $0 and $10,000

2022 Repayment Caps for Advance Premium Tax Credit (APTC)

Income (as % of federal poverty line)	Taxpayers filing as Single	Taxpayers using other filing statuses
Under 200%	$325	$650
200%-299%	$825	$1,650
300%-399%	$1,400	$2,800
400% and above	No cap (full repayment)	No cap (full repayment)

- Filing thresholds and federal poverty line tables have been adjusted for inflation.
- Details about these and other updates can be found in the Premium Tax Credit lesson and in the Volunteer Resource Guide, Tab H, Other Taxes, Payments, and Premium Tax Credit.

Health Savings Account (HSA) Deduction

For 2022, the annual contribution limits on deductions for HSAs for individuals with self-only coverage is $3,650 (increase of $50) and $7,300 for family coverage (increase of $100). There is an additional contribution amount of $1,000 for taxpayers who are age 55 or older.

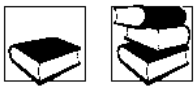
Extended and Expired Legislation

The following were one-year provisions for tax year 2020 and may have 2022 application:

- Deferred payment of the employer's share of Social Security tax for self-employed individuals. The last payment is due January 3, 2023.
- Coronavirus-related withdrawals up to $100,000 from IRAs or workplace retirement plans taken in 2020 could be spread over three tax years (2020, 2021, 2022) or recontributed to a qualified plan within three years of the day after the date of distribution.
- Higher education emergency financial aid grants may be awarded through September 30, 2023. These grants are excludible from gross income. See the Temporary Changes lesson.

Congress may enact additional legislation that will affect taxpayers after this publication goes to print. Any changes will be reflected in Publication 4491-X, VITA/TCE Training Supplement, available in mid-January on **www.irs.gov**

Course Introduction



Welcome

We're glad you decided to take advantage of this challenging, yet rewarding, experience as an important player in the tax administration process. This training material will introduce you to the major components of the Volunteer Income Tax Assistance and Tax Counseling for the Elderly (VITA/TCE) return preparation process.

Your course instructor will provide all the available technical publications and forms required for this course. If any of the suggested forms and publications are not available in the classroom or at the site, they can be viewed or downloaded at **www.irs.gov**.

Objectives

At the end of this lesson you will be able to describe:

- The various course levels and certification process
- The responsibilities of a VITA/TCE volunteer, including due diligence
- The critical components involved in the return preparation process
- The resources available to assist you
- The procedures for helping a taxpayer with identity theft
- Site Coordinator Training for volunteers acting in this role.

What do I need?

- Form 13614-C
- Publication 4012
- Publication 17
- Publication 4961
- Publication 5101
- Form 6744
- Form 13614-C Job Aid in Publication 4012
- Form 13615

Optional:

- Publication 4299
- Internet access (optional but highly recommended)

What will I learn?

To successfully assist taxpayers in satisfying their tax responsibilities, you must understand tax law and the tools available to assist you in preparing and filing accurate individual income tax returns. A tax return is accurate when tax law is applied correctly and it is free from error based on your interview of the taxpayer, the taxpayer's supporting documentation, and a completed Form 13614-C, Intake/Interview & Quality Review Sheet.

The VITA/TCE return preparation process consists of several critical components that you will learn in your training class or Link & Learn Taxes (L&LT):

- VITA/TCE Volunteer Standards of Conduct – Ethics Training
- Tax law training – understanding and applying tax law
- Research skills – using references, resources, and tools including return preparation software
- Intake/Interview and Quality Review Training
- Tax return preparation
- Site Coordinator Training for volunteers acting in this role.

Volunteer Standards of Conduct training and test are located in Publication 4961, VITA/TCE Volunteer Standards of Conduct – Ethics Training, and on Link & Learn Taxes. The Intake/Interview and Quality Review Training (Publication 5101) can be found on ***VITA/TCE Central****. Volunteer Coordinators must review Site Coordinator training (Publication 5088). Form 6744, VITA/TCE Volunteer Assistor's Test/Retest, contains the Volunteer Standards of Conduct, Intake/Interview and Quality Review and Site Coordinator tests.*

Unlike most classes, there is no need to memorize a lot of information. You can use information from irs.gov, your course materials, and other print and electronic sources to gain the knowledge and insights you need to serve the taxpayers you assist.

At the completion of your course of study, you will fully understand how to apply critical aspects of each component of the process and complete an accurate return for each taxpayer you assist.

Thank you for your interest in helping the IRS achieve its mission of providing America's taxpayers with top quality service by helping them understand their tax responsibilities and by applying the tax law with integrity and fairness to all.

Let's get started!

How is the course structured?

Due to the production schedule for this training guide, draft forms may be used in illustrations. The draft forms should never be used for actual tax preparation. Final forms are available on **https://apps.irs.gov/app/picklist/list/formsPublications.html***, in the tax preparation software, in the instruction booklet (e.g., Form 1040 Instructions), or in other publications.*

There are two tax law certification paths and two optional specialty courses presented in this publication, each representing a level of certification. The first six lessons apply to all levels of certification. Beginning with the Income lessons, the course levels for the subject being covered will be indicated by the following icons:

Basic covers the completion of wage earner type returns.

Advanced covers the completion of the full scope of VITA/TCE returns.

Military covers topics applicable to members of the Armed Forces, Reserve, and National Guard.

International covers topics applicable to military and non-military taxpayers living outside the United States.

Note

Tip

TaxSlayer Software Hint

Example

Exercises

Tax Law Application

These icons emphasize specific information that is important for your learning experience.

Volunteers wishing to certify in Military or International must follow the Advanced certification path and should also review the applicable specialty course.

Foreign Student and Scholar and Puerto Rico certifications are separate specialty courses available on L&LT.

At the beginning of each lesson, icons are displayed after the lesson title. If a section of a lesson is associated with only one certification level, the corresponding icon is displayed at the beginning of that section. If no icons are displayed in a section, all icons displayed with the lesson title apply.

What is the training approach?

Each course uses the process-based training (PBT) approach. PBT is a structured fact-gathering process that combines tax software and tax law training to help you prepare an accurate return. To complete the process, you will use:

- Form 13614-C Intake/Interview & Quality Review Sheet, or the appropriate Form 13614 for your program, (such as Form 13614-NR), to interview the taxpayer for filing status, dependency, income, credits, deductions, validate the information provided, and prepare the return.
- Reference materials, such as Publication 4012, Volunteer Resource Guide; Publication 17, Your Federal Income Tax for Individuals; and tax software help features, as well as other resources available at your site, to prepare the return. These materials will assist you with standardized questions to ask taxpayers during your interview, to help you prepare a 100% accurate tax return.
- Volunteer Resource Guide, Tab K – Quality Review Process, to conduct a quality review of all returns. Adhering to a quality review process helps ensure accurate returns are prepared at all VITA/TCE sites.

In most cases, when you have completed the return, it will be filed electronically. There should only be rare instances when the taxpayer may need to mail the tax return to the IRS.

What do I need to get started?

In addition to this publication, VITA/TCE training materials include the following items:

- Publication 4012, Volunteer Resource Guide
- Form 6744, Volunteer Assistor's Test/Retest
- Publication 4961, VITA/TCE Volunteer Standards of Conduct – Ethics Training
- Publication 5101, Intake/Interview & Quality Review Training

You may find it convenient to have Publication 4012, Volunteer Resource Guide, available during your training, preferably the digital version from the NTTC.

What other resources are available to help me learn?

Finalized blank forms and instructions can be accessed at **apps.irs.gov/app/picklist/list/formsPublications.html**

You may use the Practice Lab found at **vita.taxslayerpro.com/IRSTraining/en/Account/Access**, which is integrated with the online course, L&LT, to complete exercises, practice returns, and test scenarios using the tax software.

What happens after I complete this course?

After completing this course, you will have an understanding of tax law and the guidelines and tools needed to prepare an accurate return. The next step will be to complete the required certification test for the certification path chosen.

How does this certification work?

Beginning FS 2023, all volunteers must register and certify via Link & Learn Taxes. The online tests are available at **www.linklearncertification.com/d/**. Online testing is fast and efficient; it provides test results immediately. Volunteers who do not pass the test the first time may review the course material and try again. Also, volunteers who prefer to take the certification test on paper utilizing Form 6744, VITA/TCE Volunteer Assistor's Test or Retest, may continue to complete the test using this method but must transcribe

their answers to the test in Link & Learn Taxes. After passing any of the exams, you may sign your Form 13615, Volunteer Standards of Conduct Agreement electronically and provide to your Coordinator prior to volunteering. Please refer to Publication 5378, Link & Learn Taxes Certification Tests: Getting Started for additional information on how to register and complete the required certification tests in Link & Learn Taxes.

To participate in the VITA/TCE programs, all volunteers must pass the Volunteer Standards of Conduct test. In addition, all tax preparers, quality reviewers, instructors, and coordinators must pass the Intake/Interview and Quality Review test. To prepare tax returns in the VITA/TCE programs, you must then pass at least the Basic certification test. Alternatively, you may certify at the Advanced level. You are not required to certify in Basic before taking the Advanced test. A minimum score of 80% is required to pass any certification test.

You must pass the Volunteer Standards of Conduct and Intake/Interview and Quality Review tests prior to accessing the Basic or Advanced certification test.

Tax-Aide Counselors must certify at the Advance level.

All designated reviewers and peer-to-peer reviewers are required to have Basic or higher certification based on the complexity of the return. Volunteers are strongly encouraged to certify at the Advanced level. SPEC encourages the Quality Reviewers to be the most experienced volunteers in tax law application. Volunteer instructors must certify at Advanced and an applicable specialty course, depending on the tax topics instructed.

If a volunteer does not achieve the minimum required score on the test or the retest, the volunteer is encouraged to participate in the program in another capacity such as greeter, client facilitator, communication specialist, or technical support.

When you achieve the certification(s) and present your signed Form 13615, Volunteer Standards of Conduct Agreement, your Coordinator or instructor may provide you with a VITA/TCE programs Volunteer ID Insert. The insert was created to acknowledge the accomplishment of certified volunteers, as well as to assist internal and external stakeholders in identifying certified volunteers, but is not intended to be used as proof of certification. You should bring your Volunteer Standards of Conduct Agreement, Form 14509, Volunteer ID Insert (if you have one), and photo ID to the tax preparation site.

What types of returns can I prepare?

It is important that you assist only with returns, supporting schedules, and forms for which you have been trained and certified. You are protected by the federal Volunteer Protection Act of 1997 as long as you are only preparing returns within the scope of the VITA/TCE programs. Refer taxpayers with tax situations outside your scope of training and certification to your Coordinator and/or a professional tax return preparer. Refer to the Return Preparers Office at **https://irs.treasury.gov/rpo/rpo.jsf** for a listing of preparers recognized by the IRS. The training resources and tools discussed in this guide support the completion of a basic Form 1040 and associated tax forms. A complete list of what is within the scope of the VITA/TCE programs can be found in the front of the Volunteer Resource Guide. Do not prepare returns that fall outside the scope of the VITA/TCE programs or your training and certification. Applicable lessons list some out of scope tax law topics for the VITA/TCE programs.

Am I legally liable for returns I prepare?

VITA/TCE program volunteers are not considered paid preparers; therefore, you are not legally liable under federal law for the return you prepare. This means you cannot accept payment of any kind from the taxpayer for preparing a federal tax return or for providing any other tax-related assistance. You are protected by the federal Volunteer Protection Act of 1997, as long as all of the following conditions are true:

- You are acting within the scope of your volunteer responsibilities.
- You completed the level of training and certification required for preparing tax returns at your site.
- The harm was not caused by willful, criminal, reckless, grossly negligent, or conscious, flagrantly indifferent acts.

How does the IRS identify volunteer-prepared returns?

Each return should be identified with the appropriate site identification number (SIDN) to ensure it is readily identifiable by the IRS. Your site's SIDN is an 8-digit number preceded by the letter "S" that must appear in the Paid Preparer Use Only section on all returns you prepare, both paper and electronic. Your Coordinator provides this number along with other necessary guidelines for completing the return.

Identity Protection PIN (IP PIN) Program

Nationwide, identity theft continues to grow at an alarming rate. The IRS developed a strategy to address the problem of identity theft-related tax administration issues. The IRS strategy continues to evolve, but is focused on three priorities that are fundamental to addressing this challenge: victim assistance, outreach, and prevention.

- Victim assistance: The IRS is working to speed up case resolution and provide more training for employees who assist victims of identity theft.
- Outreach: The IRS is educating taxpayers so they can prevent and resolve tax-related identity theft issues quickly.
- Prevention: The IRS is implementing new processes for handling returns, new filters to detect fraud, new initiatives to partner with stakeholders, and a continued commitment to investigate the criminals who perpetrate these crimes.

Refer to the IRS Identity Theft Central page at **www.irs.gov/identity-theft-central** to stay current on IRS efforts to combat this growing problem. A wide range of information on identity theft is presented, ranging from how to contact the IRS with a case of identity theft to tips for keeping taxpayer records safe.

How to assist taxpayers who may be victims of identity theft at VITA/TCE sites

Being sensitive towards victims of identity theft is critical to assisting taxpayers through a confusing and frustrating situation. Remember victims of identity theft are:

- Victimized by identity thieves – mostly through no fault of their own and
- Trying to comply with tax laws – file tax returns and pay their fair share of taxes

Every December, the IRS mails Notice CP01A to taxpayers previously identified as identity theft victims. The notice includes a 6-digit Identity Protection Personal Identification Number (IP PIN) to be entered on the tax return. Taxpayers are mailed Notice CP01A every year as long as the identity theft indicator remains on their account (usually 3 years). Use the most recent IP PIN regardless of the tax year.

Use the following table when assisting taxpayers who are victims or may be victims of identity theft at a VITA/TCE site.

If...	Then...
Identity Protection PIN (IP) PIN was issued to primary/secondary taxpayer and dependent.	Ensure the IP PIN is input correctly on the tax return.
Taxpayer received an IP PIN but did not bring it.	1. Complete a paper tax return for the taxpayer. 2. Provide taxpayer with a complete copy of the tax return. (Provide two copies if the taxpayer will mail the tax return.) 3. Refer to the Lost, Misplaced, or Non-Receipt of IP PIN information below. 4. If taxpayer wants to e-file, arrange for the taxpayer to provide the IP PIN by returning to the site or via telephone.
Taxpayer received an IP PIN but misplaced or lost it.	1. Complete a tax return for the taxpayer. 2. Provide taxpayer with a complete copy of the tax return. (Provide two copies if the taxpayer will mail the tax return.) 3. Refer to the Lost, Misplaced, or Non-Receipt of IP PIN information below. 4. If the taxpayer receives an original or a reissued IP PIN and wants to e-file, arrange for the taxpayer to provide the IP PIN by returning to the site or via telephone.
Taxpayer did not receive an IP PIN, but IRS rejected the e-filed tax return because the IP PIN was not entered.	1. Refer to the Lost, Misplaced, or Non-Receipt of IP PIN information below. 2. Provide taxpayer with two complete copies of the tax return. 3. If the taxpayer receives the original or a reissued IP PIN and wants to e-file, advise the taxpayer to provide the IP PIN by returning to the site or via telephone. 4. If the IRS does not provide the IP PIN, advise taxpayer to follow IRS instructions in mailing the tax return. There may be processing delays as IRS verifies the taxpayer's identity.
IRS rejected the taxpayer's tax return because the taxpayer's primary/secondary and dependent SSN was previously used.	1. Advise the taxpayer to contact the IRS for assistance. If required, the IRS will advise the taxpayer to complete Form 14039 and to mail it with their tax return to the IRS. Taxpayers can use the Federal Trade Commission (FTC) web portal to file IRS Form 14039, Identity Theft Affidavit, online and the IRS will respond with a letter about 30 days after it has received all necessary information. See **www.identitytheft.gov** 2. Provide the taxpayer with two copies of the tax return.

Lost, Misplaced, or Non-Receipt of IP PIN

If a taxpayer did not receive a new IP PIN or the taxpayer misplaced it, the taxpayer has two options:

1. Register and create a user profile to get a current IP PIN. The registration process will require the taxpayer to provide specific personal information and answer a series of questions to validate his/her identity. Use key words "IP PIN" in the search window at irs.gov to access the Retrieve Your Identity Protection PIN (IP PIN) application.
2. Contact the IRS at 1-800-908-4490 to request the IP PIN be reissued by mail if the taxpayer is unable or unwilling to create an account on irs.gov.

If the reissued IP PIN letter is not received within 21 days after contacting the IRS or the taxpayer cannot meet the requirements for a reissued IP PIN, filing by paper is the taxpayer's only option.

Identity Protection PIN on Form 1040 Returns

Form 1040 includes a series of six boxes just to the right of the taxpayer's and spouse's occupation (page 2). These boxes are clearly marked as "Identity Protection PIN." Refer to the Volunteer Resource Guide, Tab P, Partner Resources, or go to irs.gov to view Form 1040.

If taxpayers choose to file the return on paper, the letter issued by the IRS will instruct them to write the six-digit IP PIN in the area just to the right of the taxpayer's and/or spouse's occupation.

For the IP PIN to be accepted, all six digits must be input on Form 1040. The IP PIN may begin with a zero.

Effect of the IP PIN on Tax Administration

The IP PIN acts as an identity validation tool only. The IP PIN indicates that taxpayers previously provided IRS with information that validates their identity and that IRS is satisfied that the taxpayers are the valid owners of the SSNs.

Returns that are filed on accounts with an IP PIN indicator present are processed as valid returns using standard processing procedures.

Returns that are filed on accounts with an IP PIN indicator present that do not have an IP PIN, or the IP PIN was not input correctly, will experience delays while IRS validates the identity of the taxpayer against IRS records.

What are my responsibilities as a VITA/TCE program volunteer?

As a VITA/TCE programs volunteer, you have a responsibility to provide quality service and to uphold the ethical standards of the program. When you begin as a volunteer, you will be asked to sign the Volunteer Standards of Conduct Agreement, which states that you will adhere to these standards:

- Follow the Quality Site Requirements (QSR)
- Do not accept payment, ask for donations, or accept refund payments for federal or state tax return preparation from taxpayers
- Do not solicit business from taxpayers you help or use the information you gained about them (their information) for any direct or indirect personal benefit for yourself or any other specific individual
- Do not knowingly prepare false returns
- Do not engage in criminal, infamous, dishonest, notoriously disgraceful conduct, or any other conduct considered to have a negative effect on the VITA/TCE Program
- Treat all taxpayers in a professional, courteous, and respectful manner

As a volunteer, follow these standards for return preparation: become certified, use the intake/interview and quality review process, use reference materials, complete the steps to electronically file tax returns, and adhere to the privacy and confidentiality guidelines.

What is due diligence?

Due diligence means doing your part to ensure tax returns are correct. As an IRS-certified volunteer, you ensure the information on the return you are preparing or reviewing is correct and complete.

Doing your part includes:

- Confirming a taxpayer's (and/or spouse if applicable) identity
- Providing top-quality service by helping taxpayers understand and meet their tax responsibilities

- Clarifying information that may appear to be inconsistent or incomplete

Generally, you can rely on good faith for taxpayer information without requiring documentation as verification. However, exercise caution when taxpayers want to claim refundable credits, especially if these credits are maximized.

Top 4 Things to Remember about Due Diligence

1. Do your part to ensure a tax return is correct.
2. Question any unusual, inconsistent, or incomplete items.
3. If you are unsure about a deduction or credit, make an effort to research the answer, or ask another certified volunteer for assistance.
4. Remind taxpayers that when they sign their tax returns, they are stating under penalty of perjury that the return is accurate to the best of their knowledge.

The following examples illustrate unusual or questionable situations that call for more information from the taxpayer.

Larry goes to a VITA/TCE site to have his taxes prepared. Larry tells the tax preparer:

- *His filing status is Head of Household*
- *He wants to claim his 2-year-old nephew for EIC*
- *He has no child care expenses*
- *He earned $19,000 in wages*
- *He is 26 years old*

Larry's information regarding his qualifying child and filing status is questionable. Further inquiries are needed to determine:

- *Why the uncle is claiming the child and not the parents?*
- *Why isn't there child care expense and who cares for the child while the taxpayer works?*
- *Is there anyone else living in the household that contributes?*
- *Is there anyone else eligible to claim the child?*
- *Do the tie-breaker rules apply?*
- *If asked, can the taxpayer provide proof that the qualifying child lived with him for more than half of the year?*

Steven goes to a VITA/TCE site to have his taxes prepared. Steven tells the tax preparer:

- *He is 22 years old*
- *He has two sons, ages 10 and 11*
- *He has Social Security cards for both boys and himself*
- *His W-2 wage indicates earnings of $20,000*

Steven's age and the age of the qualifying children appear to be inconsistent. Further inquiries are needed to determine:

- *Are the boys his sons by birth, foster sons, adopted sons, step-sons?*
- *Is there anyone else eligible to claim the children as qualifying children?*

- *Do the tie-breaker rules apply?*
- *If asked, can the taxpayer provide proof that the qualifying children lived with him for more than half of the year?*

As a certified volunteer, remember due diligence and take reasonable steps to ensure the tax return is correct:

- Ask enough questions to determine if allowable expenses were incurred and that income reported is correct.
- Include all taxable income in the tax return.
- If the item is questionable and/or unallowable, do not claim the deduction or credit on the tax return. Make a note on Form 13614-C, Intake/Interview & Quality Review Sheet to alert the reviewer (Form 13614-NR for Foreign Student and Scholar program).
- If you are uncomfortable with the information and/or documentation provided by a taxpayer, do not prepare the tax return.
- If the taxpayer wishes to take a position on their return that is contrary to your training, you should not prepare the return.

Tax return integrity means volunteers must take reasonable steps to ensure the tax return is correct, which includes:

- Verifying that all Social Security numbers presented by the taxpayer match the Social Security numbers listed on the tax return.
- Not preparing out of scope returns.
- Not preparing returns for which you have not been certified.
- Explaining to the taxpayer what income is taxable and why a deduction or credit can or cannot be included on their return. Use IRS reference materials to support your statements.
- Having a second certified volunteer quality review the completed return and discuss it with the taxpayer.
- Not making changes or corrections to the tax return after the taxpayer leaves the site without notifying the taxpayer.

In conclusion, as an IRS-certified volunteer preparer, you have the responsibility to perform adequate due diligence on EVERY return. The goal is not to prepare as many tax returns as possible, but to accurately report taxpayer income and deductions.

How do I maintain the taxpayer's trust?

You are the key to the integrity of the VITA/TCE programs. Taxpayers will trust that all information you receive from them is protected from disclosure. To maintain this trust:

- Do not disclose any personal tax information gained as a result of the service provided.
- Do not openly discuss taxpayers by name in the presence of other volunteers or taxpayers. You may discuss tax situations with other volunteers. For example, a volunteer may refer to a *situation* (not a taxpayer) and ask for or give advice about the appropriate tax treatment for that specific situation.
- Do not retain taxpayers' documents for a follow-up visit. If you cannot fully complete the taxpayer's return at the time of service, return all documents to the taxpayer.
- Do not take taxpayers' information for preparation of the return outside the presence of the taxpayer, unless Virtual VITA/TCE procedures are being used.
- Do not prepare a tax return when you suspect an individual is not providing truthful information.
- Do not exclude any of the taxpayer's relevant income or expenses, regardless of whether they increase or decrease the amount of tax due or refund.

Having the taxpayer present in the tax preparer's site is not always possible. In these cases, Virtual VITA/TCE processes can be used to prepare returns without taxpayer being in-person. Certified volunteers may interview taxpayers over the phone while preparing their return. The alternative process used to prepare returns must be approved by the responsible IRS Territory Manager prior to the start of the filing season to ensure all procedures are in place as described in the Quality Site Requirements (QSR). Most importantly, the taxpayer's and government's interests must be properly protected. In some cases, the taxpayer information must be left at the site to be prepared and mailed to the taxpayer. Adequate security and privacy is expected to ensure taxpayer records are properly safeguarded.

Some individuals may attempt to defraud the government by filing false tax returns. If you have any question about the validity of information provided by a taxpayer, or are uncomfortable with a taxpayer situation, discuss your concern with your Coordinator.

If you or a taxpayer have a concern or issue regarding unethical behavior at a site, e-mail **WI.Voltax@irs.gov**. The email notification should include your name, contact number, site name, and a detailed description of the incident including the individuals full name, date the incident occurred and the number of taxpayer's affected by the violation if applicable. Also, see Publication 730, Important Tax Records Envelope (VITA/TCE), Publication 4454, Your Civil Rights Are Protected, or Publication 4053, Your Civil Rights Are Protected Poster for IRS Assisted Programs, for reporting Civil Rights (Title VI) and EEO concerns.

Taxpayer Civil Rights

The Department of the Treasury – Internal Revenue Service will not tolerate discrimination based on race, color, national origin (including limited English proficiency), disability, reprisal, sex (in education programs or activities) or age in programs or activities receiving federal financial assistance from the Internal Revenue Service.

If a taxpayer believes that he or she has been discriminated against, a written complaint should be sent to:

Operations Director, Civil Rights Unit
Internal Revenue Service, Room 2413
1111 Constitution Avenue, NW
Washington, DC 20224

For all questions about taxpayer civil rights, contact us at the above address, or by e-mail at **edi.civil.rights.division@irs.gov**

Do not send tax returns, payments, or other non-civil rights information to this address.

Low Income Taxpayer Clinics

Low Income Taxpayer Clinics (LITCs) are independent from the IRS. LITCs serve individuals whose income is below a certain level and need to resolve tax problems with the IRS, such as audits, appeals, and tax collection disputes. In addition, clinics can provide information about taxpayer rights and responsibilities in different languages for individuals who speak English as a second language. Services are offered for free or a small fee.

For more information or to find a clinic near you, see the LITC page at **www.taxpayeradvocate.irs.gov/about/litc** or **Publication 4134**, Low Income Taxpayer Clinic List. This publication is available online at IRS.gov or by calling the IRS at 1-800-829-3676.

What is the Taxpayer Advocate Service?

The Taxpayer Advocate Service (TAS) is an independent organization within the IRS that helps taxpayers and protects taxpayer rights. Its job is to ensure every taxpayer is treated fairly and that taxpayers know and understand their rights under the Taxpayer Bill of Rights.

TAS offers free help to taxpayers in resolving tax problems they haven't been able to resolve on their own. If the taxpayer qualifies for TAS assistance, the taxpayer will be assigned to one advocate who will work through the process and do everything possible to resolve the issues. TAS can help if:

- The problem is causing financial difficulty for the taxpayer's family or business
- Taxpayer or taxpayer's business is facing an immediate threat of adverse action
- Taxpayer has tried repeatedly to contact the IRS, but no one has responded, or the IRS has not responded by the date promised

TAS has at least one taxpayer advocate office located in every state, the District of Columbia, and Puerto Rico. The local advocate's number is in the local directory and at **www.taxpayeradvocate.irs.gov**, or can be reached at 1-877-777-4778.

What is the Taxpayer Bill of Rights?

The Taxpayer Bill of Rights describes ten basic rights that all taxpayers have when dealing with the IRS. The Tax Toolkit at **www.taxpayeradvocate.irs.gov** can help taxpayers understand what these rights mean and how they apply.

How else does the Taxpayer Advocate Service help taxpayers?

TAS works to resolve large-scale problems that affect many taxpayers. If you know of one of these broad issues, please report it at **www.irs.gov/sams**.

Are there other materials available to assist me?

When you arrive at the tax preparation site, your Coordinator will assist you with your resource needs. Your site may even have a technical research library from which you can access various forms, publications, and worksheets. These materials can also be downloaded from **www.irs.gov**.

You should **not** use this guide at your tax preparation site; it is designed for training purposes only. The Volunteer Resource Guide will be available for use in printed or electronic format. Publication 17 will be available in electronic format. Your Coordinator should be able to provide access to the following key resources as well:

- Instruction booklets, schedules, and worksheets for Form 1040
- Frequently used tax publications (e.g., Publication 596, Earned Income Credit and Publication 3, Armed Forces' Tax Guide)
- Equipment and supplies along with security requirements and use restrictions

Recipients of government property and equipment must certify that the equipment will be used for volunteer tax return preparation purposes. Commercial and certain personal uses of the property may terminate the agreement. This applies to hardware and software, as well as supplies.

You may reinforce your knowledge of tax law by viewing online training courses such as Link & Learn Taxes, found at **apps.irs.gov/app/vita/**.

A toll-free tax information hotline is available for volunteer use only. If you have a tax law question and cannot get the answer from your Coordinator or your reference material, call 1-800-829-8482 (1-800-TAX-VITA). **Do not give this phone number to taxpayers.** The volunteer hotline is generally available from February 1 until the filing deadline.

For inquiries about refund offsets, taxpayers can call the Treasury Offset Program toll-free at 1-800-304-3107. Other helpful contact information can be found near the back of the Volunteer Resource Guide.

How do I get started using the tax software?

The majority of VITA/TCE sites use IRS-sponsored tax preparation software. The tax software is used to prepare returns and includes a help feature to assist in understanding the application of tax law; it is available in both desktop and online (internet-based) versions.

Your instructor or Coordinator will provide you with the information, user names, and passwords required for logging into the program for training and tax preparation purposes.

Where do I find information about the tax software?

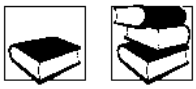
The Volunteer Resource Guide contains step-by-step procedures for electronic return preparation and helpful hints for using the tax software within each applicable tax law topic. Information about completing the return is listed in the Volunteer Resource Guide, Tab K, Finishing the Return.

Summary

Welcome to the VITA/TCE programs. Remember:

- Make sure you have the resources and support you need to provide each taxpayer with high-quality service and an accurate return.
- A return is accurate when tax law is applied correctly and the return is free from error based on the taxpayer's interview and supporting documentation, and a completed Form 13614-C, Intake/Interview & Quality Review Sheet (or Form 13614-NR).
- Know your roles and responsibilities, adhere to the Volunteer Standards of Conduct, and follow due diligence.
- Prepare returns that are:
  - within the scope of the VITA/TCE programs
  - within your certification level
- Use VITA/TCE equipment and supplies (including hardware and software) for their intended purposes.
- The procedures for helping a taxpayer with identity theft.

Temporary Provisions



Introduction

Some of the provisions contained in this lesson have been commonly referred to as “extenders.” Others are temporary provisions contained in recent legislation. In some instances, these provisions modify only portions of the existing tax law. In those cases, we have included caution statements in the affected lessons redirecting volunteers to explore the temporary modifications in this lesson. The following topics are covered here:

- Student loan forgiveness *
- Business expenses paid to restaurants *
- Employer provided educational assistance *
- Higher education emergency financial aid grants *
- Mortgage insurance premiums deductible as qualified residence interest (currently expired)
- Credit for nonbusiness energy property (Renamed the energy efficient home improvement credit)
- Cancellation of debt on a principal residence

* The temporary provisions for these items have been incorporated into the respective lesson for Tax-Aide. The original text has been left in this Temporary Provisions lesson for quick review.

Taxpayers who had a coronavirus-related distribution in 2020 and elected to spread the distribution over three years will report 1/3 of the taxable amount on their 2022 return. Refer to the retirement income lesson for details. The 2021 and 2022 expansion of the premium tax credit (PTC) has been extended through 2025 and is covered in the Premium Tax Credit lesson. Self-employed individuals who deferred payment of some of their self-employment tax in 2020 need to finish their payments by January 3, 2023 as discussed in the Other Taxes lesson.

What temporary provisions should I be aware of?

Student loan forgiveness

An exclusion from gross income is available for student loan forgiveness after 2020 and before 2026 for most forgiven student loans. If eligible for the exclusion, the lender should not issue Form 1099-C. Further, the recipient's qualified eduction expenses are not reduced and can be fully used for an education credit or other benefit, if otherwise eligible.

Business expenses paid to restaurants

There is a temporary exception to the 50% limit on the amount that businesses may deduct for food or beverages. The temporary exception allows a 100% deduction for food or beverages from restaurants. Beginning January 1, 2021, through December 31, 2022, businesses can claim 100% of their food or beverage expenses paid to restaurants as long as the business owner is present when food or beverages are provided and the expense is not lavish or extravagant under the circumstances.

Under the temporary provision, restaurants include businesses that prepare and sell food or beverages to retail customers for immediate on-premises and/or off-premises consumption. However, restaurants do not include businesses that primarily sell pre-packaged goods not for immediate consumption, such as grocery stores and convenience stores. See **Notice 2021-25** for details.

Exclusion for certain employer payments of student loans

Employers may provide a student loan repayment benefit to employees on a tax-free basis. Under the provision, an employer may contribute up to $5,250 annually toward an employee’s student loans, and such payment would be excluded from the employee’s income. The $5,250 cap applies to both the new student loan repayment benefit as well as other educational assistance (e.g., tuition, fees, books) provided by the employer. This provision has been extended through 2025.

Higher education emergency financial aid grants

Emergency financial aid grants under the CARES Act for unexpected expenses, unmet financial need, or expenses related to the disruption of campus operations due to the COVID-19 pandemic, such as unexpected expenses for food, housing, course materials, technology, health care, or childcare, are qualified disaster relief payments under section 139 of the Internal Revenue Code. Available through September 30, 2023, this grant is not includible in gross income. Further, the student's qualified education expenses are not reduced for this nontaxable grant for an education benefit.

Itemized Deductions

What about qualified mortgage insurance premiums? (expired)

This provision was in effect through 2021 and is currently expired. If extended, taxpayers can deduct private mortgage insurance premiums paid during the current tax year on Schedule A in the Interest You Paid section. The insurance must have been in connection with home acquisition debt, and the insurance contract must have been issued after 2006. Volunteers need to be aware that this potential deduction may not be reported on Form 1098. Ask homeowners with a mortgage if they paid mortgage insurance premiums during the tax year. Failure to ask could result in a substantial deduction loss for taxpayers filing Schedule A. Refer to Publication 4491-X, VITA/TCE Training Supplement, to confirm if this provision is extended.

Other itemized deductions are discussed in a later lesson.

What are residential energy credits?

Individuals who purchase qualified energy efficient improvements for their main home may be allowed nonrefundable tax credits. There are two types of residential energy credits:

- Residential clean energy credit (previously named the residential energy efficient property credit) (Form 5695, Residential Energy Credits, Part I, which is out of scope for the VITA/TCE programs)
- Energy efficient home improvement credit (previously named the nonbusiness energy property credit) (Form 5695, Part II)

The adjusted basis of the home is reduced by the residential credit received.

Other credits are discussed in the Miscellaneous Credits lesson.

The IRS provides guidance on what property qualifies for the energy credits. Homeowners generally can rely on manufacturers' certifications that their property qualifies. See the Volunteer Resource Guide, Tab EXT, Legislative Extenders, IRS.gov, or **www.energystar.gov** for more information.

What is the residential clean energy credit?

This residential clean energy credit is claimed on Form 5695, Part I, and is out of scope for the VITA/TCE programs. For awareness only, taxpayers may claim an energy credit for qualified solar electric, solar water heating, biomass stoves, small wind energy, and geothermal heat pump property costs. Check for qualifying energy property purchases to determine if the taxpayer should see a professional tax preparer to claim the credit.

What is the Energy efficient home improvement credit?

This provision was extended through 2032. The credit is available for certain qualifying energy efficiency improvements or residential energy property costs. The qualifying items are:

- Heating, ventilating, air-conditioning (HVAC)
- Insulation
- Roofs (metal and asphalt)
- Water heaters (non-solar)
- Windows and doors

The energy efficient home improvement credit is subject to the following limitations:

- The total combined credit limit for all tax years after 2005 is $500, and the combined credit limit for windows is $200.
- The maximum credit for residential energy property costs is $50 for any advanced main air circulating fan; $150 for any qualified natural gas, propane, or oil furnace, or hot water boiler; and $300 for any item of energy efficient building property.

It is important to note that:

- The credit is only available for existing homes that are the taxpayer's main home – new construction and rentals do not qualify. The taxpayer must own the home to qualify.
- Amounts provided by subsidized federal, state, or local energy financing do not qualify for the credit.
- The adjusted basis of the home is reduced by the residential credit received.

Costs for on-site preparation and installation depend on the type of qualified property. Review the Form 5695 Instructions for more information.

Recent legislation extended, increased and modified this credit. The increase and modifications apply to property placed in service after December 31, 2022. Those changes will be reflected in the 2023 version of this publication.

Cancellation of Debt (COD) – Principal Residence

Cancellation of credit card debt is included in the Other Income lesson of this publication for Advanced certification. Exclusion from gross income of qualified principal residence indebtedness has been extended through 2025 on a modified basis.

In Scope for VITA/TCE Programs

Refer to Publication 4731-A, Screening Sheet for Foreclosures/Abandonments and Cancellation of Debt, to ensure that the tax return being prepared is within scope of the VITA/TCE programs. This screening sheet is contained in the Volunteer Resource Guide, Legislative Extenders tab.

- Use Publication 4731-A, Part I for taxpayers with Form 1099-A for a foreclosure or abandonment of their principal residence
- Use Publication 4731-A, Part II for taxpayers with Form 1099-C, or Forms 1099-A and 1099-C resulting from cancellation of debt on a home mortgage loan

Recourse vs. Nonrecourse Debt

There are two types of debts: recourse and nonrecourse. A recourse debt holds the borrower personally liable. All other debt is considered nonrecourse.

In general, recourse debt (loans) allows lenders to collect what is owed for the debt even after they've taken the collateral (home, car, etc.). Lenders have the right to garnish wages or levy accounts in order to collect what is owed.

A nonrecourse debt (loan) does not allow the lender to pursue anything other than the collateral. For example, if a borrower defaults on a nonrecourse home loan, the bank can foreclose on the home only. The bank generally cannot take further legal action to collect the money owed on the debt. Whether a debt is recourse or nonrecourse may vary from state to state, depending on state law.

If a lender cancels a debt and issues Form 1099-C, the lender will indicate on the form if the borrower was personally liable (recourse) for repayment of the debt.

If property securing the debt was foreclosed on or abandoned, the taxpayer may need to report the disposition (sale) on Form 8949 and Schedule D. This is covered in more detail later in this lesson.

Generally, if taxpayers abandon property that secures debt for which they are personally liable, they do not have a gain or loss until the foreclosure is completed.

If taxpayers abandon property that secures debt for which they are not personally liable, the abandonment is treated as a sale or exchange.

For more information on abandonments see Publication 4681, Canceled Debts, Foreclosures, Repossessions, and Abandonments.

Recourse debt holds the borrower personally liable for any amount not satisfied by the surrender of secured property.

- If a lender forecloses on property subject to a recourse debt and cancels the portion of the debt in excess of the fair market value (FMV) of the property, the canceled portion of the debt is treated as ordinary income from cancellation of indebtedness. This amount must be included in gross income unless it qualifies for an exception or exclusion.
- In addition to this cancellation of indebtedness income, the taxpayer may realize a gain or loss on the disposition of the property; this amount is generally the difference between the FMV of the property at the time of the foreclosure and the taxpayer's basis in the property.

Nonrecourse debt is satisfied by the surrender of the *secured property* regardless of the FMV at the time of surrender, and the borrower is not personally liable for the debt.

- If property that is subject to nonrecourse debt is abandoned, foreclosed upon, subject of a short sale, or repossessed by the lender, the circumstances are treated as a sale of the property by the taxpayer.
- In determining the gain or loss on the disposition of the property, the balance of the nonrecourse debt at the time of the disposition of the property is included in the amount realized (generally the selling price). Since the borrower is not personally liable for the debt, the difference between the FMV of the property and the balance of the loan is not included in gross income.

Jason lost his home to foreclosure because he could no longer make his mortgage payments. At the time of foreclosure, he owed a balance of $170,000 to the lender and the FMV of the property was $140,000.

If Jason is personally liable for the debt (recourse loan), the selling price would be $140,000. If Jason is not personally liable for the debt (nonrecourse loan), the selling price would be $170,000.

	Recourse Debt	Nonrecourse Debt
Borrower is...	Personally liable	Not personally liable
Canceled portion of debt is generally...	Treated as ordinary income and included in gross income (unless it qualifies for an exception or exclusion)	Not applicable. Nonrecourse debt is satisfied by the surrender of the secured property regardless of the FMV at the time of surrender.
Gain or loss on disposition of the property	Generally determined by the difference between the FMV of the property and the adjusted basis	The amount realized includes the balance of the nonrecourse debt at the time of the disposition of the property. This is true even if the FMV of the property is less than the outstanding debt.

Exceptions and Exclusions

Some canceled or forgiven debts may be *eliminated* from income by applying exceptions, or *reduced* by applying exclusions to the general rule. **Exceptions are applied before exclusions.**

Exceptions

Exceptions may allow the taxpayer to eliminate the following types of canceled debt from income:

- Amounts otherwise excluded from income (e.g., gifts and bequests)
- Certain student loans, in addition to the general exclusion noted above for tax years 2021 through 2025 (e.g., doctors, nurses, and teachers serving in rural or low-income areas)
- Deductible debt (e.g., home mortgage interest that would have been deductible on Schedule A)
- Price reduced after purchase (e.g., debt on solvent taxpayer's property is reduced by the seller; basis of property must be reduced)

For more information on exceptions, refer to Publication 4681.

Exclusions

There are several exclusions from the general rule for reporting canceled debt as income.

Form 982, Reduction of Tax Attributes Due to Discharge of Indebtedness, must be filed with the taxpayer's return to show the amount of the canceled debt excluded.

The exclusions are:

- Discharge of debt through bankruptcy
- Discharge of debt of insolvent taxpayer
- Discharge of qualified farm indebtedness
- Discharge of qualified real property business indebtedness
- Discharge of qualified principal residence indebtedness

The issues involved in exclusions can be complex. Only cancellation of qualified principal residence indebtedness exclusion is within the scope of VITA/TCE.

Discharge of Qualified Principal Residence Indebtedness

Taxpayers may exclude from income certain debt forgiven or canceled on their principal residence. If the canceled debt qualifies for exclusion from gross income, the debtor may be required to reduce tax attributes (certain credits, losses, and basis of assets) by the amount excluded.

If a property was taken by the lender (foreclosure) or given up by the borrower (abandonment), the lender usually sends the taxpayer Form 1099-A, Acquisition or Abandonment of Secured Property. Form 1099-A will have information needed to determine the gain or loss due to the foreclosure or abandonment.

If the debt is canceled, the taxpayer will receive Form 1099-C, Cancellation of Debt. If foreclosure/abandonment and debt cancellation occur in the same calendar year, the lender may issue only Form 1099-C, including the information that would be reported on Form 1099-A.

Qualified Principal Residence Indebtedness

Qualified principal residence indebtedness includes:

- Any debt incurred in acquiring, constructing, or substantially improving a principal residence that is secured by the principal residence
- Any debt *secured by the principal residence resulting from the refinancing of debt* incurred to acquire, construct, or substantially improve a principal residence, but only to the extent that the amount of debt does not exceed the amount of the refinanced indebtedness

A principal residence is generally the home where the taxpayer lives most of the time. A taxpayer can have only one principal residence at a time.

Exclusion Limit

The maximum amount that can be treated as qualified principal residence indebtedness for discharges after 2020 and through 2025 is $750,000 ($375,000 in the case of a married individual filing a separate return).

Canceled qualified principal residence indebtedness cannot be excluded from income if the cancellation was for services performed for the lender or on account of any factor not directly related to a decline in the value of the residence or the taxpayer's financial condition.

Criteria for Canceled Principal Residence Debt

Volunteers may assist taxpayers who meet the following requirements:

- The home was never used in a business or as rental property
- The debt was not canceled because the taxpayer filed bankruptcy
- The taxpayer is not in bankruptcy when he/she comes to the site for assistance
- Form 1099-C does not include an amount for interest
- The debt must be a mortgage used only to buy, build, or substantially improve the taxpayer's primary residence, i.e., this money was not used to pay off credit cards, medical/dental expenses, vacations, etc.
- The mortgage was secured by the taxpayer's primary residence
- The mortgage was not more than $750,000 ($375,000 in the case of a married individual filing a separate return)

Bob refinanced his personal residence and used the loan proceeds from the equity in his home to build a new master bedroom suite on the main level of his house. This debt is qualified principal residence indebtedness.

Tom refinanced his personal residence and used the loan proceeds from the equity in his home to pay off credit cards and buy a car. This debt is not qualified principal residence indebtedness.

EXERCISE

Use Publication 4731-A, Part II, to answer the following questions. The answers appear at the end of the lesson.

Question 1: A volunteer with Advanced certification is working with Angie. Angie confirmed that she had to give up her principal residence and produced Form 1099-C for the cancellation of the mortgage loan. Angie explains that she did not file for bankruptcy, even though she experienced hardship due to the loss of income from no longer being able to rent out an upstairs bedroom and bath. Angie also verified that the mortgage loan was used entirely to purchase the home and was secured by the home. Her Form 1099-C lists the amount of debt canceled as $60,000.

Should the volunteer assist Angie with her return?

a. Yes

b. No

Question 2: Fred went to his local VITA site to have his tax return prepared. The volunteer went through Fred's records and noticed Form 1099-C reflecting a canceled debt of $50,000.

Using Publication 4731-A, Part II, as a guide, the volunteer learned Fred lost his job and could no longer make his mortgage payments. The bank foreclosed on Fred's home. Due to the housing market slump, the value of Fred's home had declined, and his mortgage balance was more than the fair market value of the home. The bank sold Fred's home and canceled the remaining debt ($50,000) not covered by the sale price.

Upon further questioning, the volunteer learned Fred had refinanced his home two years ago and used the equity in the home to pay off some credit cards and take a trip to Las Vegas.

Should the volunteer assist Fred with the preparation of his return at the VITA site?

a. Yes

b. No

State tax laws may differ.

Foreclosures and Capital Gain or Loss

If a taxpayer does not make payments owed on a loan secured by property, the lender may foreclose on the loan or repossess the property. The foreclosure or repossession is treated as a sale from which the taxpayer may realize a gain or loss. This is true even if the taxpayer voluntarily returns the property to the lender.

Figure the gain or loss from a foreclosure or repossession the same way as the gain or loss from a sale. The gain is the difference between the amount realized and the adjusted basis of the transferred property (amount realized minus adjusted basis). The loss is the difference between the adjusted basis in the transferred property and the amount realized (adjusted basis minus amount realized).

When a residence that is security for a mortgage is abandoned or foreclosed upon, the gain or loss must be reported on the return and is subject to the rules for a sale of residence.

Generally, the amount realized on a foreclosure is considered to be the selling price. But this selling price depends, in part, on whether the debt was recourse debt or nonrecourse debt. In addition, the taxpayer may also have ordinary income from the cancellation of debt.

Use the Worksheet for Foreclosures and Repossessions in Publication 4681 to figure the ordinary income from the cancellation of debt and the gain or loss from a foreclosure or repossession.

A loss on the sale or disposition of a personal residence is not deductible. A gain may qualify for the Section 121 exclusion ($250,000 or $500,000 for Married Filing Jointly taxpayers and some surviving spouses) for a gain on the sale of a principal residence.

Generally, the taxpayer's gain or loss from a foreclosure or abandonment is reported on Form 8949 and Schedule D.

If the taxpayer is personally liable for the debt (recourse debt), and the amount of outstanding debt (mortgage) is more than the home's FMV, the difference is treated as cancellation of debt income.

- If the canceled debt qualifies as excludible from gross income, the exclusion is reported on Form 982, Reduction of Tax Attributes Due to Discharge of Indebtedness (And Section 1082 Basis Adjustment)
- Otherwise, the canceled debt is reportable as ordinary income on Form 1040, Schedule 1 and is beyond the scope of VITA/TCE

If the canceled debt is reportable on Form 1040, Schedule 1 or the canceled debt is not fully excludable from gross income, the issue is beyond the scope of the VITA/TCE programs.

Form 1099-A, Acquisition or Abandonment of Secured Property

When a personal residence is foreclosed upon, and the lender cancels a portion of the debt, the taxpayer will generally receive Form 1099-A and Form 1099-C. If, in the same calendar year, the debt is canceled in connection with a foreclosure of secured property, the lender has the option of issuing Form 1099-C only.

The filing requirements of Form 1099-A are met by the lender completing the following on Form 1099-C:

- Debt description
- The debtor was personally liable for the repayment of the debt
- Fair market value of property

For more information on determining the basis for sale of residence see the lesson on Income – Capital Gain or Loss, Publication 523, Selling Your Home, or Publication 551, Basis of Assets.

Verify with the taxpayer that the information on Form 1099-A and Form 1099-C is correct. Pay particular attention to the amount of debt forgiven and the fair market value reported. Advise the taxpayer to contact the lender immediately if any of the information is not correct.

Form 1099-A, issued by the lender, reports the outstanding debt and the fair market value of the property. This form provides information needed to determine the amount of any gain or loss due to foreclosure or abandonment. Report the gain or loss on Form 8949 and Schedule D. A loss on the disposition of a personal asset is not deductible.

The sale price (amount realized) is based on whether the taxpayer is personally liable (recourse loan) or not personally liable (nonrecourse loan) for the debt.

- If the taxpayer is personally liable, the sale price is the **lesser** of the balance of the principal mortgage debt outstanding or the fair market value
- If the taxpayer is not personally liable, then the sale price is the full amount of the outstanding debt, as reflected on Form 1099-A
- For both recourse and nonrecourse loans, add any proceeds the taxpayer received from the foreclosure sale to the amount realized

Generally, if there is a loss on the sale of a principal residence or the entire gain is excluded under the Section 121 exclusion ($250,000 or $500,000 for Married Filing Jointly and certain surviving spouses), the sale does not have to be reported. However, taxpayers who receive Form 1099-A should report the sale to account for the basis in the property.

Failure to report a foreclosure or abandonment transaction on Form 8949 and Schedule D may result in an IRS notice to the taxpayer.

Form 1099-C, Cancellation of Debt

Lenders or creditors are required to issue Form 1099-C if they cancel a debt owed to them of $600 or more. Generally, an individual taxpayer must include all canceled amounts (even if less than $600) on the other income line of Form 1040, Schedule 1.

However, under certain circumstances, a taxpayer may not have to include canceled debt in income. For example, if the canceled debt is related to the taxpayer's principal residence, the taxpayer may be able to exclude all or a portion of canceled debt if it is qualified principal residence indebtedness. The amount excluded due to the discharge of qualified principal residence indebtedness is reported on Form 982.

In addition to debtor information, Form 1099-C reports the amount of debt canceled and the date canceled. **If the form has event code A indicating bankruptcy, or if an amount is included for interest, refer the taxpayer to a professional tax preparer.**

Form 982 must be filed with the taxpayer's return to report the excluded amount of discharged indebtedness and the reduction of certain tax attributes. Taxpayers excluding discharged debt from qualified principal residence indebtedness must complete only a few lines on Form 982. Refer to the Volunteer Resource Guide, Tab EXT, Legislative Extenders, for details. If the taxpayer kept ownership of the home, the basis adjustment to the principal residence for the excluded canceled debt must be reflected on the form.

Coordination with Form 1099-A

As mentioned earlier, if a personal residence is foreclosed upon, and the debt is canceled in the same year, the taxpayer may receive Form 1099-C *only*. The required filing information from Form 1099-A will be shown on Form 1099-C.

Generally, the gross foreclosure bid price is considered to be the FMV. For an abandonment or voluntary conveyance in lieu of foreclosure, the FMV is generally the appraised value of the property.

For a recourse loan, the sale price is the **lesser** of the balance of the principal debt (mortgage) outstanding or fair market value.

Mortgage Workouts and Form 1099-C

Homeowners whose mortgage debt is partly forgiven through a loan modification, or workout, which allows them to continue owning their residence, will receive Form 1099-C reporting the amount of debt discharged. Because the taxpayer kept ownership of the home, there is no gain or loss to be reported.

However, if the canceled debt meets the requirements of qualified principal residence indebtedness, Form 982 must be completed to report the amount excluded from gross income and the reduction of tax attributes.

See Publication 4012, Tab EXT, Legislative Extenders, Entering Forgiveness of Qualified Principal Residence Indebtedness, for directions on completing Form 982.

Taxpayers who are not personally liable for the debt (nonrecourse debt) do not have ordinary income from the cancellation of the debt unless the lender:

- Offered a discount for the early payment of the debt or
- Agreed to a loan modification that resulted in the reduction of the principal balance of the debt

If a lender offers to discount (reduce) the principal balance of a loan that is paid off early, or agrees to a loan modification (workout) that includes a reduction in the principal balance of a loan, the amount of the discount or the amount of the principal reduction is *canceled debt* whether or not the taxpayer is personally liable for the debt. The amount of the canceled debt must be included in income unless the exceptions or exclusions discussed earlier apply.

Gain or Loss Reported on Form 8949 and Schedule D

Form 8949, Sales and Other Dispositions of Capital Assets, includes all capital gain and loss transactions. The subtotals from Form 8949 are carried over to Schedule D, Capital Gains and Losses, where gain or loss is calculated in aggregate.

Losses on a personal residence are never deductible. Gains (all or part) may be excluded under the rules regarding the sale of a personal residence (Section 121 exclusion).

For more information on how to report the gain or losses, see the Volunteer Resource Guide, Tab D, Capital Gains or Losses Sale of Main Home.

Case Study – Reporting a Foreclosure and Canceled Debt

The following case studies are only examples of how the mentioned issues and forms can look and be reported. The dates and years of the forms are not relevant for these case studies.

Frank bought his home on May 14, 2017. His basis in the home was $200,000. After he lost his job last year, he was not able to make the payments. The bank foreclosed in June of the current tax year, and Frank moved out. At the time of the foreclosure, the fair market value of the home was $125,000 and the principal balance of the mortgage was $195,000. All of the debt was incurred to purchase the home. Frank received Form 1099-C for the amount of debt canceled by his bank.

Frank has qualified principal residence indebtedness. His tax return should include Form 8949 and Schedule D to show the basis of the home disposed of through foreclosure, and Form 982 to exclude the debt cancellation from income.

Form 1099-C & Form 8949:

☐ CORRECTED (if checked)

CREDITOR'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no.	1 Date of identifiable event	OMB No. 1545-1424	
FIRST BANK **ANYWHERE USA**	**6/25/20XX**	**20XX**	**Cancellation of Debt**
	2 Amount of debt discharged **$ 20,000.00**		
	3 Interest if included in box 2 $	Form **1099-C**	

CREDITOR'S federal identification number	DEBTOR'S identification number	4 Debt description	Copy B For Debtor
XX-XXXXXXX	**XXX-XX-XXXX**	**HOME MORTGAGE LOAN** **1111 ANYWHERE STREET** **ANYWHERE TOWN, STATE ZIP**	This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if taxable income results from this transaction and the IRS determines that it has not been reported.
DEBTOR'S name **FRANK LINCOLN**		5 If checked, the debtor was personally liable for repayment of the debt ☒	
Street address (including apt. no.) **ANYWHERE**			
City or town, state or province, country, and ZIP or foreign postal code **CITY, STATE ZIP USA**			
Account number (see instructions) **1234567**		6 Identifiable event code	7 Fair market value of property $

Form **1099-C** (keep for your records) www.irs.gov/form1099c Department of the Treasury - Internal Revenue Service

Form 8949 Attachment Sequence No. **12A** Page **2**

Name(s) shown on return. Name and SSN or taxpayer identification no. not required if shown on other side	Social security number or taxpayer identification number
FRANK LINCOLN	**XXX-XX-XXXX**

Before you check Box D, E, or F below, see whether you received any Form(s) 1099-B or substitute statement(s) from your broker. A substitute statement will have the same information as Form 1099-B. Either may show your basis (usually your cost) even if your broker did not report it to the IRS. Brokers must report basis to the IRS for most stock you bought in 2011 or later (and for certain debt instruments you bought in 2014 or later).

Part II **Long-Term.** Transactions involving capital assets you held more than 1 year are long term. For short-term transactions, see page 1.

Note. You may aggregate all long-term transactions reported on Form(s) 1099-B showing basis was reported to the IRS and for which no adjustments or codes are required. Enter the total directly on Schedule D, line 8a; you are not required to report these transactions on Form 8949 (see instructions).

You *must* check Box D, E, *or* F below. Check only one box. If more than one box applies for your long-term transactions, complete a separate Form 8949, page 2, for each applicable box. If you have more long-term transactions than will fit on this page for one or more of the boxes, complete as many forms with the same box checked as you need.

☐ **(D)** Long-term transactions reported on Form(s) 1099-B showing basis was reported to the IRS (see **Note** above)
☐ **(E)** Long-term transactions reported on Form(s) 1099-B showing basis was **not** reported to the IRS
☒ **(F)** Long-term transactions not reported to you on Form 1099-B

1 (a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold or disposed (Mo., day, yr.)	(d) Proceeds (sales price) (see instructions)	(e) Cost or other basis. See the **Note** below and see *Column (e)* in the separate instructions	Adjustment, if any, to gain or loss. If you enter an amount in column (g), enter a code in column (f). See the separate instructions. (f) Code(s) from instructions	(g) Amount of adjustment	(h) Gain or (loss). Subtract column (e) from column (d) and combine the result with column (g)
Main Home Form 1099-A	**05/14/17**	**06/25/XX**	**$ 125,000**	**$ 200,000**	**L**	**$ 75,000**	**$ 0**

2 **Totals.** Add the amounts in columns (d), (e), (g), and (h) (subtract negative amounts). Enter each total here and include on your Schedule D, **line 8b** (if **Box D** above is checked), **line 9** (if **Box E** above is checked), or **line 10** (if **Box F** above is checked) ▶	$ 125,000	$ 200,000		$ 75,000	$ 0

Note. If you checked Box D above but the basis reported to the IRS was incorrect, enter in column (e) the basis as reported to the IRS, and enter an adjustment in column (g) to correct the basis. See *Column (g)* in the separate instructions for how to figure the amount of the adjustment.

Form **8949**

Schedule D (Form 1040) & Form 982:

term capital gains or losses, go to Part II below. Otherwise, go to Part III on the back

Part II **Long-Term Capital Gains and Losses—Assets Held More Than One Year**

See instructions for how to figure the amounts to enter on the lines below. This form may be easier to complete if you round off cents to whole dollars.	(d) Proceeds (sales price)	(e) Cost (or other basis)	(g) Adjustments to gain or loss from Form(s) 8949, Part II, line 2, column (g)	(h) Gain or (loss) Subtract column (e) from column (d) and combine the result with column (g)
8a Totals for all long-term transactions reported on Form 1099-B for which basis was reported to the IRS and for which you have no adjustments (see instructions). However, if you choose to report all these transactions on Form 8949, leave this line blank and go to line 8b				
8b Totals for all transactions reported on Form(s) 8949 with **Box D** checked				
9 Totals for all transactions reported on Form(s) 8949 with **Box E** checked				
10 Totals for all transactions reported on Form(s) 8949 with **Box F** checked	$125,000	$200,000	$75,000	$0

11 Gain from Form 4797, Part I; long-term gain from Forms 2439 and 6252; and long-term gain or (loss) from Forms 4684, 6781, and 8824	11	
12 Net long-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1	12	
13 Capital gain distributions. See the instructions	13	
14 Long-term capital loss carryover. Enter the amount, if any, from line 13 of your **Capital Loss Carryover Worksheet** in the instructions	14	( )
15 **Net long-term capital gain or (loss).** Combine lines 8a through 14 in column (h). Then go to Part III on the back	15	$0

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 11338H **Schedule D (Form 1040)**

Form **982**
(Rev. July 20XX)
Department of the Treasury
Internal Revenue Service

Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)

► **Attach this form to your income tax return.**
► **Information about Form 982 and its instructions is at *www.irs.gov/form982*.**

OMB No. 1545-0046
Attachment Sequence No. **94**

Name shown on return: **FRANK LINCOLN**
Identifying number: **XXX-XX-XXXX**

Part I **General Information** (see instructions)

1 Amount excluded is due to (check applicable box(es)):
- a Discharge of indebtedness in a title 11 case ☐
- b Discharge of indebtedness to the extent insolvent (not in a title 11 case) ☐
- c Discharge of qualified farm indebtedness ☐
- d Discharge of qualified real property business indebtedness ☐
- e Discharge of qualified principal residence indebtedness ☒

2 Total amount of discharged indebtedness excluded from gross income 2 **$70,000**

3 Do you elect to treat all real property described in section 1221(a)(1), relating to property held for sale to customers in the ordinary course of a trade or business, as if it were depreciable property? ☐ Yes ☐ No

Part II **Reduction of Tax Attributes.** You must attach a description of the transactions in the reduction in

Case Study Alternative – Mortgage Workout

If Frank had been able to negotiate a workout with his mortgage lender (reducing the amount he owed on the mortgage and staying in the home), he would not have completed Form 8949 and Schedule D because he had not disposed of the asset.

Assume Frank's lender agreed to reduce his mortgage debt from $195,000 to $175,000. The lender issued Frank a Form 1099-C showing $20,000 of canceled debt. Frank's Form 982 would be completed, but the amount of debt forgiven (or his basis in the home, whichever was smaller) would need to be entered on the form, and his basis in the home would be decreased by that amount.

Form 1099-C & Form 982:

☐ CORRECTED (if checked)

CREDITOR'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no.
FIRST BANK
ANYWHERE USA

1 Date of identifiable event: **6/25/20XX**
2 Amount of debt discharged: **$ 20,000.00**
3 Interest if included in box 2: $

OMB No. 1545-1424
20**XX**
Form **1099-C**

Cancellation of Debt

CREDITOR'S federal identification number: **XX-XXXXXXX**
DEBTOR'S identification number: **XXX-XX-XXXX**

DEBTOR'S name
FRANK LINCOLN

Street address (including apt. no.)
ANYWHERE
City or town, state or province, country, and ZIP or foreign postal code
CITY, STATE ZIP USA

4 Debt description
HOME MORTGAGE LOAN
1111 ANYWHERE STREET
ANYWHERE TOWN, STATE ZIP

5 If checked, the debtor was personally liable for repayment of the debt ▶ ☒

Account number (see instructions)
1234567

6 Identifiable event code

7 Fair market value of property
$

Copy B
For Debtor
This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if taxable income results from this transaction and the IRS determines that it has not been reported.

Form **1099-C** (keep for your records) www.irs.gov/form1099c Department of the Treasury - Internal Revenue Service

Form **982**
(Rev. July 20XX)
Department of the Treasury
Internal Revenue Service

Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)

► Attach this form to your income tax return.
► Information about Form 982 and its instructions is at *www.irs.gov/form982*.

OMB No. 1545-0046

Attachment Sequence No. **94**

Name shown on return: **FRANK LINCOLN**

Identifying number: **XXX-XX-XXXX**

Part I **General Information** (see instructions)

1 Amount excluded is due to (check applicable box(es)):
- a Discharge of indebtedness in a title 11 case . . . ☐
- b Discharge of indebtedness to the extent insolvent (not in a title 11 case) . . . ☐
- c Discharge of qualified farm indebtedness . . . ☐
- d Discharge of qualified real property business indebtedness . . . ☐
- e Discharge of qualified principal residence indebtedness . . . ☒

2 Total amount of discharged indebtedness excluded from gross income . . . 2 **$20,000**

3 Do you elect to treat all real property described in section 1221(a)(1), relating to property held for sale to customers in the ordinary course of a trade or business, as if it were depreciable property? . . . ☐ Yes ☐ No

Part II **Reduction of Tax Attributes.** You must attach a description of any transactions resulting in the reduction in basis under section 1017. See Regulations section 1.1017-1 for basis reduction ordering rules, and, if applicable, required partnership consent statements. (For additional information, see the instructions for Part II.)

Enter amount excluded from gross income:

4	For a discharge of qualified real property business indebtedness applied to reduce the basis of depreciable real property	4	
5	That you elect under section 108(b)(5) to apply first to reduce the basis (under section 1017) of depreciable property	5	
6	Applied to reduce any net operating loss that occurred in the tax year of the discharge or carried over to the tax year of the discharge	6	
7	Applied to reduce any general business credit carryover to or from the tax year of the discharge	7	
8	Applied to reduce any minimum tax credit as of the beginning of the tax year immediately after the tax year of the discharge	8	
9	Applied to reduce any net capital loss for the tax year of the discharge, including any capital loss carryovers to the tax year of the discharge	9	
10a	Applied to reduce the basis of nondepreciable and depreciable property if not reduced on line 5. *DO NOT use in the case of discharge of qualified farm indebtedness*	10a	
b	Applied to reduce the basis of your principal residence. *Enter amount here ONLY if line 1e is checked*	10b	**$20,000**
11	For a discharge of qualified farm indebtedness applied to reduce the basis of:		
a	Depreciable property used or held for use in a trade or business or for the production of income if not reduced on line 5		

EXERCISES (continued)

Question 3: A volunteer with Advanced certification is working with Robert. Following up to a "yes" answer on the Intake & Interview Sheet, the volunteer asks Robert if he underwent foreclosure or had to give up his home during the tax year. Robert confirmed that he did, and produced Form 1099-A. The volunteer asked Robert if he had received Form 1099-C, and Robert replied that he did not. Examining the form, the volunteer noted the balance of principal outstanding was $234,000. What should the volunteer do next?

a. Ask the questions on Publication 4731-A

b. Ask enough probing questions to determine if Robert had a gain or loss on the foreclosure

c. Refer Robert to a professional tax preparer

d. Complete Form 982

Question 4: Mary purchased her main home in June 2004 for $175,000. She lost her job and was no longer able to make her mortgage payments during the current year. In July of the current tax year, Mary moved out of the home to live with relatives. On July 15, the bank foreclosed on the home. On November 15, the bank discontinued its collection activity and canceled the remaining debt. The fair market value at the time of foreclosure was $100,000 because of the poor housing market, but Mary still owed $150,000 on the mortgage. None of the loan proceeds were used for any purpose other than to buy, build, or substantially improve the principal residence. Mary never used the home for business or rental purposes and has not filed for bankruptcy. Based on this information, what should the volunteer do?

a. Refer Mary to another source for tax return preparation

b. Report a loss of $50,000 on Schedule D

c. Report $50,000 debt canceled on Form 982

d. Include the debt cancellation amount in income

Question 5: After Tom became ill and could not work full time, he and his wife, Grace, were having difficulty making their mortgage payments. Rather than go through the expense of a foreclosure, the lender agreed to reduce the principal on their loan and refinance it with a better interest rate and lower payments. The principal balance before November 1 of the current tax year workout was $130,000, and the lender reduced the loan to $110,000. None of the loan proceeds were used for any purpose other than to buy, build, or substantially improve the principal residence. The home has never been used for business or as rental property, and the taxpayers have not filed for bankruptcy.

Based on this information, what should the volunteer do?

a. Refer Tom and Grace to another source for tax return preparation

b. Report the reduction in the basis of the home on line 10b of Form 982

c. Report the $20,000 as a loss on Schedule D

d. Include the debt cancellation amount in income

Question 6: Gene bought his home in 2003. His basis in the home was $210,000. He lost his job in January of the current tax year and was not able to make the mortgage payments. The bank foreclosed in August and Gene moved out. At the time of the foreclosure, the fair market value was $145,000 and the principal balance of the mortgage was $185,000. All of the debt was incurred to purchase the home, it was never used for business or as a rental property, and Gene has not filed for bankruptcy. Gene has a Form 1099-C. Gene is personally liable for repayment of the debt.

How should the foreclosure and loss be reported?

a. Report the $40,000 debt cancellation on Form 982, line 10b

b. Report the $40,000 debt cancellation on Form 982, line 2, only

c. Report the $40,000 debt cancellation on Form 982, line 2, and the foreclosure on Form 8949 and Schedule D

d. Report the $40,000 debt cancellation on Form 1040

Summary

This lesson included the following temporary changes. Refer to the retirement income lesson for deferred Coronavirus-related distributions. Changes to the premium tax credit are discussed later in the Premium Tax Credit lesson.

Student loan forgiveness and Higher Education Emergency Financial Grants

Both of these provisions represent nontaxable income to the recipient. Further, the recipient's qualified education expenses are not reduced and can be fully used for an education credit or other benefit, if otherwise eligible.

Business expenses paid to restaurants

Allows self-employed individuals who incur business meal expenses paid to a restaurant to claim 100% of such cost instead of the normal 50%.

Itemized Deductions

If extended, taxpayers may be able to deduct qualified mortgage insurance premiums.

Nonbusiness Energy Property Credit

If extended, taxpayers who make certain energy-efficient improvements to their main home may be eligible for this credit (Form 5695, Part II). The limit for this credit is $500 total for all tax years after 2005.

Cancellation of Debt (COD – Principal Residence

Cancellation of debt can be complex. VITA/TCE volunteers may assist a taxpayer with issues related to cancellation of debt as long as the taxpayer meets all the criteria for discharge of qualified principal residence indebtedness.

Taxpayers who go through a foreclosure or abandonment of their principal residence receive Form 1099-A, Acquisition or Abandonment of Secured Property. Form 1099-A will have information needed to determine the gain or loss due to the foreclosure or abandonment.

If the debt on the principal residence is canceled, the taxpayer will receive Form 1099-C, Cancellation of Debt. If foreclosure/abandonment and debt cancellation occur in the same calendar year, the lender may issue only Form 1099-C, including the information that would be reported on Form 1099-A.

What situations are out of scope for the VITA/TCE programs?

The following are out of scope for this lesson. While this list may not be all inclusive, it is provided for your awareness only.

- Residential clean energy credit (Form 5695, Part I) and qualified electric vehicle credits (Form 8834)
- Cancellation of debt on a residence other than a qualified principal residence
- Cancellation of debt for a principal residence that was used in a business or as rental property

- Cancellation of debt when Form 1099-C includes an amount for interest
- Cancellation of debt was because the taxpayer filed bankruptcy or was insolvent immediately before the debt was canceled

EXERCISE Answers

Answer 1: b, No. Because Angie used part of the home as rental property, all the canceled debt may not qualify to be excluded from income. The rules involving mortgage debt exclusions are complex. Angie should be referred to a professional tax preparer.

Answer 2: b, No. Fred's situation is outside the scope of the volunteer program since a portion of his refinanced debt was used for purposes other than to buy, build, or substantially improve his principal residence. Fred should be referred to a professional tax preparer, per the guidance in Publication 4731-A.

Answer 3: a. The volunteer should use Publication 4731-A, Part I to determine if Robert had a gain or loss on the foreclosure. If the taxpayer receives a Form 1099-C, the volunteer would use the screening sheet to determine if the related tax issues are within scope.

Answer 4: c. The volunteer would need to complete Form 8949, Schedule D, and Form 982. Although there is a loss, it cannot be deducted. The mortgage debt cancellation is not included in income on the tax return because it is covered by the qualified principal residence indebtedness exclusion on Form 982.

Answer 5: b. The volunteer would complete Form 982 and report the reduction in the basis of the home. The $20,000 in debt cancellation can be excluded as qualified principal residence indebtedness on Form 982 and is not counted as income on the tax return. Form 8949 and Schedule D are not required because Tom and Grace did not dispose of the home.

Answer 6: c. Form 982, Form 8949, and Schedule D should be completed. When a residence that is security for a mortgage is abandoned or foreclosed upon, it is treated as having been sold. This results in the foreclosure being reported on Form 8949 and Schedule D as sale of home. Failure to file Form 8949 and Schedule D may result in an IRS notice to the taxpayer.

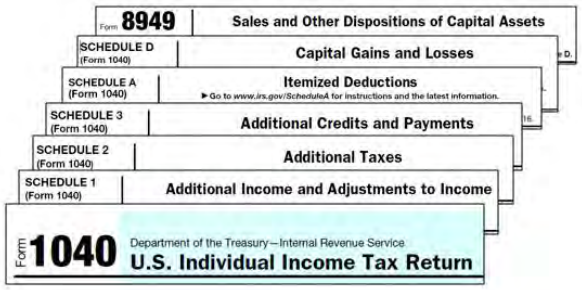
Introduction to Federal Income Tax Law

Our federal tax laws can be generally summarized to say:

All income is taxable – unless there is a provision to say it is not

No deduction or credit is allowable – unless there is a provision for it

The IRS provides tax forms that enable taxpayers to comply with our federal tax laws. These forms are generally arranged as a main summary form with additional forms as necessary to provide details or to make a calculation. The main form for individuals is Form 1040 (or Form 1040-SR for seniors) and is structured to capture income, deductions and tax credits to arrive at their total tax liability.



Income tax is imposed on **taxable income** computed as:

	Gross Income
Minus	Adjustments (also known as above-the-line deductions)
Equals	Adjusted Gross Income ("AGI")
Minus	Deductions
Equals	**Taxable Income**

The tax rates used to compute the tax depend on the filing status claimed by the taxpayer, which may depend on whether the taxpayer can claim a dependent or other individual for a more favorable filing status. These statuses are discussed in the Filing Status lesson. Other taxes may apply, depending on the taxpayer's specific facts.

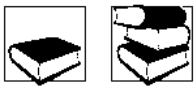
Income tax credits can reduce the amount of tax due or even result in a net refund. Total taxes minus credits is the net tax liability.

Taxpayers must generally prepay their net tax liability throughout the year through withholding tax or making estimated tax payments. If there is a balance remaining after prepayments, it must be paid on time to avoid penalties and interest. If there is an overpayment, the taxpayer will receive a refund or can apply some or all of the overpayment to their next year's taxes.

The IRS provides the VITA/TCE Programs with tax software to complete individual income tax returns. That software greatly simplifies the preparation of an accurate return and prevents mathematical errors. The software is also used to electronically transmit returns (e-file) to avoid having to mail paper returns.

This training guide covers all the items of income, deduction, additional tax, or credit that are in scope for the VITA/TCE Programs. Staying within the scope of the program is critical and cannot be overemphasized.

Filing Basics



Introduction

This lesson will help you determine which taxpayers must or should file a tax return. You will also find information on how to verify a taxpayer's identity, which form to use, and completing the Basic Information Section.

Objectives

At the end of this lesson, using your reference materials, you will be able to:

- Determine who *must* file a tax return
- Determine who *should* file a tax return
- Verify the taxpayer's identity
- Determine how to file the return

What do I need?

- Form 13614-C
- Publication 4012
- Publication 17

Optional:

- Publication 559
- Form 1040 Instructions
- Publication 4299

Who must file?

U.S. citizens or residents of the United States must file a return based on three factors. There are special rules for dependents, surviving spouses, U.S. citizens and residents living outside the U.S., residents of Puerto Rico, and individuals with income from U.S. possessions.

Remember to use the interview techniques and tools when determining who must file.

What do I need to know?

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

- Age
- Gross income
- Filing status

Where do I get information on the taxpayer's age?

Look at the intake and interview sheet for the taxpayer's date of birth. Confirm this date during the interview. Refer to the sample Intake/Interview & Quality Review sheet in the Volunteer Resource Guide, Tab B, Starting a Return and Filing Status.

Where do I get information on the taxpayer's gross income?

An approximation of gross income is enough to see if a taxpayer must file a return. Gross income is **all** the income the taxpayer received during the tax year in the form of money, goods, property, and services that is not exempt from tax. It includes both earned and unearned income.

The Income section of the Volunteer Resource Guide lists the sources of income that should be included and excluded in determining a person's gross income. You can also refer to the Income lessons in this training guide.

To approximate gross income:

- Add the amounts from all the taxpayer's Form(s) W-2, Box 1
- Add taxable amounts reported on any Form(s) 1099
- Using the intake and interview sheet, review the income questions with the taxpayer to see if there was any additional income not reported on Form W-2 or Form 1099 and determine each amount

Total the above amounts to determine the taxpayer's approximate gross income.

Do not include Social Security benefits when determining filing requirement unless the taxpayers are married, are filing a separate return, and lived with their spouse at any time during the tax year.

Where do I get information on the taxpayer's filing status?

Taxpayers may or may not know which filing status to use. For the purposes of determining whether a person must file a return, narrowing the choices down to the most likely filing status(es) is adequate in most cases.

Check the Taxpayer Information section of the intake and interview sheet for:

- The taxpayer's marital status
- Whether the taxpayer can be claimed as a dependent on someone else's tax return
- The taxpayer's potential dependents

Use the Volunteer Resource Guide's Determination of Filing Status decision tree and the Interview Tips in Tab B, Starting a Return and Filing Status, for helpful probing questions.

Who is legally required to file a federal tax return?

To determine whether a taxpayer is legally required to file a return, start with the Volunteer Resource Guide, Tab A, Who Must File. Use the charts to review the examples.

Lucy is 36 years old and single, and her gross income is $20,000. She must file a tax return since her income exceeds the amount for her age and filing status.

Henrietta and Javier are married and plan to file a joint return. Henrietta is 67 and had a gross income of $11,000 for the tax year. Javier is 66. His gross income was $5,000 for the year. Since their combined gross income is less than the minimum amount for their ages and filing status, they do not have to file a return.

What are special situations that require a taxpayer to file?

If the Who Must File charts show that an individual is not required to file a return, then continue to Chart C – Other Situations When You Must File in the Volunteer Resource Guide to see if any of the special conditions require the person to file.

The most common special situations when individuals are legally required to file a return are:

- Self-employed with net earnings of $400 or more
- Taxpayers who owe special taxes
- Taxpayers who received advanced payments of the premium tax credit (APTC) for themselves, their spouse, or a dependent

Taxpayers who received the 2008 first-time homebuyer credit are required to file a return to repay a portion of the credit.

EXERCISES

Refer to the Who Must File section of the Volunteer Resource Guide to answer these questions. Answers are at the end of the lesson summary.

Question 1: Bob is 27 years old and single. His gross income was $17,000 during the tax year. Based only on this information, is he required to file a tax return?

a. Yes

b. No

Question 2: Janet and Harry are married, file jointly, and lived together all year. During the tax year, she turned 66 and he turned 64. Their gross income was $19,800. Based only on this information, are they required to file a tax return?

a. Yes

b. No

Question 3: Juanita has a dependent child and can file as a Qualifying Surviving Spouse. She is 47 years old. Her gross income was $27,000. Based only on this information, is she required to file a tax return?

a. Yes

b. No

Who should file?

Even if individuals are not required to file a tax return, they should file a return if they qualify for certain credits or a refund. These items are listed in the Volunteer Resource Guide, Tab A, Who Must File.

Individuals *should* file a return if they are eligible to claim:

- A refund of withheld taxes
- The earned income credit (EIC)
- The additional child tax credit
- Premium tax credit
- The American opportunity credit

Tax-Aide only:
• Zero-AGI returns: To assist in identifying and preventing tax identity theft, Tax-Aide recommends that all taxpayers e-file. Because -0- AGI returns cannot be e-filed, enter $1 as other income. Describe as "IN ORDER TO E-FILE."

Taxpayers who should file may be entitled to a refundable tax credit, and filing a return is the only way to get it. Individuals who are not required to file a federal return may be able to identify or deter tax identity theft by filing a federal return or may benefit by filing for state purposes.

A nonrefundable credit is a dollar-for-dollar reduction of the tax liability. A nonrefundable credit can only reduce the tax liability to zero. A refundable credit can zero out the tax liability and result in a cash refund to the taxpayer.

How do I find out if a taxpayer is eligible to claim a refund or refundable credit?

The taxpayer may qualify for a tax refund, earned income credit, additional child tax credit, premium tax credit, or American opportunity credit if:

- Federal or state income tax was withheld on any income form
- The taxpayer had earned income
- The taxpayer has a qualifying child

- The taxpayer or their dependent paid higher education expenses
- The taxpayer made estimated tax payments
- The taxpayer purchased health coverage through the marketplace

The earned income credit may apply with or without a child. See the Earned Income Credit and Child Tax Credit lessons for details on determining eligibility.

If a taxpayer is not required to file a tax return, and you are uncertain if they will benefit from filing, begin a return to determine if filing a tax return would benefit the taxpayer. Again, filing a return may help identify or deter tax identity theft.

How do I verify taxpayer identity?

As the first step in the interview process, you should verify the identity of the taxpayer(s), address, and the spelling of names entered on the taxpayer's intake and interview sheet.

What documents do I use to verify identity?

Ask to see original photo identification such as:

- Valid driver's license (U.S.)
- Visa
- State ID (U.S.)
- Military ID
- Passport
- National ID
- Employer ID
- School ID

Judgment should be used in accepting any other valid form of identification. For example, the Coordinator can allow proof of identity of an elderly person with a disability who has an expired driver's license and passport but also provides a valid birth certificate. IRS-tax-law certified volunteers preparing tax returns are required to confirm the identity of the taxpayer to avoid identity theft, tax fraud, and to validate the correct name and Social Security number. If a taxpayer cannot prove their identity, or if the volunteer is uncomfortable accepting the items presented as proof of identity, the taxpayer should be advised to return with an acceptable form of identification.

Exceptions to requiring photo ID should only be made under extreme circumstances and should be approved by the Coordinator. For example, there may be limited situations where an exception may apply to a person with a disability, the elderly, or other unique circumstances. Additionally, the Coordinator has discretion to approve exceptions to verification of taxpayer identity rules. Refer to Publication 4299, Privacy, Confidentiality and Civil Rights for additional information.

A spouse who is Married Filing Separately is not required to provide the Social Security card for the other spouse, although the return cannot be e-filed without the spouse's Social Security number.

In addition to photo identification for taxpayers, they must also present proof of taxpayer identification numbers (TIN) for themselves and all persons listed on their tax return. (TIN is explained in next section.) Exceptions to this rule should be rare and only the Coordinator has discretion to approve an exception.

Taxpayers who **cannot** prove their identity should seek professional tax assistance.

What about taxpayers filing for decedents?

If you are assisting someone who is filing a return for a decedent:

- Be aware that volunteers need to take steps to protect a taxpayer's identity and avoid possible identity theft.
- Ask to see the surviving spouse's identification or a copy of the death certificate.
- A personal representative may be filing the return for the deceased taxpayer. Verify the identity of the person who is filing for the decedent and ask if they have court documents or other documentation authorizing them to file the tax return.
- Representatives or surviving spouses who do not have the necessary documentation with them should be advised to return once they have the information. If they cannot provide the information, refer them to a professional tax preparer.

For additional information about filing a return for a decedent, refer to the Return Signature in the Volunteer Resource Guide, Tab K, Finishing the Return, Form 1040 Instructions, Form 1310, Publication 17, or Publication 559.

What are Taxpayer Identification Numbers?

IRS regulations require that each person listed on a U.S. federal income tax return have a valid Taxpayer Identification Number (TIN). The types of TINs are:

- Social Security Number (SSN)
- Individual Taxpayer Identification Number (ITIN)
- Adoption Taxpayer Identification Number (ATIN)

Who has a Social Security number?

Any individual who is legally eligible for employment in the United States must have a Social Security number.

Some Canadians have both U.S. and Canadian Social Security numbers. Never use the Canadian number on a U.S. tax return.

Who has an Individual Taxpayer Identification Number?

Some individuals who need to file tax returns do not have SSNs. The IRS issues ITINs to nonresidents and others living in the U.S. who are required to have a U.S. TIN but who are not eligible to obtain SSNs.

The ITIN contains nine digits and is formatted like an SSN (XXX-XX-XXXX), but begins with the number 9 and has a specified range of numbers in the fourth and fifth digits. Generally, you should enter the ITIN on the return wherever the SSN is requested.

Under the Protecting Americans from Tax Hikes (PATH) Act, ITINs that have not been used on a federal tax return at least once in the last three consecutive years will expire at the end of the year. Affected taxpayers who expect to file a tax return for 2022 must submit a renewal application.

Taxpayers with an ITIN are able to file their returns but are not eligible for certain tax credits, such as the earned income credit. This is covered in later lessons.

Who has an Adoption Taxpayer Identification Number?

Taxpayers who are in the process of adopting a child and who are able to claim the child as their dependent or are able to claim the child and dependent care credit need an ATIN for their adoptive child.

The IRS issues an ATIN for the child while a final domestic adoption is pending, and the adopting taxpayers do not have the child's SSN.

Like an ITIN, the nine-digit ATIN begins with the number 9. Generally, you should enter the ATIN on the return wherever the child's Social Security number is requested.

Taxpayers who cannot obtain an SSN must apply for an ITIN if they file a U.S. tax return or are listed on a tax return as a spouse or dependent. These taxpayers must file Form W-7, Application for Individual Taxpayer Identification Number and supply documentation that will establish foreign status and true identity. A federal tax return must be associated with all Form W-7 applications with exceptions as noted in the Form W-7 Instructions.

Taxpayer, spouse, or dependent name and Social Security number mismatches are some of the most frequent errors in processing a tax return.

What are acceptable documents if the taxpayer does not have a Social Security card?

For individuals who do not bring their original or a copy of their Social Security card, you may accept either of the following:

- An SSA letter or a Form SSA-1099 statement
- An ITIN card or letter

Driver's licenses and passports are not acceptable substitutes for Social Security or ITIN cards.

What if the taxpayer does not have an SSN or ITIN?

For individuals without a valid SSN, explain that they must have a taxpayer identification number before you can assist them. Direct them to the Social Security Administration and advise them to complete Form SS-5, Social Security Number Application. If the individual is not eligible for an SSN, refer them to the IRS for Form W-7, Application for IRS Individual Taxpayer Identification Number.

For a taxpayer who cannot obtain an SSN and has not yet applied for an ITIN, you can use a temporary identification number to prepare the return in the tax software. Turn to the Volunteer Resource Guide, Tab L, Resident/NR Alien.

When preparing a tax return for an ITIN application, include all Forms W-2, even if the SSN on the W-2 does not belong to the taxpayer. Do not change any information on the W-2. Send it in with the return as it is. Since it is not going to be transmitted electronically, it does not matter if the SSN does not match in the software.

Attach the tax return behind Form W-7 along with documentation that will establish foreign status and true identity and have the taxpayer submit the application package according to the Form W-7 instructions.

- If it is not available at the volunteer site, the taxpayer can obtain Form W-7 by calling the IRS at 1-800-829-3676 (1-800-TAX FORM) or download it at **https://www.irs.gov/pub/irs-pdf/fw7.pdf**

- If taxpayers need assistance in completing Form W-7, refer them to an IRS Taxpayer Assistance Center unless a volunteer at that site has been trained in the completion of Form W-7 or a Certifying Acceptance Agent (CAA) is available. A list of VITA sites that offer CAA services is located at **www.irs.gov/individuals/vita-sites-that-offer-caa-services**. Alternatively, refer the taxpayer to a professional tax preparer.
- An ITIN will expire for any taxpayer who fails to file a federal income tax return for three consecutive tax years. Any ITIN will remain in effect as long as a taxpayer continues to file U.S. tax returns. This includes ITINs issued after Jan. 1, 2013. These taxpayers will no longer face mandatory expiration of their ITINs and the need to reapply. A taxpayer whose ITIN has been deactivated and needs to file a tax return can reapply using Form W-7.

When preparing a return to include with a Form W-7 application, refer to the instructions in the Volunteer Resource Guide, Tab L, Resident/NR Alien.

EXERCISES (continued)

Question 4: It is your responsibility as a volunteer tax preparer to enter each Social Security number correctly on the tax return.

a. True

b. False

How do I choose the appropriate schedules to include with the tax return?

Form 1040 allows many taxpayers to file a short, simple form. Form 1040-SR, U.S. Income Tax Return for Seniors, is also available. It may be used by taxpayers who are age 65 or older at the end of the tax year. Schedules 1 through 3 have been created for instances where additional information needs to be carried over to the face of Form 1040/1040-SR.

The schedules are as follows:

- Schedule 1: Additional Income and Adjustments to Income
- Schedule 2: Additional Taxes
- Schedule 3: Additional Credits and Payments

How do I file a return?

Detailed instructions for completing and filing the return are covered in the Volunteer Resource Guide.

A return can be filed electronically using IRS e-file or by sending in a paper return. The due date for filing a return for most taxpayers is April 15, unless it falls on a Saturday, Sunday, or legal holiday.

What is electronic filing?

IRS e-file is a quick, easy, and more accurate alternative to paper returns. With e-filing, taxpayers receive their refund in half the usual time, and even faster with direct deposit.

How do I answer taxpayers' general non-tax questions?

The Volunteer Resource Guide, Publication 17, Form 1040 Instructions, and IRS.gov contain answers to many general non-tax questions asked by taxpayers during the interview process.

Questions such as "How can I get a copy of my prior year's return" or "How can I get an IRS form or publication" can be answered by researching your reference materials.

Turn to the "Frequent Taxpayer Inquiries" located in the Volunteer Resource Guide, Tab P, Partner Resources, and review this helpful information. For a list of helpful phone numbers, refer to "Information for Volunteers," located on the back of the Volunteer Resource Guide.

Review the index in the back of Publication 17 and locate answers to taxpayers' questions that are not answered in the Volunteer Resource Guide.

EXERCISES (continued)

Using your reference materials, answer the following question.

Question 5: A taxpayer wants to know about the Presidential Election Campaign Fund. Where can you find that information?

What potential pitfalls should I keep in mind?

To avoid any difficulties when preparing tax returns:

- Always treat the information used to prepare an individual's income tax return as confidential.
- Canadians have a number that is like a Social Security number, but it is for their Canadian old age pension. Do not use this number on a U.S. tax return. Canadians often have both a U.S. and a Canadian Social Security number.
- Be alert to the following possible indications of fraudulent activity:
  - A Form W-2 that is typed, handwritten, or has noticeable corrections
  - A Form W-2 that looks different from other Forms W-2 issued by the same company
  - A suspicious person accompanying the taxpayer and observed on other occasions
  - Multiple refunds directed to the same address or P.O. box
  - Employment or earnings, which are a basis for refundable credits, that are not well documented
  - Similar returns (e.g., same amount of refund, or same number of dependents, or same number of Forms W-2)
- Notify your site's coordinator if you suspect any fraudulent or unusual activity.

Summary

Who must file?

To determine whether an individual is required to file a federal tax return:

- Obtain the person's age
- Calculate the person's approximate gross income
- Determine the person's likely filing status
- Use the table and guidelines in the Volunteer Resource Guide, Who Must File section

How do I verify taxpayer identity?

An initial step in the interview process is to verify the identity of the taxpayer(s), the accuracy of each SSN or ITIN, and spelling of names with the appropriate documents.

Which tax forms are used?

Form 1040/1040-SR are used with Schedules 1 through 3.

Filing the Return

E-filing is the safest, fastest, and easiest way to file a tax return. With e-file, taxpayers can generally expect their refund in less than 21 calendar days after the receipt of their tax return.

No refund for an overpayment for a taxable year shall be made to a taxpayer before February 15 if the taxpayer claimed a refundable credit such as the earned income credit on the tax return.

What situations are out of scope for the VITA/TCE programs?

The following are out of scope for this lesson. While this list may not be all inclusive, it is provided for your awareness only.

- Taxpayers who may qualify for the for the repayment of previously taxed income
- Taxpayers who **cannot** prove their identity

EXERCISE Answers

Answer 1: a, Yes, Bob is required to file a return.

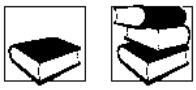
Answer 2: b, No, Janet and Harry are not required to file.

Answer 3: a, Yes, Juanita must file.

Answer 4: a, True. To prevent processing delays, check the accuracy of each Social Security number you enter on the return, as well as the spelling of the name associated with the number.

Answer 5: The Form 1040 Instructions provide an answer and the index in Publication 17 directs us to a paragraph in the chapter on Filing Information.

Filing Status



Introduction

This lesson will help you determine the most advantageous (and allowable) filing status for the taxpayer. Selecting and entering the correct filing status is a critical component of completing the taxpayer's return.

See Tab B, Starting a Return and Filing Status, in the Volunteer Resource Guide for filing status interview tips with helpful probing questions to use in your interview with the taxpayer.

Objective

At the end of this lesson, using your resource materials, you will be able to:

- Determine the most beneficial filing status allowed for the taxpayer.

What do I need?

- Form 13614-C
- Publication 4012
- Publication 17

Optional:

- Publication 501
- Publication 555
- Publication 971
- Form 1040
- Form 2120
- Form 8379

What are the five filing statuses?

Taxpayers must use one of five filing statuses. Filing status impacts the calculation of income tax, affects the amount of the standard deduction, and determines allowance or limitation of certain credits and deductions. The following list puts them in order from the most beneficial to the least beneficial to the taxpayer.

- Married Filing Jointly
- Qualifying Surviving Spouse
- Head of Household
- Single
- Married Filing Separately

Most nonresident aliens and dual status aliens have different filing requirements and may have to file Form 1040-NR. In this case, the return is Out of Scope. Refer the taxpayer to a site with Foreign Student certification.

Taxpayers may qualify for more than one filing status. Choose the filing status that results in the lowest tax for the taxpayer. Use the Volunteer Resource Guide to help determine the correct filing status.

Filing status is selected in the Basic Information section. Go to the Volunteer Resource Guide to review the software entries.

How does marital status affect filing status?

The first step in determining taxpayers' filing status is to confirm their marital status on *the last day of the tax year. Avoid using information from the prior year*, as it may have changed.

Generally, taxpayers are considered to be **unmarried** for the entire year if, on the last day of the tax year, they were:

- Unmarried.
- Legally separated from their spouse under a divorce or separate maintenance decree. State law governs whether taxpayers are married or legally separated under a divorce or separate maintenance decree.

Taxpayers are considered to be **married** for the entire year if:

- They were married on the last day of the tax year, **or**
- The spouse died during the year and the surviving spouse has not remarried

What are the requirements for each filing status?

Who is considered Single?

Taxpayers can use the Single filing status if, on the last day of the tax year, they were:

- Not married
- Legally separated or divorced, or
- Widowed before the beginning of the tax year and did not remarry

A marriage that has been legally annulled is treated as never having existed, even if it is annulled in a later year.

Can Single taxpayers qualify for another status?

Some single taxpayers qualify for Head of Household or for Qualifying Surviving Spouse status, which can mean a lower tax. These statuses will be discussed later in this lesson.

What is Married Filing Jointly?

Married taxpayers who choose to file a joint return will use one return to report their combined income and to deduct combined allowable expenses. Married taxpayers can select this status even if one of the spouses did not have any income or any deductions. The Married Filing Jointly status can be claimed by taxpayers who, on the last day of the tax year:

- Were married and lived together.
- Were married and living apart, but were not legally separated under a divorce or separate maintenance decree, (such as medical reasons or Military separation). State law governs whether taxpayers are married or legally separated under a divorce or separate maintenance decree.
- Were common law married pursuant to the laws of the state in which they live (or in the state where the common law marriage began) and the marriage has not been dissolved, such as by death or divorce.
- Are the surviving spouse who did not remarry before the end of the tax year (surviving taxpayer can file a joint return with the deceased spouse).

Taxpayers who file a joint return can't choose to file separate returns for that year after the due date of the return. See the Amended and Prior Years Returns lesson for an exception for executors.

A citizen or resident alien married to a nonresident alien may be able to choose from more than one filing status. More information can be found in the Unique Filing Situations lesson.

Filing a joint return for a common law marriage applies to the federal return only. Volunteers must check state or local laws before completing a state return. Volunteers are not responsible for determining whether a couple is in a common law marriage. If taxpayers are not certain, refer them to a professional tax preparer.

What are the responsibilities of each taxpayer on a joint return?

Both taxpayers must include all worldwide income on their joint return. They each may be held responsible for all the tax and for any interest or penalty due, even if all the income was earned by only one spouse. A subsequent divorce usually does not relieve either spouse of the liability associated with the joint return.

In some cases, a spouse may be relieved of joint liability. Information is available in Publication 971, Innocent Spouse Relief, however, this topic is beyond the scope of the VITA/TCE programs. Refer taxpayers in this situation to a professional tax preparer.

When a joint return is filed and only one spouse owes a past-due amount, the other spouse may be considered an injured spouse and able to claim their portion of a joint refund. This is discussed later in this lesson.

What is Married Filing Separately?

The Married Filing Separately status is for taxpayers who are married, and either:

- Choose to file separate returns, or
- Cannot agree to file a joint return

Taxpayers who file as Married Filing Separately each report their own income and deductions on separate returns. These rules do not apply in community property states. More information on community property is provided later in this lesson.

Taxpayers can change their filing status from a separate return to a joint return by filing an amended return using Form 1040-X. If an amended return is filed to change the filing status, you must file a paper return.

Can Married Filing Separately taxpayers qualify for another status?

Some married taxpayers may be considered unmarried even if they are not divorced or legally separated. Such taxpayers may be able to use the Head of Household filing status, which may result in a lower tax than Married Filing Separately. Refer to the topic “Can married taxpayers ever file as Head of Household?” in this lesson to see if the “considered unmarried” definition applies.

Why are taxes usually higher for Married Filing Separately?

Special rules apply to Married Filing Separately taxpayers, which generally result in a higher tax. For example, when filing separately:

- The tax rate is generally higher than on a joint return.
- Taxpayers cannot take the child and dependent care credit, education credits, and certain other benefits and credits.
- Some credits and deductions, such as the child tax credit and the retirement savings contributions credit, are reduced at income levels that are half those for a joint return.
- If a taxpayer is Married Filing Separately and the spouse itemizes deductions on their return, the taxpayer must itemize and cannot take the standard deduction.

For Married Filing Separately taxpayers, enter the spouse’s name and Social Security number or ITIN on the tax return. If the taxpayer does not know the spouse’s Social Security number, refer to the Volunteer Resource Guide, Tab B, Starting a Return and Filing Status, Entering Basic Information (continued). The return will need to be paper filed.

Whether or not a spouse is itemizing is only a concern for Married Filing Separately status. Married taxpayers qualified to file as Head of Household can take the standard deduction even if their spouse is itemizing.

For the complete list of special rules, see Publication 17, Filing Status.

Are there special rules for taxpayers who live in community property states?

The income of taxpayers who lived in Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, or Wisconsin during the tax year and who choose to file separate returns may be considered separate income or community income for tax purposes. The states of Tennessee and South Dakota have passed elective Community Property Laws. Each state has its own community property laws, which may affect the amount of tax owed by taxpayers. See Publication 555, Community Property, for more information.

If your tax assistance program views community property tax laws for taxpayers who are Married Filing Separately or who are filing as Head of Household because they can be considered unmarried for income tax filing purposes as beyond the scope of the program, refer such taxpayers to a professional tax preparer.

If the taxpayer is in one of the community property states and is married and files a separate return from the spouse, Form 8958, Allocation of Tax Amounts Between Certain Individuals in Community Property States, must be completed in order to e-file the return. See the instructions for Form 8958 for details on completing the form.

If filing jointly generally results in the lowest total tax, why would married taxpayers want to file separately?

Married taxpayers sometimes choose to file separate returns when one spouse does not want to be responsible for the other spouse's tax obligations, or because filing separately may result in a lower total tax. For example, if one spouse has high medical expenses, separate returns may result in lower total taxes because a lower adjusted gross income allows more expenses to be deducted.

Another common reason taxpayers file as Married Filing Separately is to avoid an offset of their refund against their spouse's outstanding debts. This includes past due child support, past due student loans, or a tax liability the spouse incurred before they were married. If married taxpayers want to file separately, and a potential refund offset is the reason, suggest that they file a joint return with Form 8379, Injured Spouse Allocation or, after having filed separately, they can later amend and elect to file a joint return.

Who is considered to be an injured spouse?

When a joint return is filed and only one spouse owes a past-due amount, the other spouse can be considered an injured spouse. Injured spouses may file Form 8379 to receive their share of the refund shown on the joint return. The injured spouse:

1. Must not be legally obligated to pay the past-due amount, *and*
2. Must have made and reported tax payments (such as federal income tax withheld from wages or estimated tax payments), or claimed a refundable tax credit (see the credits listed in Publication 17 under Who Should File?).

Both of these conditions must apply unless the injured spouse lived in a community property state at any time during the tax year. In community property states, the injured spouse must meet only the first condition. If the taxpayer meets these requirements, Form 8379 can be e-filed with the joint return. See the Instructions for Form 8379 for details on how to complete the form.

Taxpayers may not realize the cost of filing separately when Form 8379 could be used instead. Emphasizing the loss of credits, such as the earned income or education credits, may be helpful.

If a taxpayer already filed a joint return and the refund was offset, Form 8379 can be filed by itself. When filed after the offset, it can take up to eight weeks for the taxpayer to receive a refund. Do not attach the previously filed tax return, but *do* include copies of all Forms W-2 and W-2G for both spouses and any Forms 1099 that show income tax withheld. The processing of Form 8379 may be delayed if these forms are not attached. A separate Form 8379 must be filed for each tax year to be considered.

An injured spouse claim is different from an innocent spouse relief request. Form 8379 allows an injured spouse to request the division of the tax overpayment attributed to each spouse. An innocent spouse uses Form 8857, Request for Innocent Spouse Relief, to request relief from joint liability for tax, interest, and penalties on a joint return for items of the other spouse (or former spouse) that were incorrectly reported on the joint return. For information on innocent spouses, see Publication 17, Innocent Spouse Relief and Relief from Joint Responsibility. Form 8858 is out of scope for the VITA/TCE programs.

What if a spouse died during the tax year?

Remember, taxpayers whose spouses died during the tax year are considered married for the entire year, provided they did not remarry. The surviving spouse is eligible to file as Married Filing Jointly or Married Filing Separately.

Surviving spouses who have remarried must file with the new spouse, either jointly or separately. The deceased spouse's filing status becomes Married Filing Separately.

Surviving spouses who have an eligible child may be able to use the Qualifying Surviving Spouse status in the two tax years following the year of the spouse's death. This is discussed later in this lesson.

Who is Head of Household?

Taxpayers may qualify for the Head of Household filing status, if they:

- Are unmarried or "considered unmarried" on the last day of the tax year, and
- Paid more than half the cost of keeping up a home for the required period of time, and
- Had a qualifying person living in their home for more than half the year (except for temporary absences, such as school)

A qualifying person who is the taxpayer's dependent parent does not have to live with the taxpayer. However, the parent(s) must qualify as the taxpayer's dependent(s) for the taxpayer to qualify as Head of Household without using the multiple support provision (Form 2120, Multiple Support Declaration). For more information, review the Volunteer Resource Guide, Tab B, Starting a Return and Filing Status, Who is a qualifying person for Head of Household status?

For a married taxpayer to be "considered unmarried," there are special rules, discussed later in this topic.

What are the costs of keeping up a home?

The costs of keeping up a home include expenses such as rent, mortgage interest, real estate taxes, insurance on the home, repairs, utilities, and food eaten in the home. Under proposed regulations, a taxpayer may treat a home's fair market rental value as a cost of maintaining a household instead of the sum of payments for mortgage interest, property taxes, and insurance. See Publication 17, Filing Status, Keeping Up a Home, for more information.

What is the required period of time?

If a new household is established during the taxpayer's taxable year (for example, if spouses separate and one moves out of the family home with the child), the cost of maintaining the new household for the year is the cost of maintaining that household beginning with the date the new household is established. If one spouse and the child remain in the family home and the other parent moves out of the home, the cost of maintaining the household for the year is the cost of maintaining the household beginning with the date the other spouse moves out.

What about a shared residence?

If two or more taxpayers not filing a joint return reside in the same living quarters, each taxpayer may be treated as maintaining a separate household if each provides more than one-half of the cost of maintaining the separate household. For this purpose, two households in the same living quarters are not considered separate households if any individual in one household is the spouse of any individual in the other household, or if any individual in one household may claim, or would have priority under the tiebreaker rules to claim, any individual in the other household as a dependent.

Two sisters and their respective children reside in the same living quarters. Neither sister may claim the other sister as a dependent. Each sister pays more than one-half of the expenses for herself and her children, and each sister claims each of her own children as a dependent. Because neither sister may claim the other sister as a dependent, and because neither sister would have priority to claim any of the other sister's children as a qualifying child under the tiebreaker rules, each sister is treated as maintaining a separate household.

Grandparent, Parent, and Child live together and Child meets the definition of a qualifying child for both Parent and Grandparent. Both Parent and Grandparent pay their respective expenses, and both contribute to paying Child's expenses. Neither Parent nor Grandparent may claim the other as a dependent. Under the tiebreaker rules, Parent would have priority over Grandparent to claim Child as a qualifying child. Therefore, Grandparent may not be treated as maintaining a household for Grandparent and Child separate from the household of Parent. However, Parent may be treated as maintaining a household for Parent and Child separate from the household of Grandparent.

Source: proposed dependency regulations.

Who is a qualifying person for Head of Household status?

Turn to the chart, Who Is a Qualifying Person Qualifying You To File as Head of Household? in the Volunteer Resource Guide. A qualifying person for Head of Household is defined as:

- A qualifying child who is single (whether or not the child can be claimed as a dependent)
- A married child who can be claimed as a dependent
- A dependent parent
- A qualifying relative who lived with the taxpayer more than half the year, *and* is one of the relatives listed on the chart, *and* can be claimed as a dependent by the taxpayer

Sometimes no one provides more than half of the support of an individual. Instead, two or more persons, each of whom would be able to claim the individual as a dependent but for the support test, together provide more than half of the individual's support. When this happens, a person who individually provides more than 10% of the individual's support can claim the individual as a dependent by agreement (Form 2120). An individual who is claimed as a dependent only because of a multiple support agreement is not a qualifying person for Head of Household status.

A person may be a qualifying relative dependent, but not qualify the taxpayer for Head of Household filing status. For example, a companion or friend who lives with the taxpayer all year may be the taxpayer's dependent but not a qualifying person for Head of Household filing status.

Refer to the Volunteer Resource Guide, Tab B, Starting a Return and Filing Status, Who is a Qualifying Person Qualifying You To File as Head of Household? chart, when reviewing these examples. You will learn more about who can be claimed as a dependent in a later lesson.

Kate's unmarried 16-year-old daughter, Shelby, lived with her all year. Kate is single, provided all of Shelby's support, and paid all the costs of keeping up the home. Shelby is Kate's qualifying child dependent and is Kate's qualifying person for Head of Household filing status.

Michael provided all the costs of keeping up his home for the year. Michael's son Justin lived with him the entire year. Justin is 22 and was not a full-time student during the tax year, so he cannot be Michael's qualifying child. Although Justin only worked part-time, his income is greater than the gross income threshold amount for Michael to claim him as a qualifying relative dependent. Therefore, Michael cannot file Head of Household because he does not have a qualifying person.

Jane and Todd are not married. Their daughter, Amanda, lived all year with Jane in an apartment. Todd lived alone. Todd earns more than Jane, and provides for some of her living expenses. He paid over half the cost of Jane's rent and utilities. He also gave Jane extra money for groceries. Even though Todd paid over half the cost of providing a home for Jane and Amanda, he cannot file Head of Household because Amanda did not live with him over half the year. Jane cannot be Head of Household either because she did not provide more than half the cost of keeping up the home for her daughter.

Nancy is single and lives alone. Nancy's mother, Maxine, lives alone in another city. Maxine receives Social Security payments, but has no other income. Nancy pays all of the costs of keeping up the home her mother lives in, and provides over half her support. Even though Maxine did not live with her, Maxine is Nancy's qualifying person for Head of Household filing status because Nancy can claim her mother as a dependent under the rules for qualifying relative.

EXERCISES

Answers are after the lesson summary.

Question 1: Alexandra's younger brother, Sebastian, is seventeen years old. Sebastian lived with his grandparents for the first two months of the year. From March through July, he lived with Alexandra. On August 1, Sebastian moved in with some friends and stayed there for the rest of the year. Since Sebastian did not have a job, Alexandra gave him money every month. Assuming Alexandra had no other dependents, can she file as Head of Household?

a. Yes

b. No

Since her spouse died five years ago, Joan has lived with her friend, Mary Ann, who is also a widow. Joan is a U.S. citizen, is single, and lived with Mary Ann all year. Joan had no income and received all of her support from Mary Ann. Joan is Mary Ann's qualifying relative because she lived with Mary Ann all year as a member of her household. Mary Ann can claim Joan as a dependent on her return.

However, Joan is not a qualifying person for Head of Household filing status because she is not related to Mary Ann in one of the ways listed on the chart in the Volunteer Resource Guide. She is Mary Ann's qualifying relative dependent only because she lived with Mary Ann all year as a member of her household.

Notice that the relatives who qualify a person for Head of Household may not be the same individuals who could qualify as a taxpayer's dependent. One such situation is when the custodial parent releases the child's exemption to the noncustodial parent. The child remains the custodial parent's qualifying person for Head of Household status.

The qualifying person for Head of Household filing status must be related to the taxpayer.

What are the advantages of filing as Head of Household?

The Head of Household filing status provides a higher standard deduction and, generally, a lower tax rate than Single or Married Filing Separately.

Who can be "considered unmarried" for Head of Household?

Married taxpayers may be "considered unmarried" and file as Head of Household if they:

- File a return for the tax year separate from their spouse.
- Paid more than half the cost of keeping up their home. See the Worksheet for Cost of Keeping Up a Home in the Volunteer Resource Guide.
- Lived apart from their spouse during the entire last six months of the tax year. The spouse is considered to have lived in the home even if temporarily absent due to special circumstances, such as military service or education.
- Provided the main home for more than half the year of a *dependent* child, stepchild, or foster child placed by an authorized agency. This test is also met if the taxpayer cannot claim the exemption only because the noncustodial parent can claim the child using the rules described in Publication 17.

Denise is married but has lived apart from her spouse for two years. Denise pays all the costs of keeping up her home for herself and her dependent 12-year-old son, who lives with her. Denise can choose to file as Head of Household for the tax year because she meets the definition of "considered unmarried."

A taxpayer who is married to a nonresident alien spouse may be able to file as Head of Household even if the taxpayer lived with the spouse for the year. Review the Unique Filing Situations lesson for more information.

Who is a Qualifying Surviving Spouse?

Taxpayers who do not remarry in the year their spouse dies can file jointly with the deceased spouse. For the two years following the year of death, the surviving spouse may be able to use the Qualifying Surviving Spouse filing status. To qualify, the taxpayer must:

- Be entitled to file a joint return for the year the spouse died, regardless of whether the taxpayer actually filed a joint return that year.
- Have had a spouse who died in either of the two prior years. The taxpayer must not remarry before the end of the current tax year.
- Have a child, stepchild, or adopted child who qualifies as the taxpayer's dependent for the year or would qualify as the taxpayer's dependent except that he or she does not meet the gross income test, or does not meet the joint return test, or except that the taxpayer may be claimed as a dependent of another taxpayer.
- Live with this child in the taxpayer's home all year, except for temporary absences.
- Have paid more than half the cost of keeping up the home for the year.

A foster child does not qualify a taxpayer for the Qualifying Surviving Spouse filing status.

The standard deduction and tax tables are the same for Qualifying Surviving Spouse and Married Filing Jointly filing statuses. These are more favorable than those for Head of Household filing status.

Laura's spouse, Jim, died in September of the tax year. She has not remarried, and provides all the support for their dependent children, ages 8 and 10. Laura can file as Married Filing Jointly for this tax year. For the next two tax years, she can use the Qualifying Surviving Spouse status if she does not remarry.

How do I determine the correct filing status?

To determine the correct filing status, follow the Filing Status Interview Tips in the Volunteer Resource Guide, Tab B, Starting a Return and Filing Status. Be sure to complete the shaded dependent portion on the Intake/ Interview and Quality Review Sheet.

EXERCISES (continued)

Check your understanding of each filing status. Review the lesson and use the Filing Status Interview Tips in the Volunteer Resource Guide to determine the answer. Answers are after the lesson summary.

Question 2: Jane's husband moved out of their home in February of the tax year and has not returned. Jane provides all the cost of keeping up the home for herself and her two dependent children. Jane refuses to file a joint return with her husband. What filing status should she use?

a. Single

b. Married Filing Separately

c. Head of Household

d. Qualifying Surviving Spouse

Question 3: Seth lives alone and has never married. He does not support either of his parents. What filing status(es) can he use?

a. Single

b. Married Filing Jointly

c. Married Filing Separately

d. Head of Household

e. Qualifying Surviving Spouse

Question 4: Tanya's divorce became final in early September of the tax year. She has sole custody of her three children, who lived with her the entire year. The children are all under the age of 19. She provided more than half of the cost of keeping up the home. What filing status(es) can she use?

a. Single

b. Married Filing Jointly

c. Married Filing Separately

d. Head of Household

e. Qualifying Surviving Spouse

Question 5: Sydney's spouse died two years ago in January. He filed a joint return for that year as the surviving spouse. Since then, Sydney has not remarried, maintains a home for his young children who lived with him all year, and provides their sole support. Using the Filing Status Interview Tips in the Volunteer Resource Guide, determine what filing status Sydney should use?

a. Single

b. Married Filing Jointly

c. Married Filing Separately

d. Head of Household

e. Qualifying Surviving Spouse

Summary

This lesson covered the five filing statuses:

- Single
- Married Filing Jointly
- Married Filing Separately
- Head of Household
- Qualifying Surviving Spouse

If taxpayers qualify for more than one filing status, choose the one that results in a lower tax. For example, in most cases, married couples pay less tax if they file a joint return.

In general, the Head of Household filing status is for unmarried taxpayers who paid more than half the cost of maintaining a home for a qualifying person for the required period of time. However, some married taxpayers who lived apart from their spouse during the last six months of the year and provided for dependent children may be "considered unmarried" and qualify to file as Head of Household.

A widow or widower with one or more qualifying children may be able to use the Qualifying Surviving Spouse filing status, which is available for two years following the year of the spouse's death.

What situations are out of scope for the VITA/TCE programs?

The following are out of scope for this lesson. While this list may not be all inclusive, it is provided for your awareness only.

- A spouse who may be relieved of joint liability as an innocent spouse
- Depending on your tax assistance program, married taxpayers who wish to file a separate return from their spouse and are subject to community property tax laws
- Taxpayers who are not certain they are in a common law marriage (rules are complex and differ from state to state)

EXERCISE Answers

Answer 1: b, No. Sebastian lived with Alexandra for five months, which is less than half the year.

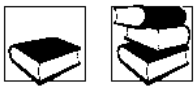
Answer 2: c, Head of Household. Even though Jane is still married to her husband, she meets the requirements to be “considered unmarried” for filing status purposes and qualifies to file as Head of Household. Although technically she could file as Married Filing Separately, it would not be to her advantage to do so.

Answer 3: a, Single. He is not married, has no dependents living in his household, and does not claim his parents as dependents, Seth can only file as Single.

Answer 4: d, Head of Household. Because she is legally divorced, Tanya could file as Single. However, because she has children and meets the requirements for Head of Household, she should use this as her filing status because it will result in a lower tax.

Answer 5: e, Qualifying Surviving Spouse. Although Sydney meets the requirements to file as Single, Head of Household or Qualifying Surviving Spouse, the Interview Tips will help you to determine that he should use the Qualifying Surviving Spouse filing status because it will result in the lowest tax.

Personal Exemptions



Introduction

Identifying and entering the correct number of exemptions is an important component of completing taxpayers' returns.

Objectives

At the end of this lesson, using your resource materials, you will be able to:

- Distinguish between personal and dependency exemptions
- Determine if a taxpayer can be claimed as a dependent on another taxpayer's return

What do I need

- Form 13614-C
- Publication 4012
- Publication 17

Optional:

- Publication 501

What are exemptions?

An **exemption** is a dollar amount that can be deducted from an individual's total income, thereby reducing the taxable income. Taxpayers may be able to claim two kinds of exemptions:

- Personal exemptions generally allow taxpayers to claim themselves (and possibly their spouse)
- Dependency exemptions allow taxpayers to claim qualifying dependents

The deduction for personal exemptions is suspended (reduced to $0) for tax years 2018 through 2025 by the Tax Cuts and Jobs Act. Although the exemption amount is zero, the ability to claim an exemption may make taxpayers eligible for other tax benefits.

When can a taxpayer claim personal exemptions?

To claim a personal exemption, the taxpayer must be able to answer "no" to the intake question, "Can anyone claim you or your spouse as a dependent?"

This applies even if another taxpayer does not actually claim the taxpayer as a dependent. In this case, the taxpayer must check the box on Form 1040 that indicates that they can be claimed as a dependent. Married taxpayers filing a joint return should also check the box if the spouse can be claimed as a dependent by another taxpayer. This means they may have to use a smaller standard deduction amount. See the lesson Standard Deduction and Tax Computation for more information on this topic.

An individual is not a dependent of a person if that person is not required to file an income tax return and either does not file an income tax return or files an income tax return solely to claim a refund of estimated or withheld taxes. If this is the situation, the taxpayer should answer "no" to "can anyone claim you as a dependent?" If that other individual chooses to file a return as described, they should **not** list the taxpayer as a dependent.

Refer to the next lesson for the rules for claiming a dependent.

Review the Volunteer Resource Guide Tab B, Starting a Return and Filing Status, for the required entries if the taxpayer is not able to claim his or her own personal exemption.

Taxpayer Interview and Tax Law Application

Ray Jackson is a college student who worked during the tax year. Use the Volunteer Resource Guide to help him determine if his parents can claim him as a dependent. Here's how the conversation might sound:

Sample Interview

Volunteer Says...	Ray Responds...
The questions I'm about to ask you will help us figure out if you can be claimed as a dependent by your parents. First of all, you aren't married and you are a U.S. citizen, correct?	Yes, that's correct.
And you were under age 24 at the end of the tax year and a full-time student?	That's right.
Did you live with your parents for more than half the year?	I lived with them during the summer and other school breaks, but when school was in session, I lived in the dorm on campus.
Okay, that's considered a temporary absence so for tax purposes, you lived with your parents all year. Did you pay more than half of your own support?	I worked part-time, but I didn't make that much. I used my money to buy a few books and some food, but my parents paid my tuition, room and board, and most of my other expenses like clothing and medical bills.
Based on what you've told me, you are considered a qualifying child of your parents and they can claim you as a dependent. We will indicate this on your return so it doesn't cause problems for your parents when they file their return.	Okay, thanks.

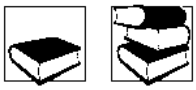
Summary

There are two types of exemptions:

- Personal
- Dependency

The deduction for personal exemptions is suspended (reduced to $0) for tax years 2018 through 2025. If a taxpayer can be claimed as a dependent on a taxpayer's return, they must check the box on Form 1040 that indicates that they can be claimed as a dependent. An individual is not a dependent of a person if that person is not required to file an income tax return and either does not file an income tax return or files an income tax return solely to claim a refund of estimated or withheld taxes. If this is the situation, the taxpayer should answer "no" to "can anyone claim you as a dependent?" and the other individual should not list the taxpayer as their dependent if they file a return.

Dependents



Introduction

Identifying and determining the correct number of dependents is a critical component of completing the taxpayer's return. The deduction for personal and dependency exemptions is suspended for tax years 2018 through 2025 by the Tax Cuts and Jobs Act. Although the exemption amount is zero, the ability to claim a dependent may make taxpayers eligible for other tax benefits. For example, the following tax benefits may all be associated with a dependent: child tax credit, additional child tax credit, credit for other dependents, earned income credit, child and dependent care credit, head of household filing status, and other tax benefits.

See the Volunteer Resource Guide, Tab C, Dependents for helpful probing questions to use when interviewing the taxpayer.

When the interview is complete, the results are documented on the intake and interview sheet. This information will be the basis of your entries in the tax software.

Objectives

At the end of this lesson, using your resource materials, you will be able to:

- Determine if a taxpayer may claim a dependent by applying the applicable dependency tests

What do I need?

- Form 13614-C
- Publication 4012
- Publication 17

Optional:

- Publication 501
- Form 2120
- Form 8332

Who are dependents?

Dependents are either a qualifying child or a qualifying relative of the taxpayer. The taxpayer's spouse cannot be claimed as a dependent. Some examples of dependents include a child, stepchild, brother, sister, or parent.

Individuals who qualify to be claimed as a dependent may be required to file a tax return if they meet the filing requirements.

Who are NOT dependents?

An individual is not a dependent of a person if that person is not required to file an income tax return and either does not file an income tax return or files an income tax return solely to claim a refund of estimated or withheld taxes.

How do I apply the dependency tests?

The Marital Status and Household Information section of the intake and interview sheet addresses the issues concerning dependency, but you will still need to use your interview skills to clarify whether the individuals listed are eligible to be claimed as dependents.

Use caution when preparing this section of the taxpayer's return. Use the Volunteer Resource Guide, Tab C, Dependents, for guidance on asking probing questions to verify the information on the intake and interview sheet. Avoid using information from the taxpayer's prior year documents to complete this section.

Tax-Aide volunteers can use the Qualifying Child or Relative Resource Tool available on the Portal. If using the latest print version, be sure to pen in the errata items (also on the Portal).

How do I use the Volunteer Resource Guide?

Refer to Tab C, Dependents, in the Volunteer Resource Guide for tools to assist you in determining if a taxpayer may claim a dependent. Whether you are a new or returning volunteer, Tables 1, 2, and 3 provide interview tips with guidelines and definitions to help you apply the dependency tests. They incorporate all of the exceptions, such as the special rules for children of divorced or separated parents as well as the special multiple support rules.

When determining if a taxpayer can claim a dependent, always begin with Table 1: All Dependents. If you determine that the person is not a qualifying child, then move to Table 2: Qualifying Relative Dependents. Depending on the taxpayer's answers, you may also be prompted to use Table 3: Children of Divorced or Separated Parents or Parents Who Live Apart or you may use the Qualifying Child of More Than One Person chart. All of these tools are found in the Volunteer Resource Guide, Tab C, Dependents. As you become more experienced with the qualifying child and qualifying relative rules, you may find that you prefer the Overview of the Rules for Claiming a Dependent chart instead.

What tests must be met for all dependents?

A dependent may be either a qualifying child or a qualifying relative. Both types of dependents have unique rules, but some requirements are the same for both.

To determine if an individual can be claimed as a dependent, begin with the rules that apply to **both** qualifying child and qualifying relative dependents:

- Dependent taxpayer test
- Joint return test
- Citizen or resident test

Dependent Taxpayer Test

A taxpayer (or taxpayer's spouse, if filing a joint return) who may be claimed as a dependent by another taxpayer may not claim anyone as a dependent on his or her own tax return. Part I of the intake and interview sheet asks, "Can anyone claim you or your spouse as a dependent?" If taxpayers answer yes, they cannot claim a dependent. Use your interview skills because some taxpayers, particularly students, might not be sure of the answer to this question. An individual is not a dependent of a person if that person is not required to file an income tax return and either does not file an income tax return or files an income tax return solely to claim a refund of estimated or withheld taxes. If this is the situation, the taxpayer should answer "no" to "can anyone claim you as a dependent?"

Joint Return Test

A married person who files a joint return cannot be claimed as a dependent unless that joint return is filed only to claim a refund of withheld income tax or estimated tax paid.

Ruth, who had no income, was married in November of the tax year and moved out. Ruth's husband had $30,000 income and had a filing requirement. Although Ruth's father supported her and paid for the wedding, he cannot claim her as a dependent because she is filing a joint return with her husband; but he can claim child care credit (if Ruth is incapable of self-care) and medical expenses for Ruth (but not QSS because Ruth moved out) — refer to the NTTC Qualifying Child or Relative Resource Tool.

Citizen or Resident Test

To be claimed as a dependent, a person must be a U.S. citizen, U.S. resident alien, U.S. national, or a resident of Canada or Mexico.

- If a U.S. citizen or U.S. national legally adopts a child who is not a U.S. citizen, U.S. resident alien, or U.S. national, this test is met as long as the child lives with the taxpayer as a member of the household all year.

If all other dependency tests are met, the child can be claimed as a dependent. This also applies if the child was lawfully placed with the taxpayer for legal adoption.

- Foreign exchange students generally are not U.S. residents and do not meet the citizen or resident test; they cannot be claimed as dependents.

Joan, who is a U.S. citizen, adopted an infant boy from Cambodia who lived with her for the entire tax year. Even though Joan's child is not yet a U.S. citizen, he meets the citizen or resident test because he was a member of Joan's household for the entire year.

Taxpayers may be able to claim a qualifying person for a credit or other tax benefit even if the person cannot be claimed as a dependent.

What are the tests for a qualifying child?

The next step to determine if the taxpayer has a dependent is to apply the rules for a qualifying child. If these tests are not met, see if the tests for a qualifying relative are met. Remember, a person must meet the requirements of either a qualifying child or a qualifying relative to be claimed as a dependent. While reading about these tests, follow steps 5-9 in the Volunteer Resource Guide, Tab C, Dependents, Table 1.

Relationship

To meet this test, the child must be:

- The taxpayer's son, daughter, stepchild, foster child (placed by an authorized placement agency), or a descendant (for example, a grandchild) of any of them
- The taxpayer's brother, sister, half-brother, half-sister, stepbrother, stepsister, or a descendant (for example, niece or nephew) of any of them

An adopted child is treated as the taxpayer's own child for the purposes of the relationships described above. For example, an adopted brother or sister is a brother or sister of the taxpayer. An adopted child includes a child who was lawfully placed with a person for legal adoption.

Age

To meet this test, the child must meet one of the following three criteria:

- Under age 19 at the end of the tax year and younger than the taxpayer (or the taxpayer's spouse, if filing jointly)
- A full-time student under the age of 24 at the end of the year and younger than the taxpayer (or spouse, if filing jointly)
  - To qualify as a student, the child must be enrolled in the number of hours or courses the school considers full-time during some part of at least five months of the year. See Publication 17 for additional details.
- Any age if permanently and totally disabled at any time during the year. An individual is considered permanently and totally disabled if both of the following conditions apply:
  - He or she can't engage in any substantial gainful activity because of a physical or mental condition.
  - A doctor determines the condition has lasted or can be expected to last continuously for at least a year or can lead to death.

Sarah's son Julio is 32 years old and is permanently and totally disabled. Because he is disabled, Julio meets the age test to be a qualifying child of Sarah. If he meets all the other tests, Sarah can claim him as a dependent.

Attending an on-the-job training course, correspondence school, or a school offering courses only through the internet, does not qualify the child as a student.

Residency

To meet this test, the child must have lived with the taxpayer for more than half the year. The taxpayer's home is any location where they regularly live; it does not need to be a traditional home. For example, a child who lived with the taxpayer for more than half the year in one or more homeless shelters meets the residency test.

Exceptions to the Residency Test

The child is considered to have lived with the taxpayer during periods of time when either the child or the taxpayer is temporarily absent due to illness, education, business, vacation, military service, institutionalized care for a child who is permanently and totally disabled, or incarceration.

A child who was born (or died) during the year is treated as having lived with the taxpayer for more than half of the year, if the taxpayer's home was the child's home for more than one-half of the portion of the taxable year during which the individual was alive.

Taxpayers may claim as a dependent a child who was born or died, or was kidnapped during the year, as long as the other dependency tests are met.

In the case of a child who was born and died during the year, a SSN is not required but the return cannot be e-filed. The tax return must be mailed. Refer to Publication 17 for specific rules for these rare situations.

A taxpayer may *not* claim a stillborn child as a dependent on their federal return. State tax laws may differ.

In most cases, because of the residency test, a child is the qualifying child of the custodial parent. However, special rules apply to divorced or separated parents or parents who live apart, which are covered later in this lesson.

Support

To meet this test, the child cannot have provided more than half of his or her own support during the tax year. This test is different from the support test for qualifying relative. A person's own funds are not support unless they are actually spent for support. If the taxpayer is unsure whether the child provided more than half of his or her own support, review the Worksheet for Determining Support in the Volunteer Resource Guide together.

Bob, 22, is a full-time student and lives with his parents when he is not in the dorm. He worked part-time, but did not pay over half of his total support. Bob meets the relationship, age, residency, and support tests.

Doris, a U.S. citizen, is 8 years old and had a small role in a television series. She made $60,000 during the tax year, but her parents put all the money in a trust fund to pay for college. She lived with her parents all year. Doris meets the relationship, age, and residency tests. Doris also meets the support test since the $60,000 in earnings were not used for her own support. She meets the tests for a qualifying child.

State benefits provided to a person in need, such as welfare, food stamps or housing, are generally considered support provided by state. A proposed rule on which taxpayers may choose to rely treats governmental payments made to a recipient that the recipient uses, in part, to support others are treated as support of the others provided by the recipient, whereas any part of such a payment used for the support

of the recipient would constitute support of the recipient by a third party. For example, if a mother receives Temporary Assistance for Needy Families (TANF) and uses TANF payments to support her children, the proposed regulations treat the mother as having provided that support.

On the other hand, if a child receives Social Security benefits that are used for the child's own support, the benefits are considered to be provided by the child.

A scholarship received by a child who is a student isn't taken into account in determining whether the child provided more than half of his or her own support.

Can the child be a qualifying child of more than one person?

Although a child could meet the conditions to be the qualifying child of more than one person, only one taxpayer can claim the child as a qualifying child for the following tax benefits (exception: if the special rule for children of divorced or separated parents or parents who live apart applies):

- Dependent
- Child tax credit or credit for other dependents
- Head of Household filing status
- Credit for child and dependent care expenses
- Exclusion from income for dependent care benefits
- Earned income credit
- Premium tax credit, generally

See the Volunteer Resource Guide, Tab C, Dependents, Qualifying Child of More Than One Person chart.

If two taxpayers have the same qualifying child, then only one taxpayer can claim all of the benefits for that particular qualifying child. They cannot agree to split these benefits. The other taxpayer cannot claim any of the benefits, based on the same qualifying child.

To determine which taxpayer can treat the child as a qualifying child and claim the benefits, apply these rules keeping in mind that an adopted child is treated as the taxpayer's own child:

- If only one of the taxpayers is the child's parent, the child is the qualifying child of the parent.
- If the parents file a joint return together and can claim the child as a qualifying child, the child is treated as the qualifying child of the parents.
- If the parents do not file a joint return together but both parents claim the child, IRS will treat the child as the qualifying child of the parent with whom the child lived for the longer period of time during the tax year. If the child lived with both parents the same amount of time, IRS will treat the child as the qualifying child of the parent who had the higher Adjusted Gross Income (AGI) for the tax year.
- If no parent can claim the child as a qualifying child, the child is treated as the qualifying child of the person who had the highest AGI for the tax year and who meets the requisite tests.
- If a parent can claim the child as a qualifying child but no parent does, the child is treated as the qualifying child of the person who had the highest AGI for the year, but only if that person's AGI is higher than the highest AGI of any of the child's parents who could claim the child. If the parents file a joint return together, this rule allows the parents to divide their combined AGI equally (between themselves).

Using these tie-breaker rules, taxpayers may be able to choose which one claims the child. If the qualifying child is claimed on more than one tax return in a given year, IRS will apply these tie-breaker rules to determine who will receive the benefits.

Mary and her 3-year-old daughter, Jane, lived with Mary's mother, Dorothy, all year. Mary is 25 years old, unmarried, and has an AGI of $19,000. Dorothy has an AGI of $25,000. Jane's father didn't live with Mary or Jane. Mary has not signed Form 8332 (or a similar statement).

Jane is a qualifying child of both Mary and Dorothy because she meets the relationship, age, residency, support, and joint return tests for both Mary and Dorothy. However, only one of them can claim Jane. Jane isn't a qualifying child of anyone else, including her father.

Mary agreed to let her mother claim Jane. This means Dorothy can claim Jane as a qualifying child for all of the five tax benefits listed earlier, if the mother qualifies for each of those benefits (and if Mary doesn't claim Jane as a qualifying child for any of those tax benefits).

However, if Mary and Dorothy can't agree, only Mary will be allowed to claim Jane as a qualifying child.

In the example above, if circumstances are the same except Mary's AGI is $28,000, only Mary can claim Jane as a qualifying child. Because Dorothy's AGI isn't higher than Mary's, Dorothy cannot claim Jane.

When both taxpayers are the child's parents and not filing a joint return, they may agree between themselves who will claim the child. This may occur when the parents are not married but the family lives together.

When a taxpayer's e-filed return is rejected because he or she claimed a dependent that was already claimed by another person, apply the tie-breaker rules. If the taxpayer is the person eligible to claim the dependent based on these rules, a paper return must be filed.

Lynne and her mother, Margaret, share a home and both contribute to the household expenses. Lynne's twelve-year-old-daughter, Karen, lives with them. Although Karen meets all the conditions to be a qualifying child for both Lynne and her mother, Karen is considered Lynne's dependent.

However, if Lynne chooses not to claim Karen, then Margaret may claim Karen as a qualifying child if Margaret's AGI is higher than Lynne's.

Publication 17 and Publication 501, Dependents, Standard Deduction, and Filing Information, provide more information about qualifying children of more than one person.

What are the tests for a qualifying relative?

The tests for qualifying relative are applied only when the tests for qualifying child are not met.

Dependents who do not meet the tests for qualifying child might meet the slightly different tests to be a qualifying relative. In addition to the dependent taxpayer, joint return, and citizen or resident tests, there are four additional tests that must be met for a person to be a qualifying relative. The tests are:

- Not a qualifying child test
- Member of household or relationship test
- Gross income test, and
- Support test

Unlike a qualifying child, a qualifying relative can be any age. Turn to the Volunteer Resource Guide, Tab C, Dependents, Qualifying Relative Dependents table, to follow along as the tests are described.

Not a Qualifying Child Test

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

However, there is an exception to this statement. A child may qualify as the taxpayer's dependent under the tests for qualifying relative, even if that child is the qualifying child of another taxpayer. This is allowed only when the child's parent (or other person for whom the child is a qualifying child) is not required to file an income tax return and either:

- Does not file a return, or
- Only files to get a refund of income tax withheld or estimated tax paid

Todd has lived with his girlfriend, Eva, and her two children all year in his home. Eva is not required to file, and does not file, a tax return this year. Eva and her two children pass the "not a qualifying child test" to be Todd's qualifying relatives. If Todd meets all other tests, Eva and her two children are qualifying relatives. (Eva and Todd's relationship does not violate local laws.)

EXERCISES

Answers are after the lesson summary.

Question 1: All the facts are the same as in the previous example, except that Eva's gross income is $25,000, and she is required to file a return. In this situation, are the children Todd's qualifying relatives?

a. Yes

b. No

Sally has been supporting her friend Ann and Ann's young son, Bobby. Ann and Bobby lived with Sally the entire year and meet all the tests to be Sally's qualifying relatives. Ann worked part-time and made $3,100 in wages. Ann files a return only to have her withholding refunded. Sally can claim Ann and Bobby as dependents.

Member of Household or Relationship Test

To meet this test, the person must either:

- Live as a member of the taxpayer's household all year, or
- Be related to the taxpayer in one of the following ways:
  - Child, stepchild, foster child or a descendant of any of them
  - Brother, sister, half-brother, half-sister, stepbrother or stepsister
  - Father, mother, grandparent or other direct ancestor, but not foster parent
  - Stepfather or stepmother
  - Son or daughter of the taxpayer's brother or sister (nephew or niece)
  - Son or daughter of the taxpayer's half-brother or half-sister
  - Brother or sister of the taxpayer's father or mother (uncle or aunt)
  - Son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law

An adopted child is treated as the taxpayer's own child for the purposes of the relationships described above. For example, an adopted brother or sister is a brother or sister of the taxpayer. An adopted child includes a child who was lawfully placed with a person for legal adoption.

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

An unrelated person who lived with the taxpayer for the entire year can also meet the member of household or relationship test. If the relationship violates local laws, this test is not met. For example, if the taxpayer's state prohibits cohabitation, then that person cannot be claimed, even if all other criteria are met.

Susan and Ted are married and file a joint return. They supported Ted's parents throughout the tax year. Even though Ted's parents do not live with Ted and Susan, Ted's parents meet the member of household or relationship test.

Note that:

- A person is still considered living with the taxpayer as a member of the household during periods when that person or the taxpayer is temporarily absent due to special circumstances such as illness, education, business, vacation, military service, and placement in a nursing home.
- Cousins can meet the relationship test for qualifying relative only if they live with the taxpayer for the entire year.
- Qualifying relatives can be unrelated, as long as they lived with the taxpayer all year.
- A taxpayer may not claim a housekeeper or other household employee as a dependent.

Mary is a live-in nanny for Jack and Jane in exchange for room and board for the entire year. Mary does not meet the test for qualifying relative.

Gross Income Test

To meet this test, the dependent's gross income for the tax year must be less than the threshold amount.

Refer to the Volunteer Resource Guide for the current year threshold amount. Gross income is all income in the form of money, property, and services that is not exempt from tax. Specific examples are found in the Volunteer Resource Guide, Tab D, Income. Remember this test does not apply to qualifying children, only qualifying relatives. For purposes of this test, the gross income of an individual who is permanently and totally disabled does not include income from a sheltered workshop.

Joe is 65 years old and lives with his son and daughter-in-law. Joe's taxable pension income for the year was $10,000. Joe is not a qualified relative because his income exceeds the threshold amount.

Support Test

To meet this test, the taxpayer must have provided more than 50% of the person's total support for the tax year. Note that this support test is different from the one for a qualifying child, which tests whether the child provided more than one half of their own support.

When calculating the amount of total support, taxpayers should compare their contributions with the entire amount of support the person received from all sources (such as taxable income, tax-exempt income, and loans). Review the list of valid support expenses and the Worksheet for Determining Support in the Volunteer Resource Guide, Tab C, Dependents, or in Publication 17.

Sherrie's father received $2,700 from Social Security, but he put $300 of it in a savings account and spent only $2,400 for his own support. Sherrie spent $2,600 of her income for his support, so she has provided over half of his support.

Steve provided $4,000 toward his mother's support during the year. His mother had nontaxable Social Security benefit payments of $4,800 and tax-exempt interest of $800. She used all of these for her support. Steve's mother provided more than half of her total support of $9,600. Therefore, Steve cannot claim his mother as a dependent.

State benefit payments like welfare, Temporary Assistance for Needy Families (TANF), food stamps, or housing assistance are generally considered support provided by the state, not by the taxpayer. A proposed rule on which taxpayers may choose to rely treats governmental payments made to a recipient that the recipient uses, in part, to support others as support of the others provided by the recipient, whereas any part of such payment used for the support of the recipient would constitute support of the recipient by a third party. For example, if a mother receives TANF and uses the TANF payments to support her children, the proposed regulations treat the mother as having provided that support.

Social Security benefits received by a child and used toward support are considered to have been provided by the child.

A scholarship received by a child who is a student isn't taken into account in determining whether the child provided more than half of his or her own support.

Refer to the Worksheet for Determining Support in the Volunteer Resource Guide, Tab C, Dependents, or the Dependents chapter of Publication 17.

Multiple Support Agreements (Form 2120)

Sometimes no one provided more than half the support of a person. Multiple support means that two or more people who could claim the person as a dependent (except for the support test) together provide more than half the dependent's support. In this situation, the individuals who provide more than 10% of the person's total support, and who meet the other tests for a qualifying relative, can agree that one of them will claim the person as a dependent for any applicable tax benefits.

- The taxpayer claiming the dependent must file Form 2120, Multiple Support Declaration or similar statement, with the tax return.
- The other taxpayers providing over 10% of the person's support must provide a written and signed statement agreeing *not* to claim the dependent for that year. The person who claims the dependent must keep a copy of this written statement as a record. A list of the statement requirements can be found in Form 2120 Instructions.

Multiple Support Agreements apply only to a qualifying relative, not to a qualifying child.

If you can claim a person as a dependent only because of a multiple support agreement, that person isn't a qualifying person for Head of Household status.

Fred's father, Charlie, lives with him and receives 27% of his support from Social Security, 40% from Fred, 24% from Charlie's brother Ray, and 9% from one of Charlie's friends. Charlie may be a qualifying relative for either Fred or Ray because they each provided more than 10% of Charlie's support, and together contributed more than 50% toward his support. If they agree that Fred will claim Charlie as a dependent, Ray will sign Form 2120 and Fred will attach the form to his tax return.

EXERCISES (continued)

Question 2: Diane and her brother each provided 20% of their grandmother's support for the year. Two persons who are not related to Diane's grandmother, and who do not live with her, provided the remaining 60% of her support equally. Who is entitled to claim the grandmother as a dependent?

The taxpayers who provide multiple support for a dependent decide among themselves who will claim the dependent for the year. Volunteer tax preparers do not decide.

Special Rule for Children of Divorced or Separated Parents or Parents Who Live Apart

In most cases, the child is the qualifying child of the custodial parent. However, a child will be treated as the qualifying child or qualifying relative of his or her noncustodial parent if all the following conditions apply:

This rule does not apply for Head of Household filing status, the credit for child and dependent care expenses, or the earned income credit. For these benefits, the child must meet the residency test. The custodial parent may still qualify for these provisions even though the noncustodial parent can claim the dependent for other tax benefits.

1. The parents
   - o are divorced or legally separated under divorce or separate maintenance decrees or written separation agreements, or
   - o lived apart at all times during the last six months of the year whether or not they are or were married
2. The child received over half of his or her support for the year from the parents. (Multiple Support Agreement rules do not apply.)
3. The child was in the custody of one or both parents for more than half the year.
4. The custodial parent signs a written declaration (Form 8332 or a similar statement) that he or she will not claim the child as a dependent for the year and the noncustodial parent attaches this declaration to his or her return. If the decree or agreement went into effect after 1984 and before 2009, the noncustodial parent may be able to attach certain pages from the decree or agreement instead of Form 8332. For a pre-1985 decree or agreement, see Publication 17.

This special rule is the exception to:

- The residency test for qualifying child
- The support test for qualifying relative

Custodial and Noncustodial Parent

The custodial parent is the parent with whom the child lived for the greater number of nights during the year. The other parent is the noncustodial parent.

If the parents divorced or separated during the year and the child lived with both parents before the separation, the custodial parent is the one with whom the child lived for the greater number of nights during the rest of the year.

A child is treated as living with a parent for a night if the child sleeps:

- At that parent's home, whether or not the parent is present, or
- In the company of the parent, when the child does not sleep at a parent's home (for example, the parent and child are on vacation together).

Chloe has one child, Timmy, and is divorced. During the tax year, Timmy lived with Chloe 210 nights and with his father 155 nights. Chloe is the custodial parent because Timmy lived with her more nights during the year.

If the child lived with each parent for an equal number of nights during the year, the custodial parent is the parent with the higher adjusted gross income.

EXERCISES (continued)

Question 3: Ted is divorced and has a daughter who lived with him and his ex-spouse for an equal number of nights. Ted's adjusted gross income is $45,000 and his ex-spouse's adjusted gross income is $30,000. Who is considered the custodial parent?

If a child is emancipated under state law, the child is treated as not living with either parent. See more examples and additional information in Publication 17.

When Troy turned age 18 in May, he became emancipated under the law of the state in which he lives. As a result, he is not considered in the custody of his parents for more than half of the year. The special rule for children of divorced or separated parents does not apply.

Revocation of Release of Claim to an Exemption

Custodial parents can revoke a release of claim to exemption they previously provided to the noncustodial parent on Form 8332 or a similar statement. The custodial parent must provide, or make a reasonable effort to provide, the noncustodial parent with written notice of the revocation in the calendar year prior to the tax year in which the revocation is to take effect. Part III of Form 8332 can be used for this purpose. Attach a copy of the revocation to the return for each tax year the child is claimed as a dependent as a result of the revocation.

The tax software determines the taxpayer's dependents based on the Dependents/Qualifying Person information entered in the Basic Information section.

Be sure to complete and review all the family and dependent information on the taxpayer's intake and interview sheet before entering the data into the tax software.

For detailed instructions on entering a dependent's information, refer to the Volunteer Resource Guide, Tab B, Starting a Return and Filing Status.

This table summarizes the benefits associated with having a dependent that remain with the custodial parent, even after they have released the dependent to the noncustodial parent.

Who May Claim?	**Custodial Parent**	**Noncustodial Parent with Form 8332**
Dependent		✓
Head of Household	✓	
Earned Income Credit (EIC)	✓	
Child Tax Credit or Credit for Other Dependents		✓
Dependent Care Credit	✓	
Education credits		✓
Premium Tax Credit		✓

Be sure to add the “dependent” to the custodial parent’s return, even though you will indicate that they are not a dependent. The software will then have the information needed for an accurate return.

Tax Law Application

Elaine Smith has one Form W-2 from her clerk job of 36 years, showing wages of $37,000. She has been divorced from her husband for over 20 years. She pays all the costs of keeping up her home and is the main provider for her seven-year-old granddaughter, Lisa and her 30-year-old son, Todd. Lisa is Todd's niece. Both her son and granddaughter lived with Elaine all year. Her son worked part time and earned $9,000. He is not disabled. She would like to file a tax return and claim her son and granddaughter as dependents.

How do I apply the dependency tests to Elaine's son?

Use the tables in the Volunteer Resource Guide, Tab C, Dependents, to apply the test to Elaine's son.

How do I apply the dependency tests to Elaine's granddaughter?

Use the tables in the Volunteer Resource Guide, Tab C, Dependents, to apply the test to Elaine's granddaughter. You will find that Lisa is a qualifying child of both Elaine and Todd. However, under the tie-breaker rules, Elaine is entitled to claim Lisa as a dependent because she has the higher AGI.

Dependent/Nondependent Determinations

Elaine can claim her granddaughter as a dependent, but cannot claim her adult son because he does not meet the gross income test to be Elaine's qualifying relative.

Summary

For a taxpayer to claim a dependent, the following conditions must be met:

- The taxpayer may not claim a dependent if the taxpayer may be claimed as a dependent on another taxpayer's return.
- The taxpayer may not claim a dependent who files a joint return unless the joint return is filed only to claim a refund and no tax liability would exist for either spouse on separate returns.
- A person cannot be claimed as a dependent unless that person is a U.S. citizen, U.S. resident alien, U.S. national, or a resident of Canada or Mexico, for some part of the year. (There is an exception for certain adopted children.)
- A dependent must be either a *qualifying child* or *qualifying relative*.

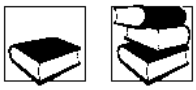
EXERCISE Answers

Answer 1: No, since Eva has a filing requirement and her children meet the tests to be Eva's qualifying children, Todd cannot claim the children as qualifying relatives.

Answer 2: No one is entitled to claim the grandmother as a dependent. The individuals who provided more than half of the grandmother's support are not eligible to claim her because they are not related to her and did not live in the same household all year.

Answer 3: Ted is his daughter's custodial parent because he had a higher adjusted gross income.

Unique Filing Situations



Introduction

This lesson will assist you in addressing some filing status issues you may encounter when helping taxpayers who are not U.S. citizens.

This lesson also covers dependent issues related to taxpayers who may have nonresident alien stepchildren (children of a nonresident spouse who is married to U.S. citizen or resident alien).

This lesson does not cover the preparation of returns for taxpayers who are in the U.S. on an F, J, M, or Q visa. Refer taxpayers with one of these visas to a volunteer who is certified to prepare tax returns for foreign students or to a professional tax preparer.

The Foreign Student and Scholar course and certification test are part of Link & Learn Taxes, which is available on **https://apps.irs.gov/app/vita/**

Objectives

At the end of this lesson, using your resource materials, you will be able to:

- Determine whether an individual is a resident or nonresident alien
- Apply the support test and citizen or resident test to determine whether an individual can be claimed as a dependent
- Apply special rules for Head of Household status when the spouse is a nonresident alien

What do I need?

- Form 13614-C
- Publication 4012
- Publication 17
- Publication 519
- Optional:
- Publication 3
- Publication 54
- Form 1040-NR

How do I apply tax law to nonresident aliens?

Nonresident aliens can include students, teachers, trainees, or undocumented immigrants. Your role is to determine if the nonresident alien can be treated as a resident alien for tax purposes; most tax rules that apply to a U.S. citizen will also apply to the resident alien, including filing status and dependent issues. Resident aliens and U.S. citizens must report worldwide income on their Form 1040.

Nonresident aliens may have a filing requirement in the U.S. in certain situations. On the other hand, a person who appears to be resident is treated as nonresident under certain circumstances or under a treaty. These situations are described in Publication 519 and are out of scope for the VITA/TCE programs.

Keep in mind that a person is considered married no matter where in the world they were married. It does not matter if one spouse is living in another country. The person who is the resident alien or citizen still must follow the tax rules for married persons.

Filing a tax return as a resident alien does not affect the person's immigration status in any way.

Who is a resident alien or nonresident alien?

Let's begin by looking at the intake and interview sheet. Locate the part of the form where taxpayers and their spouses indicate whether they are U.S. citizens. In another part of the form, taxpayers indicate citizenship or residency of family members and dependents.

If the taxpayer has checked "No" for U.S. citizen on the intake and interview sheet, you must determine if the person can be treated as a resident alien for tax purposes before continuing. An individual must meet **one** of the following tests to be considered a resident alien for tax purposes:

- Green card test
- Substantial presence test

What is the green card test?

Individuals who were lawful permanent residents of the U.S. at any time during the tax year are resident aliens. They were given the privilege, according to immigration laws, of residing permanently in the U.S. They receive alien registration cards, commonly known as a "green cards," attesting to this status. Green cards are approximately the size of driver licenses. They are no longer green in color but still hold the name. Most green card holders have valid Social Security numbers and must follow the same tax laws as U.S. citizens, including the requirement to report worldwide income on their tax returns.

What is the substantial presence test?

This test is based on a formula of days and years a person is physically present in the United States. Individuals who do not have green cards may still be considered resident aliens if they meet the requirements of the substantial presence test for the calendar year.

Use the Resident or Nonresident Alien Decision Chart in the Volunteer Resource Guide, Tab L, Resident/NR Aliens, or on the next page, to determine an individual's residency status for tax purposes. Information can also be found in Publication 519, U.S. Tax Guide for Aliens.

On their intake sheet, Gloria indicated that her husband, Dante, is not a U.S. citizen. During the interview, you learn that Dante does not have a tax home in another country. He was physically present in the U.S. for 150 days during the current tax year and both of the two prior years. Using the Nonresident Alien or Resident Alien? – Decision Chart on the following page, determine if Dante is a resident alien under the substantial presence test for the tax year.

The decision chart indicates that Dante does meet the substantial presence test and is considered a resident alien for tax purposes. You can assist Gloria and Dante in filing their joint return.

Current tax year: 150 days Prior year: 1/3 of 150 = 50 days Two years prior: 1/6 of 150 days = 25 days

Total = 225 days

Resident or Nonresident Alien Decision Chart

Determine residency status for federal income tax purposes.

Step	Probe	Action
1	Were you a lawful permanent resident of the United States (had a "green card") at any time during the current tax year?	YES – RESIDENT Alien for U.S. tax purposes[1, 2] NO – Go to Step 2
2	Were you physically present in the United States on at least 31 days during the current tax year?[3]	YES – Go to Step 3 NO – NONRESIDENT Alien for U.S. tax purposes[3]
3	Were you physically present in the United States on at least 183 days during the 3-year period consisting of the current tax year and the preceding 2 years, • counting all days of presence in the current tax year, • 1/3 of the days of presence in the first preceding year, and • 1/6 of the days of presence in the second preceding year?[3]	YES – Go to Step 4 NO – NONRESIDENT Alien for U.S. tax purposes[4]
4	Were you physically present in the United States on at least 183 days during the current tax year?[3]	YES – RESIDENT Alien for U.S. tax purposes[1, 2] NO – Go to Step 5
5	Can you show that for the current tax year you have a tax home in a foreign country and have a closer connection to that country than to the United States? (*Out of Scope, Form 8840, Closer Connection Exception Statement for Aliens required)	YES– NONRESIDENT Alien for U.S. tax purposes[5] NO – RESIDENT Alien for U.S. tax purposes[1, 2]

Footnotes

[1] If this is your first year of residency, you may have a dual status for the year. See Dual Status Aliens in Pub 519, U.S. Tax Guide for Aliens. (Out of Scope)

[2] In some circumstances you may still be considered a nonresident alien and eligible for benefits under an income tax treaty between the U.S. and your country. Check the provision of the treaty carefully. (Out of Scope)

[3] See Days of Presence in the United States in Pub 519 for days that do not count as days of presence in the U.S. (Exempt individuals such as students, scholars, and others temporarily in the U.S. under an F, J, M, or Q visa's immigration status do not count their days of presence in the U.S. for specified periods of time.)

[4] If you meet the substantial presence test for the following year, you may be able to choose treatment as a U.S. resident alien for part of the current tax year. See Substantial Presence Test under Resident Aliens and First Year Choice under Dual Status Aliens in Pub. 519. (Out of Scope)

[5] Nonresident students from Barbados, Hungary, and Jamaica, as well as trainees from Jamaica, may qualify for an election to be treated as a U.S. Resident for tax purposes under their tax treaty provisions with the U.S. A formal, signed, election statement must be attached to the Form 1040 (preparation of the statement is Out of Scope). (It continues until formally revoked.)

Taxpayers should be referred to a professional tax preparer if they:

- *Are dual-status aliens, or*
- *Wish to claim a special treaty provision or tax topic not specifically addressed as within the scope of the Foreign Student and Scholar training, or*
- *Wish to claim resident status for a prior year based on days present in the U.S. after that year (first-year choice), or*
- *Wish to claim a closer connection exception on Form 8840*

What counts as days of presence?

Count any day a person is physically present in the United States at any time during the day as a day of presence. There are exceptions to this rule. For example, do not count days a person regularly commutes to work in the United States from their home in Canada or Mexico or days the person is an exempt individual. The full list of exceptions and an explanation of each can be found in Publication 519, U.S. Tax Guide for Aliens.

Who is an exempt individual?

Generally, an exempt individual is a:

- Foreign government-related individual
- Teacher or trainee who is temporarily present under a J or Q visa
- Student who is temporarily present under an F, J, M, or Q visa
- Professional athlete who is temporarily in the United States to compete in a charitable sports event

Do not count the days present in the U.S. for purposes of the substantial presence test for an exempt individual. In general, they will be considered nonresident aliens for tax purposes and should file a Form 1040-NR if required. Exempt individuals must file Form 8843, Statement for Exempt Individuals and Individuals with a Medical Condition, to exclude days present in the U.S. from the substantial presence test. Refer these individuals to a VITA site that prepares tax returns for foreign students or to a professional tax preparer.

Publication 519 has detailed information on determining who is a resident or nonresident alien.

If a person's visa has expired or the person is not complying with the requirements of the visa, then that person is not an exempt individual and cannot exclude those days he or she is physically present in the U.S.

What if a nonresident alien meets the substantial presence test?

Nonresident aliens who meet the substantial presence test are treated as resident aliens for tax purposes.

No paperwork or documentation is needed to indicate that a person is a nonresident alien filing as a resident alien under the substantial presence test.

Even if an individual meets the substantial presence test, they can be treated as a nonresident alien if they:

- Are present in the United States for less than 183 days during the year,
- Maintain a tax home in a foreign country during the year, and
- Have a closer connection during the year to one foreign country in which you have a tax home than to the United States (unless you have a closer connection to two.

Treaty provisions may also take precedence. See Publication 519 for more information. These situations are out of scope for VITA/TCE.

All persons listed on the return must have either a valid Social Security number or an individual tax identification number (ITIN). ITINs are discussed in the Filing Basics lesson.A return with an ITIN can be e-filed. A return missing an ITIN cannot be e-filed.

What if a nonresident alien does not meet the green card or substantial presence test?

If an unmarried nonresident alien does not meet the green card or substantial presence test, refer the taxpayer to a VITA site that handles Foreign Students/Scholars, if appropriate, or a professional tax preparer to file Form 1040-NR.

If a U.S. citizen or resident alien is married to a spouse who is not a resident alien using the green card or substantial presence test, you may be able to provide assistance. Their options are discussed next.

Paul, a U.S. citizen, is married to Gabriella, who does not have a green card or a valid visa. They have no children and are not supporting anyone else.

Gabriella lived in the U.S. for 120 days during the current tax year. She was also in the U.S. for 120 days in each of the prior two years. Gabriella does not have a tax home in another country. Does Gabriella meet the substantial presence test?

Following the decision tree, you find that Gabriella does not meet the substantial presence test. For tax purposes, she is considered a nonresident alien.

Current tax year: 120 days Prior year: 1/3 of 120 days = 40 days Two years prior: 1/6 of 120 days = 20 days

Total = 180 days

Individuals can be both a nonresident alien and a resident alien during the same tax year. This usually occurs in the year of arrival in or departure from the United States. This is referred to as a dual-status tax year. Individuals with a dual-status for the tax year are out of scope. Refer these individuals to a professional tax preparer. This does not apply to an individual who is married and chooses to be treated as a U.S. resident for the entire year.

What are the filing status options?

A U.S. citizen or resident alien who is married to a nonresident alien spouse who does not meet either the green card or substantial presence test generally has three filing status options:

- The taxpayer may choose to file as Married Filing Separately
- The couple may choose to file as Married Filing Jointly
- The taxpayer may qualify for Head of Household under the regular rules for a married person who is “considered unmarried” even while living with the nonresident alien spouse

What happens when a U.S. citizen and nonresident alien spouse file separate returns?

The U.S. citizen can file a Married Filing Separately return. The nonresident alien spouse, if required to file a return, would file Form 1040 NR. In this situation, the volunteer can assist in the preparation of Form 1040 for the U.S. citizen but must refer the spouse to a professional tax preparer.

When can nonresident aliens file a joint return?

A married couple may elect to treat a nonresident alien spouse as a resident alien for tax purposes and file a joint return. If taxpayers make this choice, both spouses are treated for income tax purposes as residents for the entire tax year. Neither spouse can claim under any tax treaty not to be a U.S. resident. Both spouses are taxed on worldwide income.

How does a married couple elect to treat the nonresident alien spouse as a resident alien?

If the nonresident alien spouse agrees to file a joint return, worldwide income of both spouses must be reported. To make this election, Publication 519 requires a declaration signed by both spouses and attached to their joint return. The statement should include:

- One spouse was a nonresident alien and the other spouse was a U.S. citizen or resident alien on the last day of the tax year
- They choose to be treated as U.S. residents for the entire year, and
- The name, address, and SSN or ITIN of each spouse

Preparation of the required statement outlined in Publication 519 is out of scope.

How does this election affect the filing status in future years?

The election continues in future years, but the spouses can file separately after the first year, if they so choose. The election to treat the spouse as a resident is terminated by revocation, the death of either spouse, their legal separation, or the IRS may terminate it for failure to keep adequate records. Consult Publication 519 for more details on this option.

In the previous example, you determined that Gabriella, Paul's nonresident alien wife, does not meet either the green card or the substantial presence tests to be considered a resident alien. However, Paul and Gabriella choose to treat Gabriella as a resident alien. They must attach a signed statement to their return that indicates this choice. You can assist Paul and Gabriella in preparing their joint return. They must report their worldwide income for the year and for all later years unless the choice is ended or suspended. Although Paul and Gabriella must file a joint return for the year they make the choice, they may file either joint or separate returns for later years.

When can a citizen or resident alien, who lives with a nonresident alien spouse, file as Head of Household?

There is an exception that allows U.S. citizens and resident aliens who have a nonresident alien spouse to file as Head of Household. All of the following requirements must be met:

- The taxpayer is a U.S. citizen, or resident alien for the entire year.
- The nonresident alien spouse chooses **not** to file a joint return.
- The taxpayer meets the other requirements for this filing status.
- The spouse is **not a qualifying person** for head of household purposes. The taxpayer must have a qualifying person in order to be eligible for this filing status.

EXERCISES

Answers are at the end of the lesson summary.

Question 1: Gloria's husband, Dante, meets the substantial presence test for the entire tax year. Gloria is a U.S. citizen. They do not have any children and do not support anyone else. Dante is applying for an ITIN. Gloria has an SSN. They live together.

What filing status options do Gloria and Dante have?

Question 2: Raul is a U.S. citizen and serving in the U.S. Army in Japan. His wife and his children live with him and he is able to claim the children as dependents. Raul's wife, a citizen of Japan, chooses not to be treated as a resident alien for tax purposes. She does not want to file a joint return with him.

Raul meets all of the other qualifications for Head of Household. Even though he is married and living with his spouse, can he claim Head of Household status?

a. Yes

b. No

In the Volunteer Resource Guide, Tab B, Starting a Return and Filing Status, note that if a spouse is a nonresident alien, the living apart rule does not apply to the taxpayer. This information is found in Publication 519.

Can a taxpayer with a nonresident alien spouse claim the earned income credit?

A taxpayer with a nonresident spouse can claim the earned income credit only if their filing status is married filing jointly. A taxpayer who is considered unmarried for head of household purposes because he or she is married to a nonresident alien is still considered married for purposes of the earned income credit and cannot claim EIC. See Publication 596, Earned Income Credit, for more information.

Which family members can be claimed as dependents?

Can a taxpayer claim a nonresident alien spouse as a dependent?

A taxpayer's spouse does not meet the relationship test for either qualifying child or qualifying relative. Thus, taxpayers cannot claim a spouse as their dependent.

Can a child born overseas be claimed as a dependent?

A child born overseas to U.S. citizen parents is considered a U.S. citizen for tax purposes. A child can be claimed as a dependent as long as all the other rules for qualifying child or qualifying relative are met.

The birth of a child abroad should be reported as soon as possible to establish an official record of the child's claim to U.S. citizenship. Form FS-240, Consular Report of Birth Abroad, establishes official evidence that the child is a U.S. citizen.

EXAMPLE

Patricia, a U.S. citizen, is married to Gilberto, a nonresident alien from Spain. Their daughter, Eva, was born while they were living in Spain.

Eva is entitled to U.S. citizenship. Eva will need a Social Security number to be claimed as a dependent on her mother's tax return.

While applying for the Consular Report of Birth Abroad, parents should also apply for a Social Security number and passport for their child. Without a Social Security number, the parents will not be able to claim the child as a dependent or take advantage of credits, such as the earned income credit or the child tax credit, even if all of the other prerequisites are met.

Can a foreign-born stepchild be claimed as a dependent?

Before determining if a foreign-born stepchild is a dependent, it is necessary to determine the child's U.S. residency status for tax purposes by answering the questions in the Nonresident Alien or Resident Alien decision chart. If the foreign-born child is a nonresident alien for tax purposes, the child must be a resident of Canada or Mexico to be claimed as a dependent.

Terry, a U.S. citizen, is married to a German citizen whose three children are German citizens and do not have green cards. Terry has not adopted the children. They all live in Germany. The children were not physically present in the U.S. during the tax year.

Since the children are not U.S. citizens and are not residents of the U.S., Canada, or Mexico, Terry cannot claim the children as dependents.

EXERCISES (continued)

Question 3: Terry moved his family to the U.S. in January of the tax year. His stepchildren are not U.S. citizens and they do not have green cards. They meet the other dependency tests. If he can claim them, he will apply for ITINs for them. Can he claim the stepchildren as dependents on his tax return?

a. Yes

b. No

Question 4: John, a U.S. citizen, lives in Germany. His wife is a German citizen who has never lived in the U.S. Their two-year-old son was born in Germany. John's 12-year-old stepdaughter, a German citizen whom John has not adopted, also lives with them. John and his wife provide all the support for the two children. How many dependents can John claim?

a. One

b. Two

c. Three

d. Zero

Can a taxpayer claim an adopted foreign-born child as a dependent?

A U.S. citizen or national can claim a legally adopted child who is not a U.S. citizen, U.S. resident alien, or U.S. national provided the child is a member of the taxpayer's household all year. All the other rules for a qualifying child or qualifying relative must be met, and the child must have an SSN, ITIN, or ATIN to be claimed as a dependent.

An Adoption Taxpayer Identification Number (ATIN) can be obtained when a domestic adoption is pending and other rules are met. An ATIN can be obtained in a foreign adoption when the child already possesses a green card or a certificate of citizenship, which identifies a child born overseas as a U.S. citizen.

See Publication 519 for more information about the citizen or resident test, including who is considered a U.S. national.

An adopted nonresident alien child must live with the taxpayer all year to pass the citizen or resident test.

Summary

Resident aliens follow the same tax laws as U.S. citizens.

To determine the residency status of a noncitizen, use the Nonresident Alien or Resident Alien decision chart in the Volunteer Resource Guide, Tab L, Resident/NR Alien.

If a citizen or resident alien is married to a person who does not meet the green card or substantial presence test, the couple can elect to treat the nonresident spouse as a resident alien for tax purposes and file a joint return.

A U.S. citizen's child is usually a U.S. citizen by birth, even if the child is born in another country.

A nonresident alien stepchild generally will not pass the citizenship or resident test and therefore cannot be claimed as a dependent, unless the child is a resident of Canada or Mexico.

An adopted nonresident alien child can usually be claimed as a dependent if the child lives with the taxpayer the entire year.

What situations are out of scope for the VITA/TCE programs?

The following are out of scope for this lesson. While this list may not be all inclusive, it is provided for your awareness only.

- Taxpayers with F, J, M, or Q visas, unless there is a volunteer and quality reviewer at your site with Foreign Student certification
- Nonresident aliens who do not meet the green card or substantial presence test and are not married to a U.S. citizen or resident alien
- Individuals having a dual status for the tax year
- Nonresidents who are married to U.S. citizens or resident aliens can make an election to file a joint return for tax purposes and file as Married Filing Jointly. Preparation of the required statement is out of scope.

EXERCISE Answers

Answer 1: Since Dante meets the substantial presence test, he is considered a U.S. resident alien for tax purposes and must follow U.S. tax laws. Dante and Gloria can use either the Married Filing Jointly or Married Filing Separately filing status.

Answer 2: a, Yes. Raul can claim Head of Household status because his children are his qualifying persons. If Raul did not have a qualifying person, he would have to use the Married Filing Separately filing status since his wife chose not to file a joint return.

Answer 3: a, Yes. The children meet the substantial presence test because they were in the United States more than 183 days. Terry's stepchildren are considered resident aliens for tax purposes. As long as the other requirements for qualifying child or qualifying relative are met, Terry can claim the stepchildren as dependents on his tax return. They have to obtain SSNs or ITINs.

Answer 4: a. John can claim his son as a dependent. The son qualifies as a U.S. citizen because his father is a U.S. citizen. The stepdaughter does not meet the U.S. citizen or resident test. A spouse is never considered a dependent.

Income – Wages, Interest, Etc.

Introduction

This is the first of nine lessons covering the Income section of the taxpayer's return. A critical component of completing the taxpayer's return is distinguishing between taxable and nontaxable income and knowing where to report the different types of income on Form 1040.

Objectives

At the end of this lesson, using your resource materials, you will be able to:

- Distinguish between taxable and nontaxable income
- Distinguish between earned and unearned income
- Report income correctly on Form 1040

The following chart will help you select the appropriate topic for your certification course.

	Certification Course			
	Basic	Advanced	Military	International
Wages & Reported Tips	Yes	Yes		
Unreported Tip Income		Yes		
Scholarship and Fellowship Income	Yes	Yes		
Interest Income	Yes	Yes		
Dividend Income	Yes	Yes		
Taxable Refunds	Yes	Yes		
Alimony Received	Yes	Yes		
Business Income		Yes		
Capital Gain/Loss		Yes		
Other Gains/Losses	N/A	N/A	N/A	N/A
IRA Distributions*	Yes	Yes		
Pensions/Annuities*	Yes	Yes		
Rental Income			Yes	
Schedule K-1 Distributions		Yes		
Farm Income	N/A	N/A	N/A	N/A
Unemployment Compensation	Yes	Yes		
Social Security Benefits	Yes	Yes		
Other Income	Yes	Yes		
Foreign Earned Income				Yes
Military Income			Yes	

*Basic only if the taxable amount is shown in box 2a.

What do I need?

- Form 13614-C
- Publication 4012
- Publication 17

Optional:

- Form 1040 Instructions
- Form 1099-PATR

Schedule B

- Publication 531
- Publication 550
- Publication 926
- Publication 970

How do I determine taxable and nontaxable income?

The Income Quick Reference Guide in the Volunteer Resource Guide, Tab D, Income, includes examples of taxable and nontaxable income.

Gross income is all income received in the form of money, goods, property, and services that is not exempt from tax. It includes income from sources outside the U.S. or from the sale of a primary residence, even if part or all of that income can be excluded. Gross income may include part of Social Security benefits received and certain scholarship and fellowship grants.

- Income that is taxable must be reported on a taxpayer's return and is subject to tax.
- Income that is nontaxable may have to be shown on a taxpayer's return but is exempt from tax.

What are types of taxable income?

Form 1040 and its associated schedules are used to report earned and unearned taxable income.

- Earned income – any income received for work, such as wages or business/self-employment income
- Unearned income – any income not earned from work, such as unemployment income or income produced by investments, such as interest on savings, dividends on stocks, or rental income

What are examples of nontaxable or exempt income?

Some nontaxable income such as gifts and inheritances are excludable and not shown on the return.

Exempt income includes such things as interest income produced from certain types of investments. There are some instances when exempt income is shown on the return but not included in the income tax computation, for example, tax-exempt municipal bond interest income.

Under the Victims of Terrorism Tax Relief Act of 2001, the following amounts are not included in income:

- Certain disability payments received in tax years ending after September 10, 2001, for injuries sustained in a terrorist attack
- Payments from the September 11th Victim Compensation Fund of 2001
- Qualified disaster relief payments made after September 10, 2001, to cover personal, family, living, or funeral expenses incurred because of a terrorist attack
- Death benefits paid by an employer to the survivor of an employee if the benefits are paid because the employee died as a result of a terrorist attack

The Act also provides that the federal income tax liability of those who died as a result of the following attacks is forgiven for certain tax years:

- The September 11, 2001 attacks on the World Trade Center, the Pentagon, and United Airlines Flight 93 in Somerset County, Pennsylvania
- Terrorist attacks involving anthrax occurring after September 10, 2001, and before January 1, 2002
- The April 19, 1995 attack on the Alfred P. Murrah Federal Building

For additional details, see Publication 3920, Tax Relief for Victims of Terrorist Attacks.

How do I get started?

To determine a taxpayer's income, discuss and review the Income section of the intake and interview sheet with the taxpayer.

Income is reported on a variety of forms depending on its source. Ask taxpayers to show you all Forms W-2, Forms 1099, and other statements reporting income. Also ask taxpayers if they received income that was not

reported on a tax form, such as odd jobs or tips from customers. (Do not confuse Form 1099 with Form 1098. Generally, Form 1098 reports expenses the taxpayers have paid, not income they have received.)

After you have collected all the income statements, review the pages on income documents and How/Where to Enter Income in the Volunteer Resource Guide, Tab D, Income. These pages will show you where to correctly report income items.

Tax-Aide scope: Any transaction using a virtual currency and buying, owning, or selling a virtual currency are out of scope. Refer affected taxpayers to a professional paid preparer. Identify these situations as early in the interview as possible.

Virtual currency is a digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value. In some environments, it operates like "real" currency (i.e., the coin and paper money of the United States or of any other country that is designated as legal tender, circulates, and is customarily used and accepted as a medium of exchange in the country of issuance), but it does not have legal tender status in the U.S. Virtual currency that has an equivalent value in real currency, or that acts as a substitute for real currency, is referred to as "convertible" virtual currency. Bitcoin is one example of a convertible virtual currency.

How do I report wages, salaries, tips, etc.?

What is Form W-2?

Employers must report wages and other employee compensation on Form W-2. Employers are not required to mail Forms W-2, but they must make them available to employees by January 31. Employees may need to pick up Form W-2 from their employers or obtain it electronically. Most employers issue a standardized version of Form W-2, Wage and Tax Statement. Go to **www.irs.gov** to view Form W-2.

Additional Medicare Tax applies to an individual's wages, Railroad Retirement Tax Act compensation, and self-employment income that exceeds a threshold amount based on the individual's filing status. This topic is out of scope for the VITA/TCE programs. Taxpayers affected by the Additional Medicare Tax should be referred to a professional tax preparer. Additional information can be found on **www.irs.gov**

A Form W-2 with code Q in Box 12, indicating combat pay, requires Military certification to complete the return.

Refer to the Volunteer Resource Guide, Tab D, Income, for instructions on entering income. Once you enter all Forms W-2 into the software, it carries the total to Form 1040 and transfers necessary information for credits, deductions, withholding, etc., to other sections of the tax return.

What if the taxpayer does not receive Form W-2 by January 31?

Taxpayers who do not receive Form W-2 by January 31 should first contact the employer and find out if, or when, the form was mailed, or if it can be picked up or accessed online. Also, taxpayers may order transcripts from IRS.gov and receive the information by mail.

If Form W-2 is still not received after allowing a reasonable amount of time for the employer to issue or reissue it, then the taxpayer should contact the IRS for assistance after February 15.

If taxpayers do not receive Form W-2 before the filing deadline, they should file their tax return with Form 4852, Substitute for Form W-2, Wage and Tax Statement, or Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc. Taxpayers will need to provide the information required to complete Form 4852, such as the last paycheck stub. Taxpayers should keep a copy of Form 4852 for their records. Your coordinator may need to determine whether Form 4852 can be filed with a state return as well.

If the taxpayer eventually receives the employer's Form W-2, and the numbers differ from those on Form 4852, the taxpayer will need to amend the return to report the correct amounts.

If the earnings reported on Form 4852 are not reflected on the taxpayer's Social Security Statement, the taxpayer should contact the Social Security Administration at the number shown on the statement. See Publication 5396-A: Job Aid for VITA/TCE Volunteers: Using Form 4852 when Missing the Form W-2 or 1099-R (PDF) for help completing the form.

During the tax year, Tina earned income from both a full-time and a part-time job. She received two Forms W-2, each listing different employers. Her return will list her wages as the total of the amounts in Box 1, but each Form W-2 must be entered into the tax software separately.

What if the taxpayer has an ITIN, but a Form W-2 is showing a different SSN?

Use the taxpayer's ITIN when starting the return. Enter the Social Security number as shown on the Form W-2 when prompted by the tax software. Refer to the Volunteer Resource Guide, Tab D, Income, for instructions.

What is Box 10, Dependent Care Benefits?

Box 10 is used by employers to report dependent care benefits paid to the taxpayer or incurred on behalf of the taxpayer. Complete Form 2441, Child and Dependent Care Expenses, to determine if any part of this benefit is taxable to the taxpayer and the allowable amount of dependent care credit. Some employer plans provide a carryover or forfeiture of benefits that are not used by year end. This may require part III of Form 2441 to be completed.

What do Box 12 codes mean?

There are numerous code letters that the employer can use to designate certain items, such as employee contributions to the company retirement plan. Refer to the list of codes in the Volunteer Resource Guide, Tab D, Income.

The tax software will automatically transfer qualified voluntary retirement contributions to Form 8880, Credit for Qualified Retirement Savings Contributions, for the retirement savings credit. Refer to the Volunteer Resource Guide, Tab G, Nonrefundable Credits, for instructions on how to enter these amounts. Also see the Miscellaneous Credits lesson.

Code FF in Box 12 of a Form W-2 indicates a Qualified Small Employer Health Reimbursement Arrangement (QSEHRA) and is out of scope for the VITA/TCE programs. Codes R and T are also out of scope. Code Q is in scope for volunteers with Military certification only.

What do Box 13 checkmarks mean?

There are three checkboxes in Box 13:

- Statutory employees receive Form W-2 for their pay and have taxes withheld; however, statutory employees may report their income and deduct their expenses on Schedule C. See the Business Income lesson for more information.
- Retirement plan indicates that the employee participated in the employer's retirement plan. If the taxpayer or spouse (if MFJ) makes IRA contributions, their deduction may be limited. See the Adjustments lesson for more information.
- Third-party sick pay is reported on Form W-2 by the insurance company when it is taxable.

What do Box 14 codes mean?

This box may be used for other information, such as state disability insurance taxes withheld, union dues, uniform payments, health insurance premiums deducted, nontaxable income, educational assistance payments, or a minister's parsonage allowance and utilities. In addition, the following may be entered in Box 14: contributions to a pension plan: (a) nonelective employer contributions made on behalf of an employee, (b) voluntary after-tax contributions (but not designated Roth contributions) that are deducted from an employee's pay, (c) required employee contributions, and (d) employer matching contributions.

Other Wage Income

Can a disability pension be treated as wages?

An individual who has not reached their employer's minimum retirement age and is receiving a disability pension may report the disability pension as wages for tax purposes, such as the earned income credit. This is discussed in the Retirement Income lesson.

What about income received by household employees?

The term "household employee" refers to an individual who works in someone's home performing household duties such as caring for children, cleaning, or cooking. Generally, an employer is not required to provide Form W-2 to a household employee who earns less than the threshold amount for that year. In this situation, neither the employer nor the employee will owe Social Security or Medicare tax on those wages. However, employers who withhold federal income taxes from their employee's wages must issue Form W-2. Regardless of whether Form W-2 is issued, the income must be included on Form 1040.

For further information and a definition of who is a household employee, see Publication 926, Household Employer's Tax Guide.

What about Qualified Medicaid Waiver Payments?

Qualified Medicaid waiver payments, as defined in IRS Notice 2014-7, may be excluded from gross income. Qualified Medicaid waiver payments may be excluded from gross income only when the care provider and the care recipient reside in the same home. When the care provider and the care recipient do not live together in the same home, the Medicaid waiver payments may not be excluded from gross income.

A taxpayer may choose to include qualified Medicaid waiver payments in the calculation of earned income for the Earned Income Credit (EIC) and Additional Child Tax Credit (ACTC). The taxpayer may include qualified Medicaid waiver payments in earned income even if the taxpayer chooses to exclude those payments from gross income.

- A taxpayer may not choose to include or exclude only a portion of qualified Medicaid waiver payments. Either include all or none of the qualified Medicaid waiver payments for the taxable year in earned income.
- If the taxpayer chooses to include qualified Medicaid waiver payments in earned income, that amount will be included in the calculation for both the EIC and the ACTC.
- A taxpayer and spouse can each make separate elections to include or not include their respective Medicaid waiver payments in earned income.

Taxpayers who excluded qualified Medicaid waiver payments from gross income in prior tax years may amend a return for any open tax years to include Medicaid waiver payments in earned income for the EIC and ACTC.

For more information, refer to the Volunteer Resource Guide, Tab D, Income, Entering Medicaid Waiver Payments and **www.irs.gov/individuals/certain-medicaid-waiver-payments-may-be-excludable-from-income**.

Tip Income

...

If taxpayers have jobs for which they get a W-2 and in which tips are normally received (e.g., waiter/waitress, bellhop, or motel/hotel housekeeper), be sure to ask about any tips they may have received. All tip income is taxable, whether or not it is reported to the employer.

If individuals receive more than $20 per month in tips at one job and report their tip income to their employer, the tips will be included in Boxes 1 and 7 on Form W-2.

What are allocated tips?

To ensure that everyone reports their fair share of income from tips, some employers have tip allocation programs. These programs are approved by the IRS. If an employee reports tips to the employer that were less than the designated share based on the employer's formula, the employer reports the difference as "allocated tips" and includes it on the employee's Form W-2.

Allocated tips are shown separately in Form W-2, Box 8. Social Security and Medicare taxes are not withheld on allocated tips. Allocated tips are not included in the amount in Form W-2, Box 1. Explain to the taxpayers that unless they kept a written and reliable record of tips actually received at that job, the allocated tips must be included in Form 1040 as wages.

When allocated tips are reported on Form W-2, the software automatically adds them to Form 1040 and also completes Form 4137, Social Security and Medicare Tax on Unreported Tip Income. Refer to the Volunteer Resource Guide for instructions to enter the taxpayer's actual amount of tips according to their tip log

What about unreported tips?

An individual is not required to report tip income to their employer if it is $20 or less per month. Since these tips are subject to federal income tax, ask taxpayers if they have any tip income that was not reported to their employer.

Other Tips

- Noncash tips (e.g., tickets or passes) do not have to be reported to the employer, but must be included as taxable income at their fair market value.
- Tips of less than $20 per month or noncash tips are not subject to Social Security and Medicare taxes.
- If tips of more than $20 a month were not reported to the employer, the taxpayer must also pay Social Security and Medicare taxes. Complete Form 4137 if the taxpayer received tips that were not reported to the employer. This form calculates the appropriate income, Social Security, and Medicare taxes.

Self-employed taxpayers who receive tips, such as hair stylists and manicurists, should include their tips in gross receipts on Schedule C.

If the taxpayer has unreported tip income, enter the income on Form W-2, unreported tip income box. This will initiate Form 4137. Refer to the Volunteer Resource Guide, Tab D, Income, for instructions on how to enter tip income.

For more information about tip income, see Publication 531, Reporting Tip Income.

What is penal income (or prisoner income)?

An individual may be compensated while in a penal institution, a work-release program, or in a halfway house. The compensation will be reported on Form W-2 but it is not treated as earned income for most tax benefits, such as the earned income credit. The amount is reported as wages on Form 1040, Schedule 1. Refer to the Volunteer Resource Guide, Tab D, Income, for instructions on how to identify and enter penal income, also known as prisoner income.

Under the PATH Act, a wrongfully incarcerated individual does not include in income any civil damages, restitution, or other monetary award received that relates to his or her incarceration.

Scholarship and Fellowship Income (Form W-2 and Form 1098-T)

Are scholarships and fellowships taxable income?

Scholarships and fellowships may be fully or partially taxable, or nontaxable. Taxable amounts include:

- Payment for services
- Money used for personal living expenses, such as room and board

If the taxpayer received Form W-2 for the scholarship or fellowship it is considered earned income. Include the amount on Form 1040 as wages just as you would any other Form W-2.

Form 1098-T reports scholarships and grants received as well as qualified tuition and related expenses paid to the school. Verify that these amounts are correct by reviewing the student's detailed financial account transcript [ ]. If scholarships or grants exceed the qualified educational costs, some of the grant or scholarship may be taxable to the student (not the taxpayer claiming the student as a dependent).

In certain situations, the student may choose to include all or part of certain scholarships or grants in income in order to increase an education credit. This is explained in the education credits lesson, and examples can be found in the Form 8863 Instructions and Publication 970, Tax Benefits for Education.

Taxable scholarship income is treated as earned income to determine whether the student has a filing requirement and compute their standard deduction amount. Taxable scholarship income is treated as unearned income for all other purposes, such as the kiddie tax, earned income credit or additional child tax credit, etc.

Taxable scholarships are entered into the software in the Income>Less Common Income>Other compensation> Scholarships and Grants section, but are shown as part of Wages on the tax return with "SCH" printed on the line. Refer to the Volunteer Resource Guide for specific entries.

What about higher education emergency financial aid grants?

Emergency financial aid grants under the CARES Act for unexpected expenses, unmet financial need, or expenses related to the disruption of campus operations due to the COVID-19 pandemic, such as unexpected expenses for food, housing, course materials, technology, health care, or childcare, are qualified disaster relief payments under section 139 of the Internal Revenue Code. This grant is not includible in gross income and it does not reduce qualified education expenses that can be used for an education credit or deduction.

What about loan repayment assistance programs (LRAPs) for health care professionals?

Education loan repayments are not taxable if they are made to taxpayers by:

- The National Health Service Corps Loan Repayment Program
- A state education loan repayment program eligible for funds under the Public Health Service Act, or
- Any other state loan repayment or loan forgiveness program that promotes increased availability of health professionals/services in underserved areas

The taxpayer should not receive a tax form because the amount is not taxable. If there is any question, the taxpayer should contact the repayment agency.

What about ministers or other members of the clergy?

The ministry profession presents unique issues, such as the parsonage/housing allowance, whether earnings are covered under FICA or SECA (self employment tax), and the rules for being exempt. Publication 517, Social Security and Other Information for Members of the Clergy and Religious Workers, covers this topic. This information is provided for awareness only and is out of scope for the VITA/TCE programs. Taxpayers who have these issues should be referred to a professional tax preparer.

What interest is taxable?

Common sources of taxable interest income are checking and savings accounts, certificates of deposit (CDs), savings certificates, U.S. government bonds, interest on insurance proceeds, and loans that the taxpayer makes to others. Some savings and loans, credit unions, and banks call their distributions "dividends." These distributions are really interest and are reported correctly as interest on Form 1099-INT.

If a taxpayer received less than $10 in interest, the financial institution might not issue Form 1099-INT. Even if the taxpayer did not receive Form 1099-INT, they must still report all of their taxable interest income, including any interest paid by the IRS. The interest amount for the year will typically be shown on the December statement.

Taxpayers may have additional Foreign Bank and Financial Accounts (FBAR) filing requirements if they:

- *Have financial accounts or signature authority over a financial account in a foreign country (generally with a value of $10,000 or more at any time during the year).*
- *Received a distribution from, or were the grantor of, or transferor to, a foreign trust.*

If the FATCA (Foreign Account Tax Compliance Act) filing requirement box is checked on Forms 1099-INT, 1099-DIV, or any other income reporting document, the taxpayer may have a FATCA filing requirement. Refer these taxpayers to a professional tax preparer.

Where do I get interest income information?

There are many sources of information about interest income. Ask the taxpayer to supply all Form(s) 1099-INT from institutions that pay interest. Some institutions issue a year-end summary statement with the title "In lieu of Form 1099-INT or Form 1099-DIV" rather than preparing multiple documents for each account.

Original Issue Discount (OID) is a form of interest income. A debt instrument generally has OID when issued for an amount that is less than its stated redemption price at maturity. The issuer of the debt instrument will report the amount of OID that is currently taxable on Form 1099-OID, Original Issue Discount, or a similar statement.

Entries in Boxes 10,11,12 and 13 of Form 1099-INT, and Boxes 5 and 10 of Form 1099-OID are in scope. Enter the information just as it appears on the information reporting documents (type what you see) and TaxSlayer software will complete the calculations.

If the amount reported in Box 11 exceeds the amount reported in Box 1, the return is out of scope.

If the amount reported in Box 12 exceeds the amount reported in Box 3, or if the amount reported in Box 13 exceeds the amount reported in Box 8, the return is also out of scope.

If the taxpayers cashed in Series EE or Series I bonds, they should have received a Form 1099-INT. Most taxpayers report the total interest when they cash in the bonds. Few taxpayers elect to report savings bond interest as it accrues each year. This accrual method is out of scope for the volunteer program and taxpayers should be referred to a professional tax preparer.

Interest on qualified U.S. Series EE and Series I savings bonds that are used to pay for higher education expenses may be eligible for exclusion from income using Form 8815, Exclusion of Interest From Series EE and Series I U.S. Savings Bonds Issued After 1989. Form 8815 is out of scope for the VITA/TCE programs.

A Net Investment Income Tax applies to individuals, estates and trusts that have certain investment income above certain threshold amounts. This topic is out of scope for the VITA/TCE programs. Taxpayers affected by the Net Investment Income Tax should be referred to a professional tax preparer. Additional information can be found in Publication 17 or on **www.irs.gov**

If a U.S. savings bond is issued in the names of co-owners, such as the taxpayer and child, or the taxpayer and spouse, interest on the bond is generally taxable to the co-owner who purchased the bond. To determine who is responsible for paying the tax on the interest from the redemption of a bond, see Publication 17, Interest Income.

- Ask the taxpayer for all tax statements reporting the interest received.
- Ask if the taxpayer holds any loans or seller-financed mortgages.
- Ask if the taxpayer received any interest that was not reported on tax statement.

The taxpayer will likely not receive a tax form for interest received from a private borrower. The name, Social Security number, and address of the payer (the buyer) of interest on a seller-financed mortgage is required to e-file a return.

Bob holds a promissory note for a cash loan that he made to his brother-in-law, Stan. Stan pays Bob principal and interest each month. Even though Bob does not receive a Form 1099-INT, he reports that interest on Schedule B of his tax return.

Hazel has four savings accounts in four different banks. The total amount of interest earned from the accounts is $3,000. Hazel will receive four Forms 1099-INT. She will list each payer and amount on Schedule B and file it with her tax return.

The manner of reporting interest income on Series E, Series EE, or Series I U.S. savings bonds, after the death of the owner (decedent), depends on the accounting and income-reporting methods previously used by the decedent. See Publication 550, Investment Income and Expenses, for additional information.

Interest from U.S. government obligations is not taxable by any state. Refer to the Volunteer Resource Guide, Tab D, Income, for the entries needed to identify the interest that is not taxable for state purposes.

What interest income is tax-exempt?

Certain types of interest are exempt from federal income tax. However, they may be taxable on the state tax return, and sometimes the reverse is true; the interest may be taxable on the federal return and exempt from state income tax.

Interest from bonds issued by the following are exempt from federal income tax:

- State and political subdivisions (county or city)
- District of Columbia
- U.S. possessions and political subdivisions
- Port authorities
- Toll-road commissions
- Utility service authorities
- Community redevelopment agencies
- Qualified volunteer fire departments
- Amounts indicated on broker statements as tax-exempt interest or tax-exempt dividends

Read the taxpayer's Form(s) 1099-INT carefully; both taxable and tax-exempt interest may be listed. Specific software entries are needed based on the source of the municipal interest income. Consult with your Coordinator if you have any questions.

Municipal mutual funds report the exempt interest as dividends on Form 1099-DIV. This income is interest income and while you may enter the amounts as "exempt interest dividends" in the software, they will appear on the interest income line of Form 1040.

Interest from Private Activity Bonds (PAB) may be shown on the interest statement. It is a subset of tax-exempt interest and may affect the Alternative Minimum Tax. Taxpayers who are subject to the Alternative Minimum Tax should be referred to a professional tax preparer. Although tax-exempt interest is not taxable, it must be reported on Form 1040. Tax-exempt interest is used in calculating the taxability of some income items, such as Social Security benefits.

What if a bond is sold between interest payment dates?

If a bond is sold between interest payment dates, part of the sales price represents interest accrued to the date of the sale. This amount is taxable to the seller and must be reported as interest income for that tax year, even if the seller does not receive a Form 1099-INT. The buyers of the bond may receive a 1099-INT reflecting the accrued interest and will treat this amount as a return of capital investment, reducing their basis in the bond. Payers and brokers will report the correct amount of interest on the Form 1099-INT/OID for all covered securities. Taxpayers who sell noncovered bonds between interest payment dates should be referred to a professional tax preparer. If taxpayers would like additional information, refer them to Publication 550, Investment Income and Expenses.

To review information related to the software, go to the Volunteer Resource Guide, Tab D, Income, Interest Income entries.

What about the interest on an IRA?

Generally, interest on a Roth IRA is not taxable. However, if the criteria for distribution are not followed, the interest is taxable.

Interest on a traditional IRA is tax-deferred. Do not include that interest in taxable income until the taxpayer receives distributions from the IRA, which will be reported on Form 1099-R. See the Retirement Income lesson, Publication 17, and Publication 590-B, Distributions from Individual Retirement Arrangements, for more information on IRA distributions.

Mike makes contributions to a traditional IRA each year. Throughout the year, he gets statements listing the interest earned. Because it is tax-deferred, he does not report any of the interest income from his traditional IRA on his tax return.

How do I report interest income?

Interest income is entered on Form 1040. Amounts labeled Interest income and Interest on U.S. Savings Bonds and Treasury obligations on Form 1099-INT are reported as taxable interest. Be sure to enter any tax-exempt interest as directed in the software.

If the taxpayer receives Form 1099-OID, ensure that all the amounts included on Forms 1099-INT and 1099-OID are entered in the correct places in the software and on Form 1040. These will be discussed in later lessons. For example, amounts shown in the early withdrawal penalty box will appear in the Adjustments section and any federal income tax withheld is shown in the Payments section. Entries shown in the foreign tax paid and foreign country boxes will be discussed in the Foreign Tax Credit lesson.

If taxpayers indicate they are a nominee, there are adjustments needed for any of the amounts listed on Form 1099-OID, or if they have income from original issue discount but did not receive a Form 1099-OID, refer them to a professional tax preparer to ensure the correct amount is reported.

Refer to the Volunteer Resource Guide, Tab D, Income, for instructions on entering interest income. The software will file Schedule B if required.

Taxpayer Interview and Tax Law Application

Barbara Smith is a clerk with the United States Postal Service. She has one Form W-2.

Sample Interview

Volunteer Says...	Barbara Responds...
Now we will complete the income section of your return. I believe you told me that you work at the post office?	Yes. Here is my W-2.
Are you employed by anyone else?	No way, they keep me busy enough at the post office!
Did you have any disability income?	No, I'm not disabled.
Now, let's go on to interest income. Did you earn any interest on checking accounts, savings accounts, or a certificate of deposit?	Yes, I have a savings account that earns interest. Here is the 1099-INT.
What about U.S. savings bonds? I know that a lot of postal employees buy them at work	Yes, I do, every pay period.
Are they for educational purposes, or just an investment?	No, they aren't educational. I don't have any information about my bonds with me. Why would I need that?
Some people report the interest as it accrues every year. You have to make this decision in the first year after you buy the bonds. Have you ever declared accrued interest from your savings bonds on your federal tax return?	Oh, no, never.
Well, did you redeem any bonds, or did any of them mature during this tax year?	No to both questions. I've been buying them for 15 years and they don't become fully mature for 30 years.
Okay, then it sounds like your only interest income is from the savings account.	

How do I handle dividends?

The corporate distributions that volunteer tax preparers may handle are:

- Ordinary dividends
- Section 199A dividends
- Qualified dividends
- Capital gain distributions
- Unrecaptured Sec. 1250 gain — in scope for Tax-Aide
- Nondividend distributions

These are all reported on Form 1099-DIV.

What are ordinary dividends?

Ordinary dividends are corporate distributions paid out of the earnings and profits of a corporation. Any dividend received on common or preferred stock is an ordinary dividend unless the paying corporation states otherwise. Ordinary dividends are reported on Form 1099-DIV.

Olivia held both common stock and preferred stock in several U.S. corporations. Several of them paid dividends during the tax year. The following January she received Forms 1099-DIV listing these as ordinary dividends.

What are Section 199A dividends?

A subset of ordinary dividends is called Section 199A dividends, which are eligible for the qualified business income deduction. See the Standard Deduction lesson for this deduction and the Volunteer Resource Guide, Tab D, Income, for software entries.

What are qualified dividends?

Qualified dividends are ordinary dividends that qualify for lower, long-term capital gains tax rates. See Publication 550, Investment Income, for a detailed definition of qualified dividends.

Taxpayers who have questions about why a dividend is qualified or not qualified should contact the company that paid the dividend.

What are capital gain distributions?

Capital gain distributions are also called capital gain dividends. They come from mutual funds and real estate investment trusts (REITs). They are taxed at the lower long-term capital gains rate, regardless of how long the taxpayer holds the shares. Capital gain distributions are reported to the taxpayer on Form 1099-DIV. While you may enter these distributions in the dividend section of the software, these distributions will appear as long-term capital gains on Form 1040 and on Schedule D if required.

What are unrecaptured Sec. 1250 distributions? (in scope for Tax-Aide)

A subset of capital gain distributions that are not eligible for capital gain treatment. Enter the amount as shown and the tax software will make the proper tax calculation.

Capital gains are not the same as capital gain distributions. A capital gain distribution is the owner's portion of the capital gains that were realized when the mutual fund or REIT sold assets. A volunteer with a Basic certification can prepare a return with this type of income.

A capital gain occurs when the owner of a mutual fund or other capital asset sells the asset for more than its cost. A volunteer must have Advanced certification to prepare a return for taxpayers who sold mutual fund shares, or other shares of stock.

What are nondividend distributions?

Form 1099-DIV also shows nondividend distributions, which is the part of a distribution that is nontaxable because it is a return of the taxpayer's cost or other basis in a stock or security. Brokers will keep track of these and other basis adjustments for covered securities. Otherwise, taxpayers should keep this information with their tax records in order to calculate the adjusted basis of the stock when it is sold.

During the tax year, Olivia owned shares in a mutual fund and in a real estate investment trust. Both made capital gain distributions that year. The following January she received Forms 1099-DIV listing these capital gain distributions.

Where do I get dividend information?

Taxpayers that hold their securities in a brokerage account will receive Form 1099-DIV from their broker. For stocks held directly, corporations use Form 1099-DIV to report dividend distributions to each shareholder. Ask the taxpayer for any Form(s) 1099-DIV. If the taxpayers did not receive a Form 1099-DIV for a dividend, they should contact the payer or their broker to get the needed forms.

What about Patronage dividends on Form 1099-PATR?

Form 1099-PATR, Box 1, shows patronage dividends paid to the taxpayer during the year in cash, qualified written notices of allocation (at stated dollar value), or other property (not including nonqualified allocations). Any dividends paid on property bought for personal use are not taxable. Ask the taxpayer if the patronage dividends are only for personal consumption of goods. Only when the dividends are not taxable are they in scope. In this case, it is not necessary to enter the dividend into the software.

How do I report dividend information?

Generally, all dividend income is reported on Form 1040. Schedule B may be needed if the taxpayer's ordinary dividends exceed a specified amount, or if the taxpayer was the nominee for dividends that actually belong to someone else. If the taxpayer received income as a nominee or if Form 1099-DIV includes amounts in boxes labeled Section 1202 gain, Collectibles (28%) gain, Section 897 ordinary dividends, Section 897 capital gain, Cash liquidation distributions, or Noncash liquidation distributions, the return is out of scope for the VITA/TCE programs. Refer taxpayers with amounts in these boxes to a professional tax preparer.

Any federal income tax withheld shown on a Form 1099-DIV is reported on the federal income tax withheld line of the return. Foreign tax paid will be covered in the Foreign Tax Credit lesson.

Review the Volunteer Resource Guide, Tab D, Income, for guidance for entering dividend income. If the taxpayer has multiple accounts, the software will add all the dividends for you, preventing math errors.

Taxpayer Interview and Tax Law Application

Leonard and Gloria are filing a joint return. Leonard and the volunteer are discussing dividend income.

Sample Interview

Volunteer Says...	Leonard Responds...
Do you and your wife own shares of stock, mutual funds, or bond funds?	Yes, I have an IRA and I own shares in several mutual funds and a bond fund. My wife has an IRA. Here are the statements.
The earnings on the IRAs are tax deferred until you take a distribution. These 1099-DIVs are what we want right now. Are these the only Forms 1099-DIV that you received?	Yes
We will enter the information from each of these in the tax software. It will add everything up and display it properly on your tax return	

How do I report a refund of state or local income taxes?

Taxpayers who receive a refund of state or local income taxes may receive Form 1099-G reporting their refund amount(s). Only taxpayers who itemized and received a federal income tax benefit for deducting their state or local income taxes have to include their state/local tax refunds in income. Not everyone must include the refund in their taxable income.

- Taxpayers who claimed the standard deduction on the tax return for the year they received a refund of state or local income taxes do not have to include the refund in their taxable income.
- Taxpayers who itemized and deducted the state sales tax instead of the state income tax withheld or paid do not have to include the refund in their taxable income.
- Some taxpayers could not deduct all their state income taxes because of the annual cap on state and local taxes deduction. Refer to the Volunteer Resource Guide, Tab D, Income, for the State and Local Refund Worksheet in the software to determine the amount, if any, of the refund that is taxable.

Note for Tax-Aide :

The Bogart taxable refund and recovery calculator (https://cotaxaide.org/tools/Refund%20Calculator.html) is very helpful in computing the taxable amount of a tax refund or other recovery in more complicated situations, such as when the prior year had nonrefundable credits that were not used because there was not enough tax to sop up the credit. Had the deduction not been claimed in that prior, there may have been no tax benefit so that the recovery of that item is not taxable.

If the state tax refund situation is straight forward, the worksheet found in the tax software can be used. Be sure to compute and enter the amount of sales tax that could have been deducted in the prior year. Use the IRS sales tax calculator at https://apps.irs.gov/app/stdc/ to compute the prior year sales tax amount.

Refunds of state or local taxes for years prior to the preceding year are in scope for Tax-Aide if it can be readily determined to be wholly taxable or wholly not taxable. For example, it is wholly nontaxable because the standard deduction was claimed in prior years. Or, the taxpayer agrees that the refund is wholly taxable.

Nancy itemized her deductions on last year's federal return. She included the income taxes paid to her state on Schedule A. During the current tax year, she received a state refund on the overpaid portion of those taxes. When filing her current year tax return, she must use the state tax refund worksheet to see how much of the refund to include in her federal taxable income.

Form 1099-G may also report agriculture payments, market gain, or box 8 indicating that the state payments are trade or business income. These situations are beyond the scope of the VITA/TCE programs and taxpayers with these items should be referred to a professional tax preparer.

What is alimony?

Alimony is a payment to or for a spouse or former spouse under a separation or divorce instrument. It may include payments on behalf of the spouse or former spouse, such as medical bills, housing costs, and other expenses. It does not include child support or voluntary payments outside the instrument.

Post-1984 and Pre-2019 Divorces

The person receiving alimony must include it as income. The person paying alimony can subtract it as an adjustment to income. Both items are reported on Form 1040, Schedule 1. The date of divorce or separation agreement must also be provided.

If the taxpayer is unsure whether a payment is alimony or child support, ask if the payments will stop once the child is grown.

Alimony income received under a pre-2019 divorce or separation instrument is unearned income. However, it is considered compensation, which may allow the taxpayer receiving alimony income to make a deductible traditional IRA or nondeductible Roth IRA contribution.

If the agreement was executed before 1985, refer the taxpayer to a professional tax preparer.

Where do I get alimony information?

Ask if the taxpayer received alimony under a divorce or separation instrument. If so, explain that you need the exact amount, since it may also be reported as a deduction by the payor, and the two amounts must agree.

How do I report alimony income?

Enter any alimony income on the alimony received screen. The Social Security number of the person paying the alimony is not needed.

Post-2018 Divorces

The Tax Cuts and Jobs Act provides that alimony and separate maintenance payments are not deductible by the payor spouse and repeals the code provisions that specify that alimony and separate maintenance payments are included in income by the recipient of the payments.

This treatment is effective for any divorce or separation instrument executed after December 31, 2018, or for any divorce or separation instrument executed on or before December 31, 2018, and modified after that date, if the modification expressly provides that the amendments made by the Tax Cuts and Jobs Act, Section 11051, apply to such modification.

State laws may differ.

Summary

This lesson covered income reported on Form 1040, including how to differentiate taxable and nontaxable income, and earned or unearned income.

- Earned income is any income received for work, such as wages or business/self-employment income.
- Unearned income is any income produced by investments, such as interest on savings, dividends on stocks, or rental income.
- The Form 1040 line 1 includes wages, salaries, tips, and scholarships usually reported to the taxpayer on Form W-2 as well as taxable scholarships or household employee income even when not shown on a Form W-2.
- Common sources of taxable interest income are checking and savings accounts, certificates of deposit (CDs), savings certificates, or U.S. government bonds. This interest is reported by the payer on Form 1099-INT and included in the taxpayer's income on Form 1040.
- Interest on certain bonds, such as from state political subdivisions, District of Columbia, or port authorities, are exempt from federal income tax but must be reported on Form 1040.
- Dividends are reported to the taxpayer on Form 1099-DIV. Ordinary dividends are corporate distributions paid out of the earnings and profits of a corporation. Qualified dividends are ordinary dividends that qualify for lower, long-term capital gains tax rates. Capital gain distributions are reported on Form 1040 and Schedule D, if required.

- Taxpayers who itemized deductions in the previous year and received a tax benefit from deducting state or local income taxes may have to report part or all of their refund as income. Taxpayers generally receive Form 1099-G reporting their state or local tax refund.
- Alimony is income received from a spouse or former spouse under a separation or divorce instrument. If the alimony was paid pursuant to a divorce or separation instrument executed on or before December 31, 2018, it is taxable income and included on Form 1040, Schedule 1.

What situations are out of scope for the VITA/TCE programs?

The following are out of scope for this lesson. While this list may not be all inclusive, it is provided for your awareness only.

- Taxpayers with income from the following sources:
  - Other gains/losses
  - Farm income
- Tax-Aide scope: Any transaction using a virtual currency and buying, owning, or selling a virtual currency are out of scope. Refer affected taxpayers to a professional paid preparer.
- Taxpayers subject to the Additional Medicare Tax, the Net Investment Income Tax, or the Alternative Minimum Tax
- Taxpayers who use the accrual method for reporting income
- Taxpayers who buy or sell noncovered bonds between interest payment dates
- Form 1099-INT amounts reported in the box labeled Specified private activity bond interest if AMT applies
- Form 1099-INT premium amount is greater than the respective amount of interest reported.
- Form 1099-DIV amounts reported in the boxes labeled Unrecap. Sec. 1250 gain, Section 1202 gain, Cash liquidation distributions, and Noncash liquidation distributions
- Adjustments needed for any of the amounts reported on Form 1099-OID, or if the taxpayer should have received Form 1099-OID but did not receive one
- State or local income tax refunds received during the current tax year for a year other than the previous tax year if it cannot be readily determined to be wholly taxable or not taxable (Tax-Aide only)
- Alimony/divorce agreements executed before 1985
- Tax returns for ministers and members of the clergy because of unique tax issues
- The FATCA filing requirement box is checked on any 1099 form.
- The taxpayer is required to file form FINCEN 114 or received a distribution from, or was the grantor of, or transferor to, a foreign trust.
- Taxpayers whose Form 1099-G reports agriculture payments, market gain, or box 8 indicates that the state payments are trade or business income.

To gain a better understanding of the tax law, complete the practice return(s) for your course of study using the Practice Lab on L&LT.

Income – Business

Entire lesson revised for Tax-Aide

Introduction

This lesson will help you prepare an accurate return for taxpayers who have business income, including self-employment income. Form 1040, Schedule C, Profit or Loss From Business (Sole Proprietorship), is used to report income from a business or profession operated as a sole proprietor or independent contractor. Preparation of tax returns with Schedule C are in scope for VITA/TCE with certain limitations as detailed below. You will learn how business income is determined and how it affects eligibility for certain tax credits.

This lesson also discusses general recordkeeping requirements for taxpayers with business income and expenses.

The following provisions, which may affect taxpayers who have a business, are discussed in later lessons:

- Deductible part of self-employment tax
- Self-employed health insurance deduction
- Qualified business income deduction
- Self-employment tax

What do I need?

- Form 13614-C
- Publication 4012
- Publication 334
- Publication 463
- Form 1099-K
- Form 1099-MISC
- Form 1099-NEC
- Schedule C
- Schedule C Instructions

Optional:

- Publication 535
- Publication 583

Objectives

At the end of this lesson, using your resource materials, you will be able to:

- Determine what is or is not a business
- Identify “red flags” when preparing a Schedule C return with earned income credit (EIC)
- Determine the sources of business income and how to report it
- Determine which business expenses are within the scope for the VITA/TCE programs and how to report them
- Determine what records should be maintained

What is a business?

Based on your interview and the completion of the taxpayer’s intake and interview sheet, you may discover that the taxpayer or spouse had business income from being self-employed or working as an independent contractor. Taxpayers are self-employed if they carry on an unincorporated trade or business as a sole proprietor or independent contractor. Carefully review the intake and interview sheet and ask follow-up questions to determine if the taxpayer or spouse had business income. Taxpayers may not think of themselves as “self-employed” if they have a small home business or work part-time as an independent contractor.

An activity qualifies as a business if the primary purpose for engaging in the activity is for income or profit and the taxpayer is involved in the activity with continuity and regularity. For example, a sporadic activity or a hobby does not qualify as a business.

Special rules apply to certain activities and are, therefore, outside the scope of the VITA/TCE programs. These include professional gamblers, illegal activities, or activities that are a hobby or otherwise not for profit. A hobby is an activity typically undertaken for pleasure and not for profit. Refer these taxpayers to a professional tax preparer.

Carefully review the intake and interview sheet and ask follow-up questions to determine if the taxpayer or spouse had business income. Taxpayers may not think of themselves as "self-employed" if they have a small home business or work part-time as an independent contractor.

What is in scope for VITA/TCE?

Volunteers can assist taxpayers who have returns that require Schedule C with certain limits:

- Have less than $35,000 in business expenses
  - Business expenses are amounts that are ordinary and necessary to carry on the business
- Use the cash method of accounting
  - All income is reported when received and expenses are deducted when paid
- Have no inventory at the beginning of the year.
  - Inventory is the items the taxpayer buys or makes for resale to others
  - The cost of an item of inventory is generally expensed when it is sold
  - Small business cash-basis taxpayers can expense purchases and not maintain inventories, discussed below
- Did not have a net loss from the business
- Have no employees during the year and did not pay contract labor for services (Possible classification as an employee or may require a 1099 to be issued
- Do not barter property or services
  - Bartering is an exchange of property or services
- Are not required to file Form 4562, Depreciation and Amortization, for this business to report depreciation or the election to expense business assets (also called a Sec. 179 expense)
  - Depreciations refers to the cost of items that are expected to last more than a year, which is spread over a period of years rather than deducted in the year of purchase
  - The de minimis expense election is different than a Sec. 179 expense election and allows an immediate deduction as discussed below
- Do not answer Yes to the digital asset (virtual currency) question on Form 1040
- Do not deduct expenses for business use of a home

During the interview, if you discover taxpayers have issues that fall outside the scope of the VITA/TCE programs, refer them to a professional tax preparer.

*Taxpayers who must answer **Yes** to the digital asset (virtual currency) question on Form 1040 should be referred to a professional tax preparer. Identify these situations as early in the interview as possible. Refer to Scope of Service in Publication 4012, VITA/TCE Resource Guide and Instructions for Form 1040 for details on digital assets.*

More than one Schedule C can be prepared if the taxpayer has more than one business or to report each spouse's share of the business if it is jointly operated and filing a joint return.

An individual may have set up a limited liability company (LLC) or other type of legal entity to limit their business risk. Refer such individuals to a professional tax preparer.

Taxpayer Interview and Tax Law Application

As you review the intake and interview sheet with taxpayers, ask questions to determine if they have any self-employment income, their accounting method, and their business expenses, as shown in this sample interview:

Sample Interview

Volunteer Says…	Jason Responds…
What kind of business do you have and were you the sole owner?	I install air conditioners and, yes, I own the business myself. No partners or employees.
Do you have a record of your business income and expenses for last year?	Yeah, I've got a separate checking account for my business. I had a pretty decent first year actually.
Do you use the cash method of accounting?	Yes. I have a printout of my year-end summary here.
And what were your expenses?	Well, I do the installations myself. I spend a lot of money on parts, tools that last less than a year, and equipment repairs. My expenses for the year were $2,212.
Do you keep any parts in inventory?	No, I purchase the parts when an order is placed with me.
And you say you had a good year? In other words, did you make a profit?	That's correct.
Do you plan on deducting expenses for the business use of your home?	No, I don't.
Okay, and how much business income did you have?	My gross totaled $30,762.
On page 2 of the intake and interview sheet, indicate Jason's responses to these questions.	

EXERCISE

Question 1: Based on the information in the sample interview, is Jason's return in scope for VITA/TCE?

a. Yes

b. No

Statutory Employees

Statutory employees receive Form W-2 for their pay and have taxes withheld; however, statutory employees may report their income and deduct their expenses on Schedule C. Statutory employees include full-time life insurance agents, certain agent or commission drivers, traveling salespersons, and certain home workers.

Enter the statutory employee income from Form W-2, Box 1, on line 1 of Schedule C. Social Security and Medicare taxes should have been withheld from the earnings; therefore, the taxpayer does not owe self-employment tax on these earnings. Be sure to indicate that this is a statutory employee on the input screen so that the self-employment tax is not computed by the software.

Self-employment income and statutory employee income cannot be reported on the same Schedule C. The taxpayer must file two separate Schedules C.

Some employers misclassify workers as independent contractors and report their earnings on Form 1099-MISC or Form 1099-NEC. Taxpayers who believe they have been misclassified should contact the IRS and ask for help.

How do you clarify taxpayers' business income and expenses?

All IRS-certified volunteers must exercise due diligence when preparing tax returns. This means, as a volunteer, you must do your part when preparing or reviewing a tax return to ensure the information on the

return is correct and complete. Generally, you can rely in good faith on information from a taxpayer without requiring documentation as verification.

However, when preparing a tax return with a Schedule C and the earned income credit (EIC), take additional steps to determine that the net self-employment income used to calculate the amount of, or eligibility for, EIC is correct and complete. Additional clarification or inquiries should be made if the information furnished by the taxpayer appears to be incorrect, incomplete, or inconsistent. Taxpayers sometimes want to over report or under report their income to qualify for or maximize the amount of EIC.

Ask sufficient questions of taxpayers claiming self-employment income to be satisfied that:

- The taxpayer actually conducts a business
- The taxpayer has records to support income and expenses, or can reasonably reconstruct income and expense records
- All income and related expenses have been included on the taxpayer's Schedule C

Emphasize to taxpayers that in the event of an IRS audit, they would need to provide receipts to support their reported income and expenses.

What Schedule C situations raise a "red flag"?

As a volunteer preparing a tax return with Schedule C, watch for examples of incorrect, incomplete, or inconsistent information, such as:

- Income reported in round numbers
- Cash as the only source of income on a return claiming EIC
- Schedule C income that qualifies the taxpayer for the maximum EIC
- Schedule C without a Form 1099
- Little or no expenses when expenses would be expected
- Taxpayers with little or no records for income and expenses
- Taxpayers who present information that is not consistent with a legitimate business activity

If you believe the taxpayer is presenting questionable information and they are not resolving your concerns, check with your Site Coordinator for guidance. Together, you may decide to decline preparing that return.

Taxpayer Interview and Tax Law Application

A taxpayer, Dana, comes in to have her tax return prepared. She tells you she runs her own babysitting business and wants to claim the EIC. To assist the taxpayer in completing an accurate return, you need to ask more questions to determine if Dana did incur allowable business expenses and that the income she reported is correct.

Sample Interview

Volunteer Says…	Dana Responds…
Tell me about your business, and were you the sole owner?	I have a babysitting service that I handle all by myself.
Do you have a record of your business income and expenses for last year?	Well, I'm not very good at keeping records, but I can tell you that I made $14,000 over the course of the year. I didn't have any expenses.
How did you determine that you made a net profit of $14,000?	I based my income on deposits to my checking account.
I see. We may be able to reconstruct your business income based on your deposits. Did you bring any bank statements or your checkbook record with you today?	No, I'm sorry.

Volunteer Says…	Dana Responds…
How many children did you care for, and was this a full-time or part- time job for you?	Babysitting is just part-time. I watch several of my neighbors' children along with my own kids who are 8 and 10 years old.
What is your fee for babysitting?	It averages about $10 an hour.
Do you have a calendar or schedule of the children present each day?	No, but I may be able to come up with one.
Do you have a business license or permit, and do you watch the children in your own home or in a daycare facility or in the client's home?	My home and sometimes at my neighbors' homes. I don't need a permit.
Do you buy any supplies such as food, diapers, toys, or other items necessary for the business?	Sometimes I need to buy supplies. But I didn't bring receipts with me.
Did you intend to deduct expenses for the business use of your home?	No, I don't think so.
Be aware that the IRS requires that you report all income and allowable expenses on your tax return. In the event of an IRS audit, you will be responsible for providing support for the income and expenses claimed on your return. Before we can proceed, you'll need to gather some additional facts and records. I'll write down a list of items that could help us more accurately calculate your net profit from your business.	OK – thanks. I'll see what I can pull together.

The information provided by the taxpayer appears to be both inconsistent and incomplete, because it is unlikely that someone who operates this type of business:

- Has no business expenses. Most businesses have expenses, even if it is just a few dollars here and there.
- Has annual gross receipts from the business that are an exact round dollar amount, and that amount maximizes EIC.

The volunteer cannot complete a return based on information provided, but gives Dana the chance to gather materials to document her business.

Where do I get business income information?

Business income information may come from the following:

- Forms 1099-NEC, Nonemployee Compensation
- Forms 1099-MISC, Miscellaneous Income
- Forms 1099-K, Payment Card and Third Party Network Transactions
- Forms W-2, Wage and Tax Statement, with Statutory Employee checked in Box 13
- Taxpayer's books and records

Income received from all sources in a self-employed taxpayer's business must be reported, unless excluded by law.

Tax-Aide only: *Taxpayers that have a business can complete the 2022 Self-Employed Sch C Worksheet (found in the Portal Library) to summarize their business income and expenses.*

Income not reported on a tax form

Some taxpayers may indicate that they received cash income for self-employment activity. This includes checks, electronic funds transfers, etc., and must be reported, unless excluded by law. Be sure to ask about any other income the taxpayer may have received such as tips or gratuities.

If taxpayers do not have adequate records of the cash income they received, you may be able to assist them with simple record reconstruction. See the section on reconstructing records later in this lesson.

Form 1099-NEC, Nonemployee Compensation

Taxpayers who are independent contractors should receive Form 1099-NEC showing the income they earned from payers who are required to file Forms 1099. Individuals (including for-hire drivers) who receive less than $600 may not receive Form 1099-NEC, but must still report all their income. Ask for documentation of any business income that was not reported on Form W-2 or Form 1099-NEC (e.g., payments received from individual clients who do not need to file Form 1099).

Tim works as an independent contractor for ABC Construction Company. The company sent Tim a Form 1099-NEC that shows he received $15,000 for the work he did for them. He also received cash payments of $4,000 from several different individuals for the work he completed. He did not receive Forms 1099-NEC for the $4,000. Tim must include the $4,000 cash payments as self-employment income along with the $15,000 from Form 1099-NEC.

Form 1099-MISC, Miscellaneous Income

Taxpayers may receive other business income reported on Form 1099-MISC, Boxes 2 and 3. Refer to Schedule C instructions for more information. Box 2 royalties from the taxpayer's own personal services are generally reported on Schedule C. Examples include authors and composers. If from another person's services, they are generally reported as other income in Box 3. An example is inherited royalties, which are reported as other income on Schedule 1 (not on Schedule C).

Form 1099-K, Payment Card and Third Party Network Transactions

Form 1099-K is used by third-party networks (such as Visa, MasterCard, or others) to report transactions processed for taxpayers, including those who use their automobiles for hire or ride share services such as Uber, Lyft, Sidecar, etc., also known as the Gig Economy. Taxpayers may not receive the Form 1099-K if the amount is less than $600, but the amount received must still be reported. For additional information regarding Gig Economy, see Gig Economy Tax Center at **irs.gov/businesses/gig-economy-tax-center**.

The third-party processor will not know whether the activity is a business unless the taxpayer has set up their payment account properly or identified nonbusiness transactions as such. Receipt of Form 1099-K or 1099-NEC may or may not represent a business activity. Individuals who receive Form 1099-K for personal transactions should contact the reporting entity or adequately identify personal transactions so they are not reported on Form 1099-K in the future.

Amounts reported on Form 1099-K that do not relate to a business should not be reported on Schedule C. For more guidance on Form 1099-K, see the NTTC Form 1099-K Payments tax law paper on the Portal.

Volunteer sites may see more Forms 1099-K than in the past because the form filing threshold has been substantially reduced. Due diligence is needed to ascertain the correct reporting ofthese proceeds, if any.

Income from Covid-19 Related Grants

If a grant was awarded to a business, even a self-proprietor Schedule C business, the COVID grant must be declared and is taxable and subject to self-employment tax. IRS has issued guidelines for state and local governments on the taxability and reporting of certain payments [https://www.irs.gov/newsroom/irs-updates-answers-to-states-and-local-governments-on-taxability-and-reporting-of-payments-from-coronavirus-state-and-local-fiscal-recovery-funds]. If the taxpayer receives a Form 1099, it will generally indicate that the payment is taxable and should be reported on Schedule C if it relates to their business.

Forgiveness of Paycheck Protection Program loans is not taxable and no tax documents should have been received for such forgiveness.

Qualified Medicaid Waiver Payments

Certain caregiving income may be qualified Medicaid waiver payments and **may be excluded from gross income**. To be qualified Medicaid waiver payments, the care provider and the care recipient must reside in the same home. When the care provider and the care recipient do not live together in the same home, the Medicaid waiver payments are fully taxable.

Medicaid waiver payments are most often reported on Form W-2 (discussed in an earlier lesson); but, some payers report on a Form 1099. To find out how Medicaid waiver income is reported in your state, check with your Site Coordinator. Taxable caregiving income reported on Form 1099 is reported on Schedule C if it constitutes a business. If the payments are excluded, expenses related to that income are not deductible.

IRS has provided guidance on when family caregivers have or don't have a business subject to self-employment tax [https://www.irs.gov/businesses/small-businesses-self-employed/family-caregivers-and-self-employment-tax].

A taxpayer may choose to include qualified Medicaid waiver payments in the calculation of earned income for the earned income credit (EIC) and additional child tax credit (ACTC). The taxpayer may include qualified Medicaid waiver payments in earned income even if the taxpayer chooses to exclude those payments from gross income.

- A taxpayer may choose to include all or none of the qualified Medicaid waiver payments for the taxable year in earned income. They may not include or exclude only a portion of qualified Medicaid waiver payments
- If the taxpayer and spouse, filing jointly, both have Medicaid waiver payment income, each can elect to include all or none of their respective payments in earned income.
- If the taxpayer chooses to include qualified Medicaid waiver payments in earned income, that amount will be included in the calculation for both the EIC and the ACTC.

Refer the Volunteer Resource Guide, Tab D, Income, Entering the Medicaid Waiver Payments.

What business expenses are deductible and within scope for the VITA/TCE programs?

Taxpayers deduct the costs of running their business. These costs are known as business expenses. To be deductible, a business expense must be both ordinary and necessary. An ordinary expense is one that is common and accepted in the taxpayer's industry. A necessary expense is one that is helpful and appropriate for the taxpayer's trade or business. All ordinary and necessary expenses incurred in a self-employed taxpayer's business must be reported. See the Instructions for Schedule C for more detailed information on deductible business expenses. Examples of these expenses include the following:

Every self-employed taxpayer must claim all allowable deductions in computing net earnings from self-employment.

Advertising

Advertising expenses are the costs associated with promoting the business through various means including internet ads, newspapers, magazines, billboards, racing sponsors, and television spots.

Car and Truck Expenses

A taxpayer who uses a car or truck in a business may be able to deduct the costs of operating and maintaining the vehicle. Vehicle expenses can be calculated using actual expenses or the standard mileage rate.

Actual expenses include depreciation. The calculation of depreciation is outside the scope of the VITA/TCE programs. If the taxpayer has used actual expenses in the past, or wishes to use actual expenses in the current year, they must be referred to a professional tax preparer.

For the standard mileage deduction, the number of business miles is multiplied by the applicable standard mileage rate. The standard mileage rate includes depreciation, lease payments, maintenance, repairs, gasoline (including gasoline taxes), oil, insurance, or vehicle registration fees — no additional deduction is allowed for these items when claiming the standard mileage deduction.

A few items can be added when the standard mileage rate is used. Self-employed taxpayers can also deduct the business part of interest on a car loan, state and local personal property tax on the car, parking fees, and tolls. For-hire drivers may have other deductible car expenses such as cellular GPS service, fees, and ride-sharing insurance.

Commuting miles, parking tickets, traffic fines or penalties are not deductible.

The IRS defines commuting as transportation between the taxpayer's home and their main or regular place of work or primary workstation. A home office could be the regular place of work but is out of scope. In-scope for-hire drivers cannot therefore claim the mileage between their home and their first stop or from their last stop to their home if they do not claim an office-in-the-home deduction.

Wendy is a self-employed masseuse and does not maintain an office in her home. She does neck massages for office workers and travels to three office buildings each work day. It is 10 miles from home to the first office and 5 miles from the last office back home. These 15 miles are commuting miles and, therefore, not deductible. The 13 miles Wendy drives from the first office to the second office and 5 miles from the second office to the third office are deductible. Of the 33 miles driven each work day, 18 miles are deductible.

Darryl used his car only for personal purposes during the first 6 months of the year. During the last 6 months of the year, he drove the car a total of 18,000 miles. Of those miles, 15,000 miles were driven providing transportation through a ride-sharing service. He received a Form 1099-K showing the income he received from the ride-sharing business. Darryl can deduct the 15,000 miles using the standard mileage rate as well as any other ordinary and necessary business expenses, such as supplies, a cell phone, food and drinks for passengers, parking fees, tolls, roadside assistance plans, business insurance, and taxes.

For-hire drivers who have mileage in between customer pick-ups can claim the mileage as a business expense.

Commissions and Fees

Commissions or fees are paid to both individuals and businesses. If payments to a single individual are $600 or more, the taxpayer must report the payments on Form 1099-MISC or Form 1099-NEC. In this case, the taxpayer's return is out of scope for the VITA/TCE programs.

Insurance

Insurance policies and coverage are deductible for the business operation. This includes property and business liability insurance.

If the standard mileage rate is used, no deduction is allowed for regular automobile insurance premiums.

A for-hire driver's cost of extra liability coverage can be added to the standard mileage rate if separate from the main policy.

Health insurance for the sole proprietor and his or her family is not deductible as a business expense on Schedule C. However, these medical premiums may be deducted on Form 1040 as an adjustment to gross income, subject to qualifications, and is discussed in the Adjustments to Income lesson.

Other Interest

This category can include interest paid on business operating loans, but not mortgage interest. Business interest includes the business portion of interest on a car loan – it can be added to the standard mileage rate.

Legal and Professional Services

Expenses included on this line are fees paid to professionals, such as attorneys, accountants, appraisers, and engineers.

Legal fees paid to acquire business assets are not deductible. These costs are added to the basis of the property. Some accountant fees and attorney fees may be for personal services (e.g., tax returns, wills, or estates) and are not deductible as business expenses.

Payments over $600 may require a Form 1099-MISC or 1099-NEC to be filed, which would make the return out of scope.

Office Expense

Office expense generally includes supplies such as pens, paper, and postage.

Rent or Lease – Vehicle, Machinery, and Equipment

This category includes rental fees for cars, trucks, vans, machinery, equipment, and other personal property. Vehicle leases of more than 30 days are out of scope. If the taxpayer uses the standard mileage rate method for business miles of a leased vehicle, the return remains in scope.

Repairs and Maintenance

Repairs on equipment, office space, and buildings are some possible expenditures reflected in this category. Expenses that should *not* be reflected are:

- Capital equipment that is improperly expensed (see Cost Recovery in Publication 535, Business Expenses).
- Repairs that substantially improve a facility or equipment that should be capitalized.

However, see the de minimis expense election below under Other Expenses.

Supplies

Supplies expense includes costs for general operating supplies not associated with the cost of goods sold.

Business Meal Expenses

When not traveling, a business owner can deduct a percentage, generally 50%, of the actual cost of a meal if the following conditions are met:

- The meal expense was an ordinary and necessary expense in carrying on the taxpayer's trade or business;
- The expense was not lavish or extravagant under the circumstances;

- The taxpayer was present at the meal;
- The meal was provided to a current or potential business customer, client, consultant, or similar business contact; and
- In the case of food or beverages provided during or at an entertainment event, the food and beverages were purchased separately from the entertainment, or the cost of the food and beverages was stated separately from the cost of the entertainment on one or more bills, invoices, or receipts.

Beginning January 1, 2021, through December 31, 2022, businesses can claim 100% of their food or beverage expenses paid to restaurants as long as the business owner is present when food or beverages are provided and the expense is not lavish or extravagant under the circumstances. Under the temporary provision, restaurants include businesses that prepare and sell food or beverages to retail customers for immediate on-premises and/or off-premises consumption. However, restaurants do not include businesses that primarily sell pre-packaged goods not for immediate consumption, such as grocery stores and convenience stores.

Taxes and Licenses

Taxpayers can deduct taxes and license fees paid in the operation of their business. Examples include:

- State and local sales taxes imposed on the taxpayer as the seller of goods or services
- Real estate and personal property taxes on business assets
- Certain licenses and regulatory fees

State or local income taxes cannot be deducted on Schedule C.

Travel Expenses

Travel expenses are the ordinary and necessary expenses of traveling away from home for business. Examples of deductible travel expenses are in the Volunteer Resource Guide, Income tab.

Utilities

Utilities typically consist of normal electric, gas, water, and telephone expenses incurred for the business. There should be no deduction for personal expenses or expenses for a home office in this category.

Kiana runs a small business from her home. She has only one phone landline and frequently makes long- distance calls for business. The cost of the basic phone line cannot be deducted, but Kiana can deduct the long-distance charges for her business calls.

Other Expenses

Taxpayers may also be able to deduct other ordinary and necessary business expenses not deducted elsewhere on Schedule C.

Education or training: Taxpayers can deduct the cost of their education expenses (including certain related travel) related to the trade or business. Taxpayers must be able to show the education maintains or improves skills required in their trade or business, or that it is required by law or regulations, for keeping license to practice, status, or job. See Form Schedule C Instructions (Part V – Other Expenses) and Publication 535 for more information.

De minimis safe harbor: Taxpayers may elect to apply a de minimis safe harbor to amounts paid to repair, acquire or produce tangible property used in the taxpayer's trade or business. They may use this safe harbor to deduct amounts paid for tangible property up to $2,500 per invoice or item (substantiated by invoice) if they have accounting procedures in place whereby they deduct amounts paid for business property if the costs of such property are under a certain de minimis amount.

The de minimis safe harbor election does not include amounts paid for inventory or land. The election applies for the taxable year and, if made, applies to each expenditure meeting the criteria for the election.

Make the election by attaching a statement titled “Section 1.263(a)-1(f) de minimis safe harbor election” to a timely filed original federal tax return including extensions for the taxable year in which the de minimis amounts are paid. The statement should include the taxpayer’s name, address, and Taxpayer Identification Number, as well as a statement that the taxpayer is making the de minimis safe harbor election. This can also be accomplished by clearly labeling the expense as “Section 1.263(a)-1(f) de minimis safe harbor election” in Other Expenses.

Barry makes his living as a handyman and earned $17,438 during the tax year. In the same year, Barry bought a new ladder for $450 and uses it exclusively in his business. In keeping his books and records, Barry uses an accounting procedure whereby he deducts amounts he pays for business equipment if the cost of the equipment is $1,000 or less. Under the de minimis safe harbor, Barry can deduct the full cost of the ladder as a business expense, as well as any other equipment purchases for $1,000 or less.

Exception for small business taxpayers: A small business taxpayer can choose not to keep an inventory when that is the method used in its books and records. Business purchases can be expensed as "other expenses" instead of using the Cost of Goods section of Schedule C. Taxpayers who wish to maintain inventories or had inventories at the beginning of the year (a change in method of accounting form must be filed) should be referred to a professional tax preparer.

How do I complete Schedule C?

Refer to the Volunteer Resource Guide, Tab D, Business Income for software entries and guidance on completing Schedule C. The following is provided as an overview.

General Information Section

This section includes five questions:

- Accounting method — only cash method is in scope for the VITA/TCE programs; if taxpayers use another method, refer them to a professional tax preparer
- Materially participate in the operation of the business — in general, the taxpayer materially participates if based on all the facts and circumstances, the taxpayer participated in the activity on a regular, continuous, and substantial basis during the year. See the Schedule C Instructions for specific tests to determine if the taxpayer meets the requirements for material participation. If the taxpayer does not materially participate or is uncertainty about materially participating in the business, refer them to a professional tax preparer
- Did the business make any payments in the tax year that would require filing of Form(s) 1099? — only a “No” answer is in scope as discussed above
- The last question will not apply to an in-scope return and does not need to be answered.

Part I: Income

Enter each Form 1099-NEC or 1099-MISC that the taxpayer received for their business. Also enter income that was not reported on a form.

Determine if the taxpayer received business income that was not reported on Form 1099-NEC or 1099-MISC. For example, tips received by self-employed hair stylists or manicurists are to be included in Line 1 gross receipts on Schedule C. Do not enter on line 6, Other Income.

Part II: Expenses

On Schedule C there is a separate line for the most common expenses that are incurred in a business. The taxpayer will decide whether a particular expense is ordinary and necessary for their business. Your role is

to inform the taxpayer of the rules and ask probing interview questions to resolve incomplete or inconsistent data.

Part III: Cost of Goods Sold

This relates to inventory and is out of scope for the VITA/TCE programs.

Part IV: Information on Your Vehicle

This includes information for claiming the standard mileage rate for vehicle expenses.

Part V: Other Expenses

This includes all ordinary and necessary expenses not deducted elsewhere on Schedule C. Report the cost of purchases as other expenses and not as cost of goods sold for a small business using the cash method of accounting.

EXERCISES (continued)

Question 2: Daniel has his own business. He received Form 1099-NEC for $13,000 for work he completed as an independent contractor. He also received cash payments that total $2,500 for other jobs he completed for different individuals. Must Daniel report the cash payments of $2,500 on his return?

a. Yes
b. No

Question 3: Ellen has a small business. The gross income from her business is $40,000, her business expenses total $11,500, and she must file a Schedule C. Is Ellen's tax return in scope for the VITA/TCE programs?

a. Yes
b. No

Taxpayers who report a profit on Schedule C may be able to deduct up to 20% of their qualified business income on Form 1040 as a qualified business income deduction. For more information, see the Standard Deduction and Tax Computation Lesson or the instructions for Form 1040.

Recordkeeping

Taxpayers are responsible for maintaining records needed to determine their correct tax liability. That includes records of income and expenses for their business. Refer to Publication 334, Tax Guide for Small Business and Publication 583, Starting a Business and Keeping Records, for more information.

Why keep records?

Everyone in business must keep records. Good records will help the taxpayer do the following:

- Monitor the progress of their business
- Prepare their financial statements
- Identify source of receipts
- Keep track of deductible expenses
- Prepare tax returns
- Support items reported on tax returns

Kinds of records to keep

Except in a few cases, the law does not require any specific kind of records. Taxpayers can choose any recordkeeping system suited to their business that clearly shows their income and expenses.

The recordkeeping system should include a summary of business transactions. This summary is usually made in the taxpayers' books and records (for example, accounting journals and ledgers). The books and records must show the gross income, as well as the deductions and credits. For most small businesses, the business checkbook is the main source for entries in the business books and records. In addition, supporting documents must be kept.

Supporting documents

Supporting documents include sales slips, paid bills, invoices, receipts, deposit slips, bank or credit card statements, and canceled checks. These documents contain information that must be recorded in the business books and records.

When a business involves the use of a vehicle, a mileage log would be a supporting document.

It is important to keep these documents organized and in a safe place because they support the entries in the business books and records, and on the tax return. For instance, organize them by year and type of income or expense.

Records include electronic records. Taxpayers should retain paper and electronic records that support their tax return data.

Reconstructing records

Make adequate inquiries to be satisfied that the taxpayer is carrying on a business and that the income and expenses reported on the tax return are substantially correct and complete.

You may help a taxpayer with simple record reconstruction. Assisting the taxpayer in reconstruction will help teach the taxpayer about recordkeeping. Extensive record reconstruction should be performed by the taxpayer, a professional tax preparer or bookkeeper. If you are not satisfied with the accuracy of the reconstructed records, you have the right to decline to prepare the return. See your Site Coordinator for guidance in these situations.

The goal of record reconstruction is to use available documentation to develop a sound and reasonable estimate of the taxpayer's business income and expenses to support the Schedule C prepared. When reconstructing records, you can use such tools as:

- Appointment books or calendars
- Online map tools or apps that track business miles
- IRS standard allowances
- Checkbooks and canceled checks
- Cash apps and accounting software
- Bank or credit card statements
- Lists of regular clients
- Partial receipts or sales tax records
- Cell phone records, call history, or computer logs
- Prior year returns

How long to keep records

Generally, taxpayers must keep records that support income or deductions on a return until the statute of limitations for that return runs out.

The statute of limitations is the time period in which a taxpayer can amend a return to claim a credit or refund, or the IRS can assess additional tax. For more information on recordkeeping see Publication 583, Starting a Business and Keeping Records.

Taxpayer Interview and Tax Law Application

Remember our taxpayer, Dana, with a babysitting business? She said she made $14,000 in net profit from her business, and wants to claim the EIC. After careful interviewing, the volunteer has determined the return cannot be completed without record reconstruction. The volunteer asked Dana to go home and return with some documentation to support her claims.

Based on the taxpayer's materials and additional questions, you can now determine if Dana should be claiming expenses for the business use of her home. If she can, refer the taxpayer to a professional tax preparer.

Sample Interview

Volunteer Says...	Dana Responds...
Nice to see you again, and I see you have some additional materials. What kind of documentation were you able to put together?	As you suggested, I completed a calendar that shows the number of children that I cared for on each date.
That sounds great. First, let's multiply the number of children that you cared for by the corresponding charged rate to confirm your income figure. Did you also bring documents to support your business expenses?	Yes, I have some grocery store receipts, canceled checks, bank statements, and credit card statements. I have highlighted the regular purchases I made for my business.
OK, then we'll calculate a reasonable estimate of expenses incurred.	Good. I'm sure my first estimate of $14,000 business income is not accurate after all. I appreciate learning what I need to do to keep track of my income and expenses.

Self-employment Tax

Self-employment tax is due on the net profit from self-employment. The software will automatically calculate the required tax and the partial offsetting adjustment to income. See the Other Taxes and Adjustments to Income sections for additional information.

Summary

This lesson explained:

- What is or is not a business
- Certain situations involving Schedule C and EIC should raise "red flags"
- Where to get business income and expense information
- Cash income must be reported
- Subcontractors or individuals who receive less than $600 may not receive Form 1099-NEC, Form 1099-MISC, or Form 1099-K, but still must report all cash income
- What business expenses are within scope for the VITA/TCE programs
- Additional inquiries about the taxpayer's income and expenses may be necessary to ensure an accurate return
- How to complete Schedule C

- The records that should be maintained
- How to complete a simple record reconstruction

What situations are out of scope for the VITA/TCE programs?

The following are out of scope for this lesson. While this list may not be all inclusive, it is provided for your awareness only.

Schedule C with:

- Hobby income or not-for-profit activity
- Bartering income
- Returns and allowances
- Cost of goods sold (inventory), if not able to expense purchases when paid under the exemption for small businesses
- Expenses over $35,000
- Expenses for employees
- Business use of home deduction
- Contract labor
- Casualty losses
- Vehicle expenses reported as actual expenses
- Depreciation or the election to expense business assets (other than the de minimis expense safe harbor election)
- Rental or lease expenses – vehicle leases of more than 30 days (other than leased vehicles for which the standard mileage method is used)
- Accounting methods other than the cash method
- Net losses
- A “No” response that indicates the taxpayer does not meet any of the tests for material participation, or is uncertain about materially participating in a business
- Taxpayers who wish to report less than the full amount of taxable income, whether received through credit cards or otherwise
- A “Yes” response indicating there is a requirement to file Form(s) 1099
- Income from the manufacture, distribution, or trafficking of controlled substances (such as marijuana)
- Tax-Aide scope: any transaction using a virtual currency or buying, owning, or selling a virtual currency

To gain a better understanding of the tax law, complete the practice return(s) for your course of study using the practice lab on L&LT.

EXERCISE Answers

Answer 1: a, Yes. Jason meets all requirements to be considered in scope for the VITA/TCE programs.

Answer 2: a, Yes. The cash payments must be included in Daniel’s gross receipts the same as the $13,000 reported on Form 1099-NEC. Cash payments are compensation for his services and must be reported on his Schedule C.

Answer 3: a, Yes. Ellen’s business expenses are under $35,000.

Income – Capital Gain or Loss

Introduction

Net long term capital gains are important for taxpayers because they are subject to lower tax rates than ordinary income – often, a zero tax rate. This lesson will help you assist taxpayers report capital gains and/or losses on the sale of assets using Form 8949, Sales and Other Dispositions of Capital Assets, in conjunction with Form 1040, Schedule D, Capital Gains and Losses. This lesson includes topics on the sale of stock, mutual funds, and the sale of a personal residence. If the taxpayers have sold any other assets, refer them to a professional tax preparer. This lesson will help you identify the asset's holding period, adjusted basis, net short-term and long-term capital gains or losses, the taxable gain or deductible loss and the amount of any capital loss carryover.

The intake and interview sheet asks about income from the sale of property such as stock, bonds, digital assets, or real estate. Ask taxpayers if they sold any stock, securities, other investment property, or a home during the tax year. It is important to ensure that all income is accurately reported on the return.

For Tax-Aide only: Taxpayers who transacted in, bought, sold, or held a digital asset (virtual currency) during the year must be referred to a professional tax preparer.

Bonds that mature or are sold with no gain or loss or are reported on a brokerage statement with capital gain or loss only (no ordinary income/loss) are in scope.

The disposition of totally worthless securities is in scope. However, securities worth anything, even $1, are not totally worthless.

Information on the topics discussed in this lesson are in Publication 544, Sales and Other Dispositions of Assets, Publication 551, Basis of Assets, Publication 550, Investment Income and Expenses, and Publication 523, Selling Your Home.

Objectives

At the end of this lesson, using your resource materials, you will be able to:

- Determine the adjusted basis of capital assets
- Determine if the asset's holding period is long-term or short-term
- Calculate the taxable gain or deductible loss from the sale of capital assets
- Determine whether a home is the taxpayer's main home
- Determine if a taxpayer meets the ownership and use tests
- Determine when the 5-year ownership/use test period is suspended

What do I need?

- Form 13614-C
- Publication 4012
- Publication 523
- Publication 544
- Publication 550
- Publication 551

Optional:

- Form 1040 Instructions
- Form 1040, Schedule D and Instructions
- Form 1099-B
- Form 1099-DIV
- Form 1099-S
- Form 8949

What information must I have to report a capital gain or loss?

To report capital gain or loss, you will need to identify:

- Basis and/or Adjusted Basis:
  - Basis is the original cost of the asset
  - Adjusted basis includes original cost plus any increases or decreases to that cost (such as commissions, fees, depreciation, deductible casualty losses, insurance reimbursements or major improvements)
  - Brokers must report cost or other basis on Form 1099-B, Proceeds From Broker and Barter Exchange Transactions, unless the securities sold were noncovered securities. ..

- Taxpayers use codes to report if Form 1099-B was received and whether or not it showed basis reported to the IRS.

- Holding period (when acquired and when disposed):
  - Short-term property is held one year or less
  - Long-term property is held more than one year
  - Long-term capital gains are taxed at a lower rate than short-term gains
  - Brokers must report whether the gain or loss is short-term or long-term on Form 1099-B, unless the securities sold were noncovered securities.
- Proceeds from the sale:
  - Form 1099-B reflects gross or net proceeds for a stock or mutual fund
  - Form 1099-S usually reflects gross proceeds of real estate transactions
  - Other evidence in the absence of the above
- Taxpayers will have to provide the basis and holding period information for noncovered securities when it is not reported on Form 1099-B, although Brokers usually provide basis information for noncovered securities on supplemental schedules if they have it.

To review information related to the software, go to the Volunteer Resource Guide, Tab D, Income, Schedule D, Capital Gain or Loss.

What is the basis of stock?

Basis

In order to compute gain or loss on a sale, taxpayers must provide their basis in the sold property. The basis of property is usually its cost.

- If taxpayers need help determining their basis and do not have the original purchase documents, refer them to Publication 551 and their stockbroker.
- If taxpayers cannot provide their basis in the property, the IRS will deem it to be zero.

Special rules apply to inherited property; these rules are covered in this lesson in the topic, “Basis Other Than Cost.” If the taxpayer acquired the stock by means other than a purchase or inheritance, such as a gift or an employee stock option plan (ESOP), and does not know the basis of the stock, refer them to a professional tax preparer. The determination of basis in these situations is beyond the scope of the VITA/TCE programs.

Adjusted Basis

An adjustment to basis may include additional commissions or fees paid to the broker at the time of purchase or sale.

Stock is bought and sold in various quantities. It is important for the taxpayer to keep track of the basis per share of all stock bought and sold. Events that occur after the purchase of the stock can require adjustments (increases or decreases) to the “per share” basis of stock. The original basis per share can be changed by events such as stock dividends and stock splits.

- Stock dividends are issued in lieu of cash dividends. These additional shares increase the taxpayer’s ownership (number of shares). The adjusted basis of the original stock shares is split among the new total of shares, including the new stocks issued as a dividend. This lowers the taxpayer’s basis per share.

- A stock split is a method used by corporations to lower the market price of stock. A two for one stock split will decrease the basis per share by half. For example, the original basis of $200 for 100 shares becomes $200 for 200 shares.
- DRP (dividend reinvestment plan) accounts leave cash dividends with the company for the purchase of additional shares. Even though these shares are from the same company, they retain their own individual basis separate from the original purchase. Each new purchased share could have a different basis.

Brokers or mutual fund companies will track the basis of mutual fund shares for covered securities. Still, taxpayers should keep track of their basis in mutual fund shares.

- The original basis of mutual fund shares bought is usually their cost or purchase price. The purchase price usually includes any commissions or load charges paid for the purchase.
- The cost basis of mutual fund shares acquired by reinvesting distributions is the amount of the distributions used to purchase each full or fractional share. This rule applies even if the distribution was an exempt-interest dividend that was not reported as income.
- The basis in mutual fund shares may need to be increased or reduced. For more information, refer to Publication 550.

Alice paid $1,100 for 100 shares of ABC, Inc. stock (which included the broker's commission of $25). The original basis per share was $11 ($1,100 ÷ 100). She received 10 additional shares as a tax-free stock dividend. Her $1,100 basis must be allocated to the 110 shares (100 original shares plus the 10-share stock dividend). This results in an adjusted basis of $10 per share ($1,100 ÷ 110).

Basis Other than Cost

There are times when cost alone cannot be used as basis. In some cases, the fair market value (FMV) or adjusted basis is used.

- Property Received as a Gift – To determine the basis of property received as a gift, taxpayers must know its adjusted basis to the donor just before it was given to the taxpayer. Taxpayers also need to know the FMV at the time of the donation and the amount of any gift tax paid on the donation. Determination of the adjusted basis of property received as a gift can be very complex and is beyond the scope of the VITA/TCE programs.
- Inherited Property
  - Before 2010 and after 2010: the basis of property inherited during this time is generally the FMV of the property on the date of the decedent's death. However, this can vary if the personal representative of the estate elects to use an alternate valuation date or other acceptable method. If the taxpayer cannot provide the basis for the property, refer the taxpayer to a professional tax preparer.
  - During 2010 (after December 31, 2009, and before January 1, 2011): special rules may apply to property inherited from a decedent who died in 2010. Determining the basis of such property can be complex. If the taxpayer cannot provide the basis for the property, refer the taxpayer to a professional tax preparer for determination of basis issues. For more information on the special rules, refer to Publication 4895, Tax Treatment of a Property Acquired from a Decedent Dying in 2010 (Rev. October 2011). Download Publication 4895 under Prior Year Forms and Instructions on IRS.gov.
- Wash Sales
  - The reporting of wash sales is in scope only if reported on Form 1099-B (Box 1g) or on a brokerage or mutual fund statement. Report the wash sale as an adjustment on Form 8949, line 1, columns (f) and (g).
  - A wash sale is the sale of securities at a loss and the acquisition of the same (substantially identical) securities within 30 days of the sale date (before or after).
  - Taxpayers cannot deduct losses from sales or trades of stock or securities in a wash sale unless the loss was incurred in the ordinary course of business as a dealer in stock or securities. (out of scope)

- The disallowed loss is added to the cost of the new stock or securities. The result is an increase to the basis in the new stock or securities. This adjustment postpones the loss deduction until the disposition of the new stock or securities.
- The holding period for the new stock or securities includes the holding period of the stock or securities sold.

The taxpayer buys 100 shares of X stock for $1,000. The taxpayer sells these shares for $750 and within 30 days from the sale buys 100 shares of the same stock for $800. Because the taxpayer bought substantially identical stock, the taxpayer cannot deduct the loss of $250 on the sale. However, the taxpayer adds the disallowed loss of $250 to the cost of the new stock, $800, to obtain the basis in the new stock, which is $1,050.

For additional information on how to figure the basis, refer to Publication 551.

If the taxpayer knows the basis of property that was inherited or received as a gift, you can provide assistance. If they do not know the basis of the property, refer the taxpayer to a professional tax preparer.

How do I determine the holding period?

Long-Term or Short-Term

Brokerage firms report sales of securities, the acquisition cost, the dates of sale and acquisition, if there is a wash sale adjustment, and whether the cost basis was reported to the IRS on Form 1099-B.

Taxpayers will have to provide any information not reported on Form 1099-B or when their records disagree with the amount reported by the brokerage.

Form 1099-B will indicate the date the stock was sold. The purchase and sell dates will determine the holding period. Capital gains and losses are either long-term or short-term, depending on how long the taxpayer owned the stock. Stock held for:

- One year or less has a short-term holding period
- More than one year has a long-term holding period

If a taxpayer acquired property by gift or inheritance, the taxpayer must provide the basis and acquisition date. Determining these tax items is complex and outside the scope of the VITA/TCE programs.

The holding period begins the day after the shares were purchased and includes the day the shares were sold. If investment property is inherited, the capital gain or loss is treated as long-term. This is true regardless of how long the property is held.

Determining the correct holding period is important because short-term gains are taxed at regular income tax rates and long-term gains are taxed at a lower rate than the other income reported on the return.

Stock acquired as a nontaxable stock dividend or stock split has the same holding period as the original stock owned. They are considered to have been acquired on the same day as the original stock. Stock acquired in a DRP has its own purchase date. The holding period for stock received as a taxable stock dividend begins on the date of distribution.

Lenny bought 500 shares of XYZ Corporation stock for $1,500, including his broker's commission. Five years later, XYZ distributed a 2% nontaxable stock dividend (10 shares). Three days after the stock dividend was distributed, Lenny sold all his XYZ stock for $2,030.

Although Lenny owned the 10 shares for only three days, all the stock has a long-term holding period. Stock acquired as a nontaxable stock dividend has the same holding period as the original stock owned. Because he bought the stock for $1,500 and then sold it for $2,030 more than a year later, Lenny has a long-term capital gain of $530 on the sale of his 510 shares.

If taxpayers do not have the purchase documents or other records showing the date of purchase and cost, refer them to their stockbroker or financial planner.

For additional information on the holding period and other tax consequences of selling or trading investment property, refer to Publication 550.

Although brokers and mutual fund companies are not required to report basis information for noncovered securities, most brokers and mutual fund companies provide supplemental basis information that can be used if the taxpayer concurs with the information.

Mutual Funds

A mutual fund is a regulated investment company generally created by “pooling” funds of investors providing the advantage of a diversity of investments and professional management.

Owners of mutual funds may receive both Form 1099-DIV and Form 1099-B. Form 1099-DIV reports capital gain distributions from sales of stock held by the mutual fund. Profits of these sales are reported to the shareholders of the fund as capital gain distributions. If taxpayers (owners) decide to sell any of their shares in the mutual fund itself, Form 1099-B will be issued. The taxable gain or loss from the sale or exchange of the taxpayer’s shares in a mutual fund is reported on Schedule D as a capital gain or loss.

If mutual fund dividends and capital gain distributions are reinvested in new shares, the holding period of each new share begins the day after that share was purchased. Therefore, if both the new shares and the original shares are sold, there may be both short-term and long-term gains and losses.

To figure the gain or loss on the disposition of mutual fund shares, determine which shares were sold and the basis of those shares. If the shares in a mutual fund were acquired all on the same day and for the same price, figuring their basis is not difficult. However, shares are generally acquired at various times, in various quantities, and at various prices, making it more difficult to figure the basis. Taxpayers can choose to use either a cost basis or an average basis to figure the gain or loss. For more information on how to report the sale or exchange of mutual fund shares, refer to Publication 550.

Stock

Some taxpayers may own shares of stock they bought on different dates or for different prices. This means they own more than one “block” of stock. Each block may differ from the others in its basis (the amount paid for the stock), its holding period (long-term or short-term), or both.

In directing a broker to sell stock, the taxpayer may specify which block, or part of a block, to sell. This is called “specific identification.” To be valid, the specification must be made before or at the time of sale, **not** after the sale. If the taxpayer does not do this, the shares are sold from the earliest block purchased (FIFO method – or First In, First Out).

Marie bought 100 shares of Antrim Corporation stock for $2,000. A year later, she bought another 100 shares of Antrim for $2,300. Five years later, she sold 100 shares of Antrim for $3,000 but she did not identify the specific block at the time of sale.

Because Marie purchased the earliest block of 100 shares at $2,000, the adjusted basis of the shares she sold was $2,000. The sales price of the 100 shares sold was $3,000. Marie had a long-term capital gain of $1,000.

However, if she had told her broker to sell the 100 shares from the second block of stock she bought, the adjusted basis would have been $2,300, giving Marie a long-term capital gain of $700.

What information do I need from Form 1099-B?

Sale of stock is reported to the taxpayer on Form 1099-B, Proceeds From Broker and Barter Exchange Transactions. Form 1099-B is prepared by the broker who handled the sale of the stock. Refer the taxpayer to a professional tax preparer if any of the following boxes has an entry:

- Accrued market discount
- Profit or (loss) realized on closed contracts
- Unrealized profit (loss) on open contracts – prior year
- Unrealized profit (loss) on open contracts – current year
- Aggregate profit (loss) on contracts
- Proceeds are from collectibles
- Bartering
- If there is a FATCA filing requirement

These boxes provide information about transactions that are out of scope for the VITA/TCE programs.

Most brokers report using a substitute Form 1099-B, not the IRS form. All the same information is included, but the order of the information may vary. Carefully review the broker statement during the interview to confirm that all transactions are in scope.

On a brokerage statement, margin interest is investment interest. If the taxpayer is itemizing deductions, the return is out of scope.

Form 1099-B includes these boxes for reporting sales of securities:

- Description of property
- Date acquired
- Date sold or disposed
- Proceeds
- Cost or other basis
- Wash sale loss disallowed
- Type of gain (short-term or long-term)
- Federal or state income tax withheld
- Whether the basis was reported to the IRS or if it is a noncovered security
- Whether the amount reported is gross proceeds or net proceeds

When the FATCA box is checked, the taxpayer may have additional reporting responsibilities with respect to their foreign accounts or assets. These topics are beyond the scope for the VITA/TCE programs and affected taxpayers should be referred to a professional tax preparer.

Brokers must complete boxes on the Date of sale or exchange; Date of acquisition; Type of gain or loss; Cost or other basis; and Wash sales when reporting sales of securities unless the box for Noncovered security is checked.

Date of Sale or Exchange

The stockbroker reports the date the stock was sold on Form 1099-B. If the securities sold were noncovered securities, use this date, along with the purchase date provided by the taxpayer to determine the holding period. If the securities sold were covered securities, the stockbroker reports the date the stock was acquired and whether the gain was short-term or long-term.

Sales Price

The stockbroker must reduce the gross proceeds for any commissions or transfer taxes related to the sale:

- If sales price (gross proceeds) is checked, ask the taxpayer for the amount of commissions/fees paid and enter an adjustment on the capital gains worksheet
- If sales price less commissions and option premiums (net proceeds) is checked, the broker subtracted the commissions and fees from the proceeds

Richard sold stock for $2,300. He paid his broker a commission of $35 on the sale and received net proceeds of $2,265. Richard's broker has reported:

- *Proceeds on Form 1099-B of $2,265*
- *The box next to net proceeds is checked*

EXERCISES

Answers are after the lesson summary.

Question 1: Kevin paid his broker a $75 fee on the sale of his stock. His Form 1099-B shows $925, and the box next to net proceeds is checked. What is the amount Kevin reports as his sales price?

a. $925

b. $1,000

c. $850

d. $75

Other Information

If the securities sold were noncovered securities, Form 1099-B would not report the date the stock was originally purchased, the original purchase price, or any adjustments to the basis. Some brokers report this information on a tax reporting supplement. If not, the taxpayer must provide this information.

How do I enter data on Form 8949 and Schedule D?

Generally, transactions are not reported directly on Schedule D. Instead, they are detailed on various Forms 8949. A separate Form 8949, page 1, is required for each of the three types of short-term transactions. The three types of long-term transactions are recorded on a separate Form 8949, page 2. The subtotals from Forms 8949 are carried over to Schedule D, where aggregate gain or loss is calculated.

A check box on Form 8949 identifies the type of transaction reported; a taxpayer with more than one type of transaction must file a separate form for each type.

Some taxpayers may be able to enter capital gains transactions directly on Schedule D. See the Volunteer Resource Guide, Tab D, Income, for the current information on Schedule D and Form 8949.

All entries are made on the Capital Gains Transactions screen. The software determines the holding period and enters the information on Form 8949, pages 1 and/or 2, provided correct transaction codes are properly entered in both the Capital Gains Transactions screen and Form(s) 8949. Use the Volunteer Resource Guide, Tab D, Income, to review software information.

How do I report capital gain distributions?

Capital gain distributions are reported to the taxpayer on Form 1099-DIV. If there is no sale or disposition of capital assets to report, the Form 1099-DIV amount is reported directly on Form 1040 with a checkmark in the box to indicate a Schedule D is not required.

If a taxpayer has both Form 1099-DIV *and* Form 1099-B, then capital gain distributions are added to Schedule D, Part II, line 13.

EXERCISES (continued)

Question 2: Which of the following taxpayers is required to file Form 1040 and Schedule D?

a. Marriah, who received one Form 1099-B and no Forms 1099-DIV

b. Lorraine, who received Forms 1099-DIV for capital gain distributions from three different mutual funds

c. Both of the above

If the source documents (Forms 1099-DIV and 1099-B) are recorded properly in the tax preparation program, then the numbers will be reported in the proper places. The amount from Form 1099-DIV, Box 2a, will be entered on the Dividend entry screen (along with the other information) and will automatically carry over to the capital gain distributions line (line 13) in Schedule D, Part II.

Eldridge received a Form 1099-DIV. Box 2a shows he received a total capital gain distribution of $170.

Eldridge also received a Form 1099-B that shows net proceeds of $1,200 on the sale of 600 shares of ABC Group, Inc. He held the stock for over 6 years. His basis in ABC, including commission, is $1,455.

Eldridge must use Schedule D to report his capital gain distribution because he sold stock that must be reported on Schedule D.

How do I complete reporting of capital gain or loss?

Form 8949 contains most capital gain and loss transactions. The subtotals from Form 8949 are carried over to Schedule D, where gain or loss is calculated in the aggregate.

Combining all the amounts in the gain or (loss) column on Schedule D, Part I, results in a net short-term capital gain or loss. Combining all the amounts in the gain or (loss) column on Schedule D, Part II, results in a net long-term capital gain or loss.

The combination of the net short-term and net long-term capital gains or losses impacts the tax liability. If there is a combined net capital loss in excess of $3,000 (or if Married Filing Separately, in excess of $1,500), then the excess is carried to the next tax year and carried forward until exhausted. Carryover losses retain their original holding period.

Bill bought 1,000 shares of stock for $15,000 (including commission). One year later he sold 600 shares of the stock for $7,800 in net proceeds. Bill had a net loss of $1,200 as shown below:

Basis = ($15,000 ÷ 1,000) x 600 = $9,000

Sales Price = $7,800

Gain or Loss = Sales Price – Basis = $7,800 – $9,000 = –$1,200

Bill had a short-term loss of $1,200.

Margo bought stock for $1,500 plus a $25 commission; 18 months later she sold all the stock for $2,000 and paid a $25 commission. Her Form 1099-B shows the net proceeds of $1,975 as the sales price.

Basis = ($1,500 + $25) = $1,525

Sales Price = $1,975

Gain or Loss = Sales Price – Basis : $1,975 – $1,525 = $450

Margo had a long-term gain of $450.

The Volunteer Reference Guide, Tab D, Income, contains a list of adjustment codes that can be used when completing Forms 8949. When reporting transactions on a grouped basis, use code M. If another code is needed for the grouped transactions, enter both codes in the software.

In the rare event that the net proceeds on Form 1099-B are not correct, do not change the sales price amount. Instead, use the adjustment column on Form 8949 with the proper code.

How do I calculate and report a carryover of a capital loss?

Taxpayers can deduct capital losses up to the amount of their capital gains plus $3,000 ($1,500 if married filing separately). A loss carryover can occur when losses exceed gains **or** when there is not enough taxable income to absorb the net loss deduction. The prior year's short-term and long-term carryover losses are combined with the capital gains and losses in the current year. Unused capital losses can be carried over to later years until they are completely used up.

Capital Loss Carryover Worksheet

Check the Intake sheet and the prior year's return for a capital loss deduction on Form 1040, line 7. Be sure to also look to see if taxable income on line 15 is a positive number (if it would be a negative number, it would indicate that the taxpayer did not get a benefit from their capital loss deduction). If there appears to be a capital loss carryover, look for the capital loss worksheet in the prior year's return. Note that the software may have already brought the carryover amount into the current year's return if it offered you carryover data when you started the return.

If needed, use the Capital Loss Carryover Worksheet from the Schedule D instructions to compute the amount of capital loss carryover from the previous year. To complete the worksheet, you will need information from the prior year return.

Make a note on the outside of the taxpayer's tax return record envelope to alert the next year's preparer.

For additional information on Schedule D, capital gains and losses, and carryovers, refer to the instructions to Forms 1040 Schedule D and Reporting Gains and Losses in Publication 550.

Tax software automatically calculates the taxpayer's capital loss. If the loss is over the limit, the tax software reports the maximum allowable deduction. The tax software also completes the capital loss carryover worksheet showing the amount of loss that can be carried over to future tax years.

Taxpayer Interview and Tax Law Application

Taxpayers Jeremy and Janice Smith checked the "Yes" box for income from the sale of stock on the intake and interview sheet. The volunteer asks for details.

Sample Interview

Volunteer Says...	Jeremy Responds...
Previously we discussed your dividends from the Pembroke Fund, reported on Form 1099-DIV. Did you have any other income from the sale of stock, securities, or other investments?	Yes, I sold some stock this year.
Do you have a Form 1099 for that?	Yes, I have this Form 1099-B and this stockbroker's statement.
We already discussed the capital gain distribution from the mutual fund when we entered the dividends. We'll examine the stock sale information now. I see the broker's statement has the sale details I need, but do you know when you purchased the Purdue stock?	I bought the Purdue stock back on July 13, 2000.
I see the sale date was March 10, 2021. That means the holding period for the stock was more than one year. They call that long-term, and it determines both where the information is reported and the tax rate for any gain. Now, do you know the basis for the stock?	What is that?
That's what it cost you, including any broker fees or commissions.	Yes, it cost $10,053, plus I had to pay $35 in fees.
Have you had any other costs, stock dividends, or stock splits related to the stock since then, such as additional fees?	No, that's it. Wait, when I sold it, I had to pay $35 more.
That means that the basis for the stock is $10,088. The Form 1099-B shows that you received net proceeds of $8,859 when you sold the stock so the $35 you paid on the sale is already taken into account. We'll put all these numbers into the tax software. After I enter these other transactions from the broker's statement, we'll get a final net gain or loss on Schedule D. This will determine the amount that will be reported on Form 1040. [Indicate Jeremy's responses to these questions on the intake and interview sheet.]	

Sale of Home

The intake and interview sheet lists income from the sale of real estate. Ask taxpayers if they sold any real estate, such as their principal residence or "main home" during the tax year. A home is a personal residence that has cooking, sleeping, and bathroom facilities and that the taxpayer or family member used as a residence for 15 days or more during the year. A house, a condominium, houseboat, mobile home, or co-op can be a residence. A sale or other disposition of a home is in scope for the VITA/TCE Programs. Gain on the disposition of a home is taxable, subject to the exclusion discussed below. Loss on the disposition of a home is personal and not deductible.

The sale of real estate other than a home used as a residence is out of scope for the VITA/TCE programs.

Who must report the sale of a home on Form 8949 and Schedule D?

To determine if the sale of the taxpayer's residence must be reported on Form 8949 and Schedule D, identify whether the home was the taxpayer's main home, if the taxpayer meets the ownership and use tests, and if the gain, if any, is more than the allowed exclusion amount. Taxpayers must report the sale of a home if ANY of the following is true:

- The taxpayer has a gain and does not qualify to exclude all of it because:
  - The taxpayer does not meet the ownership test
  - The taxpayer does not meet the use test
  - During the two-year period ending on the date of the sale, the taxpayer has excluded the gain from the sale of another home

- The taxpayer has a gain and chooses not to exclude it
- The taxpayer received Form 1099-S

For additional guidance in making this determination, refer to Publication 523, Selling Your Home.

Exclusion Amount

Taxpayers who sold their main home may be able to exclude gain up to a maximum of $250,000 ($500,000 for married taxpayers who file a joint return or for certain surviving spouses).

Generally, if the taxpayer can exclude all of the gain, it is not necessary to report the sale. If the taxpayer has gain that cannot be excluded, it is taxable and reported on the return.

A loss on the sale cannot be deducted, however, the taxpayer may be required to report it.

What is considered a "main" home?

Only gain from the sale of a taxpayer's main home may be excluded from the taxpayer's income; gain from the sale of a home that is *not* the taxpayer's main home will generally have to be reported as income.

A taxpayer's "main" home is where they live most of the time. It does not have to be a traditional house; for example, it may be a houseboat, mobile home, cooperative apartment, or condominium, but it must have cooking, sleeping, and bathroom facilities. The taxpayer's main home may also be a rented house or apartment. Taxpayers with more than one home cannot choose which home to designate as their main home.

EXAMPLE

Lucille owns a home in a Colorado ski area (the ski home). She stays at the ski home most weekends and spends the entire months of December, January, and February there. When she is not at the ski home, she lives in a four-room apartment that she rents in Denver. Even though she does not own it, Lucille's main home is her rental apartment in Denver, because she lives there most of the time.

What are the ownership and use tests?

To claim the exclusion on the gain from the sale of a home, the taxpayer must meet the ownership and use tests. This means that during the five-year period ending on the date of the sale, taxpayers must have:

- Owned the home for at least two years (the ownership test), and
- Lived in the home as their main home for at least two years (the use test)

There are special rules for members of the Armed Forces, intelligence personnel and Peace Corps volunteers in the application of the five-year period. See "Five-year Test Period Suspension" later in this lesson.

The required two years of ownership/use do not have to be continuous. Taxpayers meet the tests if they can show that they owned and lived in the property as their main home for either a total of 24 full months or 730 days (365 x 2) during the five-year period ending on the date of sale. Short, temporary absences are counted as periods of use even if the property is rented during those absences. Also, if the taxpayer becomes physically or mentally unable to care for themselves, and used the residence as their principal residence for 12 months in the 5 years preceding the sale or exchange, any time spent living in a care facility (such as a nursing home) counts toward the 2-year residence requirement, so long as the facility has a license from a state or other political entity to care for people with the taxpayer's condition.

Ownership and use tests can be met during different two-year periods. However, a taxpayer must meet both tests during the five-year period ending on the date of the sale.

Helen lived in a rented apartment in 2008. The apartment building was later changed to a condominium, and she bought her apartment on December 1, 2014. In 2016, Helen became ill and on April 14 of that year she moved into her daughter's home. On July 10, 2018, while still living in her daughter's home, she sold her apartment.

For the 2018 tax year, Helen can exclude all the gain on the sale of her apartment because she met the ownership and use tests. Her five-year period is from July 11, 2013, to July 10, 2018, the date she sold the apartment. She owned her apartment from December 1, 2014, to July 10, 2018 (over two years). She lived in the apartment from July 11, 2013 (the beginning of the five-year period) to April 14, 2016 (over two years).

EXERCISES (continued)

Question 3: Emily, who is single, bought a home in 2000. She lived in the home until January 1, 2009, when she accepted a temporary job assignment in Venezuela and left the house vacant. Emily returned to her home on December 31, 2010 and lived there until she sold the house on January 10, 2014. Does Emily meet the ownership and use test?

a. Yes

b. No

Reduced Exclusion

Taxpayers who owned and used a home for less than two years (do not meet the ownership and use test) may be able to claim a reduced exclusion under certain conditions. These include selling the home due to a change in place of employment (beyond a certain distance), health, or unforeseen circumstances. If any apply, refer the taxpayer to a professional tax preparer. Reduced exclusion computations/determinations are beyond the scope of the VITA/TCE programs.

Prior Exclusions

In addition, during the two-year period ending on the date of the sale, the taxpayer must not have claimed an exclusion on a gain from the sale of another home.

Married Homeowners

The ownership and use tests are applied somewhat differently to married homeowners. Married homeowners can exclude up to $500,000 if they meet *all* of these conditions:

- They file a joint return
- Either spouse meets the ownership test
- Both individuals meet the use test
- Neither one excluded gain in the two years before the sale of the current home

If either spouse does not satisfy all these requirements, they cannot claim the maximum exclusion ($500,000). The most they can claim is the total of the maximum exclusions each would qualify for if not married and the amounts were figured separately. For this purpose, each spouse is treated as owning the property during the period that either spouse owned the property. This calculation is outside the scope of the VITA/TCE programs.

Sale of Main Home by Surviving Spouse

Beginning with main home sales after 2007, the maximum exclusion ($500,000) by an unmarried surviving spouse is allowed if the sale occurs no later than two years after the date of the spouse's death, and all other requirements are met.

Upon the death of the first spouse, some or all of the property may have a new basis based on the fair market value on the date of death. Generally, the basis of the home steps up or down to value on the date of death for the decedent's half of the home in a separate property state. The entire home's basis steps to value on the date of death in a community property state when the home was community property. This may substantially reduce the amount of gain.

How do I figure the gain (or loss) from the sale of a home?

After determining that a taxpayer is eligible for the exclusion, figure the gain (or loss) on the sale based on the selling price, amount realized, basis, and adjusted basis. If the selling price of the taxpayer's home is less than the allowable exclusion of up to $250,000 ($500,000 if Married Filing Jointly), it is not necessary to calculate the gain; none of it will be taxable. Loss on the sale of a residence is not deductible. For more information, see Publication 523.

If the taxpayer used the home for business purposes or as rental property or if the taxpayer did not use it as their home, refer them to a professional tax preparer.

Selling Price

The selling price is the total amount taxpayers (the seller) received for their main home. It includes money, all notes, mortgages, or other debts taken over by the buyer as part of the sale, and the fair market value of any other property or services that the seller received.

If the taxpayer received Form 1099-S, Proceeds from Real Estate Transactions, use it to report the selling price. Box 1 shows the date of sale (closing) and Box 2 shows the gross proceeds received from the sale of the home. For taxpayers who did not receive a Form 1099-S, use sale documents and other records.

Use the gross selling price on Form 8949. Selling expenses are discussed below.

If the taxpayer can exclude the entire gain from the sale of a main home, the person responsible for closing the sale (i.e., a real estate broker or settlement agent) generally will not issue Form 1099-S. If Form 1099-S is issued and you determine that the gain is excludable, the sale should be reported on Form 8949 and Schedule D to notify the IRS of the exclusion.

If the taxpayer has a loss on the sale of a main home for which Form 1099-S was received, the taxpayer must report the loss on Form 8949 and Schedule D even though it is not deductible. Enter an adjustment to zero out the loss (nondeductible loss that will show as code L on Form 8949).

Basis

The basis in a home is determined by how the taxpayer obtained the home. If a taxpayer bought or built a home, the basis is what it cost the taxpayer to buy or build that home. If the taxpayer inherited the home, the basis is generally its fair market value on the date of the decedent's death, or on the later alternate valuation date chosen by the representative for the estate.

Alternative valuation issues and determining the adjusted basis of property received as a gift can be very complex and are outside the scope of this training. Advise taxpayers to seek assistance from a professional tax preparer if they do not know the basis and the correct holding period.

Determining the basis of property inherited in 2010 is complex and outside the scope of the VITA/TCE programs. Taxpayers who sold such property should be referred to a professional tax preparer if they do not know the basis and the correct holding period.

Adjusted Basis

The adjusted basis is the taxpayer's basis in a home increased or decreased by certain amounts.

Adjusted basis = Basis + Increases - Decreases

Increases include additions or improvements to the home such as building a recreation room or adding a bathroom. In order to be considered an increase, the improvement must have a useful life of more than one year. Repairs that maintain the home in good condition are not considered improvements and should not be added to the basis of the property. An improvement may include ancillary items, such as painting the exterior after a room addition.

Decreases to basis include deductible casualty losses and gains a taxpayer postponed from the sale of a previous home before May 7, 1997. Decreases can also include depreciation during the time the home was used for business purposes or as rental property. If any of these decreases apply, the taxpayer should be referred to a professional tax preparer.

Decreases will also include the cost of items removed from the property. An example would be a new furnace that is later replaced with a second new furnace. The cost of the first furnace is removed and only the cost of the second furnace will increase basis.

To determine basis adjustments, taxpayers can use Worksheet 2, How to Figure Your Gain or Loss, in Publication 523. While volunteers may provide assistance, the taxpayer has ultimate responsibility for all items on their return.

Selling Expenses

Selling expenses reduce the gain or increase the loss. Selling expense may include commissions, advertising fees, legal fees, mortgage points or other loan charges paid by the seller that would normally have been the buyer's responsibility, such as transfer taxes, courier fees, and many other expenses. Selling expenses would not include items such as proration of homeowner fees, property taxes, interest on the loan to the date of sale, among others. Some items may be claimed as itemized deductions (property taxes and qualified home mortgage interest). Others are never deductible because they are personal expenses.

Report the total selling expenses as an adjustment (code E). Do not reduce the gross proceeds. Use the gain after the selling expense adjustment to determine the amount of exclusion available, if any.

How much of the gain from a home sale can a taxpayer exclude?

Once you've determined the gain or loss on the sale of a taxpayer's main home, next figure the exclusion and any taxable gain from the sale.

If all the requirements are met, an individual taxpayer may exclude up to $250,000 of the gain from taxable income; taxpayers who use the Married Filing Jointly filing status and some surviving spouses may exclude up to $500,000.

Publication 523 contains Worksheet 3, Determine If You Have Taxable Gain, which may be used to figure the gain or loss, the exclusion, and the taxable gain from a sale.

Taxpayers who claimed the first-time homebuyer credit may be required to repay the credit in the year of sale. The repayment is limited to the amount of gain on the sale. This situation is out of scope for the VITA/TCE programs. Refer taxpayers to the instructions for Form 5405, Repayment of the First-Time Homebuyer Credit, or to a professional tax preparer for more information on how to adjust the basis of the home and exceptions to the repayment rule.

Gain from the sale or exchange of a main home is not excludable from income if allocable to periods of nonqualified use. Generally, nonqualified use means any period in 2009 or later where neither the taxpayer nor spouse (or former spouse) used the property as a main home (with certain exceptions). A list of exceptions to a period of nonqualified use can be found in Publication 523. To figure the portion of nonqualified use, multiply the gain by the following fraction:

$$\frac{\text{Total nonqualified use during period of ownership in 2009 or later}}{\text{Total period of ownership}}$$

This issue can be complex. Refer taxpayers with nonqualified use issues to a professional tax preparer.

Where do I report any taxable gain from the sale of a home?

The disposition of a home (residence) is reported if any part of the gain is taxable or if Form 1099-S was received. Proceeds from the sale of a main home that meets the ownership and use tests must be reported only if the gain is greater than the taxpayer's allowed exclusion; only the excess will be included in income. Gain from the sale of a home that is **not** the taxpayer's main home will generally be fully taxable.

When required to be reported on Form 8949 and Schedule D, adjustment code H is used to claim the allowable exclusion. Enter both code E (for selling expenses) and code H (for the excluded gain) and the aggregate amount of both as an adjustment.

If the home was used for business purposes or as rental property, a part of the gain may be ordinary income and would be reported on Form 4797, Sales of Business Property. Refer the taxpayer to a professional tax preparer in these situations.

..

To review information related to the software, go to the Volunteer Resource Guide, Tab D, Income, for software entries on the Sale of a Home.

How do I report a nondeductible loss if taxpayer received Form 1099-S on the sale of a main home?

If the taxpayer has a loss on the sale of a home for which Form 1099-S was received, the transaction must be reported on Form 8949 and Schedule D even though the loss is personal and not deductible. Adjustment code L is for a nondeductible personal loss. Enter both code E (for selling expenses) and code L (for the nondeductible loss) and the net amount of both as an adjustment to zero out the loss. Reporting the transaction should prevent the taxpayer from recieving a notice from the IRS.

Taxpayer Interview and Tax Law Application

Jeremy and Janice Smith checked the "Yes" box for selling some real estate on the intake and interview sheet. The volunteer asks for details.

Sample Interview

Volunteer Says...	Jeremy Responds...
Did you sell a home during this tax year?	Yes, I was going to mention that to you because I should get a tax break on that.
Well, you may be able to exclude all or part of your gain from that sale, but to find out, I have to ask you a few questions. First, how long did you own the home?	Three and a half years.
And was it the main place you lived for at least two years of that time?	Yes, we lived there the whole time.
Great, you meet the ownership and use tests. During the two years before you sold the house did you claim an exclusion on a gain from another house?	No, this is my only house.
Did you receive Form 1099-S?	No, but I do have my paperwork from the sale. My real estate broker said I wouldn't need that form because I was within the limits.
Your paperwork shows a selling price of $360,000. Do you have anything that lists the basis in the home, that is, the cost of the home at the time you bought it?	Yes, I bought it for $280,000 and put in $20,000 of improvements – mostly new bathrooms.
With a basis of $300,000, your gain from the sale is $60,000. As a married couple who meets the ownership and use tests, you can exclude up to $500,000 from the sale, so you don't have to report the sale on your return. [Indicate Jeremy's responses to these questions on the intake and interview sheet.]	

What is the Five-Year Test Period Suspension?

Taxpayers can choose to have the five-year test period for ownership and use suspended during any period the homeowner (either spouse if married) served on "qualified official extended duty" as a member of the uniformed services or Foreign Service of the United States, as an employee of the intelligence community, or as an employee or volunteer of the Peace Corps. This means that the taxpayer may be able to meet the two-year use test even if the taxpayer and/or spouse did not actually live in the home during the normal five-year period required of other taxpayers.

Taxpayers are on qualified official extended duty if they serve at a duty station at least 50 miles from their main home or live in government quarters under government order. Taxpayers are considered to be on extended duty when they are called to active duty for more than 90 days or an indefinite period.

Period of Suspension

The period of suspension cannot last more than ten years. Together, the ten-year suspension period and the five-year test period can be as long as fifteen years. The suspension can be used on only one property at a time.

For more information about the suspension of the five-year test period, see Service, Intelligence, and Peace Corps personnel, in Publication 523.

This extension of time can apply to taxpayers who have recently left the military.

For the 2014 tax year: Peter bought a home in 2004 and lived in it for 2½ years. Beginning in 2007, he was on qualified official extended duty in the U.S. Army. He sold his home in 2014 and had a $12,000 gain. Peter would normally not meet the use test in the five-year period before the sale (2009-2014). Because of the suspension, Peter's test period is the five years before he went on qualified official extended duty.

EXERCISES (continued)

Question 4: In this exercise, John purchased a home in 2003. Through your interview process, you discover that he sold his main home in 2018. John had not lived in the home for six years. Which of the following conditions would allow John to exclude his gain?

a. John went on sabbatical for four years and backpacked through Europe.

b. John lived with a co-worker for four years and let his brother occupy his home.

c. John was deployed to Europe on official extended military duty for five years.

d. John married and his bride had her own home. The couple chose to live in the wife's home and rent out John's home, until it was sold.

Summary

This lesson covered how to report the sale of capital assets and the sale of a principal residence. In most cases, a taxpayer must use Form 8949 and Schedule D to report capital gains and losses on the sale of assets. You learned how to identify the asset's holding period, adjusted basis, net short-term and long-term capital gains or losses, the taxable gain or deductible loss, and the amount of capital loss carryover.

Qualified taxpayers may be able to exclude a portion of the gain on the sale of their main home if they meet the ownership and use tests. Taxpayers can choose to have the five-year test period for ownership and use suspended during any period the homeowner (either spouse if married) served on qualified official extended duty as a member of the uniformed services or foreign service of the United States, as an employee of the intelligence community, or as an employee or volunteer of the Peace Corps. A loss on the sale of a principal residence is not deductible but must be reported if the taxpayer received Form 1099-S.

The worksheets in Publication 523 help you figure the taxable gain from the sale of a home using the selling price, amount realized, basis and adjusted basis, along with the maximum allowed exclusion.

What situations are out of scope for the VITA/TCE programs?

The following are out of scope for this lesson. While this list may not be all inclusive, it is provided for your awareness only.

- Taxpayers who have sold any assets other than stock, mutual funds, or a personal residence Assets that are out of scope include: held as a nominee, qualified small business stock, small business loss, DC zone assets, rollover of gain, inherited home not used as personal residence, and collectibles, such as artworks, jewelry, coins or stamp collections.
- Taxpayers who trade in options, futures, or other commodities, whether or not they disposed of any during the year
- Taxpayers who buy, sell, or own a digital asset (virtual currency)
- Taxpayers who invest in exchange-traded grantor trusts such as Grayscale, GLD, SLV, etc.
- Determination of basis issues:
  - Basis of any asset acquired other than by purchase or inheritance, such as a gift or employee stock option, unless the taxpayer provides the basis and holding period
  - Basis of inherited property determined by a method other than the FMV of the property on the date of the decedent's death, unless the taxpayer provides the basis and holding period
- Like-kind exchanges
- Form 1099-B, boxes with entries for any of the following: Bartering; Profit or (loss) realized on closed contracts; Unrealized profit (loss) on open contracts – prior year; Unrealized profit or (loss) on open contracts – current year; or Aggregate profit (loss) on contracts; Proceeds from collectibles; or FATCA filing requirement

- Relating to sale of a residence:
    - Reduced exclusion computations/determinations for the sale of a home
    - Married homeowners who do not meet all requirements to claim the maximum exclusion on the sale of a home
    - Decreases to basis unless taxpayer provides adjusted basis and holding period
        - ❖ Decreases may include deferred gain (pre-5/7/1997), casualties, recoveries, etc.
    - Taxpayers with nonqualified use issues
    - Sale of a home used for business purposes or as rental property

To gain a better understanding of the tax law, complete the practice return(s) for your course of study using the Practice Lab on L&LT.

You may not be able to complete the entire exercise if some of the technical issues in the exercise are not covered until later lessons in the training. In these instances, complete as much of the exercise as you can. Come back later to finish the exercise after you cover all the technical topics.

EXERCISE Answers

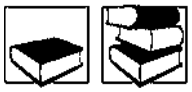
Answer 1: a. Never change the sales price.

Answer 2: a. Only Marriah sold stock and received Form 1099-B.

Answer 3: a, Yes. Emily meets the ownership and use test because she owned and lived in the home for at least two years of the five-year period ending on the date of the sale.

Answer 4: c. The only circumstance that will allow John to exclude the gain is if he can extend the five-year period due to official extended military duty.

Income – Retirement Income



Introduction

This lesson will help you identify and report the taxable portion of retirement income received by the taxpayer. To do this, you must understand the types of retirement income and the forms used to report them. You should also be able to recognize when taxpayers should adjust their withholding and determine which form to use.

For more information on the topics discussed in this lesson, see Publication 575, Pension and Annuity Income; Publication 590-B, Distributions from Individual Retirement Arrangements (IRAs); Publication 721, Tax Guide to U.S. Civil Service Retirement Benefits; and Publication 939, General Rule for Pensions and Annuities.

Objectives

At the end of this lesson, using your resource materials, you will be able to:

- Identify how retirement income is reported to the taxpayer using Form 1099-R series
- Calculate the taxable portion of different types of retirement income
- Determine how to report retirement income on the tax return
- Determine when an adjustment to withholding should be made

What do I need?

- Form 13614-C
- Publication 4012
- Publication 575

Optional:

- Publication 590-B
- Publication 721
- Publication 939
- Form 1040 Instructions
- Form 1040-ES
- Form 1099-R
- Form 5329
- Form 8606
- Form W-2
- Form W-4P
- Form W-4V
- Simplified Method Worksheet

What is retirement income?

Retirement income can include Social Security benefits as well as benefits from annuities, retirement or profit sharing plans, insurance contracts, IRAs, etc. Retirement income may be fully or partially taxable. For information about Social Security benefits and tier 1 Railroad Retirement benefits, see the Social Security Benefits lesson.

Where can I get information about a taxpayer's retirement income?

To determine if the taxpayer must report retirement income, review the taxpayer's completed intake and interview sheet, particularly the Income section. If the taxpayer had retirement income, you may need to ask additional questions to clarify the type of plan, whether the taxpayer's contributions to the plan were before-tax or after-tax dollars, etc. This is explained later in this lesson.

Be considerate when probing for the information you need to complete the return. When taxpayers cannot provide the required information (and have not retained the packet of "retirement papers" they received when they retired), suggest that they contact their former employer or annuity administrator. You may even give the taxpayer a written list of questions that need to be resolved.

Which forms are used to report retirement income?

Retirement income can be reported on one of the forms in the Form 1099-R Series:

- Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs,
- Insurance Contracts, etc.,
- Form CSA 1099-R, Statement of Annuity Paid (civil service retirement payments),
- Form CSF 1099-R, Statement of Survivor Annuity Paid, and
- Form RRB 1099-R, Annuities or Pensions by the Railroad Retirement Board
- If Form 1099-R is for an IRA-type distribution, it will be indicated in Box 7.

Examples of these forms can be found at IRS.gov. These forms indicate such information as the amount received, the taxable portion, and the taxpayer's cost (investment) in the plan.

If the taxable amount is indicated and does not need to be adjusted, volunteers with Basic certification can complete the return. In general, if the taxable amount is not indicated, volunteers with Advanced certification must calculate the taxable portion using the Simplified Method covered later in this lesson.

Qualified disability income reported on Form 1099-R with a Distribution Code 3 in Box 7, is reported as earned income wages on Form 1040 until the minimum retirement age is met. Review the software entries in the Volunteer Resource Guide, Tab D, Form 1099-R Rollovers and Disability Under Minimum Retirement Age.

What if the taxable portion is already calculated?

In many instances, the payer will compute the taxable portion of the distribution and report the taxable amount on Form 1099-R. Taxpayers with Form RRB-1099-R are in scope only for Advanced certified volunteers because the taxable portion is not shown on the form.

Refer to the Volunteer Resource Guide, Tab D, Income, Form 1099-R Pension and Annuity Income.

Amounts from Form 1099-R are reported as follows:

- The gross amount (Box 1 of Forms 1099-R, CSA- and CSF-1099-R) should be shown on Form 1040 on the IRA distributions or Pensions and annuities line
- The taxable amount (Box 2a of Forms 1099-R, CSA- and CSF-1099-R) should be shown on Form 1040 on the IRA distributions or Pensions and annuities line in the taxable amount section

In some cases, the taxable portion reported by the payer of an IRA is not correct or may be incomplete. See the discussions of Form 8606 and qualified charitable distributions (QCD) below. In the case of a retired public safety officer's pension, a portion of the distribution may be excludible as discussed below.

In-scope Roth IRA distributions are reported on Form 1040 on the IRA distributions line. Any amount of federal income tax withheld on Forms 1099-R, CSA- and CSF-1099-R should appear in the Federal income tax withheld from Form(s) 1099 line of the tax return.

What if the taxable portion is not calculated?

If the payer did not include the taxable amount on Form 1099-R, CSA- or CSF-1099-R, or if taxpayers have Form RRB 1099-R, you will need to compute the taxable portion of the distribution. The following will help you determine the additional information needed to calculate the taxable portion of distributions from IRAs, pensions, or annuities.

What do I need to know about retirement income distributions?

Retirement plans are funded by either before-tax or after-tax contributions. “Before-tax” simply means that the employee did not pay taxes on the money at the time it was contributed, i.e., the taxpayer has no cost basis in the plan. “After-tax” means the employee paid taxes on the money when it was contributed, i.e., the taxpayer has a cost basis in the plan.

If the taxpayer made all contributions to a plan with before-tax dollars, the entire distribution will be fully taxable. The funds are taxed at the time of the distribution because neither the contributions nor the earnings/investment gains were previously taxed. This is common in 401(k) and Thrift Savings Plans.

If the taxpayer did not contribute to the retirement plan, all the distributions are fully taxable.

If the taxpayer made contributions to a plan with after-tax dollars, then the distributions will be partially taxable. The portion of the distribution that is considered a return of the after-tax dollars will not be taxed again. It is considered a return of the taxpayer’s cost basis (an amount for which taxes have already been paid). The portion of the distribution that represents the earnings/investment gains is taxable since it has not been previously taxed. This is common in employer retirement plans. Qualified distributions from an employer plan designated Roth account are wholly nontaxable, similar to a Roth IRA.

Employee Contributions	Contributions		Taxability of Distributions		
	Before-Tax	After-Tax	Fully	Partially	Nontaxable
No	n/a	n/a	Yes	—	—
Yes	Yes	—	Yes	—	—
Yes	—	Yes	—	Yes	—
Yes, Roth	—	Yes	—	—	Yes

Mark retired after working 30 years for a construction company. Each week, he contributed to the Carpenter’s Pension Plan. Every year, Mark paid tax on the gross amount of his salary, including his pension contribution. This means his pension contributions were made with dollars that had already been taxed. Now that he is receiving payments from the pension, he will not be taxed on the portion that represents his contribution; he will be taxed on the portion that represents earnings.

Taxpayers may not always understand why they must pay taxes on their retirement income. When this is the case, take the time to clearly explain what retirement funds are taxed and why. It is usually a good idea to question taxpayers about the nature of their contributions to ensure that they will not be taxed twice on the same funds.

How do I find the taxable portion of IRA income?

Individual Retirement Arrangements

IRA distributions are reported on Form 1099-R. Earnings and investment gains in a taxpayer's IRA generally accumulate tax free or tax deferred until they are withdrawn as fully or partially taxable distributions. There are four kinds of IRAs, each with different tax implications:

- Traditional IRA
- Roth IRA
- Savings Incentive Match Plans for Employees (SIMPLE) IRA
- Simplified Employee Pension (SEP) IRA

Traditional IRA

Distributions from traditional IRAs are fully taxable unless nondeductible contributions have been made. See the Adjustments lesson for additional information. Form 8606, Nondeductible IRAs, is used to keep track of nondeductible contributions. **Tax-Aide scope:** Form 8606 Parts I and II are in scope. Use Part I to track the IRA owner's basis in all the individual's traditional IRAs, except inherited IRAs. Basis in each inherited IRA is tracked separately (additional Forms 8606 may be needed). A surviving spouse can elect to take the deceased spouse's IRA as their own. If they do so, it is no longer treated as an inherited IRA. Part II uses the information from Part I to determine the portion of a Roth conversion that is taxable.

Also see qualified charitable distributions below, which may reduce the taxable amount.

When you learn about IRA accounts in the Adjustments to Income lesson, be sure to note the difference between "contributions" and "deductions." Simply put, contributions are the amounts deposited into an IRA account, and deductions are the portion of the contribution that is deducted on the tax return. The deductible portion may be less than the amount allowed as a contribution.

Richard contributed $500 a year to a traditional IRA. Each year, he deducted these contributions from his income. This year he received his first distribution from the traditional IRA. It is fully taxable: Richard will pay income tax on the distributions he receives, which represent the contributions he made and deducted, as well as the earnings on these contributions over the years.

Roth IRA

Qualified distributions from a Roth IRA are tax free and may be excluded from income. The IRA trustee will indicate the distribution is qualified by using Code Q in Box 7 if the following requirements are met:

- The distribution is made after the 5-year period beginning with the first day of the first taxable year for which a contribution was made to a Roth IRA set up for the taxpayer's benefit, *and*
- The distribution is:
  - Made on or after age 59½, or
  - Made because the taxpayer was disabled, or
  - Made to a beneficiary or to an estate, or
  - To pay certain qualified first-time homebuyer amounts (up to a $10,000 lifetime limit)

The 5-year rule applies to each Roth conversion and rollover for purposes of the early distribution penalty on early distributions. See Publication 590-B.

You can identify Roth IRAs from the distribution code used on Form 1099-R. Distribution codes Q, J, H, and T are specific to Roth IRAs. Only code Q is in scope for the VITA/TCE programs. ***Tax-Aide Only:*** *the trustee may have used code J or T due to insufficient information. If the taxpayer has met the requirements to make the Roth distribution qualified and therefore not taxable, it is in scope. If any part of the distribution could be taxable, the return is out of scope. See instructions for code Q in the Volunteer Resource Guide, Tab D, Income. For rules on converted Roth IRAs, see Publication 590-B.*

Nonqualified Distributions

If the above requirements are not met, the distribution is nonqualified and additional taxes may apply. Taxpayers who received nonqualified Roth IRA distributions should be referred to a professional tax preparer.

Savings Incentive Match Plans for Employees (SIMPLE) IRA

Some employers offer their employees (including self-employed individuals) the chance to contribute part of their pay to an IRA as part of a SIMPLE plan. The employer is also generally required to make contributions on behalf of eligible employees. Generally, SIMPLE IRA contributions are not included in an employee's income when paid into an IRA, and the distributions are fully taxable when the employee receives them in later years.

Simplified Employee Pension (SEP) IRA

Some employers offer their employees (including self-employed individuals) the chance to contribute part of their pay to an IRA as part of a SEP plan. Generally, SEP IRA contributions are not included in an employee's income when paid into the IRA. Because of this, distributions are generally fully taxable when the employee receives them in later years.

EXERCISES

Answers follow the lesson summary.

Question 1: Distributions from all IRAs discussed in this topic are fully taxable with the exception of the Roth IRA.

a. True

b. False

Question 2: Mary opened a Roth IRA 3 years ago. This year, she took the full amount of her Roth IRA as a distribution to help her purchase her first home. The entire distribution is excluded from her taxable income.

a. True

b. False

Question 3: Amy contributed to a Roth IRA for 5 years. In year 6 (at age 60), she took a distribution from her IRA. The entire distribution is excluded from her taxable income.

a. True

b. False

How are IRA distributions reported?

Traditional IRA

If IRA/SEP/SIMPLE is checked on Form 1099-R and to determine whether there is any basis in the IRA, ask the taxpayer:

- Was this a distribution from a traditional IRA?
- Were the contributions deducted from income in the year they were made?
- Is this a rollover IRA, meaning that you rolled a company plan account into the IRA such as from a prior employer?

If so, the entire distribution is taxable. Report the distributions on Form 1040. If not, the distribution is partially taxable and Form 8606 is required. **Tax-Aide only:** If contributions were not fully deducted, the taxpayer has basis in their IRA and Form 8606 Part I should be completed. Even in a year that there is no distribution, Form 8606 should be included so that the basis is not lost. Form 8606, Parts I and II are in scope for Tax-Aide. Reduce the taxable amount for a QCD, if applicable

Be sure to review the prior year's tax return during the interview process – you may find Form 8606 and the basis that should be tracked.

An early distribution (code 1 in box 7 of Form 1099-R) from a traditional or Roth IRA may be subject to a 10% additional tax. Refer to the Other Taxes lesson for more information.

SIMPLE and SEP IRAs

Distributions from SIMPLE and SEP IRAs are in scope for VITA/TCE, because they are taxable and are generally reported on the return just like taxable traditional IRA distributions.

Exception: Funds distributed from a SIMPLE IRA in the first two years are subject to a 25% early distribution penalty. If this is applicable, Form 1099-R will be issued with distribution code S. If an exception to the penalty applies, complete Form 5329 as you would do with traditional IRA distributions.

Roth IRA

Distributions from a Roth IRA are not taxable as long as they meet all the criteria discussed previously. If the distribution does not meet the criteria, then all or part of the funds **may** be taxable; refer the taxpayer to a professional tax preparer.

How are rollovers handled?

Generally, a rollover is a tax-free distribution to the taxpayer from one retirement account (traditional IRA or employer's pension plan) that rolls over into another qualified retirement account within 60 days.

Form 1099-R will be issued to the taxpayer by the financial institution. If the distribution was a direct rollover by the institution to another institution, it will show distribution code G. If there is also a taxable amount in Box 2 of the 1099-R, the distribution may be partially or fully taxable.

If the taxpayer indicates that a rollover occurred but the distribution code is NOT G, then the taxpayer must have re-deposited the full amount into an appropriate account within 60 days. If this was not done, the distribution may be partially or fully taxable, in which case if the taxpayer wants to appeal to the IRS to make the whole distribution nontaxable, refer the taxpayer to a professional tax preparer unless the self-certification procedure described later applies.

Note that a transfer from one IRA account directly to another IRA account is not rollover. No 1099-R will be issued and it does not need to be reported on the return.

Distributions from SIMPLE IRAs in the first two years (distribution code S) can only be rolled over tax-free into other SIMPLE IRAs. Taxable SIMPLE IRA rollovers are out of scope for VITA/TCE.

There is a limit of one IRA rollover per twelve months. This does not affect the ability of an IRA owner to transfer funds from one IRA trustee directly to another because such a transfer is not a rollover.

What about a rollover from a Roth IRA?

Most of the rules for rollovers to traditional IRAs apply to Roth IRAs. Generally, a withdrawal of all or part of the assets from one Roth IRA and a contribution to another Roth IRA within 60 days is tax free. A rollover from a Roth IRA to an employer retirement plan is not allowed.

If there is a direct rollover of a designated Roth account distribution to a Roth IRA, the distribution code for Form 1099-R will be code H. If the distribution does not meet the tax-free rollover requirements, all or part may be taxable; refer the taxpayer to a professional tax preparer.

A conversion of a traditional IRA to a Roth IRA, and a rollover from any other eligible retirement plan to a Roth IRA, made after December 31, 2017, cannot be recharacterized as having been made to a traditional IRA.

Additional information must be entered for retirement account rollovers. Refer to the Volunteer Resource Guide, Tab D, Income, Form 1099-R.

A qualified plan loan offset distribution (Code M in Form 1099-R, box 7) is due to plan termination or severance from employment. Instead of the usual 60-day rollover period, the taxpayer has until the due date, including extensions, for filing the Federal income tax return for the taxable year in which the offset occurs to complete the rollover.

EXERCISES (continued)

Question 4: Andrew changed jobs and received Form 1099-R from his previous employer. The gross distribution amount in Box 1 is $11,200. Andrew deposited the entire $11,200 into his IRA within 30 days of receiving the check (rollover).

Which of the following statements is true?

a. The entire distribution is includible as income

b. The entire distribution is excludable from income

c. The distribution is eligible for the ten-year tax option

d. The distribution is eligible to be taxed at a special rate

What is the IRA self-certification procedure?

Procedure Helps People Making Retirement Plan Rollovers

Revenue Procedure 2016-47 explains a self-certification procedure designed to help recipients of retirement plan distributions who inadvertently miss the 60-day time limit for properly rolling these amounts into another retirement plan or individual retirement arrangement (IRA). Eligible taxpayers can qualify for a waiver of the 60-day time limit and avoid possible taxes and penalties on early distributions, if they meet certain circumstances. Taxpayers who missed the time limit will ordinarily qualify for a waiver if one or more of 11 circumstances, listed in the revenue procedure, apply:

- An error was committed by the financial institution making the distribution or receiving the contribution.
- The distribution was in the form of a check and the check was misplaced and never cashed.
- The distribution was deposited into and remained in an account that the taxpayer mistakenly thought was a retirement plan or IRA.
- Taxpayer's principal residence was severely damaged.
- One of the taxpayer's family members died.
- Taxpayer or a family member was seriously ill.
- Taxpayer was incarcerated.
- Restrictions were imposed by a foreign country.
- A postal error occurred.
- The distribution was made on account of an IRS levy and the proceeds of the levy have been returned.
- The party making the distribution delayed providing information that the receiving plan or IRA required to complete the rollover despite reasonable efforts to obtain the information.
- The distribution was made to a state unclaimed property fund **(Revenue Procedure 2020-46)**

Ordinarily, the IRS, plan administrators, and trustees will honor a taxpayer's truthful self-certification that they qualify for a waiver under these 11 circumstances. Even if a taxpayer does not self-certify, the IRS now has the authority to grant a waiver during a subsequent examination. Other requirements, along with a copy of a sample self-certification letter, can be found in the revenue procedure.

The IRS encourages eligible taxpayers wishing to transfer retirement plan or IRA distributions to another retirement plan or IRA to consider requesting that the administrator or trustee make a direct trustee-to-trustee transfer, rather than doing a rollover. Doing so can avoid some of the delays and restrictions that often arise during the rollover process.

For more information, refer to Publication 590-A, Contributions to Individual Retirement Arrangements (IRAs).

Qualified Charitable Distributions

A qualified charitable distribution (QCD) is generally a nontaxable distribution made directly by the trustee of the IRA to an organization eligible to receive tax-deductible contributions. The taxpayer must be at least age 70½ when the distribution is made. In accordance to Setting Every Community Up for Retirement Enhancement (SECURE) Act, the long-standing 70½ age limit for making contributions to traditional IRAs was eliminated for tax years beginning after 2019. In addition, the excludable portion of a QCD distribution may need to be reduced by IRA deductions once the taxpayer attains age 70½. Beginning in tax years after December 31, 2019, the amount of QCDs that a taxpayer can exclude from income is reduced by the excess of the aggregate amount of IRA contributions the taxpayer deducted for the taxable year and any prior year that the taxpayer was age 70½ or older over the amount of such IRA contributions that were used to reduce the excludable amount of QCDs. Starting with tax year 2020, taxpayers should calculate the excludable amount of their QCD using the Qualified Charitable Deduction (QCD) Worksheet in Publication 590-B. Each spouse must complete a separate worksheet if married filing jointly.

Tax-Aide only: see the NTTC tax law paper and worksheet on the portal here.

The taxpayer must have the same type of acknowledgement of the contribution that is needed to claim a deduction for a charitable contribution. Typically, a QCD counts towards the taxpayer's required minimum distribution (RMD).

The maximum annual exclusion for QCDs is $100,000. Any QCD in excess of the $100,000 exclusion limit is included in income as any other distribution. On a joint return, the spouse can also have a QCD and exclude up to $100,000.

If a QCD is reduced by an IRA contribution, the taxpayer will show that amount as a taxable distribution. Additionally, the taxpayer may claim a charitable contribution deduction for the donation.

How do I find the taxable portion of pensions and annuities?

A qualified pension plan is established by an employer to provide retirement benefits for employees and their beneficiaries. Employees typically do not pay taxes on plan assets, including earnings on those assets, until the assets are distributed.

Fully Taxable Pensions and Annuities

Pension and annuity income is reported on Form 1099-R, Form CSA 1099-R, and Form RRB 1099-R. In general, pension or annuity payments are fully taxable, if any of the following is true:

- Taxpayers did not pay any part of the cost of their pensions or annuities,
- Employers did not withhold part of the cost from the taxpayers' pay while they worked, or
- Employers withheld part of the cost from the taxpayer's before-tax pay while they worked

Social Security benefits are not reported on the pension line of the tax return. Social Security income is covered in a later lesson.

Sue worked for a software development company for 20 years. She retired and began receiving pension income the same year. Sue never contributed to the pension plan while she was working; her employer made all of the contributions. Her pension is fully taxable.

Partially Taxable Pensions and Annuities

If taxpayer made after-tax contributions toward their retirement plan, they have basis in that plan and can recover that basis a bit at a time as they get distributions from the plan. Two methods used to figure the taxable portion of each pension or annuity payment are the General Rule and the Simplified Method. Unless an exception applies, retirees must use the Simplified Method for annuity payments from a qualified plan. If a taxpayer tells you they have been using the General Rule to figure the taxable portion for past years, refer them to a professional tax preparer.

If the taxpayer's annuity starting date is before July 2, 1986, the General Rule has to be used unless the Three-Year Rule was used.

The Simplified Method is used to calculate the tax-free portion of each pension or annuity payment. The Simplified Method Worksheet calculates the taxpayer's cost basis for each monthly payment. The number of monthly payments is based on the taxpayer's age (and the spouse's age if a joint/survivor annuity is selected by the taxpayer) on the annuity start date. This calculation is not changed for subsequent events, such as divorce, marriage or death.

Taxpayer's cost basis ÷ Number of monthly payments = Monthly Tax-Free Portion

Joe elected a joint/survivor annuity when he retired and started receiving his pension on July 1, 2015. Joe was born March 5, 1950 and his wife, Mary, was born on July 23, 1953. Here is how they compute their combined ages for the Simplified Method.

	Joe	Mary	Combined
Date born	3/5/1950	7/23/1953	
Date annuity started	7/1/2015	7/1/2015	
Age when annuity started	65	61	126

Note that Mary had not reached her 62nd birthdate by the day the annuity started.

To ensure the taxable portion of the pension is calculated correctly, the age of the taxpayer(s) at the annuity start date, not their age for the tax year, must be used when determining the total number of expected monthly payments.

Refer to the Volunteer Resource Guide, Tab D, Income, Form 1099-R for more information on calculating the taxable portion using the Simplified Method.

To calculate the taxable portion of a pension or annuity using the Simplified Method, you will need certain information:

- The cost in the plan (total employee contribution on Form 1099-R)
- The taxpayer's age on the date the annuity began (and the spouse's age if joint/survivor annuity was selected). In computing the taxpayer's age, notice whether the annuity starting date is before or after the taxpayer's birthday for that year
- Total of tax-free amounts from previous years, available from the taxpayer's prior year worksheet

If the taxpayer has more than one Form 1099-R that is not fully taxable, calculate the tax-free portion for each form separately.

Melvin retired from a manufacturing plant. While he was working at the plant, his employer withheld money from each paycheck and sent it to the Engineer's Pension Fund. Melvin will receive a monthly pension payment for the rest of his life. Melvin will use the Simplified Method Worksheet to determine the tax-free part of monthly payments.

What about nonqualified annuities?

A nonqualified annuity is signified by code D in box 7 (along with a numeric code). If the taxable amount is not shown in box 2a, the simplified method cannot be used for the amount in box 9b, employee contribution. The return is in scope only if Box 2a contains the taxable amount. Additionally, the nonqualfied annuity may be subject to the net investment income tax if AGI exceeds $200,000 if Single/HOH, $250,000 if MFJ/QW, $125,000 MFS. The net investment income tax is out of scope.

EXERCISES (continued)

Question 5: Dotty worked for the local tire plant for 32 years. She retired in June and receives a monthly pension of $1,679. (She received six payments for July through December.) Dotty never contributed to the pension plan; her employer made all of the contributions. How much of her pension is taxable?

a. $12,074

b. $11,074

c. $10,074

d. $1,679

Disability Pension Income

Generally, taxpayers who retire on disability must include all of their disability payments in income. **Disability payments are taxed as wages until the taxpayer reaches the minimum retirement age – *this age is set by the employer.*** After the taxpayer reaches the minimum retirement age, disability payments are treated as pension income to determine taxability.

Taxpayers are considered disabled if they cannot engage in any substantial gainful activity because of any medically determinable physical or mental condition that can be expected to result in death or to be of long-continued and indefinite duration.

Minimum retirement age is generally the earliest age at which taxpayers may receive a pension, whether or not they are disabled.

Employers may report disability income on one of the following forms:

- Form W-2, if the taxpayer has not reached the minimum retirement age set by the employer
- Form 1099-R, with code 3 if the taxpayer has not reached the minimum retirement age for the plan, or with code 7 if the taxpayer has reached the minimum retirement age

Some employers report qualified disability income on Form 1099-R with Distribution Code 3 in Box 7 regardless of the taxpayer's age. You must confirm the employers' minimum retirement age. If the taxpayer is under the retirement age, the volunteer must take steps in the software to ensure the income is properly reflected as wages on Form 1040. When disability pay is treated as wages, it might affect the earned income credit and the taxpayer's ability to make an IRA contribution.

If Form 1099-R, Box 7, indicates a distribution code 3, and the taxpayer is on disability but under retirement age, check the box so the tax software will place the amount on Form 1040 as wages (and eligible for EIC), rather than on the pension line. Refer to the Volunteer Resource Guide, Tab D, Income, Form 1099-R for more information on how to report disability pay to ensure it is reported on the correct line of Form 1040.

EXERCISES (continued)

Question 6: Annie Jo is 47 years old and has retired on disability from her job. While loading cargo for a tractor-trailer company, a large box fell on her and left her paralyzed. She receives a monthly payment from her former employer's pension plan to which Annie Jo had not contributed. She has not reached the minimum retirement age set by her company's pension plan. How should she report her disability income on her Form 1040?

a. Estimated tax payments and amount applied from return

b. Pensions and annuities

c. Taxable pensions and annuities

d. Wages

Retired Public Safety Officers

Eligible public safety officers can elect to exclude from income distributions of up to $3,000 made directly from a government retirement plan to the provider of accident, health, or long-term disability insurance. The distribution must be from a plan maintained by the employer from which the taxpayer retired as a public safety officer. A public safety officer includes a law enforcement officer, firefighter, chaplain, or member of a rescue squad or ambulance crew. See Insurance Premiums for Retired Public Safety Officers in Publication 575, Pension and Annuity Income, for more information.

If the taxpayer is eligible for the exclusion, refer to the Volunteer Resource Guide, Tab D, Income, Form 1099-R

What other retirement income issues are there?

There are a few other issues related to reporting retirement income that you may encounter. Some of the following distributions are subject to various additional taxes that are computed on Form 5329, Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts. If certain exceptions are met, the additional tax does not apply.

Only the exceptions for early distributions not subject to the additional tax (Part I of Form 5329) are included in scope for the VITA/TCE training. Refer taxpayers who must complete other information on Form 5329 to a professional tax preparer. Form 5329 and exceptions are covered in the Other Taxes lesson.

Lump-Sum Distributions

A lump-sum distribution is the distribution or payment within one tax year of an employee's entire balance from all qualified pension, stock bonus, or profit-sharing plans that the employer maintains. The distribution does not include certain deductible voluntary employee contributions and certain amounts forfeited or subject to forfeiture. Distributions from IRAs or tax-sheltered annuities do not qualify as lump-sum distributions.

To qualify as a lump-sum distribution, the plan participant must have been born before January 2, 1936 and the payment must have been made:

- Because the plan participant died, or
- After the participant reached age 59½, or
- Because the participant (not including a self-employed individual) separated from service with the employer, or
- After the participant, if self-employed, became totally and permanently disabled

Lump-sum distributions are reported on Form 1099-R like any other pension distribution. Some lump-sum distributions qualify for special tax treatments. If Form 1099-R indicates a distribution code of A, it is a lump-sum distribution qualifying for special tax treatments. Taxpayers with this situation should be referred to a professional tax preparer.

Early Distributions

An early distribution is a withdrawal from a retirement fund by a taxpayer who is under age 59½. Early distributions can be subject to an additional 10% tax. The additional tax applies to the taxable portion of the distribution or payment.

Certain early distributions are not subject to the early distribution tax. When the distribution code on Form 1099-R is 1, the taxpayer will not be subject to the additional 10% tax if an exception applies.

If the distribution code is 2, 3, or 4, the taxpayer does not have to pay the additional tax. The exceptions for excluding early distributions, from the additional tax are covered in more detail in the Other Taxes lesson.

Minimum Distributions

To avoid an additional tax for excess accumulation, participants in retirement plans must begin taking a Required Minimum Distribution (RMD) by a specified date. That date is April 1 of the calendar year following the year in which the taxpayers either reached age 72 (70½ if the taxpayer reaches 70½ before January 1, 2020), or retired, whichever is later. For IRAs, it does not matter whether the taxpayer has retired. These rules do not apply to Roth IRAs. The trustee of the qualified plan will contact the taxpayer at the appropriate time to begin their RMD.

After the starting year for RMDs, taxpayers must receive the minimum distribution for each year by December 31 of that year. (The starting year is the year in which the taxpayer reaches age 72, 70½ before January 1, 2020, or retires.) If no distribution is received during the taxpayer's starting year, the required minimum distributions for two years must be received the following year, one of which must be taken by April 1.

If a taxpayer's 70th birthday is July 1, 2019 or later, the taxpayer does not have to take withdrawals until reaching age 72. For those who were age 70½ or younger on Jan. 1, 2020, their first RMD is not due until April 1 of the year after they turn age 72. For example, for those who turn 72 on July 1, 2021, they must take their first RMD (for 2021) by April 1, 2022, and their second RMD (for 2022) by December 31, 2022.

The RMD rules for inherited retirement accounts depend on the relationship and age of the beneficiary and are beyond the scope of the VITA/TCE programs. Generally, over 10 years with exceptions. Refer taxpayers to their trustee if they have questions about the amount of their RMD. IRS recently clarified RMD rules for inherited IRAs in regulations and grants penalty waivers. See the Other Taxes lesson.

If the taxpayer does not receive the minimum distribution, an additional tax may be imposed. The tax is 50% of the difference between the minimum distribution and the amount actually distributed for the tax year. Taxpayers may request a waiver of the 50% additional tax using Form 5329, Part IX, which is in scope for Tax-Aide to request thewaiver. See the Other Taxes lesson for more information.

Peter turned 70½ on August 20, 2018. He must receive the first required minimum distribution from his IRA by April 1, 2019. He must receive a second required minimum distribution by December 31, 2019.

Ralph retired five years ago. He turned 70½ on March 15, 2020. He must begin taking minimum distributions from his qualified plans by April 1 following the year he turns 72.

Myrna was 72 when she retired in 2018. She was required to begin taking minimum distributions from her traditional IRA by April 1 of the year following the year she turned 70½ even though she had not retired. Myrna had to take a second required distribution by December 31 of the same year.

This information is provided for your information only, to help you answer any questions a taxpayer may ask about RMD. RMD distributions are reported on Form 1099-R and included on the return using the procedures previously discussed.

Withdrawal of Excess IRA Contributions

An excess IRA contribution is the amount contributed to a traditional and/or Roth IRA during the year that is more than the smaller of the:

- Maximum IRA amount for the year based on the taxpayer's age, or
- Taxable compensation for the year

The taxpayer may not know that a contribution is excess until the tax return is completed after the end of the year. In this situation, the excess amount, with any earnings on that amount, must be withdrawn by the due date of the return (including extensions). If the excess amount is not withdrawn by the due date of the return, the taxpayer will be subject to an additional 6% tax on this amount, and the return is out of scope.

The withdrawn excess contribution is not included in the taxpayer's gross income if both of the following conditions are met:

- No deduction was allowed for the excess contribution
- All interest or other income earned on the excess contribution is withdrawn by the due date of the return, including extensions

However, taxpayers must include the earnings on the excess contribution as income on the return. This income is reported on the return for the year in which the excess contribution was made. The withdrawal of interest or other income may also be subject to an additional 10% tax on early distributions.

If the taxpayer is subject to an additional tax due to excess IRA contributions, refer them to professional tax preparer.

EXERCISES (continued)

Question 7: Taxpayers who withdraw excess contributions and earnings on the excess contributions by the due date of the tax return are not subject to an additional 6% tax on the excess contribution.

a. True

b. False

Question 8: Helen turned 70½ on March 17, 2020. She retired in 2013. She has never taken any distribution from her traditional IRA accounts. Helen is required to:

a. Take a distribution by December 31, 2020.

b. Take a distribution by April 1, 2021.

c. Take a distribution by December 31, 2021.

d. Take a distribution by April 1, 2022, and another by December 31, 2022.

What is a loss on termination of annuity?

When you see that Form 1099-R, Box 1, has a gross distribution amount, Box 2a may have -0-, and the total distribution box checked - the account is closed. If Box 5 has a number equal to or larger than Box 1, the taxpayer has not recovered all their basis in the annuity (cost of the contract). This can happen when a taxpayer cashes out an annuity or other termination of plan.

There is a loss on annuity if “total distribution” (box checked) and box 5 is greater than box 1. The taxpayer may claim a deduction for unrecovered investment in the contract as a miscellaneous itemized deduction not subject to 2% of AGI floor if due to death of annuitant. Otherwise, the loss is subject to the 2% of AGI floor for which no deduction is available for tax years 2018 through 2025 (possible state tax deduction).

Missing Form 1099-R

Similar to a missing Form W-2, if the taxpayer failed to secure the 1099-R from the payer, Form 4852 substitute form can be used. The taxpayer will need to supply all the information that appears on Form 1099-R. Some payer information may be the same as in the prior year. You can e-file the return only if the EIN is available — otherwise a paper return is required. The taxpayer should retain a copy of Form 4852 and should be advised that an amended return may be necessary if Form 1099-R is received later and the information differs

What retirement distributions qualify for tax-favorable treatment?

Qualified birth or adoption distribution may be repaid

A qualified birth or adoption distribution is any distribution from an applicable eligible retirement plan if made during the 1-year period beginning on the date on which a child was born or the date on which the legal adoption of the child was finalized.

A qualified birth or adoption distribution must not exceed $5,000 per adoption or birth. In addition, an eligible adoptee is any individual (other than the child of the taxpayer’s spouse) who has not reached age 18 or is physically or mentally incapable of self-support.

A taxpayer who received a qualified birth or adoption distribution can make one or more contributions to an eligible retirement plan that accepts rollover contributions. A qualified distribution due to the birth or adoption of a child may be repaid at any time. A refund of taxes paid in the year of distribution is limited by statute, normally three years from the due date of the return. Refer to Pub 590-B for additional information.

Special CARES Act Provisions and Tax-Favorable Treatment of Retirement Fund Distributions

The CARES Act of 2020 provided for three special rules for up to $100,000 of coronavirus-related distributions from eligible retirement plans to qualified individuals for 2020: exception to the additional tax on early distributions; distributions may be included in income over a 3-year period; and, to the extent the distribution is eligible for tax-free rollover treatment, the distribution may be recontributed. If the retirement distribution recipient is not a qualified individual, none of these provisions apply. For 2022, the three-year spread and permitted recontributions need to be reported on Form 8915-F.

What are the rules for the 3-year spread of eligible distributions?

A taxpayer who elected to include designated coronavirus-related distributions in income ratably over a 3-year period needed to file Form 8915-E with their 2020 tax return. For a 2020 designated coronavirus-related distribution received on or after January 1, 2020, and before December 31, 2020, the taxpayer will report the taxable distribution equally, 1/3 in each year 2020, 2021, and 2022. The election to opt out of the 3-year spread provision cannot be made or changed after the timely filing of the return (including extensions) for the year of the distribution.

What are the rules for recontributions of eligible distributions?

A qualified individual may recontribute part or all of their eligible designated coronavirus-related distributions to an eligible retirement plan (up to an aggregate limit of $100,000), but not an amount in excess of the amount of the distribution. Recontribution is permitted whether or not the 3-year spread is elected. The recontribution must be completed within three years beginning with the day after the date that the distribution was received.

Not all coronavirus-related distributions may be repaid. That is, a distribution that is eligible for the 3-year spread may or may not be eligible for recontribution. In general, distributions that would be eligible for tax-free rollover treatment are eligible for recontribution under the CARES Act. The following distributions are not eligible for recontribution:

1. Any coronavirus-related distribution (whether from an employer retirement plan or an IRA) paid to a qualified individual as a beneficiary of an employee or IRA owner (other than the surviving spouse of the employee or IRA owner).
2. Any distribution (other than from an IRA) that is one of a series of substantially equal periodic payments made (at least annually) for:
   - **a.** A period of 10 years or more,
   - **b.** The individual's life or life expectancy, or
   - **c.** The joint lives or joint life expectancies of the individual and the individual's beneficiary.

A pension is a periodic payment and cannot be repaid, even if the taxpayer elects to use the 3-year spread of the income.

The recontribution can be made to any qualified account that will accept the recontribution. In general, it is anticipated that eligible retirement plans will accept recontributions of coronavirus-related distributions, which are to be treated as rollover contributions. However, a recontribution under this CARES Act provision will not be treated as a rollover contribution for the one-in-12-months limitation.

Claudia is a qualified individual who received an eligible coronavirus-related distribution from her employer's 401(k) plan. She can choose to recontribute the distribution to her employer's plan, if the plan allows, or to recontribute the distribution to her IRA. The employer plan administrator or IRA trustee may request that Claudia certify she satisfies the recontribution requirements.

How are these provisions reported on a tax return?

A qualified individual will include Form 8915-E in their timely filed 2020 tax return and report:

- All their distributions and their designated coronavirus-related distributions,
- Whether they opt out of the 3-year spread for their eligible distributions,
- The amount of qualified repayments made before filing their 2020 return (but not later than the due date of the return, including extensions), and
- The amount of their designated coronavirus-related distributions taxable in 2020.

Review the taxpayer's 2020 tax return for Form 8915-E. On a jointly filed return, there could be two Forms 8915-E. No tax form will be issued for the ratable 3-year spread amount that needs to be reported in 2022.

Form 8915-F will be filed for 2021 and/or 2022 and/or 2023 to report the amount of the eligible distribution that has been repaid for the year, if any, and the taxable amount of their designated coronavirus-related distributions if the 3-year spread was elected. A repayment made by the due date of the return (including extensions), or the actual date of filing if earlier, is applied to the current tax year's ratable amount (if any) of taxable distribution first.

If a 2022 repayment exceeds the current tax year's ratable taxable amount (if any), the taxpayer can carry back the excess. A qualified individual who repays some or all of a distribution that has been included in taxable income in a prior year will need to file an amended return with an amended Form 8915-E or 8915-F for that prior year to receive a refund of tax they paid. The repaid amount is treated as a rollover in the prior year and may entitle the taxpayer to the retirement savings credit or other tax benefits.

The amount reported on Form 8915-F is not a current year distribution for purposes of the retirement savings credit. The original distribution, reduced for repayments, is a distribution for tax year 2020. (See the Miscellaneous Credits lesson later).

Taxpayer Interview and Tax Law Application

Sample Interview

Volunteer says...	James responds...
I see in your 2020 return that you elected to spread your retirement distribution over three years.	Yes, I had to take extra money out of my IRA. Being able to spread the tax seemed like a good idea.
Form 8915-E shows the amount of distribution of $45,000. Is that right? Which means $15,000 will be taxable in 2022.	Yes, that's right.
You also have the ability to repay or recontribute some or all of the distribution. If you do so, you can reduce the amount taxable in 2022 for any repayments made after you filed your 2021 return up through the day you file your 2022 return. Did you make any recontributions during that time or do you plan to do so before we file your 2022 return?	I would like to, but cash is a little tight right now. Can I recontribute it next year?
Yes. You have until three years from the day after the date your took the money out of your IRA. If you make a recontribution, an amended return will be needed as the excess can be carried back to a year already filed	Ok. Sounds good. I'll double check the date I took the distribution and keep track of any recontributions I make.

Adrian took an eligible coronavirus-related distribution of $60,000 on September 1, 2020. He uses the ratable income inclusion method for the distribution ($20,000 included in income on each federal income tax return for 2020, 2021, and 2022). He repaid $15,000 to his IRA on March 15, 2022 before filing his 2021 return. The $15,000 recontribution is applied to 2021 and Adrian includes the remaining $5,000 in income in 2021.If Adrian filed his 2021 return on March 1, 2022, before making the recontribution, the $15,000 recontribution would be applied to the ratable taxable amount for his 2022 tax year first.

LaDonna is a qualified individual who chose to include a $45,000 IRA coronavirus-related distribution she took in 2020 in income ratably over a 3-year period. She included $15,000 in income in each year 2020 and 2021. LaDonna recontributes $20,000 to her IRA in 2022 after filing her 2021 tax return. None of the ratable taxable amount will be taxable in 2022 (the ratable taxable amount of $15,000 is fully offset by the $20,000 recontribution and there is an excess recontribution of $5,000). LaDonna can choose to apply the $5,000 excess recontribution to either 2020 or 2021, or split between the two years, by amending that year's return to revise the ratable taxable amount downward.

What is not in scope?

Disaster-related distributions that are not coronavirus-related distribution are out of scope. For more information, refer to:

- Disaster Assistance and Emergency Relief for Individuals and Businesses at: **www.irs.gov/businesses/small-businesses-self-employed/disaster-assistance-and-emergency-relief-for-individuals-and-businesses**
- Publication 5396, Fact Sheet for VITA/TCE Sites Impacted by Federally Declared Disasters (January 1, 2018 – December 20, 2019) (**www.irs.gov/pub/irs-pdf/p5396.pdf**)
- Publication 5396-A, Job Aid for VITA/TCE Volunteers: Using Form 4852 when Missing the Form W-2 or 1099-R (**www.irs.gov/pub/irs-pdf/p5396a.pdf**)
- Publication 5396-B, VITA and Tax Counseling for the Elderly Casualty Loss Screening Tool (**www.irs.gov/pub/irs-pdf/p5396b.pdf**)

How do I determine when an adjustment to withholding should be made?

Taxpayers may choose to have income tax withheld from their retirement distributions. Be sure to enter any amount of federal (and state) income tax withheld on Form 1099-R.

After the completion of the return, if the taxpayer owes $1,000 or more on the tax return, you should discuss their withholding and estimated tax options with them. This is covered in more detail in the Completing the Return lesson.

Sometimes taxpayers are not aware they can request that federal income tax be withheld from their retirement income by filing Form W-4P, Withholding Certificate for Periodic Pension or Annuity Payments or Form W-4R, Withholding Certificate for Nonperiodic Payments and Eligible Rollover Distributions.This form is sent to the payer. Also, Form W-4V, Voluntary Withholding Request, is used to request withholding from Social Security benefits. This form is sent to the Social Security Administration. Every year, the Social Security Administration reports taxpayers' retirement benefits and/or voluntary withholdings on Form 1099-SSA.

Taxpayers who receive a very large refund may make better use of their funds if tax withholding is lowered. Explain ways they can reduce their withholding.

For additional help, taxpayers can refer to Publication 17, Withholding, Form W-4, or visit the IRS website and use the "Tax Withholding Estimator." A taxpayer who chooses not to have tax withheld may have to pay estimated tax each quarter. Failure to pay enough federal income tax throughout the year can result in a large amount of tax being owed when the return is due. It can also result in a penalty. Form 1040-ES, Estimated Tax for Individuals, is used to calculate the estimated quarterly payment and provides vouchers with which to remit the payments.

EXERCISES (continued)

Question 9: Faith comes to your site to get her tax return done. When you finish her return, you explain to her that she owes $985, and that she needs to pay this amount by the due date. She says that she will pay the amount, but wants to know if there is some way to have more tax withheld from her monthly pension so that she doesn't owe so much at the end of the year. Which form should she complete to increase the withholding from her pension?

a. Form W-4P

b. Form W-4V

c. Form W-4R

Summary

This lesson helped you identify, calculate, and report the taxable portion of retirement income received by the taxpayer. It reviewed the types of retirement income and the forms used to report them. You learned when taxpayers of retirement age are required to take a minimum distribution from a retirement plan and when they may need to adjust their withholding.

What situations are out of scope for the Tax-Aide program?

The following are out of scope for this lesson. While this list may not be all inclusive, it is provided for your awareness only.

- Taxpayers subject to additional tax due to excess IRA contributions
- Taxpayers subject to additional tax due to failure to take their required minimum distribution
- Roth IRA distributions that are taxable or partially taxable
- IRA rollovers that do not meet the tax-free requirements as intended by the taxpayer and for which self-certification is not available
- Taxpayers who used the General Rule to figure the taxable portion of pensions and/or annuities for past years
- Certain rarely seen distributions codes on Form 1099-R as specified in the Tax-Aide Scope Manual
- Retirement income from foreign countries (other than German or Canadian social security – see Social Security lesson) – reporting on FINCEN114 or F8938 may be required

To gain a better understanding of the tax law, complete the practice return(s) for your course of study using the Practice Lab on L&LT. You may not be able to complete the entire exercise if some of the technical issues in the exercise are not covered until later lessons in the training. In these instances, complete as much of the exercise as you can. Come back later to finish the exercise after you cover all the technical topics.

EXERCISE Answers

Answer 1: b. False. In addition to Roth IRAs, nondeductible contributions to traditional IRAs are also not taxed when they are distributed.

Answer 2: b. False. Mary's distribution was not made after the 5-year period beginning with the first taxable year she made a contribution to her Roth IRA. Therefore, the earnings/investment gains portion of the distribution will be taxable income. (She may also owe an additional tax on early distributions. This will be discussed in the Other Taxes lesson.)

Answer 3: a. True. Amy's distribution can be excluded from her taxable income because it was made more than five years after the beginning of the taxable year of her first contribution, and it was made on or after age 59½.

Answer 4: b. Andrew can exclude the entire distribution from income because it was rolled over into an IRA within the allowed 60-day period.

Answer 5: c. Dotty's entire pension amount of $10,074 (6 x $1,679) is fully taxable because she has never paid income taxes on her employer's contribution to her pension.

Answer 6: d. Because Annie Jo has not reached the minimum retirement age set by her employer, you should report her disability income as wages on her Form 1040.

Answer 7: a. True. Taxpayers must withdraw excess contributions and any earnings by the due date of the return (including extensions) to avoid the additional 6% tax on the excess contribution.

Answer 8: d. Taxpayers are required to begin receiving distributions from their qualified plan by April 1 of the calendar year following the year in which they reach age 72. Helen will turn 72 in 2021. She must take a distribution by April 1, 2022, and another distribution by December 31, 2022.

Answer 9: a. Generally, Form W-4P, Withholding Certificate for Periodic Pension and Annuity Payments, is used to request a change in withholding on a pension.

Introduction

This lesson covers the reporting of:

- Certain income from Schedules K-1 (Forms 1065, 1120S, and 1041).
- Royalty income reported on Form 1099-MISC
- Rental income and expenses are in scope only for military families renting their personal residence. Taxpayers are not required to report income and expenses if their home is rented less than 15 days during the year.
- Rental income and expenses are in scope only for the Military course. Volunteers must certify at Military level to prepare Schedule E for rental income.

Volunteers who certify at the Advanced level are permitted to prepare a Schedule E, Supplemental Income and Loss, only with Schedule K-1 income items identified in this lesson or Form 1099-MISC, Box 2, Royalties, with no associated expenses.

Rental income and expenses are in-scope only for military families renting their personal residence. Generally, the at-risk and passive activity issues in this lesson are beyond the scope of the VITA/TCE programs. These issues are referenced for those assisting military members living abroad who have limited access to resources and professional preparers.

It is important to ensure that all income is accurately reported on the return. Ask taxpayers if they rented out their home during the tax year or if they received a Schedule K-1 (Form 1041, Form 1065, or Form 1120S) from an estate, trust, partnership, or S corporation.

This lesson does not apply to taxpayers who are in the business of renting properties.

Objectives

At the end of this lesson, using your resource materials, you will be able to:

- Identify Schedule K-1 income items that are within the scope of the VITA/TCE programs
- Determine how to report Schedule K-1 income items
- Determine which types of rental income must be reported
- Identify how to report rental expenses

Sch K-1 or K-3 may report information that is not needed for an in-scope return, such as investment income or foreign tax credit per-country detail. It is not necessary to enter that information into the software. Items of taxable income, expense, or credits on a K-1 other than those listed on this page makes the tax return out of scope.

What do I need?

- Form 13614-C
- Publication 4012
- Publication 17
- Schedule A
- Schedule E

Optional:

- Publication 527
- Publication 541
- Publication 551
- Publication 559
- Publication 925
- Publication 946
- Form 8582
- Schedule K-1 (Form 1041 and Instructions)
- Schedule K-1 (Form 1065 and Instructions)
- Schedule K-1 (Form 1120S and Instructions)

Schedule K-1, Taxpayer's Share of Income, Deductions, Credits, etc.

What is reported on Schedule K-1?

Schedule K-1 is used to report the taxpayer's share of income, other distributions, deductions, and credits from partnerships, S corporations, and some estates and trusts. One copy of Schedule K-1 is sent to the IRS and is later matched with individual returns. Another copy of Schedule K-1 is sent to the taxpayer. Ask taxpayers if they received a Schedule K-1 from such an entity that reflects their share of income, reportable on their Form 1040. It is important to correctly report this income to avoid notices or correspondence from the IRS.

How and where can income be reported?

Income reported on Schedule K-1 will be included on the taxpayer's return in various places depending upon the type of income. Income reported on Schedule K-1 that is within the scope of the VITA/TCE programs includes:

The estate, trust, partnership or S corporation may have a fiscal year that is not a calendar year. Such an entity will use the forms for the year in which its fiscal year begins (that is, the prior year).

- Interest income
- Dividend income
- Qualified dividends income
- Section 199A dividends
- Net short-term capital gains and losses (Schedule D, line 5)
- Net long-term capital gains and losses (Schedule D, line 12)
- Tax-exempt interest income
- Royalty income (Schedule E)

In Part I of Schedule E, enter a code 6 for royalties. Refer to the Schedule E Instructions for more information.

Royalty income is in scope for the VITA/TCE programs only when the source document of the royalty income is reported on Schedule K-1 or Form 1099-MISC, Box 2, Royalties, with no associated expenses. Depletion allowances and any other income, deductions, credits, etc., reported on Schedule K-1 are out of scope for the VITA/TCE programs, and the taxpayer should be referred to a professional tax preparer. Except when SPEC has provided training for depletion.

Foreign taxes reported on Schedule K-1 may be within scope. See the Foreign Tax Credit lesson for more information.

Schedule K-1 (Form 1041)

The fiduciary of a domestic decedent's estate, trust, or bankruptcy estate uses Form 1041 to report income, gains, losses, etc., of the estate or trust.

Taxpayers receive Form 1041, Schedule K-1, to report their share of income from interest, dividends (ordinary, qualified, and Section 199A), and capital gains (net short-term and net long-term). The taxpayer's income from these sources should be reported on the appropriate forms and schedules as listed on Form 1041, Schedule K-1, page 2.

Schedule K-1 (Forms 1065 and 1120S)

Partnerships use Form 1065, Schedule K-1, to report the taxpayers' share of the partnership's income, deductions, credits, etc. In general, a partnership is not subject to income tax and is a flow-through entity.

This means the income flows through to the partners, who pay tax on their allocated share of the partnership income on their individual Forms 1040.

S corporations use Form 1120S, Schedule K-1, to report the taxpayers' share of the corporation's income (reduced by any tax the corporation paid on the income), as well as any deductions, credits, etc. The S corporation is also a flow-through entity with the reported income flowing through to each shareholder. Shareholders pay tax on their allocated share of the income on their individual Forms 1040.

Taxpayers receive a Schedule K-1 (Form 1065 or Form 1120S) reporting their share of income from interest, dividends, and capital gains (net short-term and net long-term) from partnerships and corporations. Schedule K-1, page 2, lists the appropriate forms and schedules where taxpayers' income from these sources should be reported.

Schedules K-1 are not filed with the tax return. Advise taxpayers to keep Schedules K-1 with their records.

Additional information may be present in various parts of Schedule K-1 for which you may need to look up the codes on the back of the form (or refer to your Volunteer Resource Guide, Tab D). These include creditable foreign taxes, exempt interest income, and Sec. 199A dividends. Other codes and Schedules K-2 and K-3 provide information that does not need to be entered in the software for in-scope returns.

How do I handle royalties reported on Form 1099-MISC?

Taxpayers will receive Form 1099-MISC if they were paid at least $10 in royalties. Royalties can be from intangible assets (such as copyrights or patents) or from tangible assets (such as oil, gas and mineral interests) and are generally taxable as ordinary income.

Generally, report oil, gas, or mineral royalties in Part I of Schedule E, Supplemental Income and Loss. However, if the taxpayer holds an operating oil, gas, or mineral interest (out of scope) or is in business as a self-employed writer, inventor, artist, etc., report royalty income and expenses on Schedule C. Refer taxpayers with operating oil, gas, or mineral interests (also called a working interest) to a professional tax preparer

If the royalty is from another person's services, such as inherited royalties, they are generally reported as other income on Schedule 1.

What is rental income?

Generally, payment received for renting a room or a home to a tenant is rental income reportable on Form 1040, Schedule E. U.S. citizens and resident aliens must report rental income, regardless of whether the rental property is located in the U.S. or in a foreign country. Gross rental income may include other payments in addition to the normal and ordinary rents received, such as:

- Advanced rent
- Security deposits, if it represents rental income
- Payments for breaking a lease
- Expenses paid by the tenant
- Fair market value of property or services received instead of rental payments

Tax-Aide only: rental of land with no improvements is in scope and reported on Schedule E. All land rental income must be reported whether on a Form 1099-MISC or not. Deductible interest or taxes can be claimed on Schedule A if itemizing. Taxpayers should be referred to a paid tax preparer when they wish to claim the expenses on Schedule E.

A cost-sharing arrangement, such as a roommate, is not a rental arrangement.

Residential rentals are in scope with Military certification when the taxpayer is active military only.

The security deposit is not included in income when the taxpayer plans on returning the deposit at the end of the lease. However, if the security deposit is intended to serve as the last month's rent, then it should be included in income when received.

The taxpayer's method of accounting affects when the rental income is reported. The cash method reports income when received and expenses when paid; most individuals use this method. The accrual method reports income when earned and expenses when incurred, and is out of scope for the VITA/TCE programs.

Refer taxpayers using the accrual method of accounting to a professional tax preparer.

Rental of a residence only is in scope. Renting personal property, such as equipment or vehicles, is out of scope for the VITA/TCE Programs.

In completing Schedule E, the following should be answered:

- Question A – Check the box “Yes” or “No” to the question: Did the taxpayer make any payments in the current year that would require the filing of Form 1099? If Yes, the return is out of scope.
- Question B – If Yes, did or will the taxpayer file all required Forms 1099? Check the box “Yes” or “No.”
- In Part I, line 2 – The number of fair rental value days and number of personal use days is reported on Schedule E.

For software entries, see the Volunteer Resource Guide, Tab D, Income.

It is important that property be rented at fair rental value. If a property is rented at less than fair rental value, the income and expenses are reported in a different manner than discussed in this lesson. Refer taxpayers who rent their property at less than fair rental value to a professional tax preparer.

What qualifies as a rental expense?

Taxpayers who reside in homes they own generally itemize and deduct mortgage interest and property taxes on Schedule A. However, when a taxpayer rents out a home, those become rental expenses along with the cost of certain other operating expenses. Taxpayers who do not use the rental home as their residence should:

- Include the rent as income and
- Deduct all of the rental expenses, even if they exceed income

Mortgage interest and property taxes

Mortgage interest on a loan used to buy or improve the property and property taxes are deductible as rental expenses. If the residence (or a portion of the residence) was used as rental property for any part of the year, the taxpayer must allocate the property tax and mortgage interest deductions between Schedule A and Schedule E.

In general, taxpayers use Schedule A, Itemized Deductions, to report the portion of the mortgage interest and property taxes that apply to their use of the home. That portion can be based on a percentage of time (4 months as a residence and 8 months used as rental) or based on an area (1,500 sq. ft. as a residence and 500 sq. ft. as the rental portion). For the part of the year and/or the portion of the home that is rented out, taxpayers report rental income and expenses (including a portion of the mortgage interest, property taxes, and other expenses that relate to the rental time/portion of the home) on Schedule E, Supplemental Income and Loss.

If any part of the property tax is designated for local benefits that increase the value of the property, such as streets and sidewalks, that portion of the tax is added to the basis of the property rather than deducted as an ordinary rental expense or an itemized deduction.

Mortgage interest is reported to the taxpayer on Form 1098, Mortgage Interest Statement. This statement may also include property taxes. If it does not, the taxpayer should have a document from the local taxing authority.

Generally, mortgage interest expense is fully deductible. However, refer taxpayers with rental-related interest expenses other than mortgage interest to a professional tax preparer.

Taxpayers who received a Mortgage Credit Certificate must be referred to professional tax preparer.

Paul Kingman lived in his home through September, when he was notified he was being transferred overseas. He rented his home beginning in October. The total amount of Paul's mortgage interest for the tax year was $2,400 and his property taxes were $600. Report nine months (January–September) of mortgage interest and property taxes as itemized deductions on Schedule A, that is, $1,800 and $450, and the other three months (October–December) as expenses on Schedule E, that is, $600 and $150.

What are other deductible rental expenses?

In addition to mortgage interest and property taxes, deductible rental property expenses may include these items listed on Schedule E:

- Advertising
- Auto and travel expenses to check on the property or to collect rents
- Cleaning and maintenance
- Commissions paid for collecting rental income
- Insurance premiums
- Mortgage points
- Legal and professional fees
- Property management fees
- Repairs
- Utilities
- Other rental-related expenses, such as rental of equipment, long distance phone calls, and condominium/ cooperative maintenance fees

Transportation expenses incurred to travel between a taxpayer's home and rental property generally constitute nondeductible commuting costs unless the home is the taxpayer's principal place of business.

When a tenant does not pay the rent, a cash-basis landlord cannot take a deduction for the unpaid rent. Taxpayers cannot take a deduction for a payment they did not include in income.

EXERCISES

Question 1: John Princeton was transferred overseas and began renting out his residence on September 1 of the tax year. How much of his mortgage interest and property taxes should be reported on his Schedule E?

a. All of it

b. Eight-twelfths (2/3 or 67%)

c. Four-twelfths (1/3 or 33%)

d. None of it

What about property insurance?

The property insurance that taxpayers pay on their residence is deductible as a rental expense for the time it is considered rental property. If the residence is rented for part of the year, only the amount that covers the rental period is deductible. If a portion of the residence is rented, the deductible portion must be allocated and deducted on Schedule E.

Insurance premiums paid more than one year in advance cannot be deducted in one year. All taxpayers must prorate advanced premium payments over the period covered by the policy. The only portion deductible in the current year is that amount that covers the current year. The remainder is spread out over the life of the insurance coverage.

Can travel expenses away from home be deducted as rental expenses?

Taxpayers can deduct ordinary and necessary travel and transportation expenses of traveling away from home if the primary purpose of the trip is to collect rental income or to manage, conserve, or maintain the rental property. If the travel was in or outside of the U.S., taxpayers should substantiate the pleasure vs. business portions of the trip and allocate the expenses accordingly.

Taxpayers who use their personal automobile for rental-related trips may use either the standard mileage rate or the actual expense method for business mileage. However, if the taxpayers wish to use the actual expense method, refer them to a professional tax preparer.

The standard mileage method multiplies the miles driven for business by a standard rate. The standard rate includes all expenses of operating the vehicle. Only parking and tolls can be added to the standard mileage deduction. See Publication 463, Travel, Gift, and Car Expenses, for the current year standard mileage rate. Taxpayers may use the standard mileage rate only if they meet one of these requirements:

- The vehicle was owned and used the standard method the first year the vehicle was placed into service or
- The vehicle was leased and used the standard method for the life of the lease

The actual expense method figures the deduction based on a variety of factors, including gasoline, oil, repairs, insurance, and rentals and may even involve depreciation or the value of a vehicle provided by the taxpayer's employer.

This lesson discusses only the standard mileage rate. If taxpayers wish to use the actual method, refer them to a professional tax preparer.

Are repairs and improvements deductible?

Taxpayers often misunderstand when an expense qualifies as a repair or an improvement. A repair keeps the property in good operating condition; the cost is a current year deduction. An improvement adds to the life or

material value of the property, prolongs its useful life, or adapts it to new uses. This cost must be depreciated over the recovery period for the improvement. The total cost of an improvement includes material, labor, and installation.

Taxpayers can elect to expense repair, improvement, or purchased items that might otherwise have to be capitalized. Items that cost $2,500 or less can be expensed immediately by using the de minimis election in the regulations. When the taxpayer makes this election, it applies to all eligible items paid during the year. Note that this is not a Section 179 expense election, which is shown on Form 4562, Depreciation and Amortization. Instead, the expense is shown as repairs or other expense on Schedule E.

Taxpayers cannot deduct the cost of their own labor when making repairs.

See the table below for examples of repairs and improvements.

Repairs (Deduction)	Improvements (Depreciation)
Painting	Adding a room
Fixing gutters	Installing a new fence
Repairing driveways	Putting in plumbing or wiring
Replacing window glass	Replacing a hot water tank
Repairing the roof	Putting on a new roof
Repairing appliances	Replacing/adding major appliances

For software entries, go to the Volunteer Resource Guide, Tab D, Income.

Additional information on rental income can be found in Publication 527, Residential Rental Property and Publication 946, How to Depreciate Property.

How do I handle depreciation of rental property?

The cost of property with a useful life of one year or more, and used in a trade or business or held for the production of income (such as rent), is recovered by deducting an expense called depreciation.

“Depreciable property” includes buildings, machinery, furniture, equipment, vehicles, and any cost for additions or improvements to rental property. The value of land, however, is not depreciable; therefore, the cost of clearing, grading, planting, or other land improvements are also not depreciable.

Depreciation allows the taxpayers to deduct some of the cost of the property each year on their tax return. The annual amount of depreciation on property reduces the taxpayers’ basis in that property. Taxpayers should claim the correct amount of depreciation expense every year. Even if they did not deduct the depreciation expense during any tax year, they must still reduce their basis in the property by the amount of depreciation that they should have deducted.

What factors determine the amount of depreciation to deduct?

The factors that determine the depreciation amount are:

- Depreciation method used
- Basis of the property
- Recovery period for the property

Depreciation Method

The most common methods for determining depreciation are:

- Straight line or declining balance: Property placed in service before 1981
- ACRS (Accelerated Cost Recovery System): Property placed in service after 1980, but before 1987
- MACRS (Modified Accelerated Cost Recovery System): Property placed in service after 1986

What is considered the basis and adjusted basis for depreciation purposes?

Generally, the basis for depreciation is the purchase price of the property, including the cost of improvements, but not including the value of the land. When property is converted from personal use to rental use, the basis is the lesser of the adjusted basis or fair market value (FMV) at the time of conversion. The total of the yearly expense deductions for depreciation can never total more than the basis of the property.

Form 4562, Depreciation and Amortization

Taxpayers must complete and attach Form 4562 for rental activities only if claiming:

- Depreciation, including the special depreciation allowance, on property placed in service during the year (out of scope)
- Depreciation on listed property (such as a car), regardless of when it was placed in service (out of scope)
- Any other car expenses, including the standard mileage rate or lease expenses (out of scope)

Otherwise, taxpayers should figure the depreciation on their own worksheet. Do not attach these computations to the return, but taxpayers should keep them in their records for future reference.

EXERCISES (continued)

Question 2: All of the following are examples of deductible rental expenses except _____.

a. Carpet cleaning fees
b. Charges for phone calls made to the property manager
c. Gas and electric bills paid for the rental property
d. Repairs made to the homeowner's personal residence

Question 3: Which of the following rental expenses must be recovered by taking depreciation?

a. Home insurance premiums
b. Painting
c. Installing a backyard fence at a cost of $3,500
d. Repairing a broken furnace

For depreciation software entries, go to the Volunteer Resource Guide, Tab D, Income

How do I handle rental property that the taxpayer also uses?

When the rental property is a portion of the taxpayer's residence, the rental income and expenses must be allocated separately from the taxpayer's personal expenses.

How do I differentiate between rental expenses and personal use expenses?

Expenses that apply to only the rental part of a property are direct business expenses and should be reported in full on Schedule E. The cost of installing a second phone line strictly for a tenant's use, for example, is deductible as a rental expense. However, the taxpayer cannot deduct any part of the cost of the first phone in a partially-rented property, even if tenants use it.

Expenses that benefit the entire property (indirect expenses) must be allocated between rental use and personal use; the rental portion is reported on Schedule E.
If deductions are itemized, the personal portion of home mortgage interest and property tax may be reported on Schedule A. The taxpayer can choose any reasonable method to allocate the expenses. The most common methods are based on the number of rooms in the dwelling or on the total area of the dwelling. On Schedule E, report expenses that apply exclusively to the rental portion and the applicable percentage of expenses that benefit the entire house. For example, if the rented portion is 10% of the property, the taxpayer could deduct:

- 100% of the cost to wallpaper the tenant's room
- 10% of property taxes, utilities, mortgage interest, and depreciation

Gloria rents one room in her 1,200 square foot house to a tenant. The rental room measures 10 feet by 12 feet (120 square feet, or 10% of the total house). She may deduct:

When taxpayers can itemize personal deductions on Schedule A, they can report the deductible expenses that benefit the entire house minus the percentage that applies to the rental portion. In Gloria's case, if she is treating the rental portion as 10% of the residence, she can deduct the following on Schedule A:

- 90% of the mortgage interest
- 90% of the property taxes

Expenses related to days of personal use do not qualify as rental expenses. The taxpayer must allocate the expenses based on the number of days of personal use to total use of the property.

Charles used his rental property for personal use 7 days and rented it for 63 days. In most cases, 10% of Charles' expenses are not rental expenses and cannot be deducted on Schedule E (7 = 10% of 70 total days: 7 personal days + 63 rented days).

EXERCISES (continued)

Question 4: For taxpayers who rent part of a property in which they live, which expenses are reported only on Schedule E and not on Schedule A?

a. Home insurance and mortgage interest

b. Property taxes and repairs

c. Utilities and home insurance

d. Depreciation and property taxes

How should taxpayers report rental expenses that exceed their rental income when they live in the home for part of the year?

Questions in Part I, line 2 of Schedule E ask for information on the number of rental days at fair rental value and the number of days for personal use. If taxpayers rented out a dwelling unit that they also used for **personal purposes** during the year, they may not be able to deduct all the expenses for the rental part.

Dwelling unit (the unit) means a house, apartment, condominium, or similar property. A day of personal use is any day, or part of a day, that the unit was used by:

- The taxpayer for personal purposes,
- Any other person for personal purposes, if that person owns part of the unit (unless rented to that person under a "shared equity" financing agreement),
- Anyone in the taxpayer's family (or in the family of someone else who owns part of the unit), unless the unit is rented at a fair rental price to that person as his or her main home,
- Anyone who pays less than a fair rental price for the unit, or
- Anyone under an agreement that lets the taxpayer use some other unit

Are there any exceptions?

Taxpayers who used a dwelling unit as their main home may not have to count all that time as "days of personal use." Do not count as personal use any day the taxpayer:

- Spends working substantially full time repairing and maintaining the unit, even if a family member used it for recreational purposes on that day, or
- Used the unit as the taxpayer's main home before or after renting it or offering it for rent, if the taxpayer rented or tried to rent it for at least 12 consecutive months (or for a period of less than 12 consecutive months at the end of which the taxpayer sold or exchanged the home).

However, this special rule doesn't apply when dividing expenses between rental and personal use.

On February 28, Trent moved out of the house he had lived in for six years because he was deployed overseas. He rented his house at a fair rental price from March 15 last year to May 14 this year. On June 1 this year, he returned from his deployment and moved back into his house. Because he rented his property for 12 or more consecutive months, his use of the house is not counted as personal use. Since these days are not counted as days of personal use, the limitations on deductions do not apply.

Are there any limitations?

There are limitations based on whether the taxpayer used the dwelling unit as a home and it meets the personal use test. The personal use test is met if the taxpayer used the unit for personal purposes in the current tax year **more than the greater of:**

- 14 days or
- 10% of the total days it was rented to others at a fair rental price

Fair rental days and personal use days are reported in Part I, line 2, of Schedule E.

If the taxpayer did not use the dwelling unit as a home, the taxpayer can deduct all the expenses for the rental part, subject to the At-Risk Rules and the Passive Activity Loss Rules. For more details on these rules, refer to Publication 527, Residential Rental Property (Including Rental of Vacation Homes).

If the taxpayer used the dwelling as a home and rented the unit for **fewer than 15 days** in the current tax year, do not report the rental income and do not deduct any rental expenses. If the taxpayer itemizes deductions on Schedule A, the taxpayer can deduct allowable interest, taxes, and casualty losses. (Remember that the topic of casualty losses is out of scope for the VITA/TCE programs.)

If the taxpayer used the dwelling as a home and rented out the unit **at least 15 days** in the current tax year, the taxpayer may not be able to deduct all of the rental expenses. The taxpayer can deduct all of the following expenses for the rental part on Schedule E:

- Mortgage interest
- Real estate taxes
- Casualty losses (out of scope)
- Other rental expenses not related to the taxpayer's use of the unit as a home, such as advertising expenses and rental agents' fees

If there is rental income left after deducting these expenses, the taxpayer can deduct other expenses, including depreciation, up to the amount of remaining income. The taxpayer can carry over to the following tax year the unused expense amounts.

If the property was used as a rental for the entire year, the income and expenses can be reported on Schedule E. If the property was used partially as a rental and partially as a residence, some expenses may need to be allocated. For software entries, go to the Volunteer Resource Guide, Tab D, Income.

How do I handle rental losses?

Deducting all rental expenses and depreciation from the rent received may result in a net loss. Rental losses are not always fully deductible. There are two restrictions on how much a loss can offset other sources of income:

- At-risk rule
- Passive activity rules

What is the at-risk rule?

The at-risk rule places a limitation on the amount the taxpayer can deduct as losses from activities often described as tax shelters. Generally, any loss from an activity subject to the at-risk rules is allowed only to the extent of the total amount the taxpayer has at risk in the activity at the end of the tax year.

What are the passive activity rules?

The passive activity rules state that passive activity losses can be deducted only from passive activity income. Passive income does not include salary, dividends, or other investment income but is generally attributed to such things as rental income. Therefore, losses that exceed rental income (the passive activity) are not deductible. However, some losses may be deductible if an exception is met.

Passive income and active participation

The limits on deducting rental losses are affected by the degree to which renting out the property is a passive activity or involves active participation:

- Passive rental activity means receiving income mainly from the use of property rather than for services.
- Active participation means making significant management decisions, such as approving rental terms, repairs, expenditures, and new tenants. Taxpayers who use a leasing agent or property manager could be considered active participants if they retain final management rights.

Exception

Rental activities are generally considered passive activities. For this reason, rental losses are not fully deductible. However, an exception to the passive activity rule provides that taxpayers who actively participate in the rental activity can use up to $25,000 of their rental losses to offset any other nonpassive income ($12,500 for married taxpayers filing separately and living apart for the entire year). Examples of nonpassive income are salaries, wages, commissions, tips, self-employment income, interest, dividends, annuities, and some royalties. (This deduction is reduced if the taxpayer's adjusted gross income (AGI) exceeds certain limits.)

What is active participation?

It is considered active participation when taxpayers own at least 10% of the rental property and make management decisions in a significant and bona fide sense. Management decisions include approving new tenants, deciding on rental terms, approving expenditure, and similar decisions.

For more information, see Publication 925, Passive Activity and At-Risk Rules.

Phase-Out of Offset

The amount allowed to offset nonpassive income is reduced if taxpayers' modified adjusted gross income exceeds certain amounts. See Publication 925 for the AGI limits.

EXERCISES (continued)

Question 5: Which restriction limits the deductibility of rental loss to the amount of rental income?

a. Phase-out of offset

b. Passive activity rules

c. Active participation rule

How are passive rental losses reported?

Taxpayers use Form 8582, Passive Activity Loss Limitations, to figure the amount of any passive activity loss allowed for the current tax year. Form 8582 summarizes losses and income from all passive activities.

Generally, taxpayers are not required to file Form 8582 if they have:

- Only one passive loss generated from a rental activity and
- MAGI of less than $100,000 (not more than $50,000 if MFS).

Completing Form 8582 is out of scope if volunteers are required by the software to enter additional data in Form 8582. For example, if passive activity losses exceed $25,000 ($12,500 for Married Filing Separately) and require a computation of unallowed passive activity losses, then the return is out of scope.

Summary

Taxpayers receive Schedule K-1 (Form 1065, Form 1041, or Form 1120S) reporting their share of income from flow-through entities. Interest, dividends (ordinary and qualified), and capital gains (net short-term and net long-term) are in scope. Schedule K-1, page 2, lists the appropriate forms and schedules where the taxpayers' income from these sources should be reported. Additionally, royalties on Schedule K-1, Forms 1065 and 1120S are within scope. Volunteers who certify to the Advanced level are permitted to prepare a Schedule E only with Schedule K-1 and limited Form 1099-MISC income items.

Rental income and deductible rental expenses are reported on Part I of Schedule E, Supplemental Income and Loss. Volunteers must certify at the Military level to prepare a Schedule E for rental income. Rental income and expenses are in-scope **only** for military families renting their personal residence.

U.S. citizens and resident aliens must report rental income for the months their home is rented, regardless of whether the rental property is located in the U.S. or in a foreign country.

When renting out part of the property, certain expenses must be allocated between rental use and personal use. Some are reported on Schedule A and some on Schedule E.

Taxpayers who do not use a dwelling unit as a home (for personal purposes) should include all the rent in their income and deduct all the rental expenses. There are special rules and limitations if the taxpayer used the dwelling unit as a home and it meets the personal use test.

Rental income and expenses are not reported if the taxpayer used the dwelling as a home and rented the unit for fewer than 15 days in the current tax year. If the taxpayer itemizes deductions on Schedule A, the taxpayer can deduct allowable interest, taxes, and casualty losses. (Remember that the topic of casualty losses is out of scope for the VITA/TCE programs.)

Because rental activities are generally considered passive activities, rental losses are not fully deductible. However, taxpayers who actively participated in the renting of the property may deduct up to $25,000 of their rental losses, up to $12,500 for married taxpayers filing separately and living apart. This deduction is subject to phase-out rules if the taxpayer's AGI exceeds certain limits.

The passive activity rules state that passive activity losses can be deducted only from passive activity income. Taxpayers with rental losses may be required to file Form 8582, Passive Activity Loss Limitations.

What situations are out of scope for the VITA/TCE programs?

The following are out of scope for this lesson. While this list may not be all inclusive, it is provided for your awareness only.

- Income reported on Schedules K-1 (other than what is listed in the introduction to this lesson)
- Deductions, credits, and other items reported on Schedules K-1 (other than listed above)
- Royalty income reported on Form 1099-MISC when there are associated expenses (other than royalties for personal services, such as an author or composer, that are reported on Schedule C)
- Residential rental income and expenses for non-military taxpayers
- Taxpayers who rent their property at less than fair rental value
- Rental-related interest expenses other than mortgage interest
- The actual expense method (auto and truck expense deductions)
- Casualty loss
- Completing Form 8582 if volunteers are required to enter additional data in Form 8582 in the software
- Completing Form 4562
- Taxpayers who filed or need to file Form(s) 1099

To gain a better understanding of the tax law, complete the practice return(s) for your course of study using the Practice Lab on L&LT.

***Tax-Aide:** check with your Local Coordinator if you have a question on scope or whether a return should be completed at your site.*

EXERCISE Answers

Answer 1: c. You would deduct four-twelfths (33%) of his mortgage interest and taxes on Schedule E, and report the other 67% on Schedule A.

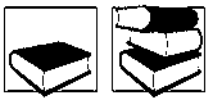
Answer 2: d. Repairs made to the homeowner's personal residence are not deductible as rental expenses. However, the other expenses are deductible, along with repairs made to rental property, legal and professional fees, and property management fees.

Answer 3: c. The fencing adds value to the property and would have to be capitalized and depreciated.

Answer 4: c. The rental portions of utilities, home insurance, repairs, and depreciation are rental deductions on Schedule E, but the personal portions are not a deductible expense reported on Schedule A. Taxpayers who rent out part of a property allocate mortgage interest and property taxes separately on both schedules.

Answer 5: b. Passive activity losses can be deducted only from passive activity income. Taxpayers who are not active participants may not deduct rental losses that exceed rental income.

Income – Unemployment Compensation and Other State Payments



Introduction

This lesson will help you assist taxpayers who have unemployment compensation income.

Objectives

At the end of this lesson, using your resource materials, you will be able to:

- Identify unemployment compensation income
- Determine how to report unemployment compensation on the tax return

What is unemployment compensation?

Unemployment compensation generally includes any amount received under an unemployment compensation law of the United States or of a state in the U.S. In most cases, unemployment compensation is taxable. If taxpayers contribute to a governmental unemployment compensation program or a governmental paid family leave program and the contributions are not deductible, amounts received under the program are not included as unemployment compensation until the taxpayers recover their contributions. If the taxpayer has already deducted all of the contributions to the program, the entire amount received under the program is taxable.

What do I need?

- Form 13614-C
- Publication 4012
- Publication 17

Optional:

- Form 1099-G

Where can I get unemployment compensation information?

Begin with the unemployment question on the intake and interview sheet. Ask the taxpayer for any Form(s) 1099-G, Certain Government Payments, that document unemployment compensation payments from each government entity.

In most states, taxpayers can elect to have federal income taxes withheld from their unemployment compensation benefits. Be sure to review Form 1099-G, Box 4, for any federal income tax withheld.

What if taxpayer did not get the unemployment benefits shown on 1099-G?

Generally, taxpayers must include in income all unemployment compensation received. If the Form 1099-G shows the wrong amount of unemployment compensation, the taxpayer should contact their state unemployment agency to correct it.

What if the taxpayer repaid some of their unemployment benefits?

If the taxpayer repaid unemployment compensation received in the same tax year, subtract the amount repaid from the total amount received and enter the difference on Schedule 1 (Form 1040), line 7. Refer to the Volunteer Resource Guide for the software entries.

If the unemployment compensation repaid in the current tax year was included in income in an earlier year and the amount is more than $3,000, the taxpayer may deduct the amount repaid on Schedule A (Form 1040), line 16, if itemizing deductions or claim a Sec. 1341 credit. If the amount of repayment is $3,000 or less, no deduction or credit is available through 2025. Repayments of more than $3,000 are out of scope for the VITA/TCE Programs.

How do I report unemployment compensation and other state payments shown on Form 1099-G?

The total for all unemployment compensation received in Form(s) 1099-G, Box 1 or Box 5 RTAA, should be entered on Form 1040, Schedule 1.

RTAA payments (reemployment trade adjustment assistance) are shown in Box 5 of Form 1099-G. These are reported as other income on Form 1040, Schedule 1, not unemployment.

Taxable grants shown on box 6 are also generally reported as other income on Form 1040, Schedule 1, unless the income relates to a business activity and should therefore be included as income on Schedule C. If the grant should be included on Schedule E, F or Form 4835, the return is out of scope for the VITA/TCE Programs.

Form 1099-G may also report agriculture payments, market gain, or have box 8 checked indicating that the state payments are trade or business income. These situations are beyond the scope of the VITA/TCE programs and taxpayers with these items should be referred to a professional tax preparer.

State tax refunds (Form 1099-G) were covered in the Wages, Interest, Etc. lesson.

The amount of withholding from Form 1099-G, Box 4 should be entered on the Federal income tax withheld from Forms W-2 and 1099 line of Form 1040.

To review information related to the software, go to the Volunteer Resource Guide, Tab D, Income.

Summary

This lesson explained:

- How to identify unemployment compensation
- How to report unemployment compensation
- How to report other taxable state payments shown on Form 1099-G.

What situations are out of scope for the VITA/TCE programs?

The following are out of scope for this lesson. While this list may not be all inclusive, it is provided for your awareness only.

- Taxpayers who repaid during the current tax year more than $3,000 of unemployment benefits that were taxed in a prior tax year.
- Taxpayers who received taxable grants that should be reported on Schedules E or F or Form 4835.

To gain a better understanding of the tax law, complete the practice return(s) for your course of study using the Practice Lab on L&LT.

Income - Social Security Benefits

Introduction

This lesson will help you assist taxpayers who have Social Security and equivalent railroad retirement benefits. These benefits may or may not be taxable.

The intake and interview sheet lists Social Security and Railroad Retirement Benefits in the Income section.

Ask the taxpayer about the receipt of either of these benefits. The Social Security Administration issues Form SSA-1099, Social Security Benefit Statement, to Social Security benefit recipients. The Railroad Retirement Board issues Form RRB-1099, Payments by the Railroad Retirement Board, and Form RRB-1099-R, Annuities or Pensions by the Railroad Retirement Board.

See Publication 575, Pension and Annuity Income, and Publication 915, Social Security and Equivalent Railroad Retirement Benefits, for additional information on the topics discussed in this lesson.

What do I need?

- Form 13614-C
- Publication 4012
- Publication 17

Optional:

- Publication 575
- Publication 915
- Form RRB-1099
- Form RRB-1099-R
- Form SSA-1099

Objectives

At the end of this lesson, using your resource materials, you will be able to:

- Determine the taxable portion of Social Security and railroad retirement benefits
- Determine the most advantageous method of reporting lump sum Social Security benefits
- Report Social Security and railroad retirement benefits on the tax return

What are Social Security and railroad retirement benefits?

Social Security Benefits

Social Security benefits are payments made under Title II of the Social Security Act. They include Old-Age, Survivor, and Disability Insurance (OASDI) benefits.

Social Security benefits include monthly retirement, survivor, and disability benefits. They do not include Supplemental Security Income (SSI). Certain government retirees who receive a pension from work are not covered by Social Security.

Some portion of the Social Security benefits received may be taxable. Generally, if Social Security benefits are the only source of income, then the benefits are not taxable. In this instance, taxpayers may not be required to file a return. However, if the taxpayers are Married Filing Separately and lived with their spouse at any time during the tax year, 85% of the benefits will be taxable.

Tax-Aide only: Canadian or German social security are treated as U.S. Social Security for tax purposes and are in scope for Tax-Aide. The taxpayer should provide the U.S. dollar amount to be reported. That should be the gross amount, before any currency conversion costs. Be careful to not confuse Canadian social security with other types of retirement income. See the NTTC tax law paper. Check your state's rules as they may differ.

Railroad Retirement Benefits (RRBs)

Railroad Retirement Benefits (RRBs) are benefits paid to railroad employees working in jobs that are covered by the Railroad Retirement Act (RRA). The RRA benefits have two components: tier 1 (Social Security equivalent benefits) and tier 2 (treated as a qualified employee plan). The tier 2 benefits are reported on Form RRB 1099-R. These funds are discussed in the previous lesson on Retirement Income.

How are these benefits reported to the taxpayer?

Form SSA-1099

Social Security benefits are reported on Form SSA-1099. Box 5 shows the amount of net benefits. Taxpayers who did not receive Form SSA-1099, or have misplaced it, may be able to get an instant printout of benefits from their personal “my Social Security” account on the Social Security Administration website at SSA.gov. Or taxpayers may call toll-free to request a benefit statement to be sent by mail. Social Security no longer provides benefit verification letters in their offices.

Form RRB-1099

Tier 1 railroad retirement benefits are equal to the Social Security benefit that a railroad employee or beneficiary would have been entitled to receive under the Social Security system. These benefits are called “Social Security equivalent benefits” and, for tax purposes, are treated like Social Security benefits. They are shown on the blue Form RRB-1099. Box 5 shows the net Social Security equivalent benefits for tier 1.

Jacob is a retired railroad switchyard operator. Using the intake and interview sheet, the volunteer determined Jacob received Railroad Retirement Benefits. He received Form RRB-1099 and Form RRB-1099-R. The amount from Form RRB-1099 will be added to any amount of Social Security benefits that he may have received from other employment.

When are Social Security benefits and tier 1 RRBs taxable?

Part of the following benefits received by the taxpayer may be taxable:

- Social Security benefits
- Railroad retirement benefits, tier 1 (Social Security equivalent portion)

To correctly calculate the taxable portion, you need to know the amount in Box 5 of Form SSA-1099 or Form RRB-1099. The taxable amount, if any, of a taxpayer’s Social Security benefits depends upon filing status and other reportable income. Generally, if Social Security (or Social Security equivalent) benefits were the taxpayer’s only source of income, the benefits are not taxable and the taxpayer does not need to file a federal income tax return.

A portion of the benefits is taxable if total income (including tax-exempt interest), plus one-half of the benefits received, is more than certain base income amounts, which vary based upon the taxpayer’s filing status. If the taxpayers are Married Filing Separately and lived with their spouse at any time during the year 85% of the benefits are taxable.

The taxable portion of Social Security benefits is never more than 85% of the net benefits the taxpayer received. In many cases, the taxable portion is less than 50%.

Enter the amounts from each Form SSA-1099 and the software will compute the portion that is taxable, if any.

Taxpayers can use Form W-4V, Voluntary Withholding Request, to request withholding from Social Security benefits.

Wanda and Dan are both retired and will file a joint return. Wanda received Form SSA-1099 with an amount of $4,300 appearing in Box 5. Dan retired from the railroad, and Box 5 of his Form RRB-1099 shows an amount of $6,800. Wanda and Dan will use the combined benefits of $11,100 and only one calculation to see if any of their benefits are taxable.

How do I report Social Security or railroad tier 1 benefits?

The tax software will perform all the calculations to determine the taxable amount based on other information on the return. Be sure to enter all income, including tax-exempt interest, in order for the software to correctly calculate taxability of benefits. Medicare premiums (Part B and D) from Forms SSA-1099 and RRB-1099 may be claimed as a self-employed health insurance deduction if the taxpayer is filing Schedule C. Otherwise, enter the total Medicare premiums so they flow to Schedule A if the taxpayer is itemizing deductions. Additionally, be sure to enter any federal income tax withholding. Go to the Volunteer Resource Guide, Tab D, Income, for software entries.

EXERCISES

Answers follow the lesson summary.

Question 1: Hank comes to your site to get some help with his tax return. He is upset because his neighbor told him that he would have to pay tax on all of his Social Security benefits this year. After talking to Hank, you learn that his wife died several years ago. This tax year, he sold all of his stock and moved into senior housing. The sale of the stock created $31,896 of taxable income for Hank. His neighbor told him, with that much income, the entire $11,724 of his Social Security benefits would be taxable. What is the maximum taxable amount of Hank's benefits?

a. $31,896

b. $20,172

c. $11,724

d. $9,965

What are lump-sum benefit payments?

Some taxpayers may have received a lump-sum benefit payment. This payment could be for the current tax year and for prior tax years. Box 3 of the taxpayer's Form SSA-1099 or Form RRB-1099 will include the lump-sum payment. The form will also show the year, or years, for which the payment is made. The additional information will be shown in Description of Amount in Box 3 on Form SSA-1099 or in Boxes 7–9 on Form RRB-1099.

Do not confuse this type of lump-sum benefit payment with the lump-sum death benefit that both the SSA and RRB pay to many of their beneficiaries. No part of the lump-sum death benefit is subject to tax.

When figuring the taxable portion of Social Security benefits, two options are available for lump-sum benefit payments:

- The **first option** allows the taxpayer to report the whole payment the year it was received. When the taxpayer chooses this option, complete the Social Security Benefits Worksheet as usual by including the entire lump-sum payment as normal.
- The **second option** is to treat the payment as received in the earlier year or years. This is done by figuring whether any part of these benefits is taxable, based on the earlier year's income. Any part that is taxable is then added to any taxable benefits for the current year and included on Form 1040. The taxpayer can elect this method if it lowers the taxable benefits.

Will the lump-sum election method lower taxable benefits?

Figuring the taxable benefits under the lump-sum election method is in scope for the VITA/TCE programs.

If the taxpayer chooses the second option, only the current year income will be adjusted. You do not file amended returns for the earlier years.

Under the lump-sum election method, refigure the taxable part of all the benefits for the earlier year (including the lump-sum payment) using that year's income and filing status; then subtract any taxable benefits for that year that were previously reported. The remainder is the taxable part of the lump-sum payment and is added by the software to the taxable part of the benefits for the current year (figured without the lump-sum for the earlier year).

In order to compute the taxable benefits, you will need copies of the taxpayer's prior year returns.

For additional information on the lump-sum election, see Publication 915.

Last year, Jane applied for Social Security disability benefits but was told she was ineligible. She appealed the decision and won. This year, she received a lump-sum payment of $6,000, of which $2,000 was for last year and $4,000 was for the current year. Jane also received $5,000 in Social Security benefits in the current year, so her Form SSA-1099 shows benefits paid of $11,000. Jane had other taxable income in both the previous year and the current year. She should figure her taxable benefits under the lump-sum election method to see if it is lower.

Because the earlier year's taxable benefits are included in the current year's income, no adjustment is made to the earlier year's return. Do not file an amended return for the earlier year.

Once a taxpayer elects this method of figuring the taxable part of a lump-sum payment, the election can only be revoked with the consent of the IRS.

The tax software will figure all the calculations after you enter the prior year tax return information. Go to the Volunteer Resource Guide, Tab D, Income, Form SSA-1099 Lump Sum Distributions, for software entries.

Form 1040 includes a checkbox for taxpayers who use the lump-sum election method when figuring taxable social security benefits and eliminates the need for the write-in "LSE."

Summary

This lesson explained how to determine whether taxpayers' Social Security benefits and railroad retirement benefits are taxable.

Generally, if Social Security benefits were the taxpayer's only source of income, the benefits are not taxable and the taxpayer does not need to file a federal income tax return. If the taxpayer received Social Security benefits and other income, the Social Security Benefits Worksheet found in the Form 1040 Instructions is completed by the software to calculate the taxable portion.

When figuring the taxable portion of Social Security benefits, two options are available for lump-sum benefit payments. The taxpayer may report the whole payment in the year it was received or treat the payment as received in the applicable earlier year or years to compute the amount of lump-sum payment that is taxable in the current year.

What situations are out of scope for the VITA/TCE programs?

The following are out of scope for this lesson. While this list may not be all inclusive, it is provided for your awareness only.

- For Tax-Aide only: social security from a foreign country other than Canada or Germany that qualify to be treated as U.S. Social Security

To gain a better understanding of the tax law, complete the practice return(s) for your course of study using the Practice Lab on L&LT. If you are unable to complete the entire exercise, complete as much as you can. Come back later to finish the exercise after you cover all the technical topics in later lessons.

EXERCISE Answers

Answer 1: d. $9,965 or 85% of the net benefits is the maximum amount that could ever be taxable.a

Income – Other Income

Introduction

This lesson will help you determine other forms of income and how to report other sources of income. Part of the lesson is for all course levels and part is only for the International level.

The International part of this lesson will help you report income earned from worldwide sources. To do this, you need to be able to identify the type of income and, if reportable, convert it to the equivalent U.S. dollar value of the foreign currency.

This lesson will also cover the foreign earned income exclusion reported on Form 2555, Foreign Earned Income, which also requires International certification.

Objectives

At the end of this lesson, using your resource materials, you will be able to determine:

- Other types of income and how to report other sources of income
- Determine whether a distribution from an ABLE or education savings account is taxable
- Determine whether a long-term care benefit must be reported or is taxable.
- Determine whether a recovery of an expense that was deducted in a prior year is taxable
- Determine when canceled credit card debt is included in gross income on Form 1040
- How to properly report income earned from worldwide sources
- Who is eligible for the foreign income exclusion and how to calculate the excludable amount using Form 2555, Foreign Earned Income

What do I need?

- Form 13614-C
- Publication 4012
- Publication 17
- Publication 54
- Form 1040 Instructions
- Form 1099-NEC
- Form 2555 and instructions

Optional:

- Publication 525
- Publication 970
- Form W-2G
- Form 1099-MISC
- Forms 1099-Q, -QA and -LTC

What is other income?

Income that does not have its own line on Form 1040 is generally reported on the Form 1040, Schedule 1. Here are some examples:

- Prizes and awards
- Gambling winnings, including lotteries and raffles
- Jury duty pay
- Alaska Permanent Fund dividends
- Recovery of a deduction claimed in a prior year
- Nonbusiness credit card debt cancellation

Tax-Aide only:

• Zero-AGI returns: To assist in identifying and preventing tax identity theft, Tax-Aide recommends that all taxpayers e-file. Because -0- AGI returns cannot be e-filed, enter $1 as other income. Describe as "IN ORDER TO EFILE."

Even if the taxpayer does not receive an income document from the payer, the taxpayer is required to report the income if it is taxable. Refer to the Income Quick Reference Guide in the Volunteer Resource Guide, Tab D, to confirm whether the income is taxable or not taxable.

If you are unsure about sources of other income, consult the Volunteer Resource Guide, Tab D, Income, and Publication 17, Other Income, or discuss the income item with your Site Coordinator.

Use the interview techniques and tools discussed in earlier lessons to ensure that all taxable income has been included.

Health Savings Accounts (HSA)

HSA distributions not used to pay or reimburse the taxpayer for qualified medical expenses are generally reported as additional income on Form 1040, Schedule 1. This topic is not covered in this lesson, it is covered in the Adjustments to Income lesson.

What are some examples of other income?

Gambling Winnings

The taxpayer may receive one or more Forms W-2G reporting gambling winnings. Total gambling winnings must be reported as other income. The amount wagered for the winnings can reduce the gross income amount. If the taxpayer also had gambling losses or expenses, the losses r expenses can only be deducted on Schedule A if the taxpayer itemizes. For tax years through 2025, expenses to gamble may be added to losses if itemizing (limited to overall winnings). See the Itemized Deductions lesson for more details.

The IRS provides rules that allow a taxpayer who maintains detailed gambling records to use a per session rule. With such detailed session records, a taxpayer can report the net win sessions as income. The net loss sessions are claimed as an itemized deduction up to the amount of winnings. Taxpayers who wish to claim gambling using the per-session method or as a business (Sch. C) must be referred to a paid preparer.

Cash for Keys Program

Cash for Keys Program income, which is taxable, is income from a financial institution, offered to taxpayers to expedite the foreclosure process. The taxpayers should receive Form 1099-MISC with the income in Box 3.

Medical trial participation pay

A taxpayer may receive Form 1099-MISC that pays them for participating in a medical trial. Taxpayers are generally not considered to have a business of participating in such trials. Report the income on Schedule 1. Reimbursements that the taxpayer receives for costs incurred in such trial would not be reported on 1099-MISC and the expenses are not be deductible.

Qualified Medicaid Waiver Payments

Qualified Medicaid waiver payments may be excluded from gross income. To be qualified Medicaid waiver payments, the care provider and the care recipient must reside in the same home. When the care provider and the care recipient do not live together in the same home, the Medicaid waiver payments are fully taxable.

A taxpayer may choose to include qualified Medicaid waiver payments in the calculation of earned income for the earned income credit (EIC) and the additional child tax credit (ACTC). The taxpayer may include qualified Medicaid waiver payments in earned income even if the taxpayer chooses to exclude those payments from gross income.

- A taxpayer may not choose to include or exclude only a portion of qualified Medicaid waiver payments. Either include all or none of the qualified Medicaid waiver payments for the taxable year in earned income.
- If the taxpayer chooses to include qualified Medicaid waiver payments in earned income, that amount will be included in the calculation for both the EIC and the ACTC.
- If both spouses have qualified Medicaid waiver income, each may elect to include or exclude all their respective MWP in earned income.

Refer to the Volunteer Resource Guide, Tab D, Income, Entering Medicaid Waiver Payments.

Strike Benefits

Strike pay comes in three forms: a payment for all strikers, whether or not they belong to a union; a return of dues specifically paid into a union strike pay fund by the employee; or money for union employees from the savings account of the Union, not tied to any prepaid funding arrangements and not available to non-union strikers. The payer will report the taxable amount on Form 1099-MISC, Box 3.

Strike benefits are not subject to self-employment (SE) tax (and should NOT be reported on Schedule C). However, strike benefits are earned income for EITC eligibility (Rev. Rul. 78-191). Refer to the Volunteer Resource Guide, Tab D, for the software entries.

Are distributions from ABLE accounts taxable?

A qualified ABLE program is a program established and maintained by a state agency under which a person may make cash contributions to an ABLE account to pay for the qualified disability expenses of an eligible individual (the designated beneficiary). Qualified beneficiaries can have only one ABLE account. Contributions are made in after-tax dollars and can be made by any person. Contributions must be made in cash and are not deductible for federal income tax purposes.

Distributions from an ABLE account that do not exceed the qualified disability expenses of the beneficiary during the taxable year are excluded from gross income. A distribution from an ABLE account that exceeds the qualified disability expenses of the beneficiary is included in the beneficiary's gross income and is subject to an additional tax of 10% imposed on the amount not used for qualified disability expenses. Taxable distributions from ABLE accounts are out of scope for the VITA/TCE programs.

Qualified disability expenses include: education, housing, transportation, employment training and support, assistive technology and personal support services, health, prevention and wellness, financial management and administrative services, legal fees, expenses for oversight and monitoring, funeral and burial expenses.

Form 1099-QA, Distributions from ABLE Accounts, is used to report distributions from an ABLE Account.

Are distributions from an Educational Savings Account (ESA), such as a Coverdell ESA and a 529 plan, taxable?

Distributions from Coverdell ESAs and Qualified Tuition Plans (QTPs) are reported on Form 1099-Q, Payments From Qualified Education Programs (Under Sections 529 and 530). Coverdell ESA distributions can be used to pay for qualified elementary, secondary, and postsecondary expenses. QTP distributions may also be used for qualified educational expenses for elementary and secondary public, private, and religious schools of up to $10,000 per year for each qualified beneficiary, certain expenses of an apprenticeship program, and the principal or interest on a qualified education loan up to a lifetime limit of $10,000 per beneficiary.

A portion of the distributions is generally taxable to the beneficiary if the total distributions are more than the beneficiary's adjusted qualified education expenses for the year. Qualified education expenses are discussed in more detail in the Education Credits lesson.

The taxable portion is the amount of the excess distribution that represents earnings that have accumulated tax free in the account. The taxable amount must be reported as other income on the tax return. Taxable distributions from ESAs and QTPs are out of scope.

For additional information about educational savings accounts, distributions, and qualified education expenses, refer taxpayers to Publication 970, Tax Benefits for Education.

An American opportunity credit or lifetime learning credit can be claimed in the same year the beneficiary takes a tax-free distribution from a QTP or Coverdell ESA, as long as the same expenses are not used for both benefits. See Publication 970, Tax Benefits for Education, for more details.

Are long-term care benefits taxable?

Long-term care benefits are either reimbursements for actual expenses incurred or a per-diem allowance. In both cases, they will generally be less than the long-term care costs paid during the year. As such, the benefits will not be taxable. Form 8853, Section C, should be completed for per diem payments to confirm that no part of the per diem payment is taxable. Forms 1099-LTC showing reimbursements do not need to be entered in the software as they will never be taxable.

Form 1099-LTC may also report accelerated death benefits in box 2. If the insured was certified by a physician as terminally ill (box 5 of the form), the benefits is fully excludible. If certified as chronically ill, the benefits are treated the same as paid under a qualified long-term care insurance contract.

If Form 1099-LTC reflects multiple payees under the insurance contract, refer the taxpayer to a professional tax preparer.

Is a recovery taxable?

Reimbursement in a later year for medical or other expenses deducted in an earlier year must be reported as income up to the amount previously deducted as medical or under another provision. However, do not report as income the amount of reimbursement received up to the amount of the prior year deductions that did not reduce the tax for the earlier year.

Tax-Aide: The Bogart taxable refund and recovery calculator (https://cotaxaide.org/tools/Refund%20Calculator.html) is very helpful in computing the taxable amount of a tax refund or other recovery in more complicated situations, such as when the prior year had nonrefundable credits that were not used because there was not enough tax to sop up the credit. Had the deduction not been claimed in that prior, there may have been no tax benefit so that the recovery of that item is not taxable.

Cancellation of Debt – Nonbusiness Credit Card Debt

For information on cancellation of debt on a principal residence, refer to the Temporary Provision lesson.

Cancellation of Debt – Basics

A debt includes any indebtedness for which a taxpayer is liable or which attaches to the taxpayer's property, such as auto loans, credit card debt, medical care, professional services, mortgages, and home equity loans. Generally, if a debt for which a taxpayer is personally liable is canceled or forgiven, the taxpayer must include the canceled amount in income. There is no income from canceled debt if the cancellation or forgiveness of debt is a gift or bequest.

Use Form 13614-C, Intake/Interview & Quality Review Sheet, to determine if the taxpayer received one or both of Forms 1099-C, Cancellation of Debt, or 1099-A, Acquisition or Abandonment of Secured Property. Refer to the Legislative Extenders section for possible exclusion of cancellation of debt income on a main home.

Taxability of Canceled Debt

Taxpayers often question the taxability of canceled debt because they did not receive money in hand. In situations where property is surrendered, such as a foreclosure, taxpayers feel that by giving up the property they are relieved from any further obligation. Explain that the benefit to the taxpayer is the relief from personal liability to pay the debt. Information in Publication 17, Your Federal Income Tax for Individuals, can assist with the explanation. Refer to Publication 4681, Canceled Debts, Foreclosures, Repossessions, and Abandonments.

Generally, when debt is canceled, the lender will issue Form 1099-C, Cancellation of Debt, which is then reported as income by the recipients on their tax return. There are exceptions and exclusions to the general rule that determines whether a canceled debt is included as income. This is covered in greater detail in the Legislative Extenders lesson and later in this lesson.

Form 1099-C

Generally, if a taxpayer receives Form 1099-C for canceled credit card debt and was **solvent** (assets greater than liabilities) immediately before the debt was canceled, all the canceled debt will be included on the tax return as other income.

Sometimes, Form 1099-C will show an interest amount in Box 3. Because only **nonbusiness** credit card debt income is in scope, any interest on the account would not have been deductible. The amount shown in Box 3 is included in Box 2; therefore, the full amount shown in Box 2 should be reported as other income.

EXAMPLE

John made a deal with his credit card company to pay $2,000 on his $7,000 balance, and the company agreed to take it as payment in full. In January of the current year, John received a Form 1099-C from his credit card company reporting $5,000 (the amount of debt canceled). John was solvent immediately before the debt was canceled. John must include the entire $5,000 as other income on his tax return.

Lenders and creditors are required to issue Form 1099-C if they cancel a debt of $600 or more. If the debt canceled is less than $600, some lenders or creditors may send a letter or some other form of notification to the taxpayer. Generally, taxpayers must include all canceled amounts (even if less than $600) in income.

The discharge of certain student loan debt in 2021 through 2025 is excluded from gross income. If excludible, the lender will not issue Form 1099-C.

For information on cancellation of debt on a principal residence, refer to the Temporary Provisions lesson.

Insolvency (Out of Scope for VITA/TCE)

Insolvency is a condition in which the fair market value (FMV) of all assets is less than one's liabilities. The amount or level of insolvency is expressed as a negative net worth.

For purposes of determining insolvency, assets include the value of everything owned (including assets that serve as collateral for debt and exempt assets which are beyond the reach of creditors under the law, such as an interest in a pension plan and the value of a retirement account).

Liabilities are amounts owed and include:

- The entire amount of recourse debts
- The amount of nonrecourse debt that is not in excess of the FMV of the property and is security for the debt

Refer to the Insolvency Determination Worksheet in the Volunteer Resource Guide, Tab D, Income, as a resource. Taxpayers must determine if they are considered insolvent.

If the taxpayer had nonbusiness credit card debt canceled, all or part of the debt may be excluded if the cancellation occurred in bankruptcy, or if the taxpayer was insolvent immediately before the cancellation. These situations are beyond the scope of VITA/TCE. If any of these situations apply, refer the taxpayer to a professional tax preparer. See IRS Publication 4681, Canceled Debts, Foreclosures, Repossessions, and Abandonments, for more information.

Publication 4731, Screening Sheet for Nonbusiness Credit Card Debt Cancellation, located in the Volunteer Resource Guide, Tab D, Income, provides step-by-step guidance for the volunteer tax return preparer to determine if the cancellation of credit card debt is within scope.

Taxpayer Interview and Tax Law Application

Here is how a volunteer advised Michelle regarding her canceled credit card debt.

Sample Interview

Volunteer Says...	Michelle Responds...
I notice you received a 1099-C from a credit card company.	Yes, I negotiated with them to cancel $3,000 of my debt.
Yes, Form 1099-C shows the amount of debt discharged.	I could only afford to pay them $1,000, so it really helped me.
Do you think your debts at the time exceeded your assets?	I'm not sure, but it's certainly possible.
Let's fill out the Insolvency Determination Worksheet to help us determine whether you were insolvent.	OK.
According to the worksheet, you are insolvent. I am afraid I am not able to help you. VITA/TCE volunteers are not trained to compute the nontaxable portion of canceled credit card debt.	Oh, I understand.
I suggest you seek assistance from a professional tax preparer.	I will, thank you.

Insolvency Determination Worksheet

Assets (FMV)		Liabilities	
Homes	$120,000.00	Mortgages	$180,000.00
Cars	$15,000.00	Home equity loans	$50,000.00
Recreational vehicles, etc.		Vehicle loans	$18,000.00
Bank accounts	$1,000.00	Personal signature loans	
IRAs, 401Ks, etc.	$60,000.00	Credit card debts	$3,000.00
Jewelry		Past-due mortgage interest, real estate taxes, utilities, and child care costs	
Furniture	$2,000.00		
Clothes	$1,550.00		
Misc.		Student loans	
Other assets		Other liabilities	
Total Assets:	$199,550.00	Total Liabilites	$251,000.00
Total Assets minus Total Liabilities = ($51,450.00) Liabilities are more than assets (Negative amount equals insolvency) Positive amount equals solvency			

EXERCISES

Question 1: Greg was released from his obligation to pay $5,000 of personal credit card debt. The credit card company sent Form 1099-C showing canceled debt of $5,000. Greg is fairly certain he has more debt than he has assets.

Can the VITA/TCE site provide tax return preparation assistance to Greg?

a. Yes, since the entire $5,000 in canceled debt is considered income and reported on Form 1040.

b. No, because it appears Greg is insolvent, which might mean some of the canceled credit card debt would be nontaxable and beyond the scope of the VITA/TCE programs.

Question 2: Kay was released from her obligation to pay personal credit card debt. She owed $10,000 to her credit card company, which agreed to accept $2,500 as payment in full. Before paying the credit card company, it was determined Kay was solvent (assets greater than liabilities) and not in bankruptcy. The credit card company issued Kay a Form 1099-C, reporting $7,500 as the amount of debt discharged.

Based on the information above, can Kay be assisted at her local VITA/TCE site?

a. Yes

b. No

Question 3: Review the information in Question 2 about Kay's canceled debt. If the VITA/TCE site is able to assist Kay, what amount would be reported on Kay's Form 1040?

a. $0

b. $10,000

c. $2,500

d. $7,500

What is Worldwide Income?

U.S. citizens and U.S. resident aliens are required to report worldwide income on a U.S. tax return regardless of where they live and even if the income is taxed by the country in which it was earned. Filing requirements are the same as for U.S. citizens and U.S. resident aliens and apply whether income is from within or outside the U.S.

U.S. citizens and U.S. resident aliens living abroad may be able to claim tax benefits such as the foreign earned income exclusion or the foreign tax credit. This part of the lesson covers the foreign earned income exclusion. The foreign tax credit will be covered in another lesson.

In the current year, Alfredo Kendall earned $40,000 while working in Dallas, Texas, for Dade Corporation. In September of this year, he transferred to their office in Stuttgart, Germany. While in Germany, he earned $30,000 (U.S. dollars). All of Alfredo's wages, including the income he earned in Germany, is included in his gross income. His Form 1040 will show $70,000 in wages.

Income is treated the same on the return regardless of the country from which it is derived. Similar income earned inside or outside the U.S. is generally taxed in the same way on the return. Likewise, income earned in the U.S. and not taxed will be treated in the same way if earned outside the U.S. The lines on which income is reported on Form 1040 are the same whether the U.S. citizen or U.S. resident alien is living within or outside U.S. boundaries.

Foreign income might be reported to taxpayers on forms or in ways that are not used in the United States. Question taxpayers closely to ensure that they are reporting all worldwide income. Review the income records to ensure that includible amounts are accurate and complete.

Taxpayers with foreign income, bank accounts, or assets may have additional filing responsibilities, which are out of scope. See Schedule B and Form 8938 for additional information.

To review information related to income from a foreign employer, go to the Volunteer Resource Guide, Tab D, Income, Entering Other Compensation in TaxSlayer.

EXERCISES (continued)

Answers are listed following the lesson summary.

Question 4: Marta Bremer, a U.S. citizen, lives in Mussbach, Germany. Her income included $22,000 in wages earned in Germany. She earned $300 in interest from her U.S. bank. What is Marta's total income?

a. $0

b. $22,300

c. $300

d. $22,000

Question 5: Mary Carleton, a U.S. citizen, lives in Belgium. Her income included $10,000 in wages from her Belgian employer, $200 in interest from her U.S. bank, $8,000 in gambling winnings, and $7,000 in child support payments from her ex-spouse. What is Mary's gross income?

a. $8,000

b. $10,200

c. $18,200

d. $25,200

How Do I Convert Foreign Income to U.S. Dollars?

Exchange rates

All amounts on the U.S. tax return must be stated in U.S. dollars. Taxpayers may provide the U.S. dollar amount to report. If they don't, convert income that taxpayers received in foreign currency into U.S. dollars using the appropriate exchange rate. U.S. exchange rates are stated in two ways:

- Units of foreign currency to one U.S. dollar: 0.74855 Euro = 1 U.S. dollar
- U.S. dollars to one unit of the foreign currency: 1.33592 U.S. dollar = 1 Euro

Exchange rates shown here are for example only. Use the exchange rates in effect when the income was received.

To convert a sum of money into U.S. dollars, **divide** the amount of foreign currency by the exchange rate for the foreign currency to one U.S. dollar.

Ryan received 3,000 Euros (€3000) on a day that the exchange rate was 0.74855 Euros to one U.S. dollar. Based on this exchange rate, the value of Ryan's €3000 is: €3000 ÷ 0.74855 = $4,007.75

In other words:

$$\frac{\text{Amount of foreign currency}}{\text{Exchange rate of foreign currency to one U.S. dollar}} = \text{Amount in U.S. dollars}$$

$$\frac{\text{3,000 Euros}}{\text{0.74855}} = \$4{,}007.75$$

EXERCISES (continued)

Question 6: Caryn received 200 Euros on a day that the exchange rate was .75514 Euros to one U.S. dollar. In U.S. dollars, she would have ____.

a. $264.85

b. $377.57

c. $115.03

d. $11.50

Question 7: Given an exchange rate of .7000, how much is 36,000 Euros worth in U.S. dollars?

a. $252.00

b. $25,200.00

c. $51,428.57

d. $61,614.00

Which exchange rate should I use?

The exchange rate for a particular currency is likely to change every day. Use the exchange rate prevailing when the taxpayer receives the pay or accrues the item. The exchange rate is determined by the date of transaction, which is either the date on the check or the date the money is credited to the taxpayer's account. If there is more than one exchange rate, use the one that most properly reflects the income.

However, the taxpayer can use the average annual exchange rate if:

- Foreign income was received evenly throughout the year, and
- The foreign exchange rate was relatively stable during the year

Taxpayers may use the monthly average exchange rates if they earned foreign income evenly for one or more months, but less than twelve months.

Edward Hall worked in Dallas for Lubbock Incorporated from January until September. On September 29, he was transferred to Lubbock's Mexico City office, where he will be working for three more years. In Mexico, he is paid in Mexican pesos. Because he did not receive his salary in Mexican pesos evenly throughout the year, he cannot use the annual average exchange rate for Mexico source income. If he does not know the exchange rate at the time he received the funds, he can use the monthly average exchange rate for October, November, and December.

Where to obtain exchange rates

In mid-January, the IRS distributes exchange rates for various currencies to its worldwide offices, including the prior year's average annual exchange rate information.

Exchange rates can be found at irs.gov by typing "foreign currency rates" in the search box. You may also contact banks that provide international currency exchange services.

Because taxpayers should use the rate that most closely reflects the value of the foreign currency at the time they receive the income, taxpayers may use an exchange rate that is different from the rates posted in IRS worldwide offices if they find it to be a true representation.

What is the foreign earned income exclusion?

Use Form 2555 to claim the foreign earned income exclusion. Certain taxpayers can exclude income earned in, and while living in, foreign countries. The maximum amount of the foreign earned income exclusion is indexed to inflation annually. The current year amount can be found in the Important Changes lesson in this publication. The foreign earned income exclusion **does not** apply to wages and salaries of U.S. military members and civilian employees of the U.S. government.

If the taxpayer qualifies to exclude foreign earned income, the excludable amount will be reported as a negative amount on the other income line of Form 1040, Schedule 1. Since the foreign earned income would have been reported on Form 1040 as taxable wages or as self-employment income, the exclusion (negative amount) will reduce the total income calculated. The method of calculating the tax when the taxpayer elects the foreign earned income exclusion is based on the Foreign Earned Income Tax Worksheet. The tax software will do this calculation automatically.

If a taxpayer elects to exclude foreign earned income, he or she cannot claim the earned income credit and the refundable portion of the child tax credit. The child and dependent care credit does not include excluded foreign income as earned income when computing the credit.

To review information related to the software for the foreign earned income exclusion, go to the Volunteer Resource Guide, Tab D, Income.

When do I choose the exclusion?

The foreign earned income exclusion is voluntary. It is not always an advantage to claim the exclusion. If taxpayers wish to claim the exclusion, they must file Form 2555 with a timely return (including extensions). If the taxpayer is not eligible for, or chooses to not claim, the foreign earned income exclusion, any taxes paid on this income to a foreign government may be eligible for the foreign tax credit. See the Foreign Tax Credit lesson for more information.

Once the taxpayer chooses to exclude foreign earned income, that choice remains in effect for that year and all later years until revoked. The taxpayer may revoke the exclusion for any tax year by attaching a statement to the return. When the exclusion is revoked, the taxpayer may not claim the exclusion again for the next five tax years without the approval of the IRS.

What are the eligibility requirements?

To claim the foreign earned income exclusion, taxpayers must:

- Demonstrate that their tax home is in a foreign country
- Meet either the bona fide residence test or the physical presence test
- Have income that qualifies as foreign earned income

The requirements are applied separately to each individual. If a married couple is working overseas, each spouse must meet all requirements to qualify for the exclusion. If they do qualify, each is entitled to an exclusion of up to the maximum amount for the current year.

The terms foreign, abroad, and overseas do not include Puerto Rico, U.S. Virgin Islands, American Samoa, Guam, the Commonwealth of the Northern Marianas, Wake Island, the Midway Islands, and Johnston Island.

EXERCISES (continued)

Question 8: Miranda has lived in Puerto Rico since 2003. Is she eligible for the foreign earned income exclusion?

a. Yes

b. No

How do I determine the tax home?

To claim the foreign earned income exclusion, the taxpayer's tax home must be in a foreign country. The tax home is defined as the country in which the taxpayer is permanently or indefinitely engaged to work as an employee or a self-employed individual, regardless of where the family home is maintained.

For taxpayers who work abroad but do not have a regular place of business because of the nature of the work, their tax home is the place where they regularly live. The tax home for members of the U.S. Armed

Forces is the permanent duty station, either land-based or on a ship.

John and Mary are both in the Armed Forces and have been permanently stationed in Germany since August 2007. Their tax home for the current year is Germany.

EXERCISES (continued)

Question 9: Alan has lived and worked in China since August 16, 2005. China is his tax home.

a. True

b. False

What is a regular place of abode?

For purposes of the foreign earned income exclusion, if taxpayers work overseas for an indefinite period of time, and their regular place of abode is the U.S., the taxpayers cannot designate the foreign country as the tax home.

"Regular place of abode" is defined as one's home, habitation, domicile, or place of dwelling. It does not necessarily include one's principal place of business.

If the taxpayer maintains a place of business, or is assigned to overseas employment in a foreign country for an indefinite period, *and does not maintain a regular place of abode in the U.S.*, the tax home is overseas and the taxpayer may be eligible for the foreign earned income exclusion.

How do I determine whether the U.S. is the taxpayer's regular place of abode?

Ask three questions to determine whether a U.S. home is the taxpayer's regular place of abode:

1. Did you use your home in the U.S. as a residence while you worked at your job in the U.S. just before going abroad to your new job, and did you continue to maintain work (e.g., contacts, job seeking, leave of absence, ongoing business) in that area in the U.S. during the time you worked abroad?
2. Are your living expenses duplicated at your U.S. and foreign homes because your work requires you to be away from your U.S. home?
3. Do you have a family member or members living at your U.S. home, or did you frequently use your U.S. home for lodging during the period you worked abroad?

If the answer to two of the questions is "no," the taxpayer is considered to be indefinitely assigned to the new location abroad and is eligible for the foreign earned income exclusion.

If the answer to all three questions is "yes" and the job duration is for less than one year with the taxpayer returning to the U.S. home, the taxpayer is considered "temporarily away" from home. In this case, the taxpayer does not qualify for the foreign earned income exclusion, but may qualify to deduct *away-from-home expenses.*

If the answer to two of the three questions is "yes," with the same expectation of job duration and return to the U.S. home, the location of the tax home depends on the facts and circumstances.

Henry is a member of the Armed Forces. He was assigned to a post in Japan last year. This assignment was for an indefinite period that exceeds one year. Margaret, his wife, accompanied him to Japan and has foreign earned income. They have not used their home in the U.S. as a place of residence for over a year. Therefore, their tax home for this year is Japan.

EXERCISES (continued)

Question 10: Stan is employed on an offshore oil rig in the territorial waters of a foreign country and works a 28-day on/28-day off schedule. He returns to his family residence in the U.S. during his off periods. Does Stan's employment satisfy the tax home test?

a. Yes

b. No

What is the period of stay requirement?

The period of stay is the amount of time the taxpayer stays in the foreign country. To meet the period of stay requirement, the taxpayer must be either:

- A U.S. citizen or U.S. resident alien from a tax treaty country who is a **bona fide** resident of a foreign country (or countries) for an uninterrupted period that includes an entire tax year, or
- A U.S. citizen or U.S. resident alien who is **physically present** in a foreign country or countries for at least 330 full days during any period of 12 consecutive months

What is the bona fide residence test?

To meet the bona fide residence test, taxpayers must show that they have set up permanent quarters in a foreign country for an entire, uninterrupted tax year (even though they intend to eventually return to the U.S.). Simply going to another country to work for a year or more is not enough to meet the bona fide residence test. A taxpayer must establish a residence in the foreign country.

A brief trip to the U.S. will not prevent the taxpayer from being a bona fide resident, as long as the intention to return to the foreign country is clear.

Charles is a military spouse who has lived and worked in England since 2006. His mother still lives in the U.S. Charles came to the U.S. for two weeks this year to be with his mother after she had surgery. Charles' trip to the U.S. does not affect his status as a bona fide resident of a foreign country.

EXERCISES (continued)

Question 11: Zach, a U.S. citizen, has homes in the U.S. and in Spain, where he has worked for the last two years. Zach's spouse, who is also a U.S. citizen, lives with him in Spain. Zach visits the U.S. occasionally. Does Zach meet the bona fide residence test in Spain?

a. Yes

b. No

What is the physical presence test?

If the taxpayers do not meet the bona fide residence test, then they may qualify under the physical presence test rules. To qualify, the taxpayers must be physically present in a foreign country 330 full days during a period of twelve consecutive months.

In order for a day to count for the test, it must be a full day in a foreign country. When arriving from the U.S., or returning to the U.S., any day in which part of the time is spent in the U.S. or over international waters does not count as a qualifying day in a foreign country.

The taxpayer may move about from one place to another in a foreign country or to another foreign country without losing full days. If any part of the taxpayer's travel is not in any foreign country and takes less than 24 hours, you are considered to be in a foreign country during that part of travel. See Publication 54, Tax Guide for U.S. Citizens and Resident Aliens Abroad physical presence test section for additional information.

If a taxpayer left England by ship at 10:00 p.m. on July 6 and arrived in Lisbon at 6:00 a.m. on July 8, the taxpayer would lose July 6, 7, and 8 as full days because the trip took more than 24 hours. In this example, if the taxpayer remained in Lisbon, the first full day would be July 9.

Figuring the 12-Month Period

Any 12-month period may be used if the 330 full days in a foreign country fall within that period. If necessary, more than one period may be used, including periods that overlap. See Publication 54 for clarification on the physical presence rules.

What is qualifying income?

To qualify for the exclusion, income must be earned income.

How does earned income qualify for the exclusion?

To qualify for the exclusion, the earned income must be for services performed in a foreign country. Amounts paid by the United States or its agencies to its employees **do not** qualify for the exclusion. This includes military pay and payment for such activities as post exchanges, commissaries, and officers clubs.

Earned income **does not include:**

- Dividends
- Interest
- Capital gains
- Alimony
- Social Security benefits
- Pensions
- Annuities

A more thorough list of earned and unearned income can be found in the Volunteer Resource Guide, Tab I.

Alisa, a U.S. resident, is a member of the Armed Forces and has lived in Japan since 2010. Her military pay is not eligible for the foreign earned income exclusion. In her spare time, she is a self-employed DJ in Tokyo. The income from her self-employment may qualify for the exclusion.

What are sources of foreign earned income?

To qualify for the exclusion, services must be performed in a foreign country. Where the payments come from or where they are deposited is not a factor in determining the *source* of the income.

If a taxpayer works predominantly in a foreign country, but does some work in the U.S., an adjustment must be made to the total foreign earned income.

Earl works and lives in the Bahamas. During the tax year, he worked 49 weeks in the Bahamas. He attended a business meeting in Florida for one week, and was on vacation for two weeks. One-fiftieth or 2% of his wages are not foreign earned income because of the week spent working in Florida.

Ron and his wife Amy, both U.S. citizens, have lived in England for two years. Ron is in the military and Amy works in a pastry shop in a nearby town. Ron's military income does not qualify for the foreign earned income exclusion but Amy's wages from the company in England does qualify. The source of Amy's income is England.

EXERCISES (continued)

Question 12: Juanita lives in Scotland. She is retired and her income consists of U.S. Social Security, a pension, and several stock dividends. Does she qualify for the foreign earned income exclusion?

a. Yes

b. No

How do I complete Form 2555?

Use the following guidelines when completing Form 2555.

- Part I is completed by all taxpayers
- Part II is completed by taxpayers who qualify under the bona fide residence test
- Part III is completed by all taxpayers who qualify under the physical presence test
- Part IV is completed by all taxpayers – list all foreign earned income
- Part V is completed by all taxpayers
- Part VI is completed by taxpayers claiming the housing exclusion and/or housing deduction
- Part VII is completed by taxpayers claiming the foreign earned income exclusion
- Part VIII is completed by taxpayers claiming the foreign income exclusion, the foreign housing exclusion, or both.
- Part IX is completed by taxpayers claiming the housing deduction if line 33 is more than line 36, and line 27 is more than line 43

To review information related to the software, go to the Volunteer Resource Guide, Tab D, Income, Form 2555.

Taxpayer Interview and Tax Law Application

Look at the following sample interview for taxpayers Hudson and Hope Howard.

Sample Interview

Volunteer Says...	Hope Responds...
	Will we be able to exclude any of my income on our tax return? I worked for Bavaria Advertising in Munich this past year and made $24,000 in U.S. dollars. I heard that you don't have to pay taxes on income earned in a foreign country and I've never done this before.
That is possible. First, we will have to determine if you meet the requirements. Were you working as a military or civilian employee of the U.S. government?	No, Bavaria Advertising is a foreign company owned by a family right there in Munich.
Great. That would qualify, but Hudson's military pay won't. Let's see. You are a U.S. citizen. You earned wages in a foreign country and the total was less than the maximum amount. You have no self-employment income or business/moving expenses and since you lived on base, you won't have a foreign housing exclusion.	Yeah, that all sounds right.
Now we have to determine if you meet the bona fide residence or physical presence test and if your tax home is in a foreign country.	It sounds complicated to me.
Don't worry, I just need to ask you a few questions. How long did you say you were in Germany?	We moved on base in Germany on March 3, 2011 and just returned to the states on January 10 this year.
No problem then. You were living in Germany for the entire year so you are considered a bona fide resident this tax year. Since your home and place of employment were both in Germany, you meet the tax home test. Now, what was your address while you were living in Germany?	1567 Albion Street, Munich.
What did you do for Bavaria Advertising?	I was a copywriter.
Do you have Bavaria Advertising's address?	I sure do; it is right here on this statement.
Were you present in the U.S. during this tax year? I have to enter the dates on this form.	Not this year. But we did come home for the holidays last year.

Summary

Total taxable income from all sources is entered on Form 1040.

Taxpayers are sometimes alarmed at how high their total income is. If this happens, reassure the taxpayer that the return is not finished yet! It is very likely that adjustments, deductions, and credits will considerably reduce the total tax owed.

Other income includes any taxable income for which there is not a specific line identified on Form 1040. This income is reported on the other income line of Form 1040, Schedule 1.

Taxpayers who receive tax forms for ABLE (Form 1099-QA), education savings account (Form 1099-Q), or long-term care (Form 1099-LTC) payments may have additional reporting requirements and/ or taxable income. Other 1099 forms are discussed in other lessons; for example, HSA distributions are covered in the Adjustments to Income lesson.

If a taxpayer receives Form 1099-C for canceled credit card debt and was solvent immediately before the debt was canceled, all the canceled debt will be included on the tax return as other income.

U.S. citizens and resident aliens are taxed on worldwide income. They must file a U.S. tax return even if all the income is from foreign sources, and even if they pay taxes to another country.

When taxpayers living abroad receive income in foreign currency, the amounts reported on the return must be converted into U.S. dollars. Use the exchange rate prevailing when the taxpayer receives the pay or accrues the item. If there is more than one exchange rate, use the one that most properly reflects the income.

If the taxpayers are eligible to exclude some or all of their foreign earned income, then Form 2555 must be completed. The excludable amount will be entered as a negative number on Schedule 1 to offset income reported as wages or self-employment income.

What situations are out of scope for the VITA/TCE programs?

The following are out of scope for this lesson. While this list may not be all inclusive, it is provided for your awareness only.

- Distributions from an ABLE account in which the funds were not fully used for qualified disability expenses
- Distributions from Educational Savings Accounts in which the:
  - Funds were not used for qualified education expenses, or
  - Distribution was more than the amount of the qualified expenses
- Taxpayers who are insolvent and had debt canceled

To gain a better understanding of the tax law, complete the practice return(s) for your course of study using the Practice Lab on L&LT.

EXERCISE Answers

Answer 1: b. Greg is fairly certain that he has more debt than he has assets, which means he is insolvent. This situation is beyond the scope of the VITA/TCE programs.

Answer 2: Yes. Kay was solvent and not in bankruptcy, and the credit card company issued her a Form 1099-C.

Answer 3: d. Kay would report $7,500 on her Form 1040.

Answer 4: b. Marta's gross income includes her wages and interest, both of which should be reported on her tax return.

Answer 5: c. Mary's gross income includes her wages, interest, and gambling winnings, all of which should be reported on her tax return. Her child support payments are her only nontaxable income.

Answer 6: a. Dividing 200 Euros by the .75514 exchange rate comes to $264.85.

Answer 7: c. Dividing 36,000 Euros by the .7000 exchange rate comes to $51,428.57.

Answer 8: b, No. Miranda is not eligible for the foreign earned income exclusion because Puerto Rico is not a foreign country.

Answer 9: a, True. Generally, the tax home is the country in which taxpayers maintain their place of business. Because Alan works in China, it is considered to be his tax home. For taxpayers who do not have a regular place of business because of the nature of the work, their tax home is the place where they regularly live.

Answer 10: b, No. Stan is considered to have a residence in the United States and does not satisfy the tax home test in the foreign country. He is not eligible for the foreign earned income exclusion.

Answer 11: a, Yes. Since Zach went to Spain to work and has established a permanent residence there with his spouse, he meets the bona fide residence test.

Answer 12: b, No. Social Security benefits, pension, and dividends do not qualify as earned income; therefore, Juanita does not qualify for the foreign earned income exclusion.

Military Income

Introduction

This lesson will help you determine which income items received by current and former members of the U.S. Armed Forces are reportable on the return, and the status of any medical separation pay or pay related to service in a combat zone.

Community property laws may impact the income reported by some military members on their returns.

Objectives

At the end of this lesson, using your resource materials, you will be able to determine:

- Which income items received by members of the U.S. Armed Forces are reportable on the tax return and
- The status of any medical separation pay or pay related to service in a combat zone

What do I need?

- Form 13614-C
- Publication 4012
- Publication 3
- Publication 525
- Publication 555

What are the types of income?

U.S. Armed Forces members receive many different types of pay and allowances. Some are includible in gross income while others are excludable from gross income.

Refer to the Volunteer Resource Guide, Tab D, Income, Armed Forces Gross Income chart, for detailed lists of these types of military pay and to determine if they are included in gross income or excluded.

What income is includible?

Includible items are subject to tax and must be reported on the tax return. The items listed in Publication 3, Armed Forces' Tax Guide, Table 1, and the Volunteer Resource Guide, Tab D, Income, are included in gross income, unless the pay is for service in a combat zone or in a qualified hazardous duty area. All includible military income will generally be shown on Form W-2, Box 1, and reported on Form 1040 as wages.

If the amount shown on Form W-2, Box 1, differs from the last Leave and Earnings Statement for the current tax year, advise the taxpayer to contact the local accounting and finance or payroll office for an explanation.

What income is excludable?

Excludable income does not have to be reported as income on the tax return. The exclusion applies whether the item is furnished in kind, or is a reimbursement or an allowance.

For example, the Basic Allowance for Housing (BAH) can be excluded from gross income as a qualified military benefit. Excludable income will not be included in the amount on Form W-2, Box 1.

If U.S. Armed Forces members were provided a commuter highway vehicle (such as a van) by their employer, refer them to Publication 525, Taxable and Nontaxable Income, and to a professional tax preparer.

EXERCISES

Answers follow the lesson summary. Use the Armed Forces Gross Income chart in the Volunteer Resource Guide, Tab D, to answer these questions.

Question 1: Enlistment and reenlistment bonuses are excluded from a service member's income.

a. True

b. False

Question 2: Which of the following items is excludable from U.S. Armed Forces members' income?

a. Hazardous duty pay

b. Basic Allowance for Housing (BAH) and Basic Allowance for Subsistence (BAS) income

c. Basic pay

d. Hardship duty pay

Homeowners Assistance Program (HAP)

HAP was created to compensate qualified military and civilian employee homeowners when base closures negatively impact the real estate market or when they were required to permanently relocate during the home mortgage crisis. These payments for qualified military base realignments and closures are excluded from income. For additional information go to **Publication 3**.

What is military separation with disability severance pay?

Disability severance pay has varying effects on a service member's income and taxes.

What is severance pay?

U.S. Armed Forces members who have been separated from the military after years of service or for medical reasons are given severance pay, which is generally taxable as wages. If the member receives disability severance pay and is later awarded Veteran's Affairs (VA) disability benefits, 100% of the disability severance benefit may be excluded from income. The VA makes the determination that the member is entitled to medical disability benefits, and the determination process can take several months, and sometimes years.

What is VA disability compensation?

VA disability compensation is a monetary benefit paid to veterans who are disabled because of injury or disease incurred or aggravated during active military service. The veteran's service must have been terminated through separation or discharge under honorable conditions. Disability compensation varies with the degree of disability and the number of dependents, and is paid monthly. The benefits are not subject to federal or state income tax. The VA does not issue Form W-2, Form 1099-R, nor any other document for nontaxed veteran's disability benefits.

What happens after a service member receives a letter of determination?

Once the VA sends a letter of determination, all future pension payments from the government are offset by the disability amount paid directly from the VA. Disability payments received directly from the VA are not taxable and are not included on Form W-2 or Form 1099-R.

Although pension payments made before the letter of determination was issued have already been taxed, the letter exempts from taxes the same amount of previous pension payments. U.S. Armed Forces members who have already filed a tax return and reported that pension income should file Form 1040-X, Amended U.S. Individual Income Tax Return, and attach a copy of the letter of determination.

EXERCISES (continued)

Question 3: Disability payments sent directly from the VA to the discharged service member _____.

a. Are taxable

b. Appear on the taxpayer's Form W-2 or 1099-R

c. Are not included on the taxpayer's Form W-2 or 1099-R

d. May begin before the VA issues the letter of determination

Anita Zapata was an active duty service member who was separated due to a medical condition, and began receiving her military pension in February of the previous tax year. Here are the payments she reported on that year's tax return:

Payments	***Amount***
• *Service pension*	*$33,000*
• *Active duty pay*	*$ 5,000*

In the current tax year, the VA determined that she was retroactively entitled to a VA disability pension of $837 each month from the date of her discharge (February of the previous tax year). She can amend her tax return to exclude $9,207 ($837 x 11 months) of the pension she received.

She must attach a copy of her letter of determination to the amended return. Her current tax year Form 1099-R will not include the nontaxable VA disability retirement payments received during that year.

What is a combat zone?

A combat zone is any area the President of the United States designates by Executive Order as an area in which the U.S. Armed Forces are engaging or have engaged in combat. An area becomes a combat zone and ceases to be a combat zone on the dates the President designates by Executive Order. Publication 3 lists the specific areas and dates.

A taxpayer serving in a combat zone may qualify for relief from certain IRS compliance actions, such as audits or enforced collections, until 180 days after the taxpayer has left the zone.

Taxpayers qualifying for such combat zone relief may notify the IRS directly of their status through a special e-mail address: **combatzone@irs.gov**. *They should provide name, stateside address, date of birth and date of deployment to the combat zone. They should not include any Social Security numbers in an e-mail. This notification may be made by the taxpayer, spouse, or authorized agent or representative. For more information visit* **www.irs.gov**.

Hazardous duty areas are determined by Congress. Members of the Armed Forces deployed overseas, away from their permanent duty station, in support of operations in a qualified hazardous duty area, or performing qualifying service outside the qualified hazardous duty area, are treated as if they are in a combat zone for federal income tax purposes.

What is the combat zone exclusion?

Members of the U.S. Armed Forces who serve in a combat zone may exclude certain pay from their income. The entitlement to the pay must have fully accrued in a month during which they served in the combat zone or were hospitalized due to wounds, disease, or injury incurred while serving in the combat zone. They do not have to receive the pay while in a combat zone, in a hospital, or in the same year they served in a combat zone.

The following section is to help you understand when pay is considered excludable as combat pay. You will not be making any decisions about what is excludable. The information on the military member's Form W-2 indicates the amount of combat pay with a code Q. If military members feel the amount is incorrect, refer them to the local accounting and finance or payroll office for clarification. Do not change any amounts on Form W-2 when entering them in the tax software.

What qualifies as service in a combat zone?

Service in a combat zone includes periods that military members are absent from duty because of illness, wounds, or leave. If, as a result of serving in a combat zone, military members become prisoners of war or are missing in action, they are considered to be serving in the combat zone as long as they remain in that status for military pay purposes.

When does service outside a combat zone qualify as service inside a combat zone?

Military service outside a combat zone is considered to be performed in a combat zone if the service:

- Is in direct support of military operations in the combat zone, and
- Qualifies a member for hostile fire/imminent danger pay due to dangers or risks from the combat zone

Military pay received for this service will qualify for the combat zone exclusion if the other requirements are met.

What is nonqualifying presence in a combat zone?

The following military service does not qualify as service in a combat zone:

- Presence in a combat zone while on leave from a duty station located outside the combat zone
- Passage over or through a combat zone during a trip between two points that are outside a combat zone, and
- Presence in a combat zone solely for a member's personal convenience

Sgt. Bobby Osage was not assigned to a combat zone but he performed duty that qualified for hostile fire pay. He can exclude that income.

U.S. service members are considered to be serving in a combat zone if they are either assigned on official temporary duty to a combat zone or they qualify for hostile fire/imminent danger pay while in a combat zone.

EXERCISES (continued)

Question 4: Which of the following may qualify as service in a combat zone?

a. Temporary duty in a combat zone

b. Traveling through a combat zone between two points outside of the combat zone

c. Presence in a combat zone while on leave from a duty station located outside the combat zone

d. Direct support of a qualified hazardous duty area but not entitled to hostile fire/imminent danger pay

What is the amount of the combat zone exclusion?

- Enlisted members, warrant officers, or commissioned warrant officers who serve in a combat zone during any part of a month (even one day) can exclude all of that month's military pay, including awards and re-enlistment bonuses for which the member becomes eligible while in the combat zone. Military pay earned while hospitalized due to wounds, disease, or injury incurred in the combat zone can also be excluded.
- Commissioned officers (including limited duty officers) may exclude pay according to the rules for enlisted members. However, the amount of the exclusion is limited to the highest rate of enlisted pay plus the amount of imminent danger/hostile fire pay received for each month during any part of which they served in a combat zone or were hospitalized as a result of their combat zone service.

Combat pay is not included in Box 1 wages on the service member's Form W-2, but the amount is shown in Box 12, with code Q. If service members believe the taxable wages on Form W-2 are incorrect, they should contact the local accounting and finance or payroll office to request a corrected Form W-2.

Nontaxable combat pay may increase the Child Tax Credit or Earned Income Tax Credit. Enter all fields from Form W-2 when preparing the tax return. The software will determine what is most beneficial to the taxpayer.

Taxpayer Interview and Tax Law Application

Here's how a volunteer might help taxpayers with combat pay:

Sample Interview

Volunteer Says...	Mrs. Fannin Responds...
Let's talk for a minute about where your husband was stationed.	My husband was in a combat zone for part of the year. Do I need to tell you the dates or anything?
The combat pay is not taxable, but it's shown on your husband's W-2, here in Box 12, with code Q. I will enter that into the system with the rest of the W-2 information, because combat pay can increase some tax credits. I can show on the tax return that he was in the combat zone, but I don't need to know the exact dates. Is he serving in Iraq?	That's right.

What are the laws regarding community property?

The community property states are Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin. The states of Tennessee and South Dakota have passed elective Community Property Laws. The states of Tennessee and South Dakota have passed elective Community Property Laws. Special rules apply to married taxpayers who file separately or who were divorced during the tax year and their ***domicile*** is in a community property state. For military members residing in these states, the key word is domicile, which describes someone's legal, permanent residence.
It is not always where the person presently lives.

Married taxpayers who choose to file separately, when subject to community property rules, have to figure community income and separate income for state and federal income tax purposes.

How do community property laws affect Armed Forces pay?

State community property laws apply to active military pay. Generally, the pay is either separate or community income based on the marital status and domicile of the couple while the service member was/is in active military service.

Whether an item is subject to community property laws depends on whether the payment is classified as active pay or retired/retainer pay:

- State community property laws apply to active military pay. Generally, the character of the pay as separate from community income is determined by the marital status and/or domicile of the service member and spouse while the member is on active military service.
- Armed Forces retired or retainer payments may be subject to community property laws. For more information see Publication 555, Community Property.

Summary

Special rules may govern whether certain income received by members of the U.S. Armed Forces is includible or excludable from taxable income reported on the return:

- Homeowners Assistance Program (HAP)
- Medical separation with disability severance pay
- Combat zone exclusion
- Community property laws

What situations are out of scope for the VITA/TCE programs?

The following are out of scope for this lesson. While this list may not be all inclusive, it is provided for your awareness only.

- U.S. Armed Forces members who were provided a commuter highway vehicle (such as a van) by their employer

To gain a better understanding of the tax law, complete the practice return(s) for your course of study using the Practice Lab on L&LT.

EXERCISE Answers

Answer 1: b, False. The payments and withholdings for the enlistment and reenlistment bonuses are reflected on the service member's Form W-2.

Answer 2: b. The Basic Allowance for Housing (BAH) and Basic Allowance for Subsistence (BAS) are both nontaxable income.

Answer 3: c. Once the VA sends the letter of determination, all pension payments are offset by the disability amount paid directly from the VA, which is not taxable and not included on any Form W-2.

Answer 4: a. Military members are considered to be serving in a combat zone if they are either assigned on official duty to a combat zone or they qualify for hostile fire/imminent danger pay while serving in direct support of a combat zone.

Adjustments to Income

Introduction

This lesson covers the Adjustments to Income section of Form 1040, Schedule 1. Taxpayers can subtract certain expenses, payments, contributions, fees, etc. from their total income. The adjustments, subtracted from total income on Form 1040, establish the adjusted gross income (AGI).

Some items in the Adjustments to Income section are out of scope. This lesson will cover all in-scope topics. Refer to the Volunteer Resource Guide, Tab B, Starting a Return and Filing Status, or go to IRS.gov to view Form 1040. The adjustments to gross income for expenses of members of the Military are covered in the next lesson.

Objectives

At the end of this lesson, using your resource materials, you will be able to:

- Identify which adjustments are within the scope of the VITA/TCE programs
- Calculate and accurately report the adjustments to income that are within the scope of the VITA/TCE programs

What do I need?

- Form 13614-C
- Form 8889
- Form 8889 Instructions
- Publication 4012
- Publication 17
- Publication 969

Optional:

- Publication 504
- Publication 590-A
- Publication 970
- Publication 4942
- Form 1040 Instructions
- Form 1040 (Sch SE)
- Form 1098-E
- Form 1099-INT
- Form 1099-OID
- Form 8606
- IRA Deduction Worksheet
- Student Loan Interest Deduction Worksheet

How do I determine if the taxpayer has adjustments to income?

To identify the adjustments to income that taxpayers can claim, you will need to ask the taxpayers if they had the types of expenses listed on the Adjustments to Income section of Schedule 1. Review the taxpayers' answers on their intake and interview sheet.

During the tax year did the taxpayer or spouse:

- Pay qualified educator expenses?
- Receive income from self-employment?
- Have self-employed health insurance?
- Pay a penalty for early withdrawal of savings?
- Pay alimony?
- Make contributions to a traditional IRA?
- Make a contribution to a health savings account?
- Pay student loan interest?
- Receive income from jury duty that was turned over to an employer?
- Have a Form W-2 Box 12 code H contribution to Sec 501(c)(18)(D) pension plan?

There are other adjustments to income, such as self-employed SEP, SIMPLE, and other qualified plans. These are beyond the scope of the VITA/TCE programs. If you believe a taxpayer could benefit from one of these other adjustments, encourage the taxpayer to consult a professional tax preparer.

To review the tax software entry screen for Adjustments, go to the Volunteer Resource Guide, Tab E, Adjustments.

How do I handle educator expenses?

Who is eligible?

Eligible educators can deduct up to $300 of qualified expenses paid during the tax year. If the taxpayer and spouse are both eligible educators, they can deduct up to $600, but neither can deduct more than their own expenses up to $300. The deduction amount is indexed for inflation, so future maximum deduction amounts may be higher.

If the taxpayer or spouse is an educator, probe a little deeper to see if they qualify for this adjustment. Ask questions such as:

- Are you or your spouse a teacher, instructor, counselor, principal, or aide in a school? (Cannot be a home school)
- What grade or grades do you teach? (Must be K-12)
- Were you employed for at least 900 hours during the school year? (Required minimum)

What expenses qualify?

If the taxpayer or spouse is an eligible educator, ask about their qualified expenses. Advise taxpayers that they must have receipts for verification if they get audited.

Expenses that qualify include books, supplies, equipment (including computer equipment, software, and services), and other materials used in the classroom. The educator's own professional development expenses related to the curriculum in which the educator provides instruction are also included. Qualified expenses also include amounts paid or incurred for personal protective equipment, disinfectant, and other supplies used for the prevention of the spread of coronavirus. Qualified expenses don't include expenses for home schooling or for nonathletic supplies for courses in health or physical education.

Gloria is a 5th and 6th grade teacher who works full-time in a year-round school. She had 1800 hours of employment during the tax year. She spent $262 on supplies for her students. Of that amount, $212 was for educational software. The other $50 was for supplies for a unit she teaches sixth graders on health. Only the $212 is a qualified expense. She can deduct $212.

Debbie is a part-time art teacher at an elementary school. She spent $185 on qualified expenses for her students. Because she has only 440 hours of documented employment as an educator during the tax year, she cannot deduct her educator expenses.

What other rules apply?

Probe to learn if the taxpayer or spouse received reimbursement that would reduce the amount of their educator expenses. For example, ask:

- Did you receive reimbursement that is not listed as income on Form W-2?
- Did you redeem U.S. Series EE or I Savings Bonds where the interest would be tax-free, such as redeeming savings bonds to pay educational expenses?
- Did you receive a nontaxable distribution from a qualified tuition program (QTP) or a distribution of nontaxable earnings from a Coverdell education savings account (ESA)?

Educator expenses are reduced by any of these applicable reimbursements.

How do I report this?

Educator expenses are reported in the adjustments section of Form 1040, Schedule 1. Don't forget to reduce the total educator expenses by any reimbursements, nontaxable savings bond interest, nontaxable distribution from a QTP, or nontaxable distribution of earnings from an ESA.

Taxpayer Example

Bob teaches elementary school. His wife Janet teaches high school chemistry. Here is how a volunteer helped them determine if they can take the deduction for educator expenses.

Sample Interview

Volunteer Says...	Janet & Bob Respond...
You've already mentioned that you both work full-time as teachers, so you may be able to deduct some of the money you spent on qualified educator expenses. Can you tell me how much you spent, or did you bring your receipts?	[Janet] Yes, all teachers keep careful records of their expenses. Here are my receipts and here are Bob's.
Can you tell me what you purchased? Janet, maybe you could go first.	[Janet] Sure. Three receipts are for quick reference cards for my chemistry students. And two are for special reagents the department doesn't stock.
Your receipts add up to $382. Now, we can count only the first $300 of educator expenses, but because you are married and filing jointly, we can count up to $300 for Bob. Bob, tell me about your expenses.	[Bob] These four receipts are for art supplies – paint and brushes, as you can see – and these two are for special papers and sculpting clay.
Yours total $263. Now, did either of you receive any reimbursement that is not shown on Form W-2?	[Janet] No, we paid these expenses out of our own pockets. [Bob] Wait, now that I think about it, I got reimbursed $50 for the clay.
That would bring your total down to $213.	[Janet] Can't we apply some of my excess expense to Bob and bring his total up to $300?
No, I'm sorry, each person's expenses have to stand alone.	[Janet] Okay.
Did you redeem U.S. series EE or I Savings Bonds during the tax year?	[Janet] No, we didn't. What if we had?
We would complete a form to see what percentage of the tax-free interest should be applied as a reimbursement. One more thing: did you receive distributions from a qualified tuition program or a Coverdell education savings account?	[Bob] No, neither of those.
Okay, we can claim $213 for Bob and the maximum $300 for Janet. That gives you a total of $513 on your joint return as a deduction for educator expenses. Any questions before we go on?	[Janet] No, I think we understand.
On the intake and interview sheet, indicate that the taxpayers are entitled to the educator expense adjustment.	

How do I handle self-employment tax?

Self-employed taxpayers can deduct a portion of their self-employment tax from their income. Self-Employment Tax is covered in the Other Taxes Lesson.

The deductible portion of the self-employment tax is automatically calculated on Schedule SE by the software and the deductible portion is carried to the adjustments section on Form 1040, Schedule 1. To review information related to the software, go to the Volunteer Resource Guide, Tab E, Adjustments.

How do I handle self-employed health insurance deduction?

Self-employed taxpayers who reported a net profit on Schedule C for the year may be able to deduct the cost of their health insurance paid as a deduction from their gross income. The insurance plan must be established under the trade or business and the deduction cannot be more than the earned income from that trade or business. When filing Schedule C, the health insurance policy can be either in the taxpayer's name, the spouse's name (if Married Filing Jointly), or in the name of the business.

Medicare premiums voluntarily paid to obtain insurance in the taxpayer's name that is similar to qualifying private health insurance can be used to figure the deduction. The spouse's Medicare premiums qualify for the deduction when Married Filing Jointly even though paid from the spouse's benefits. Include health, dental, vision, supplemental, limited coverage, and long-term care (LTC) premiums. LTC is limited to the deduction cap for Schedule A, based on age.

Self-employed taxpayers cannot deduct payments for medical insurance for any month in which they were eligible to participate in a health plan subsidized by their employer, a spouse's employer, or an employer of the taxpayer's dependent or child under age 27 at the end of the tax year. Taxpayers cannot deduct payments for a qualified long-term care insurance contract for any month in which they were eligible to participate in an employer-subsidized long-term care insurance plan.

To determine whether the self-employed individual was eligible for subsidized coverage, consider only current employers. Subsidized retiree or COBRA coverage does not preclude the self-employed health insurance deduction.

Yvette enjoys subsidized COBRA coverage from her prior employer for which she still pays her share every month. She is not eligible for any other subsidized employer coverage. Yvette can use her out-of-pocket premium cost to determine her self-employed health insurance deduction.

Retired public safety officers can reduce their taxable retirement distribution by up to $3,000 when they pay for their health coverage directly from the retirement plan. Premiums not used to reduce their taxable retirement income can be used for the self-employed health insurance deduction.

Some taxpayers may receive reimbursements from their employers, prior employers or insurance companies. Only unreimbursed costs qualify for the deduction.

Whose health coverage qualifies?

For this purpose, health coverage can be for the taxpayer, spouse, dependents, or the taxpayer's child under the age of 27 even though the child is not the taxpayer's dependent. A child includes a son, daughter, stepchild, adopted child, or foster child.

What is the limit on the self-employed health insurance deduction?

The self-employed health insurance deduction is limited to the net self-employment profit shown on the return reduced by the deduction for one-half of the self-employment tax.

Carson is single and has his own business. During the year, he paid qualified health insurance premiums of $3,000. His Schedule C shows a profit of $5,500 and his self-employment tax deduction is $389 for a net of $5,111 ($5,500 – $389). The full $3,000 premium paid is deductible as self-employment health insurance because it is less than the net profit.

When the total health insurance costs exceed the self-employed health insurance deduction limit, a taxpayer can generally include any remaining premiums as an itemized medical expense deduction Form 1040, Schedule A.

What if the insurance was purchased through the Marketplace?

Self-employed taxpayers who purchased their coverage from the Marketplace and are eligible for the Premium Tax Credit are out of scope for the VITA/TCE programs and should be referred to a professional preparer.

How do I handle penalties on early withdrawal of savings?

Taxpayers can adjust their gross income to deduct penalties they paid for withdrawing funds from a deferred interest account before maturity. Ask if the taxpayer and/or spouse made any early withdrawals during the tax year. If so, ask to see Form 1099-INT, Interest Income, or Form 1099-OID, Original Issue Discount, documenting the penalty. The early withdrawal penalty deduction is reported on Form 1040, Schedule 1.

The early withdrawal penalty amount should be entered in the interest income section if it is listed on Form 1099-INT. Otherwise, go to the Deductions section, then Adjustments, and click begin on the Penalty on Early Withdrawal of Savings or CD line.

Gloria withdrew $5,000 early from a one-year, deferred-interest certificate of deposit. She had to pay a penalty of three months' interest. She can claim this penalty amount as an adjustment to income.

How do I handle alimony paid?

Pre-2019 Divorces

Alimony is a payment to a spouse or former spouse under a divorce or legal separation instrument. The payments do not have to be made directly to the ex-spouse. For example, payments made on behalf of the ex-spouse for expenses specified in the instrument, such as medical bills, housing costs, and other expenses can qualify as alimony. Alimony does not include child support or voluntary payments outside the instrument. The person paying alimony can deduct alimony payments as an adjustment to income; the person receiving alimony must treat it as income. A summary of the alimony requirements can be found in Tab E, Adjustments, in the Volunteer Resource Guide.

When you conduct the interview, ask if the taxpayer paid alimony under a divorce or separation instrument. If so, explain that you need the exact amount, as well as the Social Security number of the recipient, because the recipient must report the payment to the IRS as income and the two amounts must agree. The date of the divorce, or a reasonable estimate, is also needed to complete Schedule 1.

For additional information on alimony, refer to Publication 504, Divorced or Separated Individuals.

Post-2018 Divorces

Alimony or separate maintenance payments made under a divorce or separation agreement (1) executed after 2018, or (2) executed before 2019, but later modified if the modification expressly states the repeal of the deduction for alimony payments applies to the modification, are no longer deductible. Alimony and separate maintenance payments received under such an agreement are not included in the gross income of the recipient.

Anthony was divorced in 2017. Under his divorce instrument, he paid his ex-wife $8,000 during the tax year. As a favor, he also made $4,000 in payments to cover part of her vehicle lease so she could keep steady employment. He can take the $8,000 as an adjustment to income. He cannot count the lease payments because those were payments not required by the divorce instrument.

EXERCISES

Answers are at the end of the lesson summary.

Question 1: Victoria divorced in 2007. Her divorce settlement states that she must pay her ex-husband $12,000 a year. She is also required to pay his ongoing medical expenses for a condition he acquired during their marriage. During the tax year, the medical expenses were $11,400. How much can she deduct as an adjustment to income?

a. $12,000

b. $11,400

c. $23,400

d. $600

How do I handle IRA contributions?

Individual Retirement Arrangements (IRAs) are personal savings plans that offer tax advantages to set aside money for retirement. This section discusses “traditional” IRAs. A traditional IRA is any IRA that is not a Roth or SIMPLE IRA. See Publication 590-A, Individual Retirement Arrangements, for more information on all types of IRAs.

Some of the features of a traditional IRA are:

- Taxpayers may be able to deduct some or all of their contributions to the IRA (depending on circumstances).
- Generally, amounts in an IRA, including earnings and gains, are not taxed until distributed.
- Contributions may be eligible for the retirement savings contributions credit.

Although contributions to a Roth IRA cannot be deducted, the taxpayer may be eligible for the retirement savings contributions credit, discussed in the lesson on Miscellaneous Credits.

Fred has a traditional IRA account and a Roth IRA account. During the tax year, Fred contributed $2,200 to his traditional IRA and $1,000 to his Roth IRA. The most Fred will be able to deduct is the $2,200 contribution to his traditional IRA.

Based on the intake and interview form, ask the taxpayer about any IRA contributions during the year or that they intend to make by the due date of the return.

Repayment of a coronavirus-related distribution is not an IRA contribution. Refer to the Income - Retirement Income lesson and Form 8915-F, Qualified Disaster Retirement Plan Distributions and Repayments, and instructions.

What are the eligibility requirements for an IRA contribution?

The taxpayer, and the taxpayer’s spouse if applicable, must meet these eligibility requirements in order to make an IRA contribution:

- Types of IRAs: Verify the types of IRAs to which the taxpayer and spouse contributed. Only contributions to traditional IRAs are deductible.

- Age limit: Under the SECURE Act of 2019, there is no age limit for either traditional or Roth IRA contributions effective for tax years beginning after December 31, 2019.
- Compensation: Individuals must have taxable compensation (i.e., wages, self-employment income, commissions, taxable alimony, or taxable scholarships or fellowships shown in Box 1 of Form W-2).
- Time limits: The IRA must be set up and the contribution must be made by the due date for filing the return, not including extensions. Verify with the taxpayer and spouse that they made the contribution(s) (or will make them) by the due date of the return.

Be sure the taxpayer knows that if a contribution is reported on the tax return but is not made by the deadline, the taxpayer must file an amended return.

A taxpayer over the age of 70½ can make qualified charitable distributions (QCD) from their retirement account. A QCD may need to be reduced by deductible IRA contributions. This is covered in the Retirement Income lesson.

How much can a taxpayer deduct for an IRA contribution?

Generally, you can deduct the lesser of:

- The contributions to your traditional IRA for the year, or
- The general limit reduced for Roth IRA contributions made for the same tax year

The deduction amount may be further reduced for taxpayers who participate in an employer's retirement plan when certain income levels are reached. This is discussed later in this lesson.

What is the compensation requirement?

Compensation is generally the income a taxpayer has earned from working; wages, salaries, tips, professional fees, bonuses, and other amounts you receive for providing personal services are compensation. Compensation also includes taxable alimony and any amount which is included in the individual's gross income and paid to the individual to aid the individual in the pursuit of graduate or postdoctoral study. See Publication 590-A, for other types of compensation.Taxpayers cannot make IRA contributions that are greater than their compensation for the year.

An IRS certified volunteer preparer must exercise due diligence when preparing or assisting in the preparation of, approving, and filing tax returns. Based on this, volunteers may rely in good faith without requiring certain documents from the taxpayer.

If married taxpayers file a joint return, their combined IRA contributions cannot exceed their combined compensation, and neither spouse can contribute more than the general IRA limit to their own IRA.

Beginning in 2019, taxpayers can elect to increase their compensation for difficulty of care payments that are excluded from gross income for the purpose of nondeductible IRA contributions which are eligible for the retirement savings credit.

Gene and Sue are married and are both over 50 years old. Gene earned $70,000 and Sue earned $1,500. During the tax year, Gene contributed $3,500 to his traditional IRA and $2,000 to a Roth IRA, making his total contributions $5,500. To figure the maximum contribution to Sue's IRA, use a total compensation of $66,000 (i.e., $71,500 – $5,500). If Gene and Sue file jointly, they can contribute up to the IRA limit to Sue's IRA even though her own compensation was just $1,500.

Although a person may have IRA accounts with several different financial institutions, the tax law treats all of their traditional IRA accounts as one single IRA. Inherited IRAs, however, are treated separately. If a taxpayer inherits a traditional IRA from a deceased spouse, they can treat the account as their own and make contributions and rollovers into the inherited account. A taxpayer cannot make a contribution to an IRA they inherited from someone other than a spouse. A surviving spouse who elects to transfer an IRA inherited from their spouse to their own IRA can make contributions to the transferred IRA.

Bill is 29. He has a traditional IRA account at City Home Savings Bank and another traditional IRA account through his stockbroker. He also opened a Roth IRA through his stockbroker. Bill can contribute to any or all of his accounts this year, but the combined contributions for the tax year cannot exceed the lesser of the general IRA limit or his compensation for the tax year.

EXERCISES (continued)

Question 2: Stan, an unmarried college student working part time, earned $4,500 during the tax year. What is the maximum he can contribute to an IRA?

a. $1,000

b. $3,500

c. $4,500

d. $5,500

Question 3: Bob and Carol are married and both are 55 years old. They both work and each has a traditional IRA. During the tax year, Bob earned $2,000, and Carol earned $50,000. If they file separate returns, what is the maximum that Bob can contribute to his IRA? $.

Are there special rules for certain military personnel?

Current or former members of the Armed Forces may qualify for additional retirement benefits. Under the Heroes Earned Retirement Opportunities (HERO) Act, taxpayers can count tax-free combat pay as compensation when determining whether they qualify to contribute to either a Roth or traditional IRA. Before this change, members of the Armed Forces whose earnings came entirely from tax-free combat pay were generally barred from using IRAs to save for retirement.

When can IRA contributions be deducted?

Deductions can be taken for contributions to traditional IRAs for returns that are in scope. The taxpayer's deduction for IRA contributions may be "phased out" (i.e., reduced or eliminated) depending on their income, filing status, and whether the taxpayer is covered by a retirement plan at work. The difference between the permitted contributions and the IRA deduction, if any, is the taxpayer's nondeductible contribution. Form 8606, Nondeductible IRAs, must be completed for any nondeductible traditional IRA contributions.

If taxpayers do not report nondeductible contributions, all of the contributions to a traditional IRA will be treated as having been deducted. This means all distributions will be taxed when withdrawn unless the taxpayer can show, with satisfactory evidence, that nondeductible contributions were made.

Tax-Aide only: Form 8606 parts I and II are in scope. Each spouse may need a form if each has an IRA with basis. Basis in each inherited is also tracked separately.

Nondeductible contributions will not show on Form 1040. They are shown on Form 8606 and Form 8880 for possible retirement savings credits. Refer to the Volunteer Resource Guide for software entries.

How do I determine the deduction amount?

The factors that affect whether traditional IRA contributions are deductible include:

- Whether the taxpayer (or spouse, if filing a joint return) is covered by a retirement plan at work.
- The taxpayer's Modified Adjusted Gross Income (MAGI) before taking the deduction. If the taxpayer or spouse is covered by a retirement plan, the deduction amount will be reduced or eliminated if the MAGI on the tax return is above a certain limit.

Retirement coverage at work

Ask if the taxpayer and/or spouse were covered by a retirement plan at work at any time during the tax year. If so, their deduction may be limited. Employees covered by a retirement plan will have Box 13 on Form W-2 checked.

Filing status and income

If the taxpayer or spouse was covered by an employer retirement plan, they may not be able to deduct the full amount. Notice that the income limitation amount may be different for each spouse on a joint return, but that the MAGI computation is the same. This is because if one spouse is covered by a retirement plan but the other is not, the noncovered spouse will have a higher income limit before their IRA deduction is phased out.

If the MAGI is greater than the income limits, the deduction cannot be taken. If this is the case, explain to the taxpayers and answer any questions they may have about why the deduction cannot be taken. The contribution may still be made, it is just not deductible.

A taxpayer who made a contribution to their traditional IRA that turns out cannot be deducted may wish to recharacterize the contribution. They would need to contact their IRA trustee and have the contribution recharacterized as to a Roth IRA. A Roth contribution can also be recharacterized as a traditional IRA contribution.

While recharacterizing a Roth conversion is no longer allowed, recharacterizing a contribution is still allowed when done by the due date of the return, including an extension.

Enter the total contributions to traditional IRAs that were made (or will be made) for each spouse (on a joint return) by the due date of the return.

Refer to the Important Changes lesson for the deduction and MAGI limits for the year.

How do I report the IRA deduction?

Report the deduction in the adjustments section of Form 1040, Schedule 1.

The software will automatically limit the IRA deduction. To review information related to the software, go to the Volunteer Resource Guide, Tab E, Adjustments.

What if the taxpayer has an excess IRA contribution?

An excess IRA contribution is an amount contributed to a traditional or Roth IRA that is more than the lesser of:

- The taxable compensation for the year, or
- General limit amount

The taxpayer may not know that a contribution qualifies as “excess” until the tax return is completed. When this situation is identified, the excess amount, with any earnings on that amount, must be withdrawn by the due date of the return (including extensions). If the excess amount is not withdrawn by the due date of the return, including extensions, the taxpayer will be subject to an additional 6% tax on this amount. This additional tax is covered in the Other Taxes lesson, but is out of scope for the VITA/TCE programs. Taxpayers subject to the additional 6% tax should be referred to a professional tax preparer.

When the taxpayer has modest wages or other compensation and traditional or Roth IRA contributions, confirm that the limit has not been exceeded.

The withdrawn excess contribution is not included in the taxpayer's gross income before the tax return is due if both of the following conditions are met:

- No deduction was allowed for the excess contribution
- All interest or other income earned on the excess contribution is withdrawn

If taxpayers timely filed the tax return without withdrawing a contribution that they made during the tax year, they can still have the contribution returned to them within 6 months of the due date of the tax return, excluding extensions.

Taxpayers must include in gross income the interest or other income that was earned on the excess contribution. Taxpayers must report it on their return for the year in which the excess contribution was made. The withdrawal of interest or other income may be subject to an additional 10% tax on early distributions.

Maria, age 35, made an excess contribution of $1,000, which she withdrew by the due date of her return. At the same time, she also withdrew the $50 income that was earned on the $1,000. She must include the $50 in her gross income (for the year in which the excess contribution was made). She must also pay an additional tax of $5 (the 10% additional tax on early distributions because she is not yet 59½ years old), but she does not have to report the excess contribution as income or pay the 6% excise tax. Maria receives a Form 1099-R showing that the earnings are taxable for the current year.

Form 1099-R

Taxpayers will receive Form 1099-R indicating the amount of the withdrawal. If the excess contribution was made in a previous tax year, the form will indicate the year in which the earnings are taxable.

How do I handle Health Savings Accounts (HSAs)?

What is an HSA?

An HSA is a tax-exempt trust or custodial account that a taxpayer sets up with a qualified HSA trustee. Contributions are deductible as an adjustment to gross income. Distributions from an HSA are nontaxable if the funds are offset by qualified medical expenses. A taxpayer must be an eligible individual to qualify to contribute to an HSA, but does not need to be eligible in the year of distribution.

Individuals Who Qualify for an HSA

To be an eligible individual and qualify for an HSA, the taxpayer must meet the following requirements:

- Be covered by a high-deductible health plan (HDHP) on the first day of the month
- Not be covered by other health insurance (see Publication 969 for exceptions)
- Not be enrolled in Medicare (the individual can be HSA-eligible for the months before being covered by Medicare)
- Not be eligible to be claimed as a dependent on someone else's tax return (see Caution)

If another taxpayer is entitled to claim the individual as a dependent, the individual cannot claim a deduction for an HSA contribution. This is true even if the other taxpayer does not actually claim the dependent.

Employers typically set up company plans to meet all the requirements.

Rules for Married Individuals

In the case of married individuals, each spouse and is an eligible individual and wants to have an HSA must open a separate HSA. Married couples cannot have a joint HSA, even if they are covered by the same

HDHP; however, distributions can be used to cover the qualified expenses of the other spouse. In the event of the death of one of the married individuals, the HSA will be treated as the surviving spouse's HSA if the spouse is the designated beneficiary of the HSA.

An employee covered by an HDHP and a health Flexible Spending Account (FSA) or a Health Reimbursement Arrangement (HRA) that pays or reimburses qualified medical expenses generally cannot make contributions to an HSA.

Contributions to HSA

Anyone can contribute to an eligible individual's HSA. For an employee's HSA, the employee, employer, or both may contribute to the employee's HSA in the same year. For an HSA established by a self-employed (or unemployed) individual, the individual can contribute. Family members or any other person may also contribute on behalf of an eligible individual. Contributions to an HSA must be made in cash. Contributions of stock or property are not allowed. Amounts contributed to an HSA, except for employer contributions and qualified HSA funding distributions from IRAs, can be used as an adjustment to income for the account owner and must be made by the April due date of the return.

A taxpayer who ceases to be an eligible individual can continue to maintain and take distributions from an existing HSA (but can no longer make new contributions).

Employer Contributions

Employer contributions (including an employee's contribution through a cafeteria plan) are allowed to be made to an employee's HSA. Generally, employer contributions are excluded from an employee's income. Employer contributions are reported on Form W-2, Box 12 using code W. An employee's contributions through a salary-reduction cafeteria plan are treated as an employer contribution and reported on Form W-2, Box 12. Taxpayers must reduce the amount they, or any other person, can contribute to their HSA by the amount of any contributions made by the taxpayer's employer (or treated as made by the employer) that are excludable from income.

An eligible employee contributed $250 to their HSA through a cafeteria plan and their employer contributed an additional $750. Form W-2, Box 12 will show $1,000 using code W. The employee cannot claim any of the $1,000 as a deduction but may make additional deductible contributions up to their limit reduced by the $1,000.

Limits on HSA Contributions

The amount the taxpayer or another other person can contribute to the taxpayer's HSA depends on the type of HDHP coverage (individual or family) the taxpayer has, the taxpayer's age, the date the taxpayer became an eligible individual, and the date the taxpayer ceases to be an eligible individual. The maximum contribution amount may need to be computed on a monthly basis when the facts change during the year.

Eligible individuals who are 55 or older by the end of the tax year can increase their contribution limit up to $1,000 a year. This extra amount is the catch-up contribution allowed for an HSA. Refer to HSA contribution limits in the Important Changes lesson or the Volunteer Resource Guide, Tab E, Adjustments.

An employee covered by an HDHP and a health flexible spending account (FSA) or a health reimbursement arrangement (HRA) that pays or reimburses qualified medical expenses can't generally make contributions to an HSA. There are exceptions for (see Publication 969):

- Limited-purpose health FSA or HRA
- Suspended HRA
- Post-deductible health FSA or HRA
- Retirement HRA

Situations where the HSA contribution could be limited due to FSA or HRA participation are out of scope for Tax-Aide.

Last-month rule

If the taxpayer is an eligible individual on the first day of every month with the same coverage for the entire year, the full contribution amount is allowed. If the taxpayer was not an eligible individual for the entire year or changed his or her coverage during the year, the contribution limit is computed using either:

• Last-month rule, which allows eligible individuals to make a full contribution for the year even if they were not an eligible individual for the entire year. They can make the full contribution for the year if:
  – They are eligible individuals on the first day of last month of their taxable year. For most people, this would be December 1, and
  – They remain eligible individuals during the testing period. The testing period runs from December 1 of the current year through December 31 of the following year (for calendar taxpayers).

OR

• Sum of the monthly contribution limits rule (use the Limitation Chart and Worksheet in Form 8889 Instructions). This is the amount determined separately for each month based on eligibility and HDHP coverage on the first day of each month plus catch-up contributions. For this purpose, the monthly limit is 1/12 of the annual contribution limit, as calculated on the Limitation Chart and worksheet.

A taxpayer whose coverage changed during the year and/or who does not use the last-month rule must use the sum of the monthly contribution worksheet to determine the maximum HSA contribution. See the Volunteer Resource Guide, Tab E, Adjustments, Health Savings Accounts.

Arnold has a high-deductible health plan with an HSA with his company. His mother contributed to his HSA as a gift on his 40th birthday, which is an allowable contribution.

Excess HSA Contributions

Taxpayer may not deduct an excess contribution, that is, a contribution over the limits. They must withdraw the excess to avoid an additional 6% tax by the April due date of the return. Any earnings on the excess must also be withdrawn and reported as other income on Form 1040, Schedule 1. If the excess is not timely withdrawn, refer the taxpayer to a professional tax preparer.

Code W in box 12 of Form W-2 is the HSA contribution made through the employer. Often, this is a salary-reduction contribution by the employee. No further deduction is available for such contributions.

Rules for Married People

The rules for married people apply only if both spouses are eligible individuals. If either spouse has family HDHP coverage, the family contribution limit applies and both spouses are treated as having family HDHP coverage and:

- The contribution limit is divided between the spouses by agreement. If there is no agreement, the contribution limit is split equally between the spouses.
- Each spouse who is 55 or older is entitled to increase his or her contribution limit with an additional contribution to their own HSA.

If each spouse, instead, has self-only HDHP coverage, the self-only limit applies to each. Each can make a catch-up contribution if age 55 or older.

This year, Mr. Auburn and his wife are both eligible individuals. They each have family coverage under separate HDHPs. Mr. Auburn is 58 years old and Mrs. Auburn is 53. Mr. and Mrs. Auburn can split the family contribution limit equally, or they can agree on a different division. If they split it equally, each can contribute one-half the maximum contribution for family coverage. Mr. Auburn can contribute an additional $1,000 to his HSA because he is age 55 or over. Refer to HSA contribution limits in the Volunteer Resource Guide, and Publication 969.

Distributions from an HSA

Distributions for Qualified Medical Expenses

An individual is responsible for medical expenses that their HDHP plan does not cover, such as the annual deductible or co-pays. They often have an "HSA debit card" that they can use to pay such bills or they can get a reimbursement from their HSA. The taxpayer can receive tax-free distributions from an HSA to pay or be reimbursed for qualified medical expenses incurred in the current or prior year, but after the taxpayer establishes the HSA.

Qualified medical expenses include the medical expenses of the taxpayer, their spouse, or a dependent at the time the expense was incurred. It does not matter whether the taxpayer has self-only or family HDHP coverage.

Qualified medical expenses also include those for any other person who could have been claimed as a dependent on the taxpayer's return except that:

- The person filed a joint return
- The person had gross income of the exemption amount or more, or
- The taxpayer or spouse (if filing jointly) could be claimed as a dependent on someone else's tax return

For this purpose, a child of parents who are divorced, separated, or living apart for the last 6 months of the calendar year is treated as the dependent of both parents whether or not the custodial parent releases claim to the child as his or her dependent.

Qualified medical expenses are expenses that generally would qualify for the medical and dental expenses deduction. Examples include unreimbursed expenses for doctors, dentists, and hospitals. Additional items that are qualified medical expenses for HSA purposes include the cost of home testing for COVID-19, and personal protective equipment for the primary purpose of preventing the spreading COVID-19 (such as masks, hand sanitizer and sanitizing wipes), the cost of menstrual care products (tampons, pads, liners, cups, sponges or other similar product), and over-the-counter products and medications. Health insurance premiums are not included as qualified medical expenses except for some LTC, COBRA, coverage while unemployed, or Medicare premiums (see Pub 969 for full information).

See Publication 502, Medical and Dental Expenses, and Publication 969 for more information.

For recordkeeping requirements on HSA distributions see Publication 969, Distributions from an HSA. Taxpayers are not required to take annual distributions from their HSA. However, taxpayers who have taken HSA distributions will receive Form 1099-SA, Distributions from an HSA, Archer MSA, or Medicare Advantage MSA, from their HSA trustee and must provide it so an accurate return can be completed.

Vikki's doctor suggested she take some exercise classes. Vikki signed up for yoga, swimming classes, and a health club. Since these are for general health improvement, they cannot be considered as qualified medical expenses.

Deceased HSA owner

The surviving spouse of the HSA owner can take the HSA as their own if they are the beneficiary. The rules that apply to an HSA distribution to someone other than a deceased owner's spouse are beyond the scope of the VITA/TCE Programs. Refer taxpayers who received such distributions to a professional tax preparer.

Mistaken Distributions

If amounts were distributed during the year from an HSA because of a mistake of fact due to reasonable cause, the account beneficiary may repay the mistaken distribution no later than the April tax return due date following the first year the account beneficiary knew or should have known the distribution was a mistake. Under these circumstances, the mistaken distribution is not included in gross income, is not subject to the additional 20% tax, and the repayment is not subject to the excise tax on excess contributions. See the instructions for Form 1099-SA for further information.

HSA Rollovers

A rollover is a tax-free distribution to the taxpayer of cash or other assets from one HSA that the taxpayer contributes to another HSA. The contribution to the second HSA is called a rollover contribution. These contributions:

- Are not included in taxpayers' income
- Are not deductible
- Do not reduce taxpayers' contribution limit

The taxpayer must roll over the amount within 60 days after the date of receipt, and may only make one rollover contribution to an HSA during a one-year period. A trustee-to-trustee transfer is not a rollover and not subject to the once in 12 month rule (similar to IRAs).

Form 8889, Health Savings Accounts (HSA)

A taxpayer must complete Form 8889 with Form 1040 if the taxpayer (or spouse if filing a joint return) had any activity in an HSA. This is true even if only the taxpayer's employer or the spouse's employer made contributions to the HSA.

Taxpayers who are filing jointly and who each have separate HSAs will each complete a separate Form 8889. Married taxpayers cannot have a joint HSA.

Ask taxpayers during the interview process if their HDHP coverage is "self-only" or "family," and check the corresponding box on Form 8889, click to view **Form 8889**.

Form 8889, Part I

Form 8889, Part 1, is used to report all HSA contributions and to compute the allowable HSA deduction. This includes contributions made by the filing deadline that are designated for the tax year. Contributions made by an employer are also shown in Part I, but are not included in the deductible amount.

An HSA may receive contributions from an eligible individual or any other person, including an employer or a family member, on behalf of an eligible individual.

Form 8889, Part II

Form 8889, Part II, is used by taxpayers to report distributions from an HSA. Taxpayers receive tax-free distributions from an HSA to pay or be reimbursed for qualified medical expenses. The taxpayer will have to tell you what types of expenses were paid or reimbursed with the distribution.

Form 1099-SA reports distributions to a taxpayer. Box 5 will indicate whether the distribution is from an HSA, Archer MSA, or a Medicare Advantage MSA. The code in Form 1099-SA, Box 3, identifies the distribution the taxpayer received. Code 1 is a normal distribution. Refer to Form 1099-SA for an explanation of the other codes.

If distributions are not rolled over and not offset with qualified medical expenses, the amount withdrawn will be included in income and reported on Form 1040. HSA distributions included in income are subject to an additional 20% tax unless the account beneficiary:

- Dies
- Becomes disabled (see Form 8889 instructions)
- Turns age 65

Form 8889, Part III

Form 8889, Part III, is out of scope for the VITA and TCE programs.

Refer to Tab E, Adjustments, in the Volunteer Resource Guide for software entries.

Case Study – Partial Year HSA Eligibility

Review: monthly eligibility is determined on the first day of each month. Remember it's the taxpayer, not the HSA, that must be eligible. The contribution is limited to the **greater** of:

- Limitation chart and worksheet
- Maximum contribution based on first day of last month of tax year (last-month rule)

Maria, age 48:

- Eligible individual with self-only HDHP coverage from January through August
- Not an eligible individual from September through December

Using the limitation chart and worksheet in the Form 8889 Instructions to calculate her maximum contribution, Maria will enter $3,600 for Jan – Aug; $0 for Sept – Dec

Maria's contribution and deduction is limited to the **greater** of $0 (the last-month rule) or $2,400 (8 X $3,600 = $28,800 ÷ 12)

January	3,600
February	3,600
March	3,600
April	3,600
May	3,600
June	3,600
July	3,600
August	3,600
September	0
October	0
November	0
December	0
Total for all months	**28,800**
Limitation. Divide the total by 12	**2,400**

Case Study – HSA Contribution Last-Month Rule

Review: An eligible individual can make a full year contribution if:

- The individual is eligible on the first day of last month of tax year
- **And** the individual remains eligible during the testing period, generally from December 1 of the current year through December 31 of the following year

Chris, age 53, is an eligible individual for HSA on December 1, 2022

- Chris has family HDHP coverage
- He expects to meet the testing period requirement by remaining eligible through December 31, 2023

Under the last-month rule, Chris can contribute up to the maximum family contribution limit for 2022.

What if the testing period is not met or what if starting June 2023 Chris is not an eligible individual for reasons other than death or disability?

He must recalculate his 2022 allowable contribution and will need to include the excess contribution in his **2023** income (subject to an additional 10% tax on Form 8889, Part III):

- He's entitled to a contribution of 1/12 of the family limit (Dec 2022) using the limitation chart
- He will included 11/12 of his 2022 contribution in his 2023 taxable income

Note that Chris' 2023 return is **out of scope**

Case Study – HSA Rules for Married Taxpayers

Review: When both spouses are HSA eligible and each has **self-only** HDHP coverage, each can contribute up to the self-only contribution limit. If either is 55 or older, they can contribute additional $1,000 to their own HSA

If either spouse has **family** HDHP coverage, both spouses are treated as having family HDHP coverage:

- The family contribution limit applies
- The limit is split evenly unless agree upon different split

If either spouse is 55 or older, they can contribute additional $1,000 to their own HSA.

If taxpayer and spouse both have HSAs:

- File a separate Form 8889 for each
- If one has family coverage
  - Use **Family** for both
  - Split the allowable contribution between taxpayer and spouse on Line 6 Form 8889
  - Each spouse age 55 or older makes the additional contribution to their own HSA
- If both spouses have self-only coverage, treat each HSA separately

Mr. and Mrs. Auburn are eligible individuals. Mr. Auburn is 58 years old, Mrs. Auburn is 53. Each has HDHP family coverage and an HSA. They may split the family contribution limit equally or may agree on a different division.

Mr. Auburn can contribute an additional $1,000 to his HSA because he is 55 or older

How do I handle student loan interest?

The student loan interest deduction is generally the smaller of $2,500 or the interest payments paid that year on a qualified student loan. This amount is gradually reduced (phased out) or eliminated based on the taxpayer's filing status and MAGI.

Robert has taken his first job after completing law school. His filing status is Single. He paid $3,000 in interest on his student loans during the tax year. With all adjustments to income (except student loan interest adjustment), his MAGI is below the limits. He can deduct $2,500 of his student loan interest as an adjustment to income.

Veronica and her husband are filing jointly. She completed her doctoral degree last year and paid $2,400 in student loan interest during the tax year. Their MAGI is above the fully deductible income limits. Due to their high MAGI, the software will calculate their deduction; it will be less than the full amount of interest that she paid.

What type of interest qualifies?

Generally, student loan interest is paid during the year on a loan for qualified higher education expenses. The loan must meet all three of these conditions:

- It was for the taxpayer, the taxpayer's spouse, or a person who was the taxpayer's dependent when the loan was obtained
- The qualified higher education expenses were paid within a reasonable period of time before or after obtaining the loan
- It was for an eligible student

Interest does not qualify if the loan was from a related person, a qualified employer plan, or if the taxpayer is not legally liable for the loan.

What are the exceptions?

For purposes of the student loan interest deduction, the following are exceptions to the general rules for dependents:

- An individual can be your dependent even if you are the dependent of another taxpayer
- An individual can be your dependent even if the individual files a joint return with a spouse
- An individual can be your dependent even if the individual had gross income for the year that was equal to or more than the threshold amount for the year (see the Volunteer Resource Guide, Tab E, Adjustments, for the current year amount)

EXERCISES (continued)

Question 4: Todd and Janet have a MAGI below the limits. They are filing jointly. Two years ago, they took out a loan so Todd's mother could earn her RN degree at night school. Todd could not claim her as a dependent on his return because he did not pay for more than one half of her support. This year, they paid $1,000 in interest on the loan. Does his mother meet the student qualifications?

a. Yes

b. No

Who is eligible for the deduction?

Generally, a taxpayer can claim the deduction if all the following are true:

- The taxpayer is not using the Married Filing Separately filing status
- The taxpayer will not be claimed as a dependent on someone else's return
- The taxpayer is legally obligated to pay interest on a qualified student loan
- The taxpayer paid interest on a qualified student loan

Conduct a probing interview to verify that the taxpayer meets all these tests for the deduction.

What are qualified higher education expenses?

Qualified expenses include: tuition and fees; room and board; books, supplies and equipment; and other necessary expenses (such as transportation).

Qualified expenses must be reduced by certain other educational benefits. Ask the taxpayer if the expenses were offset by any of the following:

- Employer provided educational assistance benefits
- Tax-free distributions from a Coverdell ESA or from a qualified tuition program
- U.S. savings bond interest excluded from income because it is used to pay qualified higher education expenses
- Certain scholarships and fellowships
- Veteran's educational assistance benefits
- Any other nontaxable payments (other than emergency financial aid grants, gifts, bequests, or inheritances) received for educational expenses

No double benefit allowed

Taxpayers cannot deduct as interest on a student loan any amount that is an allowable deduction under any other provision of the tax law (e.g., as business interest).

A taxpayer cannot deduct as interest on a student loan any amount paid from a distribution of earnings made from a qualified tuition program (QTP) after 2018 to the extent the earnings are treated as tax free because they were used to pay student loan interest.

A taxpayer cannot deduct as interest on a student loan any interest paid by their employer after March 27, 2020, and before January 1, 2026, under an educational assistance program. That assistance is not taxable and a double benefit is not allowed.

What is an eligible educational institution?

An eligible educational institution is generally any accredited public, nonprofit, or private post-secondary institution eligible to participate in the student aid programs administered by the Department of Education. It includes virtually all accredited, public, nonprofit, and privately owned profit-making post-secondary institutions. If the taxpayers do not know if an educational institution is an eligible institution, they should contact the school. A searchable database of all accredited schools is available on the U.S. Department of Education website.

Who is an eligible student?

An eligible student is someone enrolled at least half-time in a program leading to a degree, certificate, or other recognized educational credential. The standard for what is half the normal full-time work load is determined by each eligible educational institution.

This year, Jeremy paid interest on a loan that allowed his 21-year-old daughter, Kate, to complete a program in holistic medicine as a full-time student at the Southwestern College of Synergistic Therapy. Although she qualifies as his dependent, and the loan paid for books, supplies, and equipment, the college is not accredited. Therefore, Jeremy cannot deduct the interest on the student loan.

Where can I get the information?

If the taxpayer paid $600 or more in interest to a single lender, the taxpayer should receive Form 1098-E, Student Loan Interest Statement, or another statement from the lender showing the amount of interest paid. This information will assist you in completing the student loan interest deduction.

The taxpayer should keep documentation of all qualified student loan interest paid during the tax year.

See Publication 970, Tax Benefits for Education, for more information on the Student Loan Interest Deduction.

To review information related to the software, go to the Volunteer Resource Guide, Tab E, Adjustments.

Taxpayer Interview and Tax Law Application

Here is how a volunteer helped Brenda determine if she can take the deduction for her student loan interest.

Sample Interview

Volunteer Says...	Brenda Responds...
In reviewing your intake and interview sheet, I see you did not indicate if you had any educational expenses. Did you pay any student loan interest this year?	Yes, I just graduated a year ago and I'll be paying those loans for a while.
Well, you might be able to take a deduction for that. You are filing as Single, and your income before adjustments is not more than the limit for your filing status. Do you know how much interest you paid?	I have two loans; here are the statements.
The interest amounts add up to $2,600. Now, if your interest payments qualify for the deduction, the most we can claim is $2,500. Do you have any questions about that?	No, I understand.
I just need to ask a few questions to see if you qualify, okay? Earlier we decided that you can't be claimed as a dependent on someone else's return, so that's no problem. Can you tell me what you used the loan to pay for?	My tuition and fees, and my books.
Did you receive any educational assistance, like from your employer or the Veteran's Administration?	No.
How about tax-free withdrawals from a Coverdell educational savings account, another qualified tuition program, or from U.S. savings bonds?	No, none of those.
Did you get any other nontaxable payments, not counting gifts, bequests, or inheritances, which were specifically for educational expenses?	Heavens, no, I wish I had!
It looks like you can claim the maximum deduction of $2,500. [Indicate on the intake and interview sheet whether Brenda is eligible for this adjustment.]	

Is pay for jury duty an adjustment to income?

As you learned earlier, jury duty pay received by taxpayers is included in Other income on Form 1040, Schedule 1. Some employees receive their regular wages from their employers while they are serving on a jury instead of working at their jobs.

Often, employees must turn their jury duty pay over to their employers. This may be claimed as an adjustment to income.

What is an entry on Form W-2 box 12 code H?

Code H reflects a contribution to a Sec. 501(c)(18)(D) pension plan that has not reduced taxable wages. The amount carries automatically to Schedule 1 as an adjustment.

How do I determine Adjusted Gross Income?

The taxpayer's total Adjusted Gross Income (AGI) is the amount that is used to compute some limitations, such as the medical and dental deduction on Schedule A and the credit for child and dependent care expenses. To find the taxpayer's AGI:

1. Add the Income section. This is the taxpayer's total income.
2. Add the Adjustments to Income section. These are the total Adjustments.
3. Subtract the Schedule 1 adjustments from the total income. This is the AGI.

Taxpayer Interview and Tax Law Application

The volunteer assists Daniela with the adjustments to income covered in this lesson.

Sample Interview

Volunteer Says...	Daniela Responds...
Daniela, we've discussed your income, so we can go on to Adjustments to Income. We might find ways to reduce the income that you're taxed on. Do you have any questions before we go on?	No, it all makes sense.
Now, let's review the expenses listed on your intake and interview sheet and the deductions listed in the Adjustments to Income section. Do you have a Health Savings Account?	No, I don't.
Okay. That brings us to self-employment tax. The tax software will calculate the deductible portion of your self-employment tax. The same thing happens with the penalty for an early withdrawal. I will put that in when I enter your interest income, and it will show up as an adjustment.	Cool
Did you pay any alimony?	No, I've never even been married.
Did you pay any health insurance premiums during the year?	No
Now, did you contribute to an IRA?	I put in $2,000 right after Christmas.
Good for you. Will you be contributing any more? You can put money in your IRA before the deadline for filing the return.	I don't think so, but that's good to know.
Was it a traditional, Roth IRA, or a SIMPLE IRA?	It was just a plain old IRA. Here's the statement.
There we go; it is what we call a traditional IRA. Were you covered by any kind of employer retirement plan at any time during the tax year?	No, none.

Sample Interview

Volunteer Says...	Daniela Responds...
Because you weren't covered by a retirement plan, you will be able to deduct the full $2,000 you contributed. [The volunteer reviews all expenses listed on the intake and interview sheet and reviews all the adjustments on Schedule 1, asks more questions and determines that Daniela does not qualify for the remaining adjustments.]	
We'll enter all the adjustments that apply to you. The software will calculate your total income, total adjustments, and will determine your Adjusted Gross Income that will be used to determine your deductions. [On the intake and interview sheet, note that you have addressed this adjustment.]	That's great! This program makes it really easy!

Summary

In this lesson, you learned how to identify and work with these adjustments to income:

- Educator expenses
- Deductible portion of self-employment tax
- Deduction for self-employed health insurance
- Penalty on early withdrawal of savings
- Alimony paid
- IRA deduction
- Health Savings Account deduction
- Student loan interest deduction
- Jury duty pay turned over to the taxpayer's employer

If you believe a taxpayer could benefit from an adjustment that is out of scope and was not covered in this lesson, encourage the taxpayer to consult a professional tax preparer.

What situations are out of scope for the VITA/TCE programs?

The following are out of scope for this lesson:

- Other adjustments to income, such as:
  - Self-employed health insurance deduction with premium tax credits
  - Self-employed SEP, SIMPLE, and qualified plans
  - Certain business expenses of performing artists
  - Domestic production activities deduction
- Form 8606, Nondeductible IRAs Part III
- Excess contribution to an HSA not withdrawn timely
- Form 8889, Health Savings Accounts, Part III
- Participants in an FSA or HRA who also make a contribution to their HSA
- An HSA distribution due to the death of an HSA holder (when spouse is not the designated beneficiary)
- Qualified HSA funding distribution from an IRA
- Form 1099-SA for Archer (Archer MSA) or Medicare Advantage (MA MSA) Medical Savings Accounts

While this list may not be all inclusive, it is provided for your awareness only. See Form 1040, Schedule 1, page 2 for a complete list of other adjustments to gross income. Refer to the Volunteer Resource Guide, Scope of Service, for additional items not covered in the lessons.

To gain a better understanding of the tax law, complete the practice returns(s) for your course of study using the Practice Lab on L&LT.

EXERCISE Answers

Answer 1: c. She can deduct the full $23,400 because it is all required by the divorce instrument.

Answer 2: c. His IRA contributions are limited to $4,500, the amount of his compensation.

Answer 3: If Married Filing Separately, Bob can contribute no more than $2,000, the amount of his compensation.

Answer 4: b, No. Todd's mother was not their dependent at the time they took out the loan and none of the exceptions applies.

Military Adjustments to Income

Introduction

This lesson will help you determine which members of the U.S. Armed Forces are entitled to an adjustment to income for certain business expenses or moving expenses. To do this, you will need to determine certain business expenses, qualifying moves, allowances and reimbursements, and deductible moving expenses.

To determine if the taxpayer has incurred any of these expenses, it is important to ask probing questions during the taxpayer interview.

Business expenses for Armed Forces reservists are deducted on Form 2106, Employee Business Expenses.

Unreimbursed moving expenses are deducted using Form 3903, Moving Expenses. Armed Forces members receive a variety of moving reimbursements and allowances that must be considered when determining if the expenses are deductible. The travel voucher will contain much of the information needed to compute the deduction. To deduct moving expenses, the taxpayer must be a member of the Armed Forces on active duty and the move is because of a permanent change of station.

See Publication 3, Armed Forces Tax Guide, for additional information on the topics discussed in this lesson.

Objectives

At the end of this lesson, using your resource materials, you will be able to:

- Determine if a taxpayer has military business expenses that can be deducted
- Determine if a move qualifies as a permanent change of station (PCS)
- Identify deductible moving expenses
- Determine when allowances and reimbursements must be included in income

What do I need?

- Form 13614-C
- Publication 4012
- Publication 3
- Form 2106
- Form 3903

Optional:

- Form 1040 Instructions

What are military employee business expenses?

Military employee business expenses are necessary work-related expenses incurred by active and reserve members of the U.S. Armed Forces. The U.S. Armed Forces includes commissioned officers, warrant officers, and enlisted personnel in all regular and reserve units under the control of the Secretaries of the Defense, Army, Navy, Air Force, and Coast Guard. Ready Reserve Corps of the Public Health Service (part of HHS) is also included as a reserve component. It does not include members of the Merchant Marines or the American Red Cross.

What are temporary active duty reservists' expenses?

Military reservists temporarily called to active duty who must remain away from home to perform their duties may claim unreimbursed travel expenses such as meals and lodging. This applies:

- As long as the duty occurred under competent orders and
- Whether or not the reservist was compensated

Reservists include those who are in the Army, Navy, Marine Corps, Air Force, or Coast Guard Reserve; Army National Guard of the United States; Air National Guard of the United States; or Ready Reserve Corps of the Public Health Service.

To claim unreimbursed travel expenses, reservists must be stationed away from the general area of their job or business and return to their regular jobs once released. Expenses are deductible only if the reservists pay for meals and lodging at their official military post and only to the extent the expenses exceed Basic Allowance for Housing (BAH) and Basic Allowance for Subsistence (BAS). This includes any reimbursement reported under Code L in Box 12 of Form W-2.

What is the 100-mile rule for reservists?

Military reservists who must travel more than 100 miles away from home and stay overnight to attend a drill or reserve meeting may be able to deduct their travel expenses as an adjustment to income. The amount of expenses that can be deducted is limited to the:

- Federal rate for per diem (for lodging, meals, and incidental expenses)
- Standard mileage rate (for car expenses) plus any parking fees, ferry fees, and/or tolls
- For years prior to 2018, if the reservist was prohibited from wearing certain uniforms when off duty (a rule that usually applies to reservists), he or she can generally deduct the cost to buy and maintain those uniforms while performing their away-from-home reservist duties. Actual expenses paid are reduced by the amount of any uniform allowance or reimbursement received. This deduction is suspended through 2025.

Mary is in the Army Reserve. She lives in a town that is 120 miles from Base A, where she normally reports for reserve drills or meetings. During the current tax year, she occasionally traveled to Base B, which was only 40 miles from her home. Mary can claim the travel expenses she incurred going to Base A as an adjustment to income. She cannot claim the expenses for Base B as an adjustment.

How are reservists' expenses reported?

Armed forces reservists use Form 2106 to claim unreimbursed expenses as an adjustment to gross income. Expenses other than travel are not deductible due to the suspension of miscellaneous itemized deductions subject to the 2% floor.

What is a permanent change of station?

Moving expenses incurred as a result of a permanent change of station (PCS) are deductible only. A permanent change of station includes a move from:

- Home to the area of the first post of duty.
- One permanent post of duty to another.
- The last post of duty to home or to a nearer point in the U.S. The Armed Forces member must move within one year of ending active duty or within the period allowed under the Joint Travel Regulations.

What does a permanent change of station include for spouses and dependents?

If the Armed Forces moves service members and their spouses or dependents to or from separate locations, the moves are treated as a single move and the qualified expenses of both moves are combined and deducted on the same tax return.

EXERCISES

Answers are at the end of the lesson summary.

Question 1: Which of the following is a permanent change of station?

a. A move by an Air Force pilot to an airbase for a six-month detail

b. A move by an Army sergeant to his home two years after he ended active duty

c. A move by a new enlistee from her home to her first post of duty

d. A temporary move by a U.S. Marine to attend a six-month training program

What expenses are included in the moving expense adjustment?

Qualifying military moving expenses fall into the following two categories, the cost of:

- Moving household goods and personal effects
- Reasonable travel and lodging expenses

To qualify as "reasonable," the route taken must be the shortest, most direct route available, from the former home to the new home. Additional expenses for stopovers, side trips, or pre-move house hunting expenses are not deductible as moving expenses. Only miles traveled from the old home to the new home is included in the calculations.

Qualifying expenses that exceed government allowances and reimbursements are deductible.

How do I handle military reimbursements?

Determine whether any moving allowances or reimbursements provided by the government should be included in a service member's income, and how to accurately report the deduction on Form 1040.

What is a Personally Procured Move (PPM)?

Typically, Armed Forces members move their own household items in a personal or rented vehicle; this is called a Personally Procured Move (PPM), formerly known as a Do-It-Yourself (DITY) move. The Armed Forces provides an incentive payment equal to 95% of the estimated cost to the government for PPM. When the move is completed, the Armed Forces member provides receipts and paperwork to substantiate authorized expenses. The net financial profit is taxable and is reported on a separate Form W-2.

How do I report a PPM?

PPM payments are reported on Form W-2 and are entered as wages on Form 1040.

Armed Forces members may not take a moving expense deduction based on the expenses approved by the finance office when settling the PPM, as they have already been used to reduce taxable income.

Captain Cook receives orders for a PCS. He chooses to pack and drive his household goods to the new duty station in his own vehicle. The Air Force estimates that the move would have cost the government $2,500. Captain Cook's actual expenses for the move were $1,750. He receives a payment for $2,375 (95% of the government's estimate), but Form W-2, Box 1, will show only $625 ($2,375 minus $1,750) for the PPM. Captain Cook cannot deduct any of his expenses, since he's already been reimbursed.

What forms of reimbursement are *not* included as income?

Certain forms of reimbursement provided by the government are *not* to be included as income on the Armed Forces member's tax return.

- Moving or storage services furnished to the Armed Forces member
- Nontaxable allowances such as:
  - Dislocation allowance
  - Temporary lodging allowance
  - Mileage allowance in lieu of transportation
  - Per diem allowance
  - Move-in housing allowance (MIHA)

EXERCISES (continued)

Question 2: Sgt. Bishop received Form W-2 for $1,000 as a result of a PPM to a new Permanent Duty Station (PDS). In addition, the government paid her a mileage allowance of $300, a lodging allowance of $200, and a dislocation allowance of $1,200. How much should Sgt. Bishop include in her wages on Form 1040?

a. $1,500

b. $1,000

c. $300

d. $200

How do I calculate the adjustment?

Deductions can only be claimed for expenses not covered by a nontaxable reimbursement or moving allowance. If the taxpayers have allowable expenses that exceed the amount they were reimbursed, Form 3903 should be completed. Form 3903 is not needed if all the taxpayers' reimbursements were nontaxable allowances that were greater than their expenses.

The tax software addresses the Armed Forces PCS move and calculates the standard mileage amount based on miles traveled for the move. See the Important Changes lesson or the Volunteer Resource Guide for the standard mileage rate.

Taxpayer Interview and Tax Law Application

Here's how a volunteer could help Mrs. Fannin determine if she had any deductible moving expenses:

Sample Interview

Volunteer Says...	Mrs. Fannin Responds...
You said you just moved here during June of this year. Was this a PCS move?	Yes, my husband was transferred here in March, shortly before he deployed. I have family close by, so I'd rather stay here while he's overseas.
If your expenses were more than the Armed Forces reimbursement, you may be able to use the difference to reduce your gross income. We'll complete Form 3903 to see how it comes out. Did you bring your travel voucher with you?	It's right here. We drove our own car 1,000 miles to get here, and paid $120 for gas. We paid $300 for motels and $135 for meals on the way. The military moved our household goods, and we didn't have any overweight.
Did you drive directly here, or did you take any side trips?	We came right here so we could settle in before he deployed.
The IRS will let you use the standard mileage rate for a military move. To determine the moving mileage rate, let's look at Publication 4012 and multiply the rate times the number of miles.	Okay
The IRS allows lodging costs, but not food. So your total allowable expenses includes $300 for the motels and your mileage expenses. The travel voucher shows a total of $400 in reimbursements – did you receive any other reimbursements or allowances?	No, that's it.
Then you'll get to deduct the amount you spent that was more than your reimbursement. [On the intake and interview sheet, be sure to note that you've addressed this adjustment.]	

When should an Armed Forces member claim the deduction?

Armed Forces members who use the cash method of accounting (the most common) and have qualified expenses exceeding their reimbursement can deduct the expenses either in the year they paid them or in the year reimbursement was received. If taxpayers choose to deduct their moving expenses in the year of reimbursement, they can deduct:

- Expenses paid in a year before the year of reimbursement, or
- Expenses paid in the year immediately after the year of reimbursement but by the due date, including extensions, for filing the return for the reimbursement year.

If expenses are deducted and reimbursement is received in a later year, the reimbursement must be included in income.

EXERCISES (continued)

Question 3: In November of the current year, Petty Officer Wharton moved from California to Washington. The move qualified as a PCS. He incurred $800 in mileage expenses and $1,600 in lodging. He paid $1,400 to ship household goods over the allowed weight limit, and $500 to ship his dog. The following year, he filed his travel voucher and received $2,400 mileage and travel allowance. He also received a $1,500 dislocation allowance.

For what tax year(s) can Petty Officer Wharton claim his moving expenses on Form 3903?

a. Next year only

b. Current year only

c. Either current year or next year

Taxpayer Interview and Tax Law Application

Amanda was relocated to another Air Force base. Here's how a volunteer could help Amanda determine if she had any deductible moving expenses:

Sample Interview

Volunteer Says...	Amanda Responds...
So, you were transferred from Maxwell Air Force Base to Scott Air Force Base last year, right?	Yes, I was reimbursed $400 for travel expenses on the way to Scott Air Force Base.
Did you receive any other allowances?	Yes, I also received a $1,000 dislocation allowance.
Well the reimbursements were not reported on your W-2. You can only deduct expenses that are larger than your combined reimbursements and allowances. First, let's add all your qualified expenses. How much was your travel and lodging?	I spent $575 on travel and lodging and another $200 for meals along the way.
Any other expenses?	Yes, I gave a $350 security deposit to my new landlord.
Only the travel and lodging en route can be claimed on Form 3903. The security deposit and meals are not deductible expenses. Your reimbursement and dislocation allowances add up to $1,400. Since that's more than your expenses, you don't have anything to deduct. But, you don't have to include any of the excess reimbursement as income, either.	

Summary

This lesson described the types of expenses that members of the Armed Forces can deduct as an adjustment to income. These expenses are deductible on Form 1040, Schedule 1.

What situations are out of scope for the VITA/TCE programs?

While this list may not be all inclusive, it is provided for your awareness only. The following is out of scope for this lesson:

- Form 2106 for other than reservists' travel expenses

To gain a better understanding of the tax law, complete the practice returns(s) for your course of study using the Practice Lab on L&LT.

You may not be able to complete the entire exercise if some of the technical issues in the exercise are not covered until later lessons. In these instances, complete as much of the exercise as you can. Come back later to finish the exercise after you cover all the technical topics.

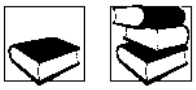
EXERCISE Answers

Answer 1: c. A move by a new enlistee from her home to her first post of duty is considered a PCS.

Answer 2: b. The $1,000 PPM payment should be included as wages. However, nontaxable allowances such as dislocation allowances, temporary lodging allowances and mileage allowances provided by the Armed Forces should not be included as gross income on the service member’s tax return, even if they exceed allowable expenses.

Answer 3: c. Because Petty Officer Wharton paid for moving expenses in the year prior to the year of reimbursement, he can claim all of his moving expenses on Form 3903 in either the year he paid or the year he was reimbursed.

Standard Deduction and Tax Computation



Introduction

This is the first of eight lessons covering computing taxable income, tax, and allowable credits. After completing this lesson on standard deductions and the Itemized Deductions lesson, you will be able to subtract the appropriate deduction, and if the taxpayer qualifies, the qualified business income deduction from the taxpayer's adjusted gross income (AGI) to figure their taxable income.

Objectives

At the end of this lesson, using your resource materials, you will be able to:

- Determine the standard deduction amount for most taxpayers
- Determine the standard deduction amount for taxpayers claimed as dependents
- Determine the amount of qualified business income deduction, if any
- Identify how taxable income and income tax are computed and reported

What are deductions?

In addition to the deductions covered in the Adjustments lesson, there are additional deductions that are subtractions from a taxpayer's AGI. They reduce the amount of income that is taxed. Most taxpayers have a choice of taking a standard deduction or itemizing their deductions. When taxpayers have a choice, they should use the type of deduction that results in the lower tax. Use the interview techniques and tools discussed in earlier lessons to assist you in determining if the standard deduction will result in the largest possible deduction for the taxpayer. Be sure to consider your state's deduction rules.

What is a standard deduction?

A standard deduction for most taxpayers is a set dollar amount based on the taxpayer's filing status. An increased standard deduction is available to taxpayers who are 65 or older or blind. There are limitations on the standard deduction for taxpayers who can be claimed as a dependent on someone else's return. The current year's standard deduction amounts are included in the Important Changes lesson of this publication and in the Volunteer Resource Guide, Tab F, Deductions. The software will use the applicable standard deduction based on your entries in the software.

James, 44, and Sara, 39, are filing a joint return. Neither is blind, and neither can be claimed as a dependent. They decided not to itemize their deductions. They will use the Married Filing Jointly standard deduction amount. The standard deduction amount can be found in the Standard Deduction Chart in the Volunteer Resource Guide.

What is an itemized deduction?

Itemized deductions allow taxpayers to reduce their taxable income based on specific personal expenses. If the total itemized deductions are greater than the standard deduction, it will result in a lower taxable income and lower tax. In general, taxpayers benefit from itemizing deductions if they have mortgage interest, very large unreimbursed medical or dental expenses when compared to their income, state taxes, or other large expenses such as charitable contributions. Itemized deductions will be covered in the next lesson.

Who cannot take the standard deduction?

Some taxpayers cannot take the standard deduction and must itemize. During the interview, find out if the taxpayer is:

- Filing as Married Filing Separately and the spouse itemizes regardless of who files first.
- A nonresident or dual-status alien during the year (and not married to a U.S. citizen or resident at the end of the year) – both are out of scope for the VITA/TCE programs
- Filing a return for a short tax year due to a change in the annual accounting period - out of scope for the VITA/TCE programs

If any of these situations apply, the taxpayer must itemize personal deductions and complete Schedule A.

A married taxpayer who qualifies to file as Head of Household may claim the standard deduction even though their spouse files as Married Filing Separately and itemizes.

Chase files as Married Filing Separately. Her spouse, Grant, will be itemizing his deductions. Chase cannot use the standard deduction; she will have to itemize her deductions.

The standard deduction is automatically calculated based on entries in the Basic Information section.

How does age or blindness affect the standard deduction?

The standard deduction is higher if the taxpayer or spouse is 65 or older, and if one or both are blind. This information is reported in the check boxes located on Form 1040 or Form 1040-SR. The more check boxes marked, the higher the standard deduction. Be sure to verify the taxpayer's and spouse's age and level of blindness as described below.

The Age 65 or older boxes are automatically checked. For software entries, go to the Volunteer Resource Guide, Tab B, Starting a Return and Filing Status.

Sherman is 73 years old and blind. He files as Single using Form 1040. Because Sherman is over 65 and blind, check the appropriate box in the software.

Who qualifies as 65 or older?

Taxpayers are entitled to a higher standard deduction if they are 65 or older at the end of the year. They are considered to be 65 on the day before their 65th birthday. In other words, a person born on January 1 is considered to be 65 on December 31 of the previous year.

The standard deduction for decedents is the same as if they had lived the entire year; however, if taxpayers die before their 65th birthday, the higher standard deduction does not apply.

Armando died on November 24. He would have been 65 if he had reached his birthday on December 12 of that same year. He does not qualify for a higher standard deduction for being 65 because he died before reaching his 65th birthday.

Who qualifies as blind?

Taxpayers are entitled to a higher standard deduction if they are considered blind on the last day of the year and they do not itemize their deductions. A taxpayer who is not totally blind must have a certified statement from an eye doctor (ophthalmologist or optometrist) that:

- The taxpayer cannot see better than 20/200 in the better eye with glasses or contact lenses or
- The field of vision is not more than 20 degrees

If the eye condition is not likely to improve beyond these limits, the statement should include that fact. Taxpayers should keep the statement for their records.

If vision can be corrected beyond those limits only by contact lenses and the taxpayer can only wear the lenses briefly because of pain, infection, or ulcers, the taxpayer can take the higher standard deduction for blindness.

What if only one spouse is over 65 or blind?

Taxpayers can take the higher standard deduction if one spouse is 65 or older, or blind, and if:

- The taxpayer files a joint return, or
- The taxpayer files a separate return and can claim an exemption for the spouse because the spouse had no gross income and an exemption for the spouse could not be claimed by another taxpayer

What is the standard deduction based on age or blindness?

The standard deduction for taxpayers who are 65 or older or are blind increases for each box checked for age or blindness. This amount can be found in the Standard Deduction Chart in the Volunteer Resource Guide, Tab F, Deductions.

Tim is 67 and is filing as Single. He is not blind and he cannot be claimed as a dependent on someone else's return. He is able to check one box and his standard deduction is computed using the chart in the Volunteer Resource Guide, Tab F, Deductions.

Kevin and Jane are both 60, and Jane is blind. They are filing as Married Filing Jointly. Neither can be claimed as a dependent on someone else's return. They are entitled to the regular standard deduction for married filing jointly plus an additional amount for being blind.

EXERCISES

Use the Standard Deduction Chart in the Volunteer Resource Guide, Tab F, Deductions to complete the following exercises. Answers are at the end of the lesson summary.

Question 1: Roderick is 64 and blind. Can he claim an additional deduction?

a. Yes

b. No

Question 2: Leticia died in May just before reaching her 65th birthday. Does she qualify as age 65?

a. Yes

b. No

What about individuals who can be claimed as dependents?

The standard deduction is generally lower for an individual who can be claimed as a dependent by another taxpayer. Taxpayers who can be claimed as a dependent must use the Standard Deduction Worksheet for Dependents to determine their standard deduction. The worksheet can be found in the Volunteer Resource Guide, Tab F, Deductions and the dependent's standard deduction can be summarized as:

- $400 plus earned income
- Minimum: $1,150
- Maximum: the regular standard deduction amount
- Plus the additional amount for age 65 or older or blind, if applicable

Remember that if the person that could claim the dependent does not have to file (and does not file a return or files only to get a refund of withheld or paid in), the “dependent” is not a dependent for all tax purposes and can use the normal standard deduction.

A dependent’s standard deduction will be automatically calculated, as long as the box indicating they can be claimed as a dependent by another taxpayer has been checked. For software entries, go to the Volunteer Resource Guide, Tab B, Starting a Return and Filing Status.

Janet is single, 22, a full-time student, and not blind. Her parents claimed her as a dependent on their current year tax return. She has no itemized deductions, so she will compute her standard deduction using the Standard Deduction Worksheets for Dependents.

How do I determine which deduction is best for the taxpayer?

If taxpayers are not required to itemize, they should take the higher of the standard deduction or the itemized expenses deduction. In general, taxpayers will benefit from itemizing their deductions if they have mortgage interest, state taxes, qualified charitable contributions, or if unreimbursed medical/dental expenses are large compared to their income. During the interview, ask the taxpayer if any of the following were applicable during the tax year:

- Large out-of-pocket medical and dental expenses
- State and local income taxes, or state and local general sales tax, plus real estate and personal property taxes
- Qualified home mortgage interest
- Gifts to charity
- Certain other miscellaneous deductions

If the taxpayer’s expenses qualify, itemizing may be a better choice.

The taxpayer’s standard deduction is automatically calculated and displayed on page 1 of the Form 1040 screen. The software automatically selects the deduction method that gives the taxpayer the best result, but only if Schedule A information is entered. For software entries, go to the Volunteer Resource Guide, Tab F, Deductions.

What is the deduction for qualified business income (QBI)?

For taxable years beginning after December 31, 2017 and before January 1, 2026, there is a deduction for "pass through" businesses. Sole proprietors are categorized as "pass through" businesses.

- A sole proprietor will be able to take up to 20% of qualified business income (QBI) as a deduction on the tax return
- REIT dividends (Sec. 199A dividends) are also eligible for the 20% QBI deduction

- The calculations on Schedule C and Schedule SE are not affected by the deduction
- The calculations of earned income (for EIC or ACTC) or compensation (for IRA contribution purposes) are not affected by the QBI deduction
- Taxable income is not reduced below zero by the 20% deduction
- The 20% deduction is limited for higher incomes
- The deduction will also be limited for specified service trades or businesses when the applicable threshold is exceeded

For taxable income that does not exceed the applicable threshold amount the QBI deduction is the lesser of:

- 20% of qualified business income (for example, it is the net profit reported on a Schedule C) plus 20% of qualified REIT (Sec. 199A) dividends or
- 20% of taxable income (equals adjusted gross income minus the applicable standard or itemized deduction) minus net capital gains and qualified dividends. See Form 1040 instructions for details.

Qualified business income is reduced by the deductible part of the self-employment tax, the self-employment health insurance deduction, and by contributions to certain qualified retirement plans (not traditional IRA deductions). Based on the taxpayer's entries, the software will compute the QBI if applicable.

When a taxpayer is itemizing, claiming health insurance premiums on Schedule A and a greater QBI deduction may produce a better result than claiming the S-E health insurance deduction. Test both ways and compare combined federal and state results.

The tax software computes the QBI deduction and completes Form 8995, Qualified Business Income Deduction Simplified Computation. Taxpayers with pass-through business income from an entity on a Schedule K-1, income over the threshold amount, or who require Form 8995-A, Qualified Business Income Deduction, should be referred to a professional tax preparer. Refer to the Important Changes lesson or to the Volunteer Resource Guide, Tab F for the threshold amounts.

How are taxable income and tax determined?

Tax is based on the amount of taxable income, which is determined by subtracting from the AGI:

- Standard or itemized deductions
- Deduction for qualified business income (QBI)

How is tax computed?

Tax on taxable income is figured using the tax tables or the tax rate schedule for higher incomes. Separate worksheets are used to calculate the tax for taxpayers with certain types of income, such as capital gains and qualifying dividends, or foreign earned income. There are other tax computations listed in the instructions to Form 1040, which are out of scope for the VITA/TCE programs.

The software automatically calculates tax based on previous entries. It is important to enter all income, deduction, and credit information correctly for the tax to be computed accurately.

What is the tax for certain children who have unearned income (Kiddie Tax)?

For children under age 18 and certain older children, unearned income over a certain amount is taxed using the tax rates applicable to their parent(s). For this purpose, “unearned income” includes all taxable income other than earned income, such as taxable interest, ordinary dividends, capital gains, rents, royalties, etc. It also includes taxable Social Security benefits, pension and annuity income, taxable scholarship and fellowship grants not reported on Form W-2, unemployment compensation, alimony, and income received as the beneficiary of a trust.

Form 8615, Tax for Certain Children who have Unearned Income, is in scope for Native Americans receiving per capita payments and Alaska residents receiving permanent fund dividends. Form 8814, Parent's Election to Report Child's Interest and Dividends, is in scope for Alaska residents receiving permanent fund dividends. In all other circumstances, tax returns for children subject to the Kiddie Tax or a parent's election to include their child's income are out of scope for the VITA/TCE programs. The following information is presented for awareness.

The Kiddie Tax might apply if all the following are true:

1. The child's unearned income was more than the ceiling amount. See the Important Changes lesson in this publication for this amount.
2. The child is required to file a return for the tax year.
3. The child either:
   - Was under age 18 at the end of the year,
   - Was age 18 at the end of the year and did not have earned income that was more than half of his or her support, or
   - Was a full-time student at least age 19 and under age 24 at the end of the tax year and did not have earned income that was more than half of the child's support.
   - At least one of the child's parents was alive at the end of the tax year.
   - The child does not file a joint return for the tax year.

Refer to the Volunteer Resource Guide, Tab A, Chart B for the filing requirements for dependents. Refer to Do you have to use Form 8615 to figure your child's tax? in the Volunteer Resource Guide, Tab H, Other Taxes, Payments, and Refundable Credits.

Summary

You should be able to identify those who can take the standard deduction, and how the deduction is affected by their filing status, age, blindness and status as a dependent. All of this will make it easier for you to help taxpayers understand how their deduction is computed and how it affects their tax.

Taxpayers who are considered sole proprietors may take up to 20% of their qualified business income as a deduction on the return. Taxpayers with qualifying REIT dividends may also be eligible for the QBI deduction.

You should also understand that the tax computation is based on taxable income and may be computed using a worksheet if the taxpayer has qualifying dividends or capital gains, foreign earned income, or is subject tot he kiddie tax. The tax may be further reduced by tax credits to be covered in an upcoming lesson.

Students who opt to include scholarships in income that exceed the unearned income ceiling amount may be subject to the Kiddie Tax, in which case the return is out of scope.

You are now ready to work with itemized deductions in the next lesson.

What situations are out of scope for the VITA/TCE programs?

The following are out of scope for this lesson. While this list may not be all inclusive, it is provided for your awareness only.

- Pass-through business income shown on any Schedule K-1 (Sec. 199A dividends are in scope)
- Taxpayers with carryover losses from the prior year for QBI deduction purposes
- Taxable income before the QBI deduction that is greater than the threshold amounts
- Form 8995-A or its schedules
- Forms 8615 or 8814, except for Native Americans or Alaska residents as noted above

To gain a better understanding of the tax law, complete the practice return(s) for your course of study using the Practice Lab on L&LT.

EXERCISE Answers

Answer 1: a, Yes. Roderick is entitled to an additional standard deduction amount for blindness.

Answer 2: b, No.

Itemized Deductions

Introduction

This lesson will assist you in determining if a taxpayer should itemize deductions. Generally, taxpayers should itemize if their total allowable deductions are higher than the standard deduction amount.

Objectives

At the end of this lesson, using your resource materials, you will be able to:

- Determine if a taxpayer should itemize deductions
- Determine the type of expenses that qualify as itemized deductions
- Accurately report itemized deductions on Schedule A, Itemized Deductions
- Explain the recordkeeping requirements for claiming charitable contributions

What do I need?

- Form 13614-C
- Publication 4012
- Publication 17
- Form 1040
- Schedule A
- Publication 502
- Publication 526
- Publication 936

Optional:

- Publication 529
- Publication 530
- Publication 561

What are itemized deductions?

Itemized deductions are subtractions from a taxpayer's Adjusted Gross Income (AGI) that reduce the amount of income that is taxed. Most taxpayers have a choice of taking a standard deduction or itemizing deductions. Taxpayers should use the type of deduction that results in the lowest tax.

Who must itemize?

Taxpayers who have a standard deduction of zero should itemize their deductions. Taxpayers who normally fall within this category are:

- Married, filing a separate return, and their spouse is itemizing — regardless of who files first
- Filing a return for a short tax year due to a change in the annual accounting period (out of scope)
- Considered to be nonresident aliens or dual status aliens during the year (and not married to a U.S. citizen or resident at the end of the tax year) (out of scope)

A married taxpayer who qualifies to file as head of household may claim the standard deduction even though their spouse files as Married Filing Separately and itemizes.

How do I decide if a taxpayer should itemize deductions?

In general, taxpayers who have deductible mortgage interest, state taxes, charitable contributions, or a very large amount of unreimbursed medical/dental expenses compared to their income would benefit from itemizing their deductions.

Use the Interview Tips – Itemized Deductions in the Volunteer Resource Guide, Tab F, Deductions, to determine if itemizing deductions would be more beneficial for the taxpayer. If you think the taxpayer may benefit from itemizing for federal or state purposes, enter the qualified expenses on Schedule A. The tax software will automatically select the larger of itemized versus standard deduction.

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Itemized deductions include amounts paid for qualified:

- Medical and dental expenses
- Certain taxes paid
- Home mortgage interest
- Gifts to charity
- Casualty and theft losses (only losses derived from federally declared disaster areas are allowed)
- Certain miscellaneous deductions

Casualty and theft losses are outside the scope of the VITA/TCE programs. Refer taxpayers with these losses to a professional tax preparer.

What medical and dental expenses are deductible?

Taxpayers can deduct only the amount of unreimbursed medical and dental expenses that exceeds 7.5% of their Adjusted Gross Income (AGI).

The standard mileage rate allowed for out-of-pocket expenses for a car when used for medical reasons can be found in the Important Changes lesson of this publication or the Volunteer Resource Guide, Tab F, Deductions. Taxpayers can also deduct parking fees and tolls.

Whose expenses are covered?

Qualified medical and dental expenses paid by the taxpayer during the tax year can be included for:

- The taxpayer
- The taxpayer's spouse
- Dependents claimed at the time the medical services were provided or at the time the expenses were paid
- Individuals who could be the taxpayer's dependent except:
  - They do not meet the gross income test, or
  - They do not meet the joint return test, or
  - The taxpayers, or their spouse if filing jointly, could be claimed as a dependent on someone else's return

If a child of divorced or separated parents is claimed as a dependent on either parent's return, each parent may deduct the medical expenses that they individually paid for the child.

Stewart and Carmen are divorced. Their son, Raymond, lives with Carmen, who claims him as a dependent. Carmen paid for and deducted Raymond's standard medical and dental bills. Stewart deducted the emergency bill he paid when Raymond broke his arm.

What types of expenses are covered?

Generally, medical expenses must be paid during the tax year and may include payments for:
- Diagnosis, cure, mitigation, treatment, or prevention of disease
- Treatments affecting any part or function of body
- Equipment, supplies, and diagnostic devices
- Premiums for insurance that covers medical care
- Long-term care insurance premiums (limited by age - see the Important Changes lesson)
- Transportation/travel to get medical care
- Home improvements needed for mobility or medical care

Refer to the Volunteer Resource Guide, Tab F, Publication 17 for the medical and dental expenses checklist, and Publication 502, Medical and Dental Expenses, for more information on medical, dental, and other expenses.

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What types of expenses are not covered?

Examples of non-qualified expenses include:

- Cosmetic surgery
- Funeral or burial expenses
- Nonprescription drugs, except insulin
- Weight loss program that is not prescribed
- Diet food

Retired public safety officers cannot include as medical expenses any health or long-term care premiums they elected to have paid with tax-free distributions from their retirement plan.

Some taxpayers may receive reimbursements from their employers, prior employers or insurance companies. Only unreimbursed costs qualify for deduction.

If you and a taxpayer disagree as to whether a particular expense is deductible, discuss the issue with the Site Coordinator. The taxpayer may be correct, but you should not deduct an expense if you believe it would lead to a false return.

EXERCISES

Answers are at the end of the lesson summary.

Question 1: Bill and Kathy Ferris file a joint return. They paid the medical and dental bills listed below. The total of Bill and Kathy's qualified medical expenses is $ _____.

Medical Expenses	Amount	Deductible?
Unreimbursed doctors' bills	$500	
Unreimbursed orthodontist bill for braces	$1,200	
Hospital insurance premiums	$300	
Life insurance premiums	$500	
Unreimbursed prescription medicines	$100	
Vitamins	$70	
Hospital bill (before insurance company's reimbursement of $1,000)	$2,000	
Smoking-cessation program	$150	
Total	$4,820	

Taxpayers may only deduct unreimbursed medical expenses. They may not deduct medical insurance premiums paid with pretax dollars, reimbursed by an insurance company, reimbursed by a current or prior employer, or reimbursed through a tax-advantaged account, such as an flexible spending account (FSA) or health savings account (HSA).

For taxpayers who receive the premium tax credit (PTC), only the premiums paid out of pocket by the taxpayer and not covered by the PTC, may be used as a medical expense when itemizing deductions. For example, if the taxpayer's insurance policy premium was $12,000 and they received a PTC of $10,000, they would only be able to deduct the $2,000 premiums paid out of pocket by the taxpayer as a medical expense deduction, subject to the appropriate applicable adjusted gross income threshold for itemized medical expenses.

Taxpayers may also deduct the excess APTC they have to repay on the return or reduce their deduction for any additional net PTC they claim on the return.

What taxes may be deductible?

Taxpayers can deduct certain taxes if they itemize. To be deductible, the tax must have been imposed on and paid by the taxpayer during the current tax year. Taxes that are deductible include:

- State and local income taxes – This includes withheld taxes, estimated tax payments, or other tax payments (such as a prior year state or local income tax refund that the taxpayer chose to credit to their estimated tax for the following year). Do not include penalties or interest.

- Sales taxes – It may be possible to deduct sales taxes in lieu of state and local income taxes (from the optional sales tax tables or actual sales tax paid). Taxpayers who use the tables may be able to add the state and local general sales taxes paid on any motor vehicle, boat, aircraft, or home construction or improvement to the tax table amounts.

Taxpayers may deduct either sales tax or state and local income tax, but not both.

- Real estate taxes
  - State and local real estate taxes based on the assessed value of the taxpayer's real property, such as the taxpayer's house or land, are deductible.
  - Taxes based on other than the assessed value of the property (such as a parcel tax) may be deductible in certain circumstances if they are levied:
    - For the general public welfare
    - By a proper taxing authority
    - At a similar rate on owners of all properties in the taxing authority's jurisdiction
  - Real estate taxes, which may be reported on Form 1098, Mortgage Interest Statement, or a similar statement from the mortgage holder, are deductible. If the taxes are not paid through the mortgage company, the taxpayer should have a record of what was paid during the year.
  - Some real estate taxes or charges that may be included on the real estate tax bill are not deductible. These include taxes for local benefits and improvements that tend to increase the value of the property, itemized charges for services, transfer taxes, rent increases due to higher real estate taxes, and homeowners' association fees.

Real estate taxes reported on Form 1098 may include nondeductible amounts. Use the interview techniques with taxpayers to determine if nondeductible amounts such as sanitation pickup and water fees are included in their Form 1098. These items should not be included on Schedule A.

  - Personal property taxes
    - The state and local personal property taxes paid, but only if the taxes were based on value alone and were imposed on a yearly basis.

Which taxes are not deductible?

Not all taxes are deductible and some items aren't actually classified as taxes. Some examples include employment taxes, federal income taxes, and license fees. No deduction is allowed for foreign property taxes unless it relates to a trade or business or for the production of income.

How do I handle taxes that are deductible?

Deductible taxes are reported on Form 1040, Schedule A in the Taxes You Paid section. The aggregate deduction for state or local income (or sales taxes in lieu of income taxes) and state or local property taxes is limited to $10,000 ($5,000 if Married Filing Separately) per return.

State and local income taxes or state and local sales taxes

Include tax withheld, estimated tax payments to a state or local government, and tax payments for an earlier year paid during the current tax year. Do *not* include penalties or interest. Enter both the state and local income taxes and the state and local sales taxes. The software will use the greater amount.

The sales tax deduction using the sales tax tables is based on the taxpayer's MAGI. Be sure to add any tax-exempt income (that is not already entered in the software) in the sales tax worksheet. Examples include life insurance proceeds, cash inheritances or gifts, or VA benefits.

The total deduction for state and local income, sales, and property taxes is limited to a combined, total deduction of $10,000 ($5,000 if Married Filing Separately). Any state and local taxes paid above this amount cannot be deducted as an itemized deduction. Taxes claimed on Schedule C, on Schedule E, or for the production of income on Schedule A, line 6, are not subject to the limitation.

Foreign income taxes

Generally, income taxes that were paid to a foreign country can be taken as an itemized deduction on Schedule A, line 6, or as a credit against U.S. income tax on Form 1040. More information will be provided on this credit in subsequent lessons. You should compare claiming the foreign taxes paid as a nonrefundable credit to taking it as an itemized deduction and use whichever results in the lowest tax. Only the Simplified Limitation Election for the foreign tax credit is in scope for Advanced certification. To be eligible for this election, qualified foreign taxes must be $300 ($600 if MFJ) or less.

See the Taxes chapter in Publication 17 for more information.

EXERCISES (continued)

Question 2: Which of the following taxes are deductible on Schedule A?

a. Federal income tax

b. State, local, and foreign income tax and real estate tax

c. Tax on alcohol and tobacco

d. Foreign sales tax

Question 3: For a tax to be deductible, a tax must be ____. (Select all that apply.)

a. Imposed during the tax year

b. Imposed on the taxpayer

c. Paid during the tax year

d. Paid by the taxpayer

How do I handle interest paid?

Certain types of interest payments qualify as itemized deductions. Home mortgage interest, points (paid as a form of interest), and investment interest can be deducted on Schedule A. Investment interest is outside the scope of the VITA/TCE programs and taxpayers with investment interest should be referred to a professional tax preparer.

Investment interest includes margin interest shown on a brokerage statement.

Home Mortgage Interest

Generally, home mortgage interest is any interest paid on a loan, line of credit, or home equity loan on the taxpayer's main home or second home that is secured by the taxpayer's main home or second home, respectively. The deduction for home equity mortgage interest is not allowed unless the loan proceeds were used to build, buy, or substantially improve the taxpayer's qualified residence. Additionally, the amount of total qualified home mortgage debt, the interest on which may be deductible, may be subject to a cap. Interest paid on debt in excess of the cap is not deductible. The flow chart Is My Home Mortgage Interest Fully Deductible? in Publication 936, Home Mortgage Interest Deduction, will help you determine if interest paid by the taxpayer should be included on Schedule A.

Taxpayers who received a Mortgage Credit Certificate must be referred to professional tax preparer.

Members of the clergy and military can deduct qualified mortgage interest even if they receive a nontaxable housing allowance. Returns for members of the clergy are out of scope.

If a taxpayer refinances their qualified home mortgage increasing the loan to take out cash used for nonqualified purposes, the interest on the qualified home mortgage amount is deductible. Principal payments are applied first to the nonqualified debt. See Publication 936 for details.

Berti refinanced his qualified home mortgage of $325,000 for a new loan of $375,000 at 3% using the additional $50,000 for personal purposes. He will use his new interest rate on $325,000 to compute his deduction until such time as the loan balance is less than $325,000. The interest on $325,000 (3% x $325,000 = $9,750 for a full year) remains deductible. The rest of the interest paid is for the nonqualified debt and is not deductible. The nondeductible interest on the personal portion will be less each year as principal payments are made.

Generally, the total amount of home mortgage interest paid by a taxpayer is shown on Form 1098. Only taxpayers who are legally liable for the debt can deduct the interest in the year it is paid. Remember that taxpayers may have more than one mortgage or may have refinanced during the year and may have multiple Mortgage Interest Statements.

When the taxpayer does not receive a Form 1098, such as a seller-financed mortgage, additional information is needed to complete Schedule A. See Form 1040 Schedule A instructions.

See the Temporary Provisions lesson contained in this publication for information regarding qualified mortgage insurance premiums.

*A taxpayer may be able to deduct interest on a main home **and** a second home. A home can be a house, cooperative apartment, condominium, mobile home, house trailer, or houseboat that has sleeping, cooking, and toilet facilities.*

From 1991 through 1998, Alfredo and Cindy Kendall obtained home equity loans totaling $91,000. Alfredo and Cindy used the loans to pay off gambling debts, overdue credit payments, and some medical expenses.

The current balance of Alfredo and Cindy's home equity loan is $72,000. The fair market value of their home is $230,000, and they carry $30,000 of outstanding acquisition debt (the amount used to buy, build, or improve their home).

If Alfredo and Cindy file a joint return, they cannot deduct the interest on their home equity loans because none of the loan proceeds was used to build, buy, or improve the taxpayer's qualified residence. The interest on the acquisition debt is deductible.

Reverse Mortgages

A reverse mortgage is a loan where the lender pays the homeowner (in a lump sum, a monthly advance, a line of credit, or a combination of all three) while the owner continues to live in the home and retains title to the home. Depending on the plan, the reverse mortgage becomes due, with interest, when the owner moves, sells the home, reaches the end of a preselected loan period, or dies. Because reverse mortgages are considered loan advances and not income, the amount received isn't taxable.

Any interest (including original issue discount) accrued on a reverse mortgage is not deductible until the interest is paid. When the interest accrues, interest on a reverse mortgage must satisfy the qualified home mortgage interest criteria to be deductible.

Taxpayers who refinance qualified home mortgage debt with the same lender cannot deduct accrued interest "paid" with the new loan. The interest must be paid with new funds from the taxpayer or from a new lender.

What are points?

Points are the charges paid by a borrower and/or seller to a lender to secure a loan. They are also called:

- Loan origination fees (including VA and FHA fees)
- Maximum loan charges
- Premium charges
- Loan discount points
- Prepaid interest

When are points deductible?

Only points paid as a form of interest (for the use of money) can be deducted on Schedule A. Generally, points must be spread over the life of the mortgage. However, if the loan is used to buy or build a taxpayer's main home, the taxpayer may be able to deduct the entire amount in the year paid.

Points paid to refinance a mortgage are generally not deductible in full the year they were paid, unless the points were paid in connection with the improvement of a main home and certain other conditions are met. Beware of certain charges that some lenders call points. Points paid for specific services, such as appraisal fees, preparation fees, VA funding fees or notary fees, are *not* interest and are *not* deductible.

Use the flow chart in Publication 936 to help determine if points are fully deductible.

What types of interest are not deductible?

Interest that *cannot* be deducted includes:

- Interest on car loans where the car is used for nonbusiness purposes
- Other personal loans
- Credit investigation fees
- Loan fees for services needed to get a loan
- Interest on a debt the taxpayer is not legally obligated to pay
- Finance charges for nonbusiness credit card purchases

EXERCISES (continued)

Question 4: Joe and Angela file a joint return. During the year, they made the interest payments listed below. The total of Joe and Angela's fully deductible interest for the tax year is $_____.

Interest Payments	Amount	Deductible?
Qualified interest on their home mortgage, reported on Form 1098	$2,180	
Credit card interest used for personal purchases	$400	
Points paid to refinance their mortgage for a better interest rate (None of the points qualify as interest.)	$1,500	
Interest on a car loan	$2,000	
Total	$6,080	

How do I handle gifts to charity?

A charitable contribution is a donation or gift to a **qualified organization**, which may be deductible if the taxpayer itemizes. Cash, check, and noncash contributions should be reported on Schedule A on either the Gifts by cash or check line or the Other than by cash or check line, respectively. Deductions may be taken for contributions to:

- Organizations that operate exclusively for religious, charitable, educational, scientific, or literary purposes
- Organizations that work to prevent cruelty to children or animals
- Organizations that foster national or international amateur sports competition if they do not provide athletic facilities or equipment
- War veterans' organizations
- Certain nonprofit cemetery companies or corporations
- The United States, or any state, the District of Columbia, a U.S. possession (including Puerto Rico), a political subdivision of a state or U.S. possession, or an Indian tribal government or any of its subdivisions that perform substantial government functions

To be deductible, contributions must be made to a qualifying organization, not an individual.

Qualified organizations are listed in Publication 78, Cumulative List of Organizations. An online version is offered to help taxpayers efficiently search organizations that are eligible to receive tax-deductible charitable contributions. To find out if the organization is a qualified charity, go to **www.irs.gov**.

Deductible items include:

- Monetary donations
- Dues, fees, and assessments paid to qualified organizations above the value of benefits received
- Fair market value of used clothing, furniture, and other items in good condition
- Cost and upkeep of uniforms that have no general use but must be worn while performing services donated to a charitable organization
- Unreimbursed transportation expenses that relate directly to the services the taxpayer provided for the organization
- Part of a contribution above the fair market value for items received such as merchandise and tickets to charity balls or sporting events
- Up to $50 per month for housing a foreign exchange student
- Unreimbursed expenses for fostering a child if placed by an agency eligible to accept charitable contributions
- Transportation expenses, including bus fare, parking fees, tolls, and either the cost of gas and oil or the standard mileage deduction may be taken. Refer to the Important Changes lesson or the Volunteer Resource Guide, Tab F for the standard mileage deduction for charitable contributions.

Form 1098-C, Contributions of Motor Vehicles, Boats and Airplanes, is out of scope if the value shown is more than $500. Taxpayers who have made these contributions should be referred to a professional tax preparer. No additional reporting is required for vehicle donations whose values is $500 or less.

Which gifts are *not* deductible?

Contributions to the following types of organizations are *not* deductible as charitable contributions:

- Business organizations, such as the Chamber of Commerce
- Civic leagues and associations
- Political organizations and candidates
- Social clubs
- Foreign organizations
- Homeowners' associations
- Communist organizations

Amounts that may *not* be deducted as charitable contributions include:

- Cost of raffle, bingo, or lottery tickets
- Tuition
- Value of a person's time or service
- Blood donated to a blood bank or Red Cross
- Car depreciation, insurance, general repairs, or maintenance
- Direct contributions to an individual
- Sickness or burial expenses for members of a fraternal society
- Part of a contribution that benefits the taxpayer, such as the fair market value of a meal eaten at a charity dinner
- Quid pro quo rule — the amount of a donation is reduced for the value of anything received in exchange, including a state or local tax credit, except if the value received is 15% or less of the donation amount. Reduce the value of the donation if the value of what is is received is more than 15% of the value of the donation. The amount of reduction may be deductible as a state tax if a state tax credit is what was received in exchange.

Susan ran a 10K organized by the Chamber of Commerce to benefit a qualified charitable organization. She paid the race organizers a $30 entry fee and received a "free" T-shirt and pancake breakfast after the race.

Susan did not make a contribution to the qualifying organization. She paid the Chamber of Commerce, which allotted funds to the benefiting organization. Therefore, none of Susan's entry fee is tax deductible. If the race had been organized by the qualifying organization itself, part of her entry fee may have been deductible.

What limits apply to charitable deductions?

Generally, a deduction for monetary contributions and noncash donations of property (whose value is less than its cost) to public charities cannot exceed 60% of AGI through tax year 2025. However, taxpayers whose charitable contributions total more than 20% or 30% of their AGI may be able to deduct only a percentage of their contributions depending on the type of gift and the type of charitable organization, generally private foundations. A donation that exceeds the limit may be carried over to a later tax year. More information on these limitations is available in Publication 526, Charitable Contributions. Individuals affected by limits on charitable deductions should be referred to a professional tax preparer.

What records must the taxpayer keep for charitable contributions?

Taxpayers must keep records to verify the cash and noncash contributions they make during the year. Advise taxpayers that they cannot deduct a cash contribution, regardless of the amount, unless one of the following records of the contribution is kept:

- A credit card statement or a bank record, such as a canceled check, a bank copy of a canceled check, or a bank statement containing the name of the charity, the date, and the amount
- A written communication or receipt from the charity, which must include the name of the charity, date of the contribution, and amount of the contribution

Single monetary contributions of $250 or more

Taxpayers can claim a deduction of $250 or more only if they have a contemporaneous written acknowledgment from the charitable organization showing the amount of any money contributed and whether the organization did or did not provide any goods or services in return for the contribution. During the interview, be sure to review the documentation requirements with the taxpayer and confirm that they have the appropriate documentation.

Out-of-pocket expenses related to donated services

For unreimbursed expenses related to donated services, the taxpayer must have:

- Adequate records of the expenses
- The organization's written acknowledgment and description of the taxpayer's services for unreimbursed expenses of more than $250

Only out-of-pocket expenses that are directly related to the donated services can be deducted. The value of time or services donated cannot be deducted. See Publication 526 for the rules applicable to out-of-pocket expenses incurred when rendering services to a qualifying organization.

What records must the taxpayer keep for noncash contribution deductions?

Deductions are not allowed for the charitable contribution of clothing and household items if the items are not in good used condition or better.

Noncash contributions less than $250

For any single contribution of less than $250, the taxpayer must keep:

- A receipt or other written communication from the organization or the taxpayer's own reliable written records for each donation, showing:
  - Name and address of the organization
  - Date and location of the contribution
  - Reasonably detailed description of the donated property
  - Fair market value of the donated property (usually thrift store value)

If the taxpayer is donating capital gain property or property that was previously depreciated, refer them to a professional tax preparer. See exception below for members of the military.

Noncash contributions of at least $250 but not more than $500

For any single contribution of at least $250 and not more than $500, the taxpayer must have all the documentation described for noncash contributions less than $250. In addition, the organization's written acknowledgment must state whether the taxpayer received any goods or services in return and a description and good faith estimate of any such items.

The taxpayer needs to provide the fair market value of noncash donations, usually thrift store value.

Noncash contributions of more than $500

Taxpayers with more than $500 in total noncash contributions must file Form 8283, Noncash Charitable Contribution, and should be referred to a professional tax preparer. See exception below for members of the military and for Tax-Aide.

EXERCISES (continued)

Question 5: Julia made the following contributions last year:

- $600 to St. Martin's Church (The church gave her a letter verifying the amount.)
- $32 to Girl Scouts (not for cookies!)
- $40 to a family whose house burned
- $50 for lottery tickets at a fundraiser
- $100 for playing bingo at her church

The amount that Julia can claim as deductible monetary contributions is $_____.

Noncash contributions of more than $500?

Noncash charitable contributions of more than $500 but not over $5,000 are in scope for active military taxpayers and for Tax-Aide. In figuring whether the deduction is $500 or more, combine claimed deductions for all similar items of property donated to any qualified organization during the year.

If taxpayers claim a deduction over $500 but not over $5,000 for a noncash charitable contribution, Form 8283, Section A, must be completed and taxpayers must have a contemporaneous written acknowledgment (defined earlier).

Form 8283 must include:

- Taxpayer's name and taxpayer identification number,
- The name and address of the qualified organization,
- The date of the charitable contribution, and
- The following information about the contributed property:

  a. A description of the property in sufficient detail under the circumstances (taking into account the value of the property) for a person not generally familiar with the type of property to understand that the description is of the contributed property;

  b. The fair market value of the property on the contribution date and the method used in figuring the fair market value;

  c. In the case of real or tangible property, its condition;

  d. In the case of tangible personal property, whether the donee has certified it for a use related to the purpose or function constituting the donee's basis for exemption under Section 501 of the Internal Revenue Code or, in the case of a governmental unit, an exclusively public purpose;

  e. In the case of securities, the name of the issuer, the type of securities, and whether they were publicly traded as of the date of the contribution;

  f. How the taxpayer got the property, for example, by purchase, gift, bequest, inheritance, or exchange;

  g. The approximate date the taxpayer got the property or, if created, produced, or manufactured by or for the taxpayer, the approximate date the property was substantially completed; and

  h. The cost or other basis, and any adjustments to the basis, of property held less than 12 months and, if available, the cost or other basis of property held 12 months or more. This requirement, however, doesn't apply to publicly traded securities.

What about casualty and theft losses?

Only casualty losses derived from federally declared disaster areas are deductible. All other losses are not allowed except to the extent of casualty gains. Taxpayers with deductible casualty and theft losses should be referred to a professional tax preparer.

What miscellaneous expenses are deductible and in scope?

Examples of miscellaneous itemized deductions include:

- Gambling losses and expenses (through 2025) to the extent of gambling winnings (taxpayers must have a record of their losses). The full amount of winnings, reduced for the cost of the winning wager, must be reported as income. The losses and expenses (up to the amount of winnings) can be claimed as an itemized miscellaneous deduction not subject to the 2% of AGI floor.
- Work-related expenses for an individual with physical or mental disabilities that enables them to work, such as attendant care services at their workplace
- **Tax-Aide only:** Loss on termination of an annuity by a deceased annuitant (see Pub 575).
    - Form 1099-R shows total distribution and an amount in box 5, employee contributions
    - Confirm the facts during the interview
    - Can claim the loss, not subject to 2% rule

Use the Bogart annuity calculator to determine the basis remaining that may be deducted.

Other miscellaneous deductions as listed in the instructions to Form 1040, Schedule A, are beyond the scope of the VITA/TCE programs.

All itemized deductions subject to the 2% of AGI limitation are not allowed through the end of 2025. This includes employee business expenses.

Gambling losses plus gambling expenses in excess of winnings are not deductible. The full amount of winnings must be reported as income and the losses (up to the amount of winnings) can be claimed as an itemized deduction.

EXERCISES (continued)

Question 6: Philip had the expenses shown below. What is the total of Philip's qualified miscellaneous itemized expenses? $_____.

Expense	Amount	Deductible?
Income tax preparation fee	$100	
Safe deposit box rental (to store bonds)	$75	
Life insurance premiums	$300	
Credit card convenience fee for income tax payment	$70	
Loss on sale of personal home	$1,800	
Investment journals and newsletters	$250	
Investment expenses	$200	
Attorney fees for preparation of a will	$100	
Total	$2,895	

Summary

Medical and Dental Expenses

Unreimbursed medical and dental expenses that exceed 7.5% of the taxpayer's AGI are deductible; they are reported on lines 1 through 4 of Schedule A.

Qualified medical and dental expenses are those paid during the tax year for the taxpayer, spouse, and dependents and certain nondependents.

Taxes

Deductible taxes are reported on Schedule A and include the following:

- State and local income taxes, or state and local general sales taxes
- State or local real estate taxes
- Personal property taxes

These taxes are subject to an aggregate limitation of $10,000 ($5,000 if Married Filing Separately).
Note: Taxes paid as part of a trade or business or for the production of income and foreign income taxes are not subject to the aggregate $10,000 limit.

Interest

Deductible interest is reported on Schedule A.

Generally, the taxpayer receives Form 1098, Mortgage Interest Statement, which shows the total amount of interest paid. To be deductible, the loan proceeds must be used to buy, build or improve the home and the interest must be paid by the taxpayer during the tax year. Only taxpayers who are legally liable for the debt can deduct the interest.

Only points paid as a form of interest (for the use of money) can be deducted on Schedule A. Generally, points must be spread over the life of the mortgage. However, if the loan is used to buy or build a taxpayer's main home, and certain other conditions are met, the taxpayer may be able to deduct the entire amount in the year paid.

Gifts to Charity

Qualified charitable contributions are reported on Schedule A. Taxpayers should be made aware of the documentation requirements that apply to charitable contributions.

The contributions to **qualifying organizations** that taxpayers can deduct include:

- Monetary donations
- Dues, fees, and assessments paid to qualified organizations above the value of benefits received
- Fair market value of used clothing and furniture at the time of donation
- Cost and upkeep of uniforms that have no general use but must be worn while performing donated services for a charitable organization
- Unreimbursed transportation expenses or out of pocket expenses that relate directly to the services the taxpayer provided for the qualifying organization
- Part of a contribution above the fair market value for items received such as merchandise and tickets to charity balls or sporting events

Taxpayers are required to keep receipts and records of all their contributions.

Miscellaneous Deductions

Only gambling losses and gambling expenses (through 2025) to the extent of gambling winnings and certain other items are in scope as miscellaneous deductions.

What situations are out of scope for the VITA/TCE programs?

The following is out of scope for this lesson. While this list may not be all inclusive, it is provided for your awareness only.

- Casualty and theft losses
- Taxpayers with a Mortgage Credit Certificate
- Investment interest
- Form 1098-C, Contributions of Motor Vehicles, Boats and Airplanes with a value over $500
- Taxpayers affected by limits on charitable deductions
- Taxpayers that file Form 8283 to report noncash contributions of more than $500, except for Tax-Aide and active Military returns with Military certification
- If the taxpayer is donating property that was previously depreciated
- If the taxpayer is donating capital gain property such as appreciated stock or artwork
- Repayment of income over $3,000. Note there is also a credit that may be better – see Publication 525, Taxable and Nontaxable Income (repayments of $3,000 or less are not deductible due to the suspension of miscellaneous itemized deduction subject to the 2% floor.)

To gain a better understanding of the tax law, complete the practice return(s) for your course of study using the Practice Lab on L&LT.

EXERCISE Answers

Answer 1: The total of qualified medical and dental expenses is $3,250, which does not include life insurance premiums, vitamins, or reimbursed hospital expenses.

Answer 2: b. State, local, foreign income tax, and real estate taxes are all deductible on Schedule A.

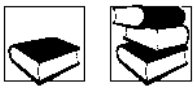
Answer 3: b, c, and d. Taxpayers cannot deduct a tax they did not owe, did not pay, or that they paid during another year. However, the tax may have been imposed in a prior year.

Answer 4: $2,180. The only interest that is fully deductible for the tax year is Joe and Angela's home mortgage interest. The points they paid to refinance are not deductible because they don't qualify as interest, and the other interest paid was personal interest and is not deductible.

Answer 5: The amount that Julia can claim as deductible cash contributions is $632 (donations to her church and to the Girl Scouts). Bingo, lottery tickets, and donations to individuals in need are not deductible.

Answer 6: Zero. None of these expenses are qualified miscellaneous itemized deductions.

Credit for Child and Dependent Care Expenses



Introduction

This lesson covers the credit for child and dependent care expenses. Some taxpayers may not be aware of this credit. Your time and effort may result in a lower tax for the taxpayers. Calculate the credit using Form 2441, Child and Dependent Care Expenses.

Don't confuse this credit with the child tax credit!

Objectives

At the end of this lesson, using your resource materials, you will be able to:

- Determine if a taxpayer is eligible for the credit
- Calculate the amount of the credit

What do I need?

- Form 13614-C
- Publication 4012
- Publication 17
- Form 2441 and instructions

Optional:

- Publication 503
- Form 1040 Instructions

What is the difference between a refundable and a nonrefundable credit?

A refundable credit can zero out the tax liability and result in a cash refund to the taxpayer. A nonrefundable credit is a dollar-for-dollar reduction of the tax liability. A nonrefundable credit can only reduce the tax liability to zero. The credit discussed in this lesson is a nonrefundable credit.

Omar has a tax liability of $100 before credits. A nonrefundable credit of $150 can reduce the liability to zero, but not produce a refund. A refundable credit credit of $150 can zero out Omar's tax liability and produce a refund of $50.

The software will calculate these credits, but the correct information must be input. The volunteer tax preparer must make the correct determinations by using the intake and interview sheet and resource materials.

What is the child and dependent care credit?

This credit is available to eligible taxpayers as a portion of their child and dependent care expenses. The credit may be claimed by taxpayers who, in order to work or look for work, pay someone to take care of their qualifying person. A qualifying person is a:

- Qualifying child under age 13
- Spouse who is incapable of self-care
- Dependent who is incapable of self-care

Individuals who are physically or mentally not able to care for themselves are incapable of self-care. They include persons who can't dress, clean, or feed themselves because of physical or mental problems. Also, persons who must have constant attention to prevent them from injuring themselves or others are considered not able to care for themselves.

The meaning of "incapable of self-care" is not the same as "permanently and totally disabled." Note the software may use the term "disabled" when it really means incapable of self-care. Refer to the Child and Dependent Care Credit chapter in Publication 17 for more details.

The credit ranges from 20% to 35% of the taxpayer's expenses. The percentage is based on the taxpayer's earned income and adjusted gross income. The amount of the credit cannot be more than the amount of income tax on the return. It can reduce an individual's tax to $0, but it will not give the taxpayer a refund.

Some taxpayers receive dependent care benefits from their employers, which may also be called "flexible spending accounts" or "reimbursement accounts." Taxpayers may be able to exclude these benefits from their income. Employer-provided dependent care benefits appear in the taxpayer's Form W-2, Box 10.

Because the child and dependent care credit is a nonrefundable credit, only taxpayers with taxable income can claim the credit. However, all taxpayers who receive employer-provided dependent care benefits are required to complete Form 2441, Part III to determine if they can exclude all or part of these benefits from their taxable income.

How do I determine if a taxpayer is eligible?

The information gathered from the intake and interview sheet, along with the screening sheet in the Volunteer Resource Guide, Tab G, Nonrefundable Credits, will help you determine the taxpayer's eligibility. Be sure to ask whether the taxpayer has paid for *any* type of dependent care for a spouse or another qualifying person.

The Volunteer Resource Guide screening sheet covers the five eligibility tests the taxpayer must meet to qualify for the credit:

- Qualifying person test
- Earned income test
- Work-related expense test
- Joint return test
- Provider identification test

Keep in mind that the taxpayer must pass all five of the tests to qualify for the credit.

What is the qualifying person test?

The taxpayer's child and dependent care expenses must be for the care of one or more qualifying people. Refer to the Volunteer Resource Guide, Tab G, Nonrefundable Credits, Child and Dependent Care Credit Expenses, to determine who is a qualifying person. Any of the following are qualifying persons:

- A qualifying child who is the taxpayer's dependent and under age 13 when the care was provided. If the child is being claimed as a dependent by the noncustodial parent under the special rules for children of divorced and separated parents, only the custodial parent may treat the child as a qualifying person for this credit.
- Someone who was physically or mentally incapable of self-care who the taxpayer claims as a dependent or for whom the taxpayer could claim, except that:
  - The person had income greater than the current year threshold amount (gross income test for a qualifying relative)
  - The person filed a joint return
  - The taxpayer or spouse, if Married Filing Jointly, could be claimed as a dependent on someone else's current year tax return
- Spouses who were physically or mentally unable to care for themselves and lived with the taxpayer more than half the year.

Jim paid someone to care for his wife, Janet, so he could work. Janet is physically unable to care for herself. Jim also paid to have someone prepare meals for their 12-year-old daughter, Jill. Both Janet and Jill are qualifying persons for the credit.

See the rules for Qualifying Child and the special rules for children of divorced or separated parents or parents who live apart in the Dependents lesson of this publication.

What questions should I ask?

Ask the questions from the screening sheet in the Volunteer Resource Guide, Tab G, Nonrefundable Credits, and the intake and interview sheet. The sample interview shown uses these questions.

Sample Interview

Volunteer Says...	Dorothy Responds...
I see you indicated on your intake sheet that you had child and dependent care expenses.	Yes, I did.
You may qualify for the child and dependent care credit. Let me ask you a few questions about that. Which of your dependents received the care?	My daughter.
Now, she is 16 years old, correct?	Yes, but she was diagnosed with a severe mental condition. She just can't take care of herself.

Even though Dorothy's daughter is over age 13, she meets the qualifying person test because she cannot care for herself.

Once you've determined if the taxpayer had eligible expenses for the child and dependent care credit, confirm that the appropriate box on the intake and interview sheet is checked.

What is the earned income test?

The taxpayer (and spouse, if married filing jointly) must both have earned income during the year. Earned income includes:

- Wages
- Salaries
- Tips
- Other taxable employee compensation
- Net earnings from self-employment
- Strike benefits
- Disability pay reported as wages

Earned income does not include amounts reported as wages that are excluded as foreign earned income on Form 2555, Foreign Earned Income.

Earned income does not include income earned while incarcerated or in a work release program. Refer to the Volunteer Resource Guide, Tab I, Earned Income Credit, Earned Income Table for the list of earned income.

What if spouses are full-time students or are unable to care for themselves?

A taxpayer's spouse is treated as having earned income for any month the spouse is physically or mentally incapable of self-care, or is a full-time student. The spouse's income is considered to be $250 for each month if there is one qualifying person in the home or $500 each month if there are two or more qualifying people. A full-time student is defined as enrolled and attending a school for the number of hours or classes the school considers full time. The spouse must be a full-time student for some part of five calendar months during the year.

If, in the same month, both the taxpayer and the taxpayer's spouse are full-time students or are not able to care for themselves, only one spouse can be considered to have earned income of either $250 for one qualifying person or $500 for two qualifying persons for that month.

What questions should I ask?

Ask the questions from the screening sheet in the Volunteer Resource Guide, Tab G, Nonrefundable Credits and the intake and interview sheet. Here is how a volunteer might interview a taxpayer about the earned income test.

Sample Interview

Volunteer Says...	Dorothy Responds...
I believe you mentioned earlier that you and your husband both work. Is that correct?	Yes.
Did you both work while your daughter was in day care?	Yes and no. My husband just changed careers. He went to school the first half of the year, but he began working full time within a month of finishing his program in July.
So, he was a full-time student for the first six months of the tax year?	Yes. Does that disqualify us?
No. That does not disqualify you.	

Dorothy and her husband meet the earned income test because her husband was a full-time student for at least five months and is considered to have earned income for those months.

What is the work-related expense test?

Expenses are considered work-related only if both of the following are true:

- The expenses allow the taxpayer (and spouse, if married filing jointly) to work or look for work and
- The expenses are for a qualifying person's care, and to provide for that person's well-being and protection

For married taxpayers, generally both must work or be looking for work. Taxpayers' spouses are treated as working during any month the spouses were full-time students or were physically or mentally unable to take care of themselves.

There is a limit on the amount of work-related expenses that can be used to figure the credit. The limit is $3,000 for one qualifying person and $6,000 for two or more qualifying persons. This $6,000 limit does not need to be divided equally among them.

If qualified expenses for the previous year were paid in the current tax year, the total credit may be increased. The software will ask for details including provider information and information from the previous year tax return.

What are examples of work-related expenses?

The following expenses count as work-related:

- Cost of care outside the home for dependents under age 13, for example, preschool or home day care, or before-school or after-school care for a child in kindergarten or higher grade
- Cost of care for any other qualifying person, for example, dependent care
- Household expenses that are paid at least partly for the well-being and protection of a qualifying person, for example, the services of a housekeeper or cook

If a taxpayer's qualifying child turned 13 during the tax year, their qualifying expenses include amounts incurred for the child while under age 13. For example, if the taxpayer's qualifying child turns 13 on September 16, count only those expenses through September 15.

What expenses do not qualify as work-related?

Expenses that do not qualify as work-related include amounts paid for food, clothing, education, or entertainment. However, small amounts paid for these items can be included if they are incidental to and cannot be separated from the cost of care. Examples of childcare expenses that do **not** qualify as work-related include:

- Education expenses to attend kindergarten or a higher grade
- The cost of sending a child to an overnight camp
- The cost of transportation not provided by a care provider

Roger takes his 10-year-old child to a private school. In addition to paying for the cost of the education, Roger also pays an extra fee so that his child can attend a before- and after-school program while he is at work. Roger can count the cost of the before- and after-school program when figuring the credit, but not the cost of the education.

Krista takes her 3-year-old child to a nursery school that provides lunch and educational activities as part of its preschool childcare service. She can count the total cost when she figures the credit.

What about taxes paid for household employees?

Taxpayers who paid someone to come into their home to provide care for their dependent or spouse may be required to pay household employment taxes. These taxes may be considered a work-related expense.

Generally, if the household employee earned less than a certain amount for the tax year, and the taxpayer did not withhold any income tax, the taxpayer is not required to pay employment taxes or provide the employee with Form W-2. Refer taxpayers who should pay employment taxes for their household employees, or are unsure about these requirements, to Publication 926, Household Employer's Tax Guide, and to a professional tax preparer.

What if the taxpayer makes payments to a relative?

Payments to relatives may qualify as work-related expenses if the taxpayer does not claim the relative as a dependent. Do not count amounts paid to:

- A dependent that the taxpayer (or spouse, if married) can claim on the tax return
- The taxpayer's child who is under age 19 at the end of the year, even if the child is not the taxpayer's dependent
- A person who was the taxpayer's spouse at any time during the year
- The other parent of the taxpayer's qualifying child who is under age 13

What questions should I ask?

Continue asking questions from the screening sheet in the Volunteer Resource Guide, Tab G, Nonrefundable Credits, and the intake and interview sheet. Here is how a volunteer might interview a taxpayer about the work-related test.

Sample Interview

Volunteer Says...	Dorothy Responds...
Did the caregivers assist your daughter only when you and your husband were at work?	That's right. We couldn't afford any more help than that. All last year, they arrived just before we left for work and they left when my mother came at 2 p.m.
Do you pay your mother to care for your daughter?	No, we don't. She just does it because she loves her granddaughter.
That's wonderful. You're all very fortunate. So all your expenses were only to allow you to work – or in your husband's case to go to school or look for work prior to becoming employed.	Yes, exactly.
No. That does not disqualify you.	

Dorothy passes the work-related expense test because the expenses are paid so that she and her husband can work and are not paid to a dependent relative.

What is the joint return test?

Generally, *married couples* who wish to take the child and dependent care credit must file a joint return. However, taxpayers can be considered unmarried if they file a separate return and:

- Are legally separated under a divorce or separate maintenance decree on the last day of the tax year or
- Lived apart from their spouse for the last 6 months of the year and paid more than half of the cost of providing a home that was also the main home of the qualifying person for more than half the year.

There is a checkbox required on Form 2441 for Married filing Separately taxpayers that meet the requirements to claim the credit.

Generally, married persons who are considered unmarried will use the filing status, Head of Household.

A taxpayer whose spouse died during the tax year, and who has not remarried, must generally file a joint return to claim the credit. The surviving spouse may, but is not required to, take into account the earned income of the spouse who died during the year. That is, the surviving spouse can use just their own earned income and ignore the decedent's earned income, which may be less.

There is another special rule if the care was for a deceased taxpayer. It applies when the surviving spouse has remarried and therefore filing MFJ with the new spouse. In this case, the deceased taxpayer will use the Married Filing Separately status and can claim the credit for their own care.

At this point, you will have already determined the filing status and can rely on that to determine if the taxpayer passes the joint return test.

What is the provider identification test?

The provider identification test requires that taxpayers provide the name, address and Taxpayer Identification Number (TIN) of the person or organization who provided the care for their child or dependent.

If the care provider is an individual, the TIN is the same as the provider's Social Security number. If the provider is an organization, then it is the Employer Identification Number (EIN). Certain tax-exempt organizations are not required to have an EIN. See Publication 503 for more details.

Taxpayers who cannot provide all of the provider's information or who have incorrect information may still be able to take the credit if they can show that they used due diligence in trying to obtain the correct information. Refer to the sections titled Due Diligence and Provider Refusal in Publication 503, Child and Dependent Care Expenses, for more information. Returns that do not include the provider information cannot be filed electronically.

EXERCISES

Use the screening sheet in the Volunteer Resource Guide, Tab G, Nonrefundable Credits, to answer the following questions. The answers appear at the end of the lesson.

Question 1: Audrey is a stay-at-home mom. Her husband works and had earned income for the tax year. They have a young son with autism who must be supervised at all times. Audrey volunteers at a local autism information hotline 12 hours a week. She and her husband pay a caregiver to stay with their son during those hours.

Do they qualify for the child and dependent care credit?

a. Yes

b. No

Question 2: Why don't Audrey and her husband qualify for the credit? (Select all answers that apply.)

a. The caregiver expense is not work-related

b. Their son is not a qualifying person

c. The caregiver's duties qualify as work-related

d. They do not pass the earned income test

Taxpayer Interview and Tax Law Application

Bill, 61, and Helen, 62, are married and have lived together for 20 years. Earlier in the interview with Bill, you learned that Helen is too sick to work and needs 24-hour care. Bill is claiming his granddaughter Lucy as a dependent, as noted in the Marital Status and Household Information section of his intake and interview sheet. She is 18 and takes care of Helen. You wonder whether Bill can take the child and dependent care credit.

Apply the questions from the credit for child and dependent care expenses screening sheet in the Volunteer Resource Guide, Tab G, Nonrefundable Credits, to find out whether Bill can take the credit, as shown in the sample interview to follow.

Sample Interview

Volunteer Says...	Bill Responds...
For the credit for child and dependent care, I'd like to ask you some questions about the care provided for your wife, Helen. You may qualify for the credit.	Oh, okay.
Why don't you tell me about your wife's illness and care?	Well, she has chronic lung disease; she can't take care of herself at all. We need to have someone in the home 24 hours a day.
I'm sorry that she is so ill. That must be difficult for both of you. [The volunteer has already determined earlier in the tax return preparation process that Bill has earned income from his full-time teaching job. So he skips these questions in the decision tree and moves ahead to the next relevant question.]	Yes, it is … well, sometimes she has good days, and I'm thankful for that.
Did you pay someone to take care of your wife so that you could go to work?	Yes, I pay my granddaughter Lucy, who just graduated from high school, to take care of Helen.
Oh, I see. Well unfortunately, you won't be able to take the credit for your wife because you are claiming Lucy as a dependent.	Oh, that's okay. Thanks for looking into it for me.
You're welcome. Just trying to help! [On the intake and interview sheet, indicate that the taxpayer doesn't qualify for this credit, and why.]	

Bill does not pass the work-related expenses test because his expenses were paid to a dependent relative.

How do I determine the amount of the credit?

To determine the amount of the credit, multiply the work-related expenses (after applying the earned income and dollar limits) by a percentage. It is possible a qualifying person could have no expenses and a second qualifying person have expenses that exceed $3,000. In that case, list $0 for one person and the actual amount for the second person. The percentage depends on the taxpayer's adjusted gross income.

The tax software performs much of the credit computation for you. To review information related to the software, go to the Volunteer Resource Guide, Tab G, Nonrefundable Credits, Form 2441, Credit for Child and Dependent Care Expenses.

How do I complete Form 2441?

Form 2441 is divided into three parts:

- Part I is for general information about the care provider
- Part II is where the child and dependent care credit is calculated
- Part III is where information is entered if the taxpayer reports employer-provided dependent care benefits

All taxpayers complete Part I first.

Taxpayers who did not receive dependent care benefits from their employers then complete Part II. Taxpayers who did receive these benefits complete Part III and then Part II.

What about employer-provided dependent care benefits?

Some taxpayers receive dependent care benefits from their employers. Taxpayers may be able to exclude these benefits from their income. Dependent care benefits include amounts the employer pays either directly to the taxpayer or to the care provider. Employer-provided dependent care benefits appear in the taxpayer's Form W-2, Box 10.

The taxpayer may still be able to claim a child and dependent care credit, but the amount of excluded benefits is not included in work-related expenses and also reduces the dollar limit for the credit. Taxpayers who receive dependent care benefits **must** complete Part III of Form 2441, even if they are not eligible for a child and dependent care credit.

Paula has one dependent child, Jenny, who is 6 years old. She paid $2,900 in qualified expenses. Paula's Form W-2, Box 10, shows she received $1,400 during the year from her employer's dependent care assistance program. Because she received dependent care benefits, Form 2441, Part III, must be completed before completing Part II.

To review information related to the software, go to the Volunteer Resource Guide, Tab G, Nonrefundable Credits, Form 2441, Credit for Child and Dependent Care Expenses.

What limits apply to this credit?

The taxpayer's expenses are subject to an earned income limit. The amount of work-related expenses used to figure the credit cannot be more than:

- The taxpayer's earned income for the year or
- If Married Filing Jointly, the smaller of the taxpayer or spouse's earned income for the year

If the taxpayer files a return as a surviving spouse after the death of a spouse during the tax year, the taxpayer may, but is not required to, include the earned income of the spouse who died. If the decedent's earned income is less than the surviving spouse, use the surviving spouse's earned income only. See the Volunteer Resource Guide, Tab G, Miscellaneous Credits, for entries to adjust the decedent's earned income so the software will make the proper calculations.

In addition to the earned income limit, there is a dollar limit on the amount of work-related expenses that can be used to figure the credit. This limit is $3,000 for one qualifying person or $6,000 for two or more qualifying persons. If the taxpayer received dependent care benefits from an employer, the amount of the benefits excluded from income must be subtracted from the dollar limit.

Care expenses paid in 2022 that relate to 2021 are subject to different rules as detailed on Form 2441 and its instructions. The taxpayer will need to provide a breakdown of the care expenses they paid during 2022 if they relate to 2022 and 2021 care.

Mary has three qualifying children. She received $4,800 in dependent care benefits through her employer. When Mary figures her credit, her work-related expenses will be limited to $1,200 ($6,000 – $4,800).`

The tax software guides you through applying the limits and computing the credit. If the taxpayer received employer-paid benefits, enter the amounts in the Form W-2 section, and this amount is carried to Part III of Form 2441.

How do I avoid common errors?

When entering information into the software, double-check your entries for the provider's name, ID number, and amounts paid. Be sure that qualified expenses are entered in step 2 of the software. If the taxpayer had an amount in any Form W-2, Box 10, the software will ask you to verify that the entry is correct, and to make sure Form 2441 is completed.

On the intake and interview sheet, make sure the box is checked to indicate that the taxpayer was eligible for the dependent care credit. Note anything unusual that the quality reviewer may need to know when reviewing this part of the tax return.

Summary

The credit for child and dependent care expenses is a nonrefundable credit that allows taxpayers to reduce their tax liability by a portion of the expenses.

The maximum expense amounts are $3,000 for one qualifying person and $6,000 for two or more qualifying persons. This $6,000 limit does not need to be divided equally among them.

The maximum credit rate is 35% of the taxpayer's expenses. A taxpayer must satisfy the five eligibility tests to qualify for the credit. The tests are the:

- Qualifying person test
- Earned income test
- Work-related expense test
- Joint return test
- Provider identification test

The credit is calculated on Form 2441.

What situations are out of scope for the VITA/TCE programs?

The following is out of scope for this lesson. While this list may not be all inclusive, it is provided for your awareness only.

- Taxpayers who need assistance in determining if employment taxes are owed for household employees

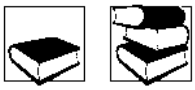
To gain a better understanding of the tax law, complete the practice return(s) for your course of study using the Practice Lab on L&LT.

EXERCISE Answers

Answer 1: b, No. They do not qualify.

Answer 2: a and d. Audrey is not using the caregiver's services to look for work or to perform work. In addition, both spouses must have earned income during the year to qualify. Only the husband had earned income for the tax year.

Education Credits



Introduction

This lesson covers tax credits available to help the taxpayer offset the costs of higher education by reducing the amount of income tax. This lesson suggests probing questions you can ask based on the intake and interview sheet, the Volunteer Resource Guide, Tab J, Education Benefits, and on the rules for claiming education credits.

During the interview, ask taxpayers if they are aware of the education credits, and give a brief description. Next, gather information to determine if any credits can be claimed.

Objectives

At the end of this lesson, using your resource materials, you will be able to:

- Determine who qualifies for an education credit
- Determine which credit the taxpayer can claim

What do I need?

- Form 13614-C
- Publication 4012
- Publication 970
- Form 1098-T
- Form 8863 and Instructions

Optional:

- Form 1040 Instructions

What are education credits?

Education credits are amounts that will reduce the amount of tax due. The amount is based on qualified education expenses that the taxpayer paid during the tax year.

There are two different education credits: the American opportunity credit and the lifetime learning credit. The American opportunity credit allows 40% of the credit to be refundable. There are general rules that apply to these credits, as well as specific rules for each credit.

For an overview of the various education tax benefits, review the Volunteer Resource Guide, Tab J, Education Benefits, Highlights of Education Tax Benefits.

Who can take an education credit?

Taxpayers can take education credits for themselves, their spouse, and/or dependents (claimed on the tax return) who were enrolled at or attended an eligible postsecondary educational institution during the tax year. The law requires that the student must generally receive a Form 1098-T, Tuition Statement, in order for the taxpayers to claim the education credit. However, if the student's educational institution is not required to furnish a Form 1098-T, the taxpayer may claim a credit if the student does not receive a Form 1098-T. The student is required to provide the information that would otherwise be included on the Form 1098-T.

Review the dependent section of the intake and interview sheet for children who are shown as full-time students. Ask the taxpayer if there are education expenses.

What basic requirements must the taxpayer meet?

To claim an education credit, verify that the following are true for the taxpayers:

- They cannot be claimed as a dependent on someone else's tax return
- They are not filing as Married Filing Separately
- Their adjusted gross income (AGI) is below the limitations for their filing status
- They were not nonresident aliens for any part of the tax year, or if they were, they elected to be treated as resident aliens

Remember that an individual is not a dependent if the person who could claim them as a dependent is not a taxpayer. A person is not a taxpayer if they do not file a tax return or file to get a refund of estimated taxes paid or taxes withheld only.

The AGI limits (and phaseouts) are the same for both credits and are fixed — they are not subject to inflation adjustment. Refer to the Important Changes lesson for the AGI limits.

Taxpayers claiming the American opportunity credit must have a valid identification number (SSN or ITIN) by the due date of the tax return (including extensions). Further, the student claimed for the credit must also have a valid identification number (SSN, ATIN, or ITIN) by the due date (including extensions). Taxpayers cannot file an amended return to claim the credit for a year that the taxpayer and/or student did not originally have a required identification number by the return due date.

How do I handle dependents?

The taxpayer must claim the student as a dependent to receive the credit for the student's qualified expenses. If the taxpayer claims the student as a dependent, all qualified education expenses of the student are treated as being paid by the taxpayer.

Carol Marshall has a grandson named Gary. He is claimed as a dependent on his parent's joint return. Carol paid Gary's tuition directly to the university. For purposes of claiming an education credit, Gary is treated as receiving the money as a gift and paying for the qualified tuition and related expenses. Since his parents are claiming him on their return, they may be able to use the expenses to claim an education credit. Alternatively, if he is claiming himself on his return, he might be able to claim the expenses as if he paid them to the school.

What is an eligible institution?

An eligible institution is generally any accredited public, nonprofit, or private college, university, vocational school, or other postsecondary institution eligible to participate in a student aid program administered by the U.S. Department of Education. The school should be able to tell the student if it is an eligible education institution. A searchable database of all accredited postsecondary institutions and programs are available at: **https://ope.ed.gov/accreditation/**.

Taxpayers claiming the American opportunity credit are required to report the EIN of the educational institution the student attended on Form 8863, Education Credits (American Opportunity and Lifetime Learning Credits). The student can get the EIN from the school if they did not receive Form 1098-T.

What are qualifying expenses?

Qualified education expenses are tuition and certain related expenses required for enrollment or attendance at an eligible educational institution. Qualified education expenses include nonacademic fees, such as student activity fees, athletic fees, or other expenses unrelated to the academic course of institution that must be paid to the institution as a condition of enrollment or attendance. However, for the American opportunity credit, the definition for "certain related expenses" is different from the lifetime learning credit. This will be discussed later in the lesson.

Ask to see documentation, such as Form 1098-T, issued by the school. The taxpayer can add other expenses that qualify for education credits, such as books or supplies not purchased through the school account. If expenses or scholarships are adjusted in a later year, the school will report the amount in box 4 or box 6 of Form 1098-T. Prior credits claimed may need to be recaptured. Refer taxpayers with adjustments to a professional tax preparer.

When Janice enrolled for her freshman year of college, she had to pay a separate student activity fee in addition to her tuition. This activity fee is required of all students and is used solely to fund on-campus organizations and activities run by students, such as the student newspaper and the student government. No portion of the fee covers personal expenses. Although labeled as a student activity fee, the fee is required for Janice's college enrollment and attendance; therefore, it is a qualified expense.

Which expenses do not qualify?

Do **not** include expenses such as:

- Room and board, insurance, medical expenses (including student health fees), transportation costs, or other similar personal, living, or family expenses
- Any course of instruction or other education involving sports, games, or hobbies, unless the course is part of the student's degree program or (for the lifetime learning credit) helps the student to acquire or improve job skills

Jackie paid $3,000 for tuition and $5,000 for room and board at an eligible university. The $5,000 paid for room and board is not a qualified expense for the education credits.

Are any amounts excluded from qualified expenses?

Tuition or other education expenses that have been used to make scholarships, grants, 529 distributions or other amounts received tax-free cannot be used to figure the credit. Once you have identified each person claiming a credit and their qualified expenses, ask if the student received any of these untaxed educational benefits during the year:

- Tax-free part of Pell grants
- Tax-free employer-provided educational assistance if applied to education expenses (tax-free employer benefits can instead be applied toward a student loan through 2025 so that qualified education expenses are still available for one of the credits)
- Veterans' educational assistance
- Tax-free parts of scholarships and fellowships
- Any other nontaxable payments received as educational assistance (other than gifts or inheritances). For example, distributions from a 529 plan reported on Form 1099-Q, Payments From Qualified Education Programs (Under Sections 529 and 530)
- Refunds of the year's qualified expenses paid on behalf of a student (e.g., the student dropped a class and received a refund of tuition)

*Do not reduce the qualified education expenses by any scholarship or fellowship reported as income on the student's tax return if the scholarship or fellowship grant (or any part of it) must be applied (by its terms) to expenses (such as room and board) other than qualified education expenses, or if the scholarship or fellowship grant (or any part of it) **may** be applied (by its terms) to expenses (such as room and board) other than qualified education expenses. Some students may choose to pay non-qualifying expenses with scholarship/Pell grants funds, making the scholarship/Pell grants taxable. This is true even if the scholarship/grant was paid directly to the school.*

Higher education emergency financial aid grants and most canceled student loans are not taxable to the student and do not reduce the student's qualified educational expenses.

Generally, any scholarship or fellowship grant is treated as tax-free educational assistance. However, a scholarship or fellowship grant is not treated as tax-free educational assistance to the extent the student includes it in gross income (the student may or may not be required to file a tax return) for the year the scholarship or fellowship grant is received. If the student includes the educational assistance in income, has a filing requirement and unearned income (including the taxable scholarship) over the ceiling amount, the student must file Form 8615, Tax for Certain Children Who Have Unearned Income (Kiddie Tax) to compute the tax. In this case, Form 8615 is out of scope. See the Volunteer Resource Guide, Tab J, Education Benefits for the ceiling amount.

Most students should receive Form 1098-T from the educational institution. The form should show the amounts the student paid for tuition and related expenses, the amounts of scholarships and grants received are shown in Box 5, and whether the student was at least a half-time student or a graduate student. Verify with the taxpayer that the amount in Form 1098-T, Box 1, is actually the amount paid in the current tax year for qualified expenses. Also ask about qualified education expenses paid outside the school, such as from a bookstore.

Form 1098-T may have incomplete information. Question the taxpayer to determine the amount of qualified expenses actually paid and adjust this amount by any non-taxable items, such as tax-free scholarships and tuition program distributions.

Joan Smith received Form 1098-T from the college she attends. It shows her tuition was $9,500 (Box 1) and that she received a $1,500 (Box 5) scholarship. She had no other scholarships or nontaxable payments. Her maximum qualifying expenses for the education credit would be $8,000 ($9,500 - $1,500).

Juan, a student, receives a grant equal to his qualifying education expenses. He otherwise has no filing requirement. He earned $9,600 from a summer job which is less than the cost of half of his support, had $4,000 in education expenses and a $4,000 Pell grant. Juan's parents file a return claiming Juan as a dependent and reported income that is within the allowable range for the American opportunity credit (AOC).

***Scenario 1:** Juan uses the grant to pay the education expenses. Juan has no filing requirement and files only to get his withholding (from his summer job) back. His parents qualified education expenses would be zero.*

Gross income = $9,600, no filing requirement, tax = 0.

***Scenario 2:** Juan chooses to declare $2,000 of the grant as income on his return and his parents use the education expenses toward the AOC. Juan's gross income is $9,600 + $2,000 = $11,600. As a dependent, Juan has no filing requirement and he has no tax. His parents claim $2,000 as qualified education expenses.*

***Scenario 3:** Juan chooses to include the entire grant as income on his return. Juan's parents can claim the entire $4,000 education expenses toward the AOC. Juan's gross income is $9,600 + $4,000 = $13,600. Since Juan's income in over the dependent's filing requirement income, the kiddie tax applies and his tax return is out of scope. His parents claim an AOC of $2,500.*

It may be better to forgo some portion of the AOC when other issues, such as the kiddie tax or premium tax credits, could be adversely affected by Juan having a filing requirement.

What about payments for the next academic year?

The taxpayers can claim payments prepaid for the academic period that begins in the first three months of the next calendar year. In that case, box 7 of Form 1098-T will be checked.

Thomas pays $1,500 in December for qualified tuition for the winter semester that begins in January. He can use the $1,500 paid in December to compute his credit for the current tax year. He cannot count it again next tax year.

What rules apply to each credit?

American Opportunity Tax Credit

Taxpayers can take the American opportunity credit for a student if they can answer all of these questions as indicated below:

- As of the beginning of the tax year, was the student still in the first four years of postsecondary education (generally, the freshman, sophomore, junior, and senior years)? *Yes*
- As of the beginning of the tax year, has the American opportunity credit been claimed for this student for four years? *No*
- Was the student enrolled in a program that leads to a degree, certificate, or other credential? *Yes*
- Was the student taking at least one-half the normal full-time workload for the course of study, for at least one academic period beginning in the current tax year? *Yes*
- Has the student been convicted of a felony for possessing or distributing a controlled substance as of year end? *No*
- Did the taxpayer and student have a taxpayer identification number (TIN) by the due date of the return (including extensions)? *Yes*

If the student does not meet all of the requirements for the American opportunity credit, the taxpayer may be able to take other education benefits for part or all of the student's qualified expenses.

Mindy's brother, Jim, started college in 2017. He was eligible for the American opportunity credit for 2017, 2018, 2019 and 2020. His parents claimed the American opportunity credit on their 2017, 2018 and 2019 returns. Jim claimed the credit on his 2020 tax return. Since the credit has been claimed for four years, the credit can't be claimed on any additional returns based on Jim's expenses.

Qualified education expenses for the AOC include course-related books, supplies and equipment purchased from any source. Computers are qualified expenses when needed for classes, such as to receive assignments, post assignments, collaborate with other students on group assignments, or receive grades. Taxpayers should keep receipts and documentation of computer or internet requirements, such as a course syllabus.

The American opportunity credit can be up to $2,500 per eligible student, depending on the amount of eligible expenses and the amount of tax on the return.

- The credit is 100% of the first $2,000 in eligible expenses and 25% of the second $2,000 in eligible expenses per student, up to the amount of tax
- 40% of the credit is a refundable credit, which means the taxpayer can receive up to $1,000 even if no taxes are owed
- Taxpayers under age 24 cannot claim the refundable portion of the credit if certain conditions are met

Note: these are the same conditions that would make the kiddie tax apply, other than having unearned income in excess of the kiddie tax ceiling amount.

Refer to Volunteer Resource Guide, Tab J, Education Benefits, Student Under Age 24 Claiming American Opportunity Credit, for details.

Toby has receipts for books and supplies for his first year at college. He spent $1,291 for required books, lab supplies, and rock-hunting equipment he needed for his introductory chemistry and geology courses. The school has no policy requiring that these books and equipment be purchased from the college in order to enroll. These are qualified expenses for the American opportunity credit.

Lifetime Learning Credit

The lifetime learning credit can be taken if the taxpayer and the expenses meet the requirements described under “What basic requirements must the taxpayer meet?”, above. Additional criteria for the lifetime learning credit include:

- Student doesn’t need to be pursuing a program leading to a degree or other recognized education credential
- Felony drug conviction doesn’t make the student ineligible
- Up to $2,000 non-refundable credit per return (20% of up to $10,000 in eligible expenses)
- Available for an unlimited number of tax years
- Available for all years of postsecondary education and for courses to acquire or improve job skills (no minimum amount of course workload)
- Course-related books, supplies, fees, and equipment (including a computer) are included in qualified education expenses only if they must be paid to the institution as a condition of enrollment or attendance

Jill attends Wanda’s School of Beauty, an eligible institution. She pays $4,400 for the course of study, which includes tuition, equipment, and books required for the course. The school requires that students pay for the books and equipment when registering for the course. The entire $4,400 would be an eligible educational expense.

Jack attends a culinary school on Saturdays. He pays $4,400 for the course of study and qualifies for the lifetime learning credit. The school provides a list of equipment that he needs to bring to class. The $4,400 is an eligible educational expense, but the cost of the equipment and supplies is not.

EXERCISES

Use the Volunteer Resource Guide, Tab J, Education Benefits, and Publication 17, Comparison of Education Credits, to answer the following questions. Answers are at the end of the lesson summary.

Question 1: Bob was a full-time student and a fifth-year senior. He has only claimed the American opportunity credit for three earlier years. Does he qualify for the American opportunity credit?

a. Yes

b. No

Question 2: Janice works full time and takes one course a month at night school. Some of the courses are not for credit, but they are meant to advance her career. Which credit is appropriate for her?

a. American opportunity

b. Lifetime Learning

Question 3: Clark is an older student who has gone back to college half time after serving 18 months in prison for felony drug possession. Which credit is appropriate for him?

a. American opportunity

b. Lifetime Learning

Can a taxpayer take multiple education benefits?

Education expenses can be taken in any of several areas on the tax return. They can be used toward one of these credits, as a business expense on Schedule C, or to reduce the taxable portion of scholarships, fellowships, grants and distributions from education savings accounts. The definition of a qualifying expense varies among these different benefits, but in general, each expense can be used only once. For example, do **not**:

- Figure the education credits based on expenses that have already been taken on Schedule C
- Take both an American opportunity credit and a lifetime learning credit for the same student in the same year

A taxpayer who has taken an early distribution from an IRA may take an exception to the 10% additional tax for an amount equal to the adjusted qualified education expenses, which include room and board if enrolled at least half-time. Refer to the Other Taxes lesson later.

To review information related to software entries, go to the Volunteer Resource Guide, Tab J, Education Benefits.

To determine the most beneficial way to claim education expenses, do not compare them until both federal and state tax returns have been otherwise completed.

How do I determine the amount of the credit?

Here are the general steps in figuring the amount of education credits:

1. Review the list of qualifying students and expenses and decide if the American opportunity credit or lifetime learning credit is more suitable (see the requirements discussed earlier).
2. Form 8863, Part III, page 2, requests information about the student, the student's eligibility for the credit, and the educational institution(s). Taxpayers must complete Part III for each eligible student for whom they are claiming an education credit before completing Parts I and II.
3. Enter each student's qualified expenses. Be sure that these:
   - Include only qualified expenses paid during the tax year
   - Are reduced by untaxed benefits
   - Do not exceed the limit for the credit
4. Find the totals for each section and apply the limits, then transfer the amounts to Parts I and II to determine the refundable and nonrefundable credits. Apply the income test and do the calculations. (Tax software does this step for you.)

To determine the amount of qualified expenses, please review Form 1098-T and have a discussion with the taxpayer to determine the qualified education expenses paid.

When entering qualified expenses, the software allows you to select an education benefit. At this point, you can make changes to determine the most beneficial education benefit to claim for the taxpayer.

If you find taxpayers claimed an education credit in a prior year and they were refunded part or all of the expenses they used to claim the American opportunity or lifetime learning credit, they may have to repay (recapture) all or part of the credit. Information can be found in Publication 970, Tax Benefits for Education, but this is beyond the scope of the VITA/TCE programs. Advise the taxpayer to consult a professional tax preparer.

Taxpayer Interview and Tax Law Application

Here is how our volunteer helped a taxpayer, Barbara Smith, determine which education credits applied to her family.

Sample Interview

Volunteer Says...	Barbara Responds...
Barbara, are you familiar with education credits?	They have something to do with tuition.
Yes, they apply to certain expenses for postsecondary education. Did anyone in the family attend college or vocational school during the tax year?	My daughter, Carla, is a freshman, going to college full time, and I am taking classes at City College.
There are two kinds of credits – here's a chart comparing the two education credits. [Explains the differences.]	Looks like American opportunity for Carla and lifetime learning for me!
I think you're right. You both meet the basic requirements, since you are both on the return and meet the income limits. Do you have your student account information showing the expenses paid?	Yes, these are for Carla's tuition, fees, and books for the tax year. These are for extracurricular field hockey.
The books will qualify but her field hockey costs will not. Did she receive any money from an employer, a scholarship, Pell grant, anything like that?	Only $5,000 from her grandfather.
We don't need to count the gift. The American opportunity credit is available for a student's first four years of college, so that might be the best for you to claim. Now let's look at your expenses.	All I have are tuition and fees for two classes in accounting, spring and fall semesters.
Are these to improve your job skills?	Yes, but my boss doesn't reimburse me.
Are all of these fees required for your courses?	Yes.
You'll be eligible for the lifetime learning credit. [On the intake and interview sheet, indicate that you've addressed education benefits.]	I'm so glad you were here to help me!

Which education benefit is better for the taxpayer?

Taxpayers have several options for using education expenses to reduce taxes. They are:

- American opportunity credit or lifetime learning credit
- Business expenses on Schedule C if the expenses qualify
- Make an unrestricted scholarship or grant tax free

Generally, taxpayers will benefit the most from claiming the education credits. The American opportunity credit will always be greater than the lifetime learning credit. However, you should compute any of the other benefits for which taxpayers are eligible to determine which gives them the lowest tax. Do not claim multiple credits for the same education expense; use the education credit that is most advantageous to the taxpayer.

Refer to the Volunteer Resource Guide, Tab J, Education Benefits for a comparison chart of some of the tax benefits for education.

How can I avoid common errors?

Make sure that you have entered the names, SSNs, and education expense amounts correctly. Check that you have not claimed more than one tax benefit for the same taxpayer or taken a credit or deduction for expenses paid with a tax-free benefit like a scholarship.

On the intake and interview sheet, make sure that the appropriate box is checked to indicate that the taxpayer had education expenses. Note anything unusual that the quality reviewer may need to know when reviewing this part of the tax return. For example, you could note if some expenses were paid with a nontaxable scholarship.

What if American opportunity credit was disallowed in a prior year?

The intake and interview sheet asks if the taxpayer was previously disallowed the American opportunity credit in a prior year. If the taxpayer answers “yes” to this question, refer to the Volunteer Resource Guide, Tab I, Earned Income Credit, Disallowance of Certain Credits.

Summary

You are now ready to help taxpayers determine which education tax benefits are best for them. When you get to this section of the return, always check the intake and interview sheet and ask probing questions based on the taxpayer’s information and on the rules for claiming education credits.

There are two education credits that may reduce a taxpayer’s tax:

- American opportunity credit
- Lifetime learning credit

These are some requirements for the credits:

- Taxpayers and students must have a TIN by the due date of the return, including extensions, to claim the American opportunity credit
- A taxpayer who claims the American opportunity credit and is not eligible can be banned up to 10 years from claiming the credit
- 40% of the American opportunity credit is refundable (up to $1,000)
- Taxpayers can claim the American opportunity credits for up to four years
- Lifetime learning credit can be claimed for an unlimited number of years
- Lifetime learning credit is a non-refundable credit of up to $2,000 (20% of up to $10,000 in expenses)
- Education expenses can be applied to those credits or deducted as business expenses on Schedule C if they qualify
- Students that include tax-free scholarships and grants in income and have a filing requirement may be required to file Form 8615, Tax for Certain Children Who Have Unearned Income, which is out of scope for the VITA/TCE programs

Other education benefits are listed in the Volunteer Resource Guide, Tab J.

One of your roles as a volunteer is to help taxpayers maximize the benefits that they are entitled to under the tax law. Stay alert to ways they can use their education expenses to lower their tax.

What situations are out of scope for the VITA/TCE programs?

The following is out of scope for this lesson. While this list may not be all inclusive, it is provided for your awareness only.

- Taxpayers who must repay (recapture) part or all of an education credit claimed in a prior year.

To gain a better understanding of the tax law, complete the practice return(s) for your course of study using the Practice Lab on L&LT.

EXERCISE Answers

Question 1: a,Yes. Bob qualifies for the American opportunity credit because he only claimed the credit in three previous tax years.

Question 2: b, Lifetime learning

Question 3: b, Lifetime learning

Review of possible education benefits – refer to Pub 970 for full information:

Scholarships, grants or fellowships One main benefit is to make scholarships, grants or other education assistance tax-free if they are offset by qualifying expenses. Scholarships or grants that are not based on work can be tax-free. If they are tax-free, they are not entered on the tax return.

Coverdell Education Savings Accounts (ESA) and Qualified Tuition Programs (QTP) These are special accounts that have been set up to pay education expenses. The earnings are tax-free if the distributions are used to offset qualifying expenses. Qualifying expenses include room and board if the student attended at least halftime, K-12 expenses as well as post-secondary education, or as a contribution to a QTP if made on behalf of a designated beneficiary of a Coverdell ESA. QTP (Sec. 529 plan) distributions can also be used for:

- K-12 tuition up to a limit of $10,000 for all years after 2017,
- certain apprenticeship programs, or
- to pay principal or interest on a designated beneficiary's or their sibling's student loan up to $10,000 lifetime
    - interest paid with a nontaxable distribution cannot be claimed as a deduction.

Upon termination of the ESA or QTP, the unrecovered basis may be deductible, if any.

Apply ESA/QTP distributions to room and board or student loan payment where possible so that AOC or LLC can be maximized with qualified education expenses.

Employer-provided educational assistance Employers may provide up to $5,250 of tax-free payments or reimbursements for an employee's education expenses, including student loan payments. Unreimbursed qualified education expenses that exceed the employer payments can be used toward other benefits.

Veterans Administration education benefit If the student qualifies for one or more VA education benefits, the payments are not included on his or her tax return, but he or she must reduce the amount of education expenses qualifying for an education tax benefit by his or her VA payments. This applies only to the part of his or her VA payments that is required to be used for education expenses.

Business deduction The taxpayer can deduct the costs of qualifying work-related education as a business expense if they are self-employed. Refer to the Business Income lesson.

Educator Expenses Professional development expenses can be claimed as part of the educator expense adjustment to gross income. Refer to the Adjustments to Income lesson.

Foreign Tax Credit

Introduction

This lesson will show you how to help taxpayers claim the foreign tax credit. This credit applies to those who have paid or accrued taxes to a foreign country on foreign-sourced income and who are subject to U.S. tax on the same income.

To help these taxpayers, you must determine which taxes and types of foreign income are eligible for the foreign tax credit and accurately compute the credit using Form 1116, Foreign Tax Credit.

If the foreign tax paid is reported on a Form 1099-INT, Form 1099-DIV, or Schedule K-1 completion of the entire Form 1116 may not be required.

If the foreign tax paid is a result of living and working outside the U.S., then all the questions on Form 1116 need to be addressed.

Although the foreign tax credit is not specifically listed on Form 13614-C, Intake/Interview & Quality Review Sheet, ask taxpayers if they paid any tax to a foreign country.

Objectives

At the end of this lesson, using your resource materials, you will be able to:

- Determine which taxes and types of foreign income are eligible for the foreign tax credit
- Determine whether Form 1116 is needed, and if so to accurately compute the credit
- Calculate and report the foreign tax credit as a nonrefundable credit

What do I need?

- Form 13614-C
- Publication 4012
- Publication 514
- Form 1116
- Form 1116 Instructions

What is the foreign tax credit?

U.S. citizens and residents compute their U.S. taxes based on their worldwide income. This sometimes results in U.S. citizens having to pay tax twice on the same income — first to the government of the foreign country where the income was earned and again to the U.S. government.

Taxpayers can choose whether to take the amount of any qualified foreign income taxes paid during the year as a foreign tax credit or as an itemized deduction. Taxpayers may change their choice each year.

As a general rule, taxpayers must choose to take either a credit or a deduction for all qualified foreign taxes. For exceptions to this general rule, see Publication 514, Foreign Tax Credit for Individuals.

The foreign tax credit was created to help taxpayers avoid this double taxation. Taxpayers who paid income, war profits, or excess profits taxes to a foreign country or U.S. possession may be entitled to a credit on their U.S. taxes. Like other nonrefundable credits, the foreign tax credit allows taxpayers to take a dollar-for-dollar reduction in the amount of U.S. tax owed. However, in some cases, not all taxes paid to a foreign government on foreign-sourced income can be used in the computation of the credit.

Four tests must be met to qualify for the credit:

1. The tax must be imposed on the taxpayer
2. The taxpayer must have paid or accrued the tax

3. The tax must be a legal and actual foreign tax liability, and
4. The tax must be an income tax

Some foreign taxes, such as foreign real property tax, are not income taxes.

What if the foreign tax credit is reported on Form 1099-INT, Form 1099-DIV, or Schedule K-1?

Taxpayers who receive Form 1099-INT, Form 1099-DIV, or Schedule K-1 may have amounts indicating that foreign taxes have been paid on their behalf by the issuer of the document.

Taxpayers can elect to report foreign tax on Form 1040, Schedule 3 without filing Form 1116 as long as the following conditions are met:

- All of the gross foreign source income was from interest and dividends and all of that income and the foreign tax paid on it were reported on Form 1099-INT, Form 1099-DIV, or Schedule K-1 (or substitute statement).
- If the tax relates to dividend income from shares of stock, those shares were held for at least 16 days.
- The taxpayer is not filing Form 4563, Exclusion of Income for Bona Fide Residents of American Samoa, or excluding income from sources within Puerto Rico.
- The total foreign taxes shown on the forms was not more than $300 (not more than $600 if married filing jointly). If the total foreign tax amount shown exceeds these amounts, Form 1116 is required to claim any foreign tax credit.
- All foreign taxes were:
  - Legally owed and not eligible for a refund, and
  - Paid to countries that are recognized by the United States and do not support terrorism.

Taxpayers who must complete Form 1116 because they cannot qualify to claim the foreign tax credit without filing Form 1116 must be referred to a volunteer with an International certification or a professional tax preparer. If Schedule K-1 shows foreign taxes were paid or accrued, Schedule K-2 is needed to properly complete Form 1116.

A credit for foreign taxes can be claimed only for foreign tax imposed by a foreign country or U.S. possession.

Additional information can be found in the Form 1040 Instructions, Form 1116 Instructions and Publication 514.

To review information related to the software, go to the Volunteer Resource Guide, Tab G, Nonrefundable Credits.

Ryan, who is single, received Form 1099-DIV showing $29 of foreign taxes paid. According to Ryan, he received no other foreign source income and paid no other foreign taxes. The dividends were paid on shares of a mutual fund that he owned all year. He is eligible to claim the foreign tax credit on Form 1040, Schedule 3 and does not have to complete Form 1116.

EXERCISES

Answers are after the lesson summary.

Question 1: To claim the foreign tax credit without filing Form 1116, a taxpayer who is filing Single must have paid foreign taxes as shown on Form 1099-DIV, Form 1099-INT, or Schedule K-1 that are equal to or less than $300.

a. True

b. False

Question 2: Clyde comes to your site seeking help with his foreign tax credit. He is single and his Forms 1099-DIV show a total of $324 of foreign tax paid. Can Clyde claim the foreign tax credit without filing Form 1116?

a. Yes

b. No

Question 3: Judy and Mark are married and will file a joint return. Their Forms 1099-DIV show a foreign tax paid of $590. Can they claim the foreign tax credit without filing Form 1116?

a. Yes

b. No

The remaining sections of this lesson are directed to volunteers seeking an International certification. All others may proceed to the next lesson.

What are the rules for claiming the foreign tax credit on Form 1116?

If the foreign tax paid is more than $300 ($600 for Married Filing Jointly) or they do not meet the other conditions to make the election to claim the foreign tax credit without filing Form 1116, taxpayers must file Form 1116 to claim the foreign tax credit. See Publication 514 for details.

Foreign tax credits that cannot be used in the current year can be carried back to the previous year or carried forward to future years. Be sure to review the prior year's return for Form 1116 and possible carryover of foreign tax credits.

The foreign earned income exclusion differs from the foreign tax credit; try both methods for taxpayers and choose the approach that results in the lowest tax.

- *The exclusion allows a portion of the foreign earned income to be excluded from taxable income.*
- *The credit adds the foreign income to the taxable income and then reduces the U.S. tax due by some portion of taxes paid to the foreign government(s).*

What qualifies taxpayers for the credit?

To qualify for the credit, the following requirements must be met. A taxpayer must:

- Have income from a foreign country
- Have paid taxes on that income to the same foreign country
- Not have claimed the foreign earned income exclusion on the same income (see the foreign earned income exclusion section of the Income – Other Income lesson)

In addition, the foreign tax must:

- Be paid to a foreign country on income derived from that country
- Be similar to the U.S. income tax
- Provide no economic benefit to the taxpayer paying the tax

Foreign taxes that qualify for the foreign tax credit generally include taxes on:

- Wages
- Dividends
- Interest
- Royalties
- Annuities

Foreign taxes for which an individual may *not* take a credit include taxes:

- On excluded income
- On foreign mineral income
- On combined foreign oil and gas income for which the taxpayer can take only an itemized deduction
- From international boycott operations
- Of U.S. persons controlling foreign corporations and partnerships
- Taxes paid to a foreign country that a taxpayer does not legally owe, including amounts eligible for refund by the foreign country

Taxpayers cannot take the foreign tax credit for foreign income taxes paid on income excluded under the foreign earned income exclusion.

Robb and his wife, Nina, are U.S. citizens who reside in France. Their Form 1040, Schedule B, Interest and Ordinary Dividends, lists $2,000 interest from a U.S. bank and $600 interest from a French bank. They paid income taxes on both amounts to both countries. On their U.S. tax return, they can compute a foreign tax credit to offset the taxes they owe to the U.S. on the interest received from the French bank. They would need to check with the French taxing authorities to determine if they can claim a similar tax credit on their French tax return to offset the taxes paid to the U.S. on the interest income earned in the U.S.

Eva is a U.S. citizen who lives in Hong Kong. Eva owns her home in Hong Kong and paid $2,000 in real estate taxes and $1,000 in personal property taxes. She also paid $3,000 in income taxes to the government of Hong Kong. She cannot claim a foreign tax credit for either the real estate taxes or the personal property taxes because they are not income taxes. Eva can compute a foreign tax credit on the $3,000 in income taxes paid to Hong Kong.

For more detailed information, see Publication 514 and the Form 1116 Instructions.

EXERCISES (continued)

Question 4: Anne is a U.S. citizen living in Japan. She listed wages, interest income, and dividend income on her U.S. tax return. She paid taxes on each of these types of income to Japan. Anne can claim a foreign tax credit for taxes paid on which of the following sources of income?

a. Wages from her job in the U.S.

b. Interest income from a U.S. bank

c. Interest income from a Japanese bank

d. Dividend income from a U.S. corporation

Question 5: Jean, a U.S. citizen, received an inheritance upon the death of an uncle in Spain and paid an inheritance tax to the Spanish government. Can Jean claim a foreign tax credit to offset the inheritance tax she paid in Spain?

a. Yes

b. No

What is "economic benefit"?

As mentioned earlier, the foreign tax paid cannot provide a specific economic benefit for the taxpayer and be included in the foreign tax credit computation. This means that the tax cannot be a payment that results in an individual receiving:

- Goods
- Services
- Fees or other payments
- The right to use, acquire, or extract resources, patents, or other property that the foreign country owns or controls
- Discharges of contractual obligations

Taxpayers are considered to receive a specific economic benefit if they conduct a business transaction with a person who receives an economic benefit from a foreign country, and under the terms and conditions of the transaction, the taxpayer directly or indirectly receives some part of the benefit.

Lawrence is a business owner who lives in China, which has a two-tier income tax system:

- *Everyone is taxed according to their income*
- *Business owners pay additional tax on their profits*

The second tier entitles business owners to certain reduced fees and other benefits, such as ability to rent space in a government building. Because of the specific economic benefits Lawrence receives, he cannot use the second-tier tax payments to compute a foreign tax credit on his U.S. tax return. However, the first-tier income taxes are similar to U.S. income taxes and can be used to figure his foreign tax credit.

What are Sanctioned Country Restrictions and Section 901(j) Income?

Taxes paid to or accrued by certain countries do not qualify for the foreign tax credit. These are countries:

- That have been designated by the Secretary of State as repeatedly providing support for acts of international terrorism,
- With which the U.S. has severed or does not conduct diplomatic relations, or
- Whose government the U.S. does not recognize, unless that government is eligible to purchase defense articles or services under the Arms Export Control Act

See Publication 514 for the current list of sanctioned countries.

Foreign income earned in sanctioned countries is subject to U.S. tax. A separate Form 1116 must be completed for foreign income from a sanctioned country, using the "Section 901(j) income" category. This is beyond the scope of the VITA/TCE programs; refer taxpayers to a professional tax preparer.

EXERCISES (continued)

Question 6: Adele lived and worked in a sanctioned country until August of this tax year, when she was transferred to Italy. She paid taxes to each country on the income earned in that country. Can Adele take a foreign tax credit on her U.S. tax return for the taxes paid on income she earned in the sanctioned country?

a. Yes

b. No

Question 7: Assume the taxpayer is a U.S. citizen or resident living in a nonsanctioned foreign country and that the tax is being paid to a foreign government on foreign-sourced income. For each listed item determine if the tax qualifies for the foreign tax credit (Q) or does not qualify for the foreign tax credit (NQ).

_____ Dividend taxes

_____ Foreign oil related income tax

_____ Interest income tax

_____ Real estate taxes

_____ Income tax on wages from a foreign country, assuming the taxpayer does not take the foreign earned income exclusion

_____ Taxes paid that are returned to the taxpayer in the form of a subsidy

What categories of income qualify for the credit?

At the top of Form 1116, Part I, taxpayers are asked to indicate the type of foreign income they received. Two of these income categories fall within the scope of the VITA/TCE programs:

- Passive category income
- General category income

A separate Form 1116 must be completed for each type of income; each Form 1116 can include income earned in as many as three foreign countries.

Passive Category Income

This category includes passive income and specified passive category income. Passive income generally includes the following:

- Dividends
- Interest
- Royalties
- Rents
- Annuities
- Net gain from the sale of property that produces such income, or non-income-producing investment property

For example, a taxpayer who lives in a foreign country and pays taxes on interest income could claim the foreign tax credit and check the Passive category income box on Form 1116.

Wages and salaries are considered to be general category income, which is discussed later in this topic. Passive category income may qualify as general category income if the foreign government taxes it at a rate higher than the highest U.S. tax rate; see High-Taxed Income later in this lesson.

For additional information on passive income and specified passive category income, see Publication 514.

General Category Income

General category income consists of income earned in a foreign country that an individual does not exclude, or excludes only part of, under the foreign earned income exclusion. Additionally, foreign income that does not come under any of the other categories on Form 1116 can typically be included as general category income.

Robert paid taxes to Spain for earned income and did not claim the foreign earned income exclusion. He can claim a foreign tax credit for the taxes paid to Spain.

What is high-taxed income?

Some passive category income can be included in general category income if it is taxed by a foreign government at a rate higher than the highest U.S. income tax rate. Therefore, if taxpayers pay more than the highest U.S. income tax rate on the foreign-sourced passive income for which they claimed the credit, the credit is computed under general category income.

Brenda is a U.S. citizen who lives in a foreign country and pays 45% income tax on her interest income in that country. She lists this as "General Category Income" on Form 1116, since the tax rate paid on this passive income is higher than the highest U.S. income tax rate.

EXERCISES (continued)

Question 8: Regina lives in a foreign country and is a U.S. citizen. She has both dividend income and interest income from foreign countries. Her foreign bank withholds 15% of her interest income for income taxes. She also pays foreign income taxes on her dividend income, at a rate of 45%. For the purposes of Form 1116, how should the following types of income be classified?

Interest Income: _____ Dividend Income: _____

a. Passive category income

b. General category income

Question 9: Bernard is a U.S. citizen who lives in Barbados. This year, he paid 17% income tax on interest income from his bank account in Barbados. For the purposes of Form 1116, Bernard's foreign interest income should be classified as:

a. Passive category income

b. General category income

Tax Law Application

There are several factors to consider when determining if taxes paid to a foreign government are eligible for the foreign tax credit. Ask the taxpayer:

- Was the income foreign-sourced?
- What type of tax was paid to the foreign government?
- Will the taxpayer receive some kind of specific economic benefit from the payment of this tax?

How do I complete Form 1116?

If the taxpayer does not qualify for the election to claim the foreign tax credit without filing Form 1116, the form must be completed. The amount of the foreign tax credit is the portion of U.S. income tax liability based on gross taxable foreign income. Certain expenses reduce foreign gross income. Some of these situations are complicated and beyond the scope of the VITA/TCE programs, such as:

- Expenses directly related to the foreign income
- Investment interest expense
- Foreign losses, such as those from selling foreign assets or a loss from a business or partnership

If the taxpayers have any of these types of deductions, refer them to a professional tax preparer.

For step-by-step instructions on completing Form 1116, go to the Volunteer Resource Guide, Tab G, Nonrefundable Credits.

Summary

Taxpayers who paid taxes to a foreign country or U.S. possession may be able to take a nonrefundable foreign tax credit. Generally, to claim the credit, taxpayers are required to file Form 1116.

Taxpayers do not have to file Form 1116 if they meet certain requirements and can elect to claim the foreign tax credit directly on Form 1040, Schedule 3. This election is in scope for the Advanced certification. VITA/TCE volunteers must have International certification to help taxpayers who are required to file Form 1116.

To qualify for the foreign tax credit, the taxpayer, income, and taxes must all meet specific requirements. The credit is computed and reported on Form 1116. A separate Form 1116 must be completed for each category of income.

The foreign tax credit is different from the foreign earned income exclusion. If the taxpayer uses the foreign earned income exclusion, foreign tax paid on the excluded income cannot be used to claim the foreign tax credit. Taxpayers can choose the approach that results in the lowest tax.

What situations are out of scope for the VITA/TCE programs?

The following are out of scope for this lesson. While this list may not be all inclusive, it is provided for your awareness only.

- Taxpayers who must complete Form 1116 because they cannot elect to report foreign tax on Form 1040 Schedule 3, unless your site has a volunteer and a reviewer with an International certification
- Taxpayers who may deduct a foreign income tax that is not allowed as a credit in certain circumstances
- Certain expenses deducted to reduce foreign gross income
- Taxpayers who must report a carryback or carryover on Form 1116
- Taxpayers who must file a separate Form 1116 required for foreign income from a sanctioned country, using the “Section 901(j) income” category

- The FATCA filing requirement box is checked on any 1099 form.
- The taxpayer is required to file form FINCEN 114 or received a distribution from, or was the grantor of, or transferor to, a foreign trust.

To gain a better understanding of the tax law, complete the practice return(s) for your course of study using the Practice Lab on L&LT.

EXERCISE Answers

Answer 1: a, True. Form 1116 is not required if the total foreign taxes paid are less than or equal to $300 ($600 if Married Filing Jointly).

Answer 2: b, No. Clyde is not eligible for the election to not use Form 1116 once his creditable foreign taxes exceed $300. Clyde will need to be referred to a volunteer with an International certification or seek the assistance of a professional tax preparer.

Answer 3: a, Yes. Judy and Mark do not have to complete Form 1116 because they file jointly and their foreign taxes are less than $600.

Answer 4: c. On Anne's tax return, she can claim a foreign tax credit to offset taxes she paid to Japan on interest received from the Japanese bank.

Answer 5: b, No. An inheritance does not qualify as income from a foreign country. Under U.S. tax law, inheritances are not taxable to the beneficiaries. Jean is not eligible to claim a foreign tax credit for the inheritance taxes she pays to the Spanish government.

Answer 6: b, No. Adele cannot take a foreign tax credit for the taxes paid on income she earned in the sanctioned country. However, this income is taxable in the U.S., since she is a U.S. citizen.

Answer 7:

Q – Dividend taxes

NQ – Foreign oil–related income tax

Q – Interest income tax

NQ – Real estate taxes

Q – Income tax on wages from a foreign country, assuming the taxpayer does not take the foreign earned income exclusion

NQ – Taxes paid that are returned to the taxpayer in the form of a subsidy.

Answer 8: Interest Income – a, passive category income; Dividend Income – b, general category income because it is high taxed income.

Answer 9: a. Since 17% (the tax rate Bernard paid) is not more than the highest U.S. income tax rate, Bernard's income falls under passive category income.

Child Tax Credit & Credit for Other Dependents

Introduction

The child tax credit is unique because if a taxpayer cannot benefit from the nonrefundable credit, the taxpayer may be able to qualify for the refundable additional child tax credit on Schedule 8812, Credits for Qualifying Children and Other Dependents. In this chapter, we will learn about both credits and their relationship to each other. Some taxpayers may not be aware of these credits. Your time, effort, and understanding of this credit may result in a lower tax for the taxpayer.

The child tax credit, credit for other dependents, and the additional child tax credit are entered on Form 1040. The intake and interview sheet, along with the Volunteer Resource Guide, Tab G, Nonrefundable Credits are critical tools needed to determine eligibility for the credit.

Don't confuse these credits with the child and dependent care credit!

Objectives

At the end of this lesson, using your resource materials, you will be able to:

- Determine the taxpayer's eligibility for the credit(s)
- Determine which taxpayer can claim the credits

What do I need?

- Form 13614-C
- Publication 4012
- Publication 17
- Schedule 8812

Optional:

- Form 1040 Instructions
- Schedule 8812 Instructions

What is the child tax credit?

The child tax credit (CTC) is a nonrefundable credit that allows taxpayers to claim a tax credit of up to $2,000 per qualifying child, which reduces their tax liability.

What is the additional child tax credit?

Taxpayers who are not able to claim the full amount of the child tax credit may be able to take the refundable additional child tax credit (ACTC). Completing Schedule 8812 may result in a refund even if the taxpayer doesn't owe any tax.

Who can claim the child tax credit?

To be eligible to claim the child tax credit, the taxpayer must have at least one qualifying child. If taxpayers claim the child tax credit or additional child tax credit but are not eligible for the credit, they can be banned from claiming the credit for either two or ten years. Refer to Disallowance of Certain Credits in the Volunteer Resource Guide, Tab I, Earned Income Credit, to determine if Form 8862, Information to Claim Certain Credits After Disallowance, must be filed.

Does the child have to be the taxpayer's dependent?

To be a qualifying child for the child tax credit, the child must be the taxpayer's dependent.

Are there special rules for children of divorced or separated parents or parents who live apart?

There are special rules for children of divorced or separated parents, as well as for children of parents who live apart. The custodial parent is the parent with whom the child lived for the greater number of nights during

the year. The other parent is the noncustodial parent. In most cases, the qualifying child is considered the dependent of the custodial parent. However, the noncustodial parent may be entitled to claim the child tax credit and additional child tax credit for the qualifying child if the custodial parent provides them with Form 8332, Release/Revocation of Release of Claim to Exemption for Child by Custodial Parent, or a similar statement. All noncustodial parents must attach Form 8332 or a similar statement to their return each year the custodial parent provides the release. Review the Child Tax Credit charts in the Volunteer Resource Guide, Tab G, Nonrefundable Credits for additional information.

Taxpayers with divorce decrees or divorce agreements executed after 2008 must use Form 8332 or a similar statement whose only purpose is to release the custodial parent's claim to the child tax credit. They cannot simply substitute pages from the divorce decree.

Mary and Ralph got a divorce in 2015. They have one child together, Amy, who lives with Mary. All are U.S. citizens and have SSNs. Mary and Ralph provide more than half of Amy's support. Mary's AGI is $31,000, and Ralph's AGI is $39,000. Amy is 12. The divorce decree does not state who can claim the child.

Ralph, the noncustodial parent, can claim the child tax credit only if Mary signs Form 8332. Mary can still claim the earned income credit, Head of Household, and child and dependent care credit for Amy assuming she qualifies for them.

Remember, a custodial parent's release of the dependent child will also release the child tax credit and the additional child tax credit, if either applies, to the noncustodial parent.

How do I determine taxpayer eligibility for the child tax credit?

Taxpayers claiming the child tax credit must have a valid identification number (SSN or ITIN) by the due date of the tax return, including extensions. In addition, the dependent claimed must have a valid SSN by the due date of the return, including extensions. Taxpayers cannot subsequently file amended returns to claim the credit for a year that they did not originally have a valid identification number by the return due date.

Taxpayers who claim the foreign income exclusion (discussed in the Adjustments to Gross Income lesson) are not eligible for the child tax credit.

To determine whether a child meets the criteria of a qualifying child for the child tax credit or additional child tax credit, use the interview techniques and tools discussed in earlier lessons. Begin by reviewing and completing the Marital Status and Household Information section of the taxpayer's intake and interview sheet. Verify that the child:

- Is under age 17 on December 31 of the tax year
- Lived with the taxpayer for more than six months of the year (remember the special rules for divorced or separated parents or parents who live apart)
- Did not provide over half of his or her own support
- Meets the relationship criteria
- Is a U.S. citizen, U.S. national, or resident of the United States
- Has a valid Social Security number

The CTC and ACTC stop once the child reaches age 17 — disability is not a factor.

If the Marital Status and Household Information section is incomplete or the taxpayer is unsure of how to respond, you may want to use Table 1: Does Your Qualifying Child Qualify You for the Child Tax Credit or Credit for Other Dependents? in the Volunteer Resource Guide, Tab G, Nonrefundable Credits. It provides helpful probing questions to ask the taxpayer.

The entries for each qualifying child in the Basic Information section will help the software determine if the child is eligible for the child tax credit.

Ed's son, Jeff, turned 17 on December 30, and has a valid Social Security number (SSN). He is a citizen of the United States. According to the child tax credit rules, he is not a qualifying child for the child tax credit because he was not under the age of 17 at the end of the tax year.

EXERCISES

Question 1: Jose and Yolanda Alameda are Married Filing Jointly and have five dependent children under the age of 17. Jose and Yolanda both have valid SSNs. Their children have Individual Taxpayer Identification Numbers (ITINs). Are their children qualifying children for the purpose of the child tax credit?

a. Yes

b. No

What is the amount of the credit?

The maximum amount taxpayers can claim for the child tax credit is $2,000 for each qualifying child. The amount claimed on Form 1040 depends on the taxpayer's filing status, modified adjusted gross income (MAGI) and tax liability. The amount of the credit may be reduced if the taxpayer's:

- MAGI is above the limit for the taxpayer's filing status; the Volunteer Resource Guide, Tab G, Nonrefundable Credits, for the limits on the credit, or
- Tax liability less the majority of the nonrefundable credits is less than the maximum child tax credit

The credit is figured on Schedule 8812. The tax software makes all these calculations based on your entries.

Stan files as Head of Household and has three children who qualify for purposes of the child tax credit. Stan's MAGI is $54,000 and his tax liability is $4,680. Stan is eligible to take a child tax credit of up to $4,680 to offset his tax liability. Stan cannot claim the full $6,000 child tax credit because it is limited to his tax liability of $4,680. Stan may also be eligible for the additional child tax credit.

May and Bob file as Married Filing Jointly and have two children who qualify for the child tax credit. Their MAGI is $56,000 and their tax liability is $954. They can only claim $954, reducing their tax to zero. As they could not claim the maximum child tax credit, May and Bob may also be eligible for the additional child tax credit.

What is MAGI?

Typically, the taxpayers' MAGI is the same as their AGI from Form 1040. For more information on MAGI as it applies to the child tax credit, refer to the Instructions for Schedule 8812.

If the taxpayers' tax liability is zero, they cannot take the credit because there is no tax to reduce. However, the taxpayers may be able to take the additional child tax credit, discussed later in this lesson.

EXERCISES

Use Table 1: Child Tax Credit from the Volunteer Resource Guide, Tab G, Nonrefundable Credits, and Publication 17 to complete the exercises. Answers are at the end of the lesson summary.

Question 2: Laura's adopted son Jack is 12. He is a citizen of the United States and lived with Laura for the entire tax year, during which time Laura provided full financial support. Is Jack a qualifying child for the child tax credit?

a. Yes

b. No

Question 3: Which one of the following individuals (all of whom have two qualifying children for the purposes of the child tax credit) are eligible to claim the maximum $2,000 per child for the child tax credit on their tax return?

a. Fiona, who is Married Filing Separately with a MAGI of $202,000

b. Ken, a Qualifying Surviving Spouse with a MAGI of $30,000 and tax liability of $490

c. Nick, who is Single with a MAGI of $70,000 and a tax liability of $5,000

d. Julie, who is Married Filing Jointly with a MAGI of $422,000

What is the additional child tax credit?

This credit is for certain individuals who get less than the full amount of the child tax credit. The additional child tax credit may give taxpayers a refund even if they do not owe any tax.

Taxpayers who do not get the full $2,000 of the child tax credit may qualify for the additional child tax credit. Review the Additional Child Tax Credit – General Eligibility chart in the Volunteer Resource Guide, Tab G, Nonrefundable Credits to see the requirements to claim the credit.

What is the amount of the credit?

The additional child tax credit allows eligible taxpayers to claim up to $1,500 for each qualifying child. The refundable portion is indexed for inflation. For taxpayers with earned income over $2,500, the credit is based on the lesser of:

- 15% of the taxpayer's taxable earned income that is over $2,500 or
- The amount of unused child tax credit (caused when tax liability is less than allowed credit)

The refund for taxpayers claiming the child tax credit will not be issued prior to February 15.

Remember May and Bob who have two qualifying children, a MAGI of $56,000, and a tax liability of $954? Because their tax liability is less than the full amount of the credit (in their case $4,000), they may be able to take the additional child tax credit of $2,800 ($4,000 - $954, but limited to $1,500 per child).

There is another method to compute the additional child tax credit for taxpayers with three or more qualifying children. These taxpayers may benefit if they:

- Had Social Security or Medicare taxes withheld from their pay
- Were self-employed and paid self-employment tax
- Paid tax on tips not reported to their employer
- Did not receive the maximum available child tax credit

The amount of the taxpayer's earned income is a factor in this calculation on Schedule 8812.

The additional child tax credit is not refundable for taxpayers electing to exclude foreign earned income from tax.

How do I calculate the additional child tax credit?

Schedule 8812 is used to calculate the credit, which is entered on the additional child tax credit line of Form 1040.

If you are using the tax software, the system will automatically calculate the credit and place that entry on the appropriate line of the refundable credits.

If you have a question about the amount that appears as the child tax credit, the taxpayer's completed Child Tax Credit Worksheet may help you understand the determination.

What is credit for other dependents?

There is a $500 credit for other dependents who do not qualify for the $2,000 child tax credit. The dependent must be a U.S citizen, U.S. national, or resident of the U.S. The dependent must have a valid identification number (ATIN, ITIN, or SSN).

The $500 non-refundable credit covers dependents who don't qualify for the child tax credit. Taxpayers cannot claim the credit for themselves (or a spouse if Married Filing Jointly).

Taxpayers that exceed the MAGI limits for the credit for other dependents will not get the full amount of the credit. The tax software automatically applies the MAGI limits and phaseouts based on the filing status of the taxpayer.

Individuals who qualify as dependents because they are residents of Canada or Mexico do not qualify for either the child tax credit or the credit for other dependents.

Robert and Susan file a joint return and they both have SSNs. Their tax liability is $2,000. They have three qualifying dependents. Tom is their 18-year-old son, has an SSN, and meets the qualifying child dependent test. Jill is their 16-year-old adopted child, has an ATIN, and meets the qualifying child dependent test. Robert's mother, Esther, is 65 years old, has an ITIN, and meets the qualifying relative test. They are all U.S. residents. Tom, Jill, and Esther are all qualifying dependents for the credit for other dependents.

How do I avoid common errors?

When considering the child tax credit or credit for other dependents, it is critical to interview the taxpayer thoroughly and complete the dependent section of the intake and interview sheet to correctly identify eligible children or other dependents.

What if credits were disallowed in a prior year?

The intake and interview sheet asks if the taxpayer was previously disallowed child tax credit or credit for other dependents in a prior year. If the taxpayer answers “yes” to this question, refer to the Volunteer Resource Guide, Tab I, Earned Income Credit, Disallowance of Certain Credits.

Summary

The child tax credit is a nonrefundable credit that allows qualifying taxpayers to reduce their tax liability to the lesser of the amount of the credit or their adjusted tax liability.

If a taxpayer is not able to benefit from the maximum $2,000 credit per qualifying child, the taxpayer may be eligible for the additional child tax credit, which is a refundable tax credit up to $1,500 (subject to indexing).

When dependents are not eligible for the child tax credit, they may be eligible for the nonrefundable $500 credit for other dependents.

Taxpayers claiming the child tax credit or the credit for other dependents must have a valid identification number (SSN or ITIN) by the due date of the return, including extensions. The qualifying child must have a valid SSN by the due date of the return including extensions. To claim the credit for other dependents, the dependent must have a valid identification number (ATIN, ITIN, or SSN) by the due date of the return including extensions.

If taxpayers claim the child tax credit or additional child tax credit but are not eligible for the credit, they can be banned from claiming the credit for either two or ten years.

To gain a better understanding of the tax law, complete the practice return(s), or supplements for your course of study using the Practice Lab on L&LT.

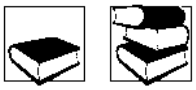
EXERCISE Answers

Answer 1: b, No. The children do not qualify for the child tax credit because they do not have valid SSNs.

Answer 2: a, Yes. Jack is a qualifying child for the child tax credit because he was under the age of 17 at the end of the current tax year; he meets the relationship requirement, lived with Laura for at least six months of the year; and he did not provide more than half of his support.

Answer 3: c. Nick may be able to take the full $2,000 credit for each of his qualifying children because his MAGI is not affected by the threshold limit for his single filing status. In addition, his tax liability of $5,000 is more than the amount of $2,000 per child for the credit.

Miscellaneous Credits



Introduction

The child and dependent care credit, lifetime learning credit, child tax credit and foreign tax credit were covered in earlier lessons. This lesson provides the information you need to be able to prepare a return with certain other nonrefundable credits.

Objectives

At the end of this lesson, using your resource materials, you will be able to:

- Determine if a taxpayer qualifies for the retirement savings contributions credit and accurately complete Form 8880, Credit for Qualified Retirement Savings Contributions
- Calculate the credit for the elderly or the disabled by completing Form 1040, Schedule R, Credit for the Elderly or the Disabled

Use the information from the intake and interview sheet, along with the documents provided by the taxpayer to determine eligibility for these credits.

What do I need?

- Form 13614-C
- Publication 4012
- Publication 17
- Form 1040
- Schedule R
- Form 8880

Optional:

- Form 1040 Instructions
- Form W-2 Instructions

What is a nonrefundable credit?

In an earlier lesson, you learned the difference between a nonrefundable credit and a refundable credit. A nonrefundable credit can only reduce the tax liability to zero. All the credits discussed in this lesson are nonrefundable credits.

Generally, nonrefundable credits are applied against federal tax in the order they are listed on Form 1040, Schedule 3, Nonrefundable Credits.

The software will calculate these credits, but the correct information must be entered. The volunteer tax preparer must make the correct determinations by using the intake and interview sheet and resource materials.

For information about the residential energy credits, see the Temporary Provisions lesson.

What is the retirement savings contributions credit?

The retirement savings contributions credit is a nonrefundable credit eligible taxpayers may claim if they made a qualifying contribution to a retirement plan.

If the contribution is tax deductible (such as a traditional IRA), the taxpayer receives the benefit of the tax deduction and a tax credit. This is considered a *double benefit* and is rarely allowed. Contributions to non-tax-deductible accounts (such as Roth IRAs) can qualify the taxpayer for the credit as well. The credit is calculated on Form 8880, Credit for Qualified Retirement Savings Contributions.

Who is eligible for the retirement savings contributions credit?

Generally, an individual who made a voluntary contribution to a retirement account, is at least 18 years of age, not a dependent, and not a full a full-time student may be eligible to claim this credit if their income is not too high. Go to the Volunteer Resource Guide, Tab G, Nonrefundable Credits, and review the Retirement Savings Contribution Credit – Screening Sheet for the qualifications.

What are eligible contributions for the purpose of the retirement savings contributions credit?

To be eligible for the credit, taxpayers' contributions must be elective or voluntary. For purposes of this credit, an employee contribution will be voluntary as long as it is not required as a condition of employment, participation in the employer's retirement plan, or in order to get benefits under the plan. Eligible contributions include:

- Traditional or Roth IRA contributions (other than rollover contributions)
- Elective deferrals to a 401(k) or 403(b) plan (including designated Roth contributions), a governmental 457 plan, SEP, or SIMPLE plan
- Voluntary employee contributions to a qualified retirement plan as defined in section 4974(c) (including the federal Thrift Savings Plan), or
- Contributions to a 501(c)(18)(D) plan

Contributions designated under Internal Revenue Code Section 414(h)(2) (government pick-up plans) are treated as employer contributions, not voluntary contributions made by the employee. They do not qualify for the credit and should not be included on Form 8880, line 2. This information is stated in the Form 8880 Instructions.

How do I know if the taxpayer made an eligible contribution?

In most cases, eligible contributions will be listed on the taxpayer's Form W-2, Box 12 and preceded by one of the following codes: D, E, F, G, H, S, AA, or BB. These are the codes most frequently seen. For a complete list of Box 12 codes, refer to the Form W-2 Instructions.

Contributions to traditional or Roth IRAs may appear on Form 5498, IRA Contribution Information. However, most taxpayers will not receive this form before they file their tax return. When reviewing the Expenses section on page 2 of the intake and interview sheet, be sure to ask if the taxpayer made a contribution to an IRA or other retirement account or if they intend to make an IRA contribution before the April due date of the return.

Contributions to Roth IRAs are limited based on the filing status and modified AGI of the taxpayer and spouse if filing jointly. Only allowable contributions are eligible for the credit. Refer to the limitations in the Important Changes lesson.

A designated beneficiary of an Achieving a Better Life Experience (ABLE) account may claim the saver's credit for contributions he or she makes to his or her ABLE account for tax years 2018-2025.

If Form W-2 is entered into the software correctly and completely, the program will carry the appropriate information to Form 8880. Review the Volunteer Resource Guide, Tab D, Income, Form W-2 Instructions, for the software entries.

If the taxpayer contributed to a Roth IRA, enter the amounts on the Retirement Savings Contributions Credits screen. The software will carry the appropriate contributions to Form 8880. Review the Volunteer Resource Guide, Tab G, Nonrefundable Credits, for the software entries.

What may reduce an eligible contribution for purposes of the credit?

Eligible contributions are reduced by the following distributions received during the testing period:

- Traditional or Roth IRAs, or ABLE accounts
- 401(k), 403(b), governmental 457, 501(c)(18)(D), SEP, or SIMPLE plans

- Qualified retirement plans as defined in section 4974(c) (including the federal Thrift Savings Plan) if the taxpayer could make voluntary contributions to the plan

Ask if the taxpayer made or could have made contributions to the plan. If so, were such contributions required to participate in the plan or were they voluntary. If not voluntary, the distribution does not reduce contributions for the credit.

The testing period includes:

- The tax year
- The two preceding tax years, and
- The period between the end of the tax year and the due date of the return, including extensions

Ask the taxpayer if they received any distributions in the testing period. Do not reduce eligible contributions by distributions received from military retirement plans or any other plan if the taxpayer could not make voluntary contributions to the plan. Also, do not include distributions that were not taxable because they were rolled over or transferred to another qualified plan. See Publication 4012, Tab G, Nonrefundable Credits, for additional exceptions that do not need to be included in total distributions.

The software automatically reduces contributions by any taxable distributions from current tax year Forms 1099-R. Other distributions that reduce the amount of contributions must be manually input on the appropriate line of the Retirement Savings Contributions Credits screen, such as distributions during the two-year lookback period. Check the box on the Form 1099-R input screen if the distribution should not carry to Form 8880.

The portion of a Coronavirus-related distribution that is taxable in the current year on Form 8915-F is not a distribution during the year for purposes of the credit. The whole amount of the 2020 Coronavirus-related distribution, reduced for any repayments, would be included in the two year lookback period.

What is the maximum contribution amount for married taxpayers for the credit?

For married taxpayers filing a joint return, both spouses may be eligible for a credit on a maximum annual contribution of $2,000 each. If either spouse has received a distribution during the testing period, *both* spouses must reduce their eligible contribution by that amount.

EXAMPLE

Jose and Lucy are married and will file a joint return. Their adjusted gross income was below the retirement savings contributions limit. They each contributed $3,000 to a 401(k) plan. They did not receive any distributions during the three-year period and cannot claim any other credits. Jose and Lucy are eligible for a credit based on the maximum eligible annual contribution amount of $2,000 each.

EXAMPLE

Joe and Mary have been married for five years and always file a joint return. In the previous tax year, Mary changed jobs and cashed in a small 401(k) from her former employer.

In the current tax year, both Joe and Mary made eligible contributions to their IRAs and otherwise qualify for the retirement savings credit. They both must reduce the amount of their eligible contributions by the amount of the distribution that Mary received last year. This calculation is completed on Form 8880.

How do I determine the amount of the credit?

Form 8880 is used to figure the credit. The credit can be as low as 10% or as high as 50% of a maximum annual contribution of $2,000 per person depending on filing status and adjusted gross income.

Review the Volunteer Resource Guide, Tab G, Nonrefundable Credits, Retirement Savings Contributions Credit, for the software entries and a table with the AGI brackets and related credit percentages.

EXERCISES

Question 1: All of these taxpayers contributed to their employers' 401(k) plan. Who qualifies for the retirement savings credit based on adjusted gross income? (Use the credit table found in the Volunteer Resource Guide, Tab G, Retirement Savings Contributions Credit)

a. Ed, who is single and has an AGI of $49,000

b. Sybil, who is married, files jointly, and has an AGI of $52,500

c. Megan, who is head of household and has an AGI of $65,400

d. Carl, who is a qualifying surviving spouse with a dependent child, and has a modified AGI of $59,250

Taxpayer Interview and Tax Law Application

Our volunteer is working with Ryan. She has already determined that Ryan's filing status is Single, no one can claim him as a dependent, his AGI is $25,000, and he is 28 years old. Using the Volunteer Resource Guide, Retirement Savings Contributions Credit – Screening Sheet, follow along with our volunteer as she determines Ryan's eligibility for the credit.

Sample Interview

Volunteer Says...	Ryan Responds...
Ryan, I see from your Form W-2 that you contributed $1,500 to your employer's 401(k) plan. Did you make contributions to any other qualified plans, such as an IRA?	No, I put all my savings into the 401(k) because my employer matches it.
That's a great benefit. Were you a full-time student during the tax year?	No, I've been out of school for several years.
Well, it looks like you qualify for the credit. I will complete Form 8880 to see how much the credit will be.	Great!
Did you receive any distributions from your retirement plan at any time this tax year or the last two years, or do you plan to take any distributions before the tax filing deadline?	Well, last year I took out a loan against my 401(k) to use as a down payment on a car. I've already paid it back through payroll deductions. Does that count?
No, your loan isn't considered a distribution, so you'll get to use the full $1,500 contribution in the calculation of your credit. The credit will be a percentage of your contribution. It will reduce your amount of total tax, so you'll end up with a bigger refund.	I'll take every penny!

How do I handle the credit for the elderly or the disabled?

The credit for the elderly or the disabled is calculated on Schedule R.

Who qualifies for the credit for the elderly or the disabled?

Individuals who qualify for the elderly or the disabled credit are:

- Age 65 or older or
- Under age 65, retired on permanent and total disability, receiving taxable disability income, and under the mandatory retirement age their company has set

A taxpayer with a permanent and total disability is unable to engage in "substantial, gainful activity," or in other words, paid employment. Taxpayers who can do such work are not considered disabled. Working in a sheltered workshop setting, however, is not considered substantial, gainful activity.

Mandatory retirement age is the age set by a taxpayer's employer at which the taxpayer would have been required to retire, had the taxpayer not become disabled.

Generally, disability income comes from an employer's disability insurance, health plan, or pension plan. The payments replace wages for the time the taxpayer missed work because of the disability. The plan must provide for disability retirement for the payments to be considered disability income.

In addition to being a qualified individual, the taxpayer's total income must be within certain limits. The income limits can be found in the Volunteer Resource Guide, Tab G, Nonrefundable Credits.

Few taxpayers qualify for this credit because the credit calculation includes the taxpayers' nontaxable Social Security, veterans' benefits, or other excludable pension, annuity, or disability benefits. Most taxpayers' Social Security benefits alone exceed the limit.

John is unmarried and filing a single return. He is 67 years old and received $12,000 in nontaxable Social Security benefits in the tax year. His AGI is $9,000. Even though John is a qualified individual, he is not eligible to claim the credit since his nontaxable Social Security benefits exceed $5,000.

How do I determine the amount of the credit?

Schedule R is used to calculate the credit, and has three parts:

- Part I, Filing Status and Age
- Part II, Statement of Permanent and Total Disability which ensures that taxpayers who are under 65 have obtained a completed physician's statement that proves they are permanently and totally disabled
- Part III, Figure Your Credit

If the taxpayer is 65 or over, or under 65 and retired on permanent and total disability, complete Schedule R to determine the amount of the credit, if any.

All Social Security and Tier 1 railroad retirement benefits must be entered on the Social Security benefits screen, even if none of the Social Security is taxable, so the tax software can correctly calculate this credit.

***Tax Software Hint:** Go to the Volunteer Resource Guide, Tab G, Nonrefundable Credits, for details about qualifying income limits for this credit. If a taxpayer appears to qualify, follow the directions in the Volunteer Resource Guide to complete a Schedule R. The taxpayer will not get the benefit of the credit unless the Schedule R is completed.*

EXERCISES (continued)

Question 2: Taxpayers may be able to take the credit for the elderly or disabled if they are:

- Under age 65 at the end of the tax year
- Retired on permanent and total disability
- Under the mandatory retirement age on January 1, of the tax year, and
- Receiving taxable disability income

a. True

b. False

Taxpayer Interview and Tax Law Application

Determining Albert's Eligibility

Albert arrives at the tax center with his tax return nearly complete, but he wants to know if he can claim the credit for the elderly or the disabled. Follow along in the conversation.

Sample Interview

Volunteer Says...	Albert Responds...
Are you either a U.S. citizen or a resident alien?	Yes, I'm a U.S. citizen.
Are you over 65?	No, I'm only 54, not even old enough for retirement. But I had to stop working last year because of my disability.
Are you retired on permanent and total disability?	Yes. In fact, I started receiving disability retirement benefits last August.
I see you received $4,430 in Social Security benefits and your adjusted gross income is $15,430. Did you receive any other pension benefits that might not be taxable?	No, I just get my Social Security and disability checks from the place I retired.
And your filing status is Single, so it looks like you might be able to claim the credit. I'll complete Schedule R in the software to see if you qualify.	

What is the mortgage interest credit?

This topic is out of scope for the VITA/TCE programs and is included for informational purposes only. Taxpayers who hold mortgage credit certificates (MCCs) under a qualified state or local government program may claim a nonrefundable credit for mortgage interest paid. The taxpayer must have a document titled, "Mortgage Credit Certificate (MCC)." The amount of the credit is listed on the certificate. Refer taxpayers who choose to claim this credit to a professional tax preparer.

How are the total nonrefundable credits reported?

Nonrefundable credits are listed on Form 1040, Schedule 3 and the total is entered on the applicable line of Form 1040.

Based on your entries for all the credits, the software calculates the total of the taxpayer's credits and enters the amount on Form 1040. Remember, the nonrefundable credits cannot exceed the taxpayer's federal income tax.

Summary

Retirement Savings Contributions Credit

Taxpayers who contributed to certain retirement plans or IRAs may be eligible for a nonrefundable qualified retirement savings contributions credit.

Be sure to ask the taxpayer if IRA contributions were made or if they intend to make an IRA contribution before the April due date of the return. Carefully review the taxpayer's Form(s) W-2 for pretax retirement plan contributions and accurately input the amounts into the tax software. The software calculates the retirement savings credit based on the information entered.

The amount of the credit is determined by the taxpayer's filing status, adjusted gross income, and the taxpayer's qualified retirement contributions.

Form 8880 is used to calculate the credit.

Taxpayers' IRA contributions are often overlooked. Ask taxpayers if they made traditional or Roth IRA contributions that may qualify for the retirement savings contributions credit. Taxpayers have until the April due date of the return to make contributions for the tax year.

Credit for the Elderly or the Disabled

Taxpayers age 65 or older, or under age 65 who retired on permanent and total disability, may be able to claim a special nonrefundable credit if they are U.S. citizens or resident aliens. Few qualify for this credit because most taxpayers' Social Security benefits exceed the income limits.

The Volunteer Resource Guide provides a flowchart for determining basic eligibility and a quick reference table of income and Social Security limits. Schedule R, Credit for the Elderly or the Disabled, is used to calculate the credit.

What situations are out of scope for the VITA/TCE programs?

The following is out of scope for this lesson. While this list may not be all inclusive, it is provided for your awareness only.

- Mortgage interest credit
- Other credits listed on Schedule 3 not included in this or a prior lesson.

To gain a better understanding of the tax law, complete the practice return(s) for your course of study using the Practice Lab on L&LT.

EXERCISE Answers

Answer 1: b. Sybil qualifies for the credit because her adjusted gross income is under the threshold limit for Married Filing Jointly.

Answer 2: a, True. A taxpayer who is under age 65 at the end of the tax year, retired on permanent and total disability, had not reached mandatory retirement age by January 1 of the tax year, and who receives taxable disability income, may be able to take the credit for elderly or disabled. All these items must first be met before a taxpayer who is under age 65 can be considered for the credit for the elderly or disabled.

Premium Tax Credit

Introduction

In this lesson you will learn how to determine if taxpayers are eligible to receive the premium tax credit (PTC). A list of terms you may need to know is included at the end of the lesson.

Objectives

At the end of this course, using your resource materials, you will be able to:

- Determine eligibility for the PTC
- Calculate the PTC
- Report taxpayers' PTC on the tax return

What do I need?

- Form 13614-C
- Publication 4012
- Publication 17
- Publication 974
- Form 1095-A & Instructions
- Form 8962 & Instructions

Optional

- Publication 5120
- Publication 5121
- Publication 5156
- Publication 5172
- Form 1095-B & Instructions
- Form 1095-C & Instructions

What is the Affordable Care Act?

Under the Affordable Care Act (ACA), the federal government, state governments, insurers, employers, and individuals share responsibility for improving the quality and availability of health insurance coverage in the United States. The ACA reforms the existing health insurance market by prohibiting insurers from denying coverage or charging higher premiums because of an individual's preexisting conditions. The ACA also creates the Health Insurance Marketplace. For more information about the Marketplace, see **www.healthcare.gov.** Some states have established their own health insurance marketplaces. We will refer to them all simply as the Marketplace.

The Marketplace is where taxpayers find information about health insurance options, purchase health insurance, and, if eligible, obtain help paying premiums and out-of-pocket costs. The Marketplace estimates the amount of the premium tax credit (PTC) that eligible taxpayers may be able to claim on their federal income tax returns. Based on that estimate, eligible taxpayers can decide if they want to have all, some, or none of their estimated credit paid in advance to their insurance company to help pay for coverage.

Did the taxpayer receive Form 1095-A?

While conducting an interview with taxpayers using Form 13614-C, Intake/Interview & Quality Review Sheet, you will determine whether taxpayers received Form 1095-A, Health Insurance Marketplace Statement from the Marketplace.

The Marketplace sends this form to individuals who enrolled themselves or family members in qualified health coverage through the Marketplace. The form includes information about the coverage, who was covered, and when.

The deadline for the Marketplaces to provide Form 1095-A to taxpayers is January 31 of the year after the year of coverage. Taxpayers expecting to receive a Form 1095-A should wait to file their income tax return until they receive that form.

Who is allowed a PTC?

The PTC helps eligible taxpayers pay for health insurance purchased through the Marketplace. When enrolling in qualified health coverage through the Marketplace, the Marketplace estimates the amount of the PTC that eligible taxpayers may claim on their federal tax return. Based on that estimate, eligible taxpayers choose to have advance payments of the premium tax credit (APTC) made on their behalf to their insurance company, or to forego APTC and get all of the benefit of the PTC when they claim the credit on their federal tax return. Those who choose to get the benefit of APTC must file a federal tax return for the year the payments are made even if they have gross income for the year that is below the income tax filing threshold.

In general, taxpayers are allowed a PTC if they meet all of the following (but individuals who can be claimed as a dependent by another taxpayer for a taxable year cannot claim a PTC for the year):

- The taxpayer, spouse (if filing a joint return), or dependents were enrolled in a qualified health plan offered through the Marketplace for one or more months in which the enrolled individual was not eligible for Minimum Essential Coverage (MEC) other than coverage in the individual market. See Terms You May Need to Know at the end of this lesson for a definition of MEC.
- The premiums for the plan or plans in which the taxpayer and his or her family members enroll are paid by the due date of the taxpayer's return (not including extensions).
- If married, the taxpayer files a joint return with his or her spouse (unless the taxpayer is considered unmarried for Head of Household filing status, or meets the criteria which allow certain victims of domestic abuse or spousal abandonment to claim the PTC using the Married Filing Separately filing status). See the instructions for Form 8962, Premium Tax Credit, for more details about these exceptions.
- The taxpayer is an applicable taxpayer. A taxpayer is an applicable taxpayer if his or her household income is at least 100 percent of the federal poverty line for the taxpayer's family size. The following exceptions allow a taxpayer with household income below 100 percent of the federal poverty line to be an applicable taxpayer, provided the taxpayer meets the other applicable taxpayer requirements:
  - The taxpayer, the taxpayer's spouse, or a dependent who enrolled in a qualified health plan is not a U.S. citizen, but is lawfully present in the U.S. and not eligible for Medicaid because of immigration status.
  - The taxpayer was determined eligible for APTC by the Marketplace and received the benefit of APTC for one or more months of coverage of a family member.

For 2022 through 2025, the PTC remains available to taxpayers with household incomes that exceed 400% of the federal poverty line.

Federal Poverty Line (FPL)

The federal poverty line (FPL) is an income amount adjusted for family size that is considered poverty level for the year. The U.S. Department of Health and Human Services (HHS) provides three sets of federal poverty guidelines:

- one for residents of the 48 contiguous states and D.C.,
- one for Alaska residents, and
- one for Hawaii residents.

If the taxpayer moved during the tax year and lived in Alaska and/or Hawaii, or is filing jointly and his or her spouse lived in a different state, use the table with the higher dollar amounts for the family size.

What is household income and what are its limits?

A taxpayer's household income is the total of the modified adjusted gross income (MAGI) of the taxpayer (and spouse, if married and filing jointly) and the MAGI of all dependents required to file a federal income tax return because his or her income meets the filing threshold.

David and Melinda are Married Filing Jointly taxpayers. They have one child, Philip, age 17, whom they claim as a dependent. Philip works part time and has a filing requirement. David and Melinda's household income calculation would include their MAGI, as well as Philip's MAGI.

MAGI, for the purpose of the PTC, is the adjusted gross income on the federal income tax return plus any excluded foreign income, nontaxable Social Security benefits (including tier 1 railroad retirement benefits), and tax-exempt interest. It does not include Supplemental Security Income (SSI) or other types of exempt or excluded income. The taxpayer's MAGI does not include the MAGI of a person who is not claimed as a dependent. Similarly, the spouse's MAGI is not included when the taxpayer is filing Married Filing Separately or qualifies to file as Head of Household.

EXERCISES

Question 1: Jocelyn and Larry file jointly and claim their child, Hank. Hank has a part-time job and earns $5,000. Hank will file a return to get a refund of the tax that was withheld from his paychecks.

Will Jocelyn and Larry include Hank's $5,000 as part of their household income for ACA purposes?

a. Yes

b. No

Question 2: (Continuing from Question 1) If Hank earned $15,000, would Jocelyn and Larry include Hank's income as part of their household income for ACA purposes?

a. Yes

b. No

For most years, only taxpayers and families whose household income for the year is between 100 percent and 400 percent of the FPL for their family size may be eligible for the PTC. For 2021 through 2025, however, taxpayers with household income of 100 percent or more of the FPL may be eligible for a PTC (no 400% limit). A taxpayer with household income meeting these income requirements must also meet the other eligibility criteria to claim a PTC.

EXERCISES (continued)

Question 3: Leana and Jake are married, but lived apart the entire year. Their son Elton lives with Jake, who qualifies to file as Head of Household. Leana will use the Married Filing Separately status.

Will Jake's return include Leana's MAGI as part of his MAGI for PTC purposes?

a. Yes

b. No

Question 4: (Continuing from Question 3.) Under what circumstances could Leana claim PTC?

a. Only if she qualifies under the exception for abused or abandoned spouses.

b. Only if she works part-time.

c. Only if she lived with Jake for at least part of the year.

Please see the Volunteer Resource Guide, Tab H, for the current year Poverty Guidelines.

Are taxpayers allowed a PTC for all enrolled family members?

A taxpayer is allowed a PTC only for months that a member of the taxpayer's tax family is (1) enrolled in a qualified health plan offered through the Marketplace and (2) not eligible for minimum essential coverage (other than individual market coverage) for one or more months of enrollment. Also, the taxpayer is not allowed a PTC for a month unless the portion of the enrollment premiums for which the taxpayer is responsible has been paid by the unextended due date of the taxpayer's return. The taxpayer's tax family consists of the taxpayer, the taxpayer's spouse if filing jointly, and all individuals the taxpayer claims as dependents. The tax family members who meet the above two requirements (enrolled in coverage through the Marketplace and not eligible for other MEC) are the taxpayer's "coverage family." The importance of the tax family and coverage family in computing the PTC is explained later.

Are taxpayers allowed a PTC if offered coverage from an employer?

Generally, a person enrolled in Marketplace coverage for months he or she is eligible for employer-sponsored coverage is not eligible for a PTC for those months, even if the person turns down the employer's coverage. This includes the employee or a family member of the employee who is eligible to enroll in the employer coverage as a result of a relationship to the employee. A person may be eligible for a PTC for his or her Marketplace coverage despite an offer of employer coverage if the employer's coverage is unaffordable or fails to meet a minimum value standard. (Employers will provide employees with information concerning whether the minimum value standard is met.)

In general, for individuals requesting APTC, the Marketplace determines whether the employer coverage is affordable by comparing the employee's cost of the employer coverage for self-only coverage to household income. The affordability test used by the Marketplace for family members of an employee who are eligible for coverage from the employer is the same as the test for the employee (compare the cost of the employee's self-only coverage to household income). If the Marketplace determines that, based on projected household income, the employer coverage would be unaffordable, the employer coverage is considered unaffordable for the employer's plan year even if it turns out it would have been affordable based on the actual household income reported on the tax return. This is referred to as the employee safe harbor.

If a household member actually enrolls in an employer plan that is minimum essential coverage, he or she is ineligible for a PTC for the months of enrollment, regardless of the affordability or minimum value of the plan. That means that a PTC is not allowed for this individual's coverage for the months the individual is enrolled in the employer coverage.

Cedric is single and has no dependents. When enrolling through the Marketplace during open enrollment, Cedric was not eligible for employer-sponsored coverage.

In August of the tax year, Cedric began a new job and became eligible for employer-sponsored coverage that is affordable and provides minimum value on September 1st. Since Cedric became eligible for employer-sponsored coverage on September 1st and the coverage was affordable and provides minimum value, he would usually be unable to claim a PTC for September and the other months he was eligible for the employer coverage. Cedric may be able to get a PTC for September if APTC was being paid for his Marketplace coverage, Cedric informed the Marketplace about his new coverage, and the Marketplace did not discontinue the APTC for September.

Maria is single and has no dependents. Her employer offers health insurance, but she didn't enroll because she felt it was too expensive. The Marketplace determined that the employer offer was not affordable, and Maria enrolled in Marketplace coverage and received the benefit of APTC. At the end of the year, she received both a Form 1095-A from the Marketplace and a Form 1095-C from her employer indicating that the employer coverage was affordable. Because of the employee safe harbor rule, Maria is not considered eligible for the employer coverage because in good faith she provided the Marketplace information about her employer offer and the Marketplace determined that the coverage was unaffordable.

What is a Qualified Small Employer Health Reimbursement Arrangement (QSEHRA)?

Eligible employers may offer a qualified small employer health reimbursement arrangement (QSEHRA) to their eligible employees. Under a QSEHRA, an eligible employer can reimburse eligible employees for health care costs, including premiums for Marketplace health insurance. If taxpayers were covered under a QSEHRA, their employer should have reported the annual permitted benefit in Box 12 of Form W-2 with code FF. If the QSEHRA is affordable for a month, no PTC is allowed for the month. If the QSEHRA is unaffordable for a month, taxpayers must reduce the monthly PTC (but not below -0-) by the monthly permitted benefit amount. If there is a code FF on Form W-2 Box, 12 and the employee has a marketplace policy and is otherwise eligible for PTC, the return is out of scope for the VITA/TCE Programs.

What is an Individual Coverage Health Reimbursement Arrangement (ICHRA)?

Employers may offer an ICHRA to reimburse their employees for individual market coverage, including premiums for Marketplace health insurance. An ICHRA is considered affordable if the employee's monthly premium for the lowest-cost silver plan offered to the employee by the employee's Marketplace, minus the employer's ICHRA contribution, does not exceed the employee's required contribution. If the ICHRA is affordable for a month, no PTC is allowed. If the ICHRA is unaffordable for a month, the employee is eligible for PTC for a Marketplace plan only if he or she opted out of the employer's ICHRA. This is out of scope for the VITA/TCE programs.

Are taxpayers allowed the PTC if they are eligible for coverage through a government-sponsored program?

An individual eligible for coverage through a government-sponsored program such as Medicaid, Medicare, CHIP or TRICARE, is not a member of the coverage family for the months in which the individual is eligible for government-sponsored coverage. Therefore, a PTC is not allowed for this individual's Marketplace coverage for the months the individual is eligible for the government-sponsored coverage. However, an individual is treated as not eligible for Medicaid, CHIP, or a similar program for a period of coverage under a qualified health plan if, when the individual enrolls in the qualified health plan, the Marketplace determines or considers the individual to be not eligible for Medicaid or CHIP.

Regarding Medicaid and CHIP, taxpayers are generally considered eligible for a government-sponsored program for a month if they met the eligibility criteria for that month, even if they did not enroll. However, if the Marketplace made a determination that the taxpayer or a family member was ineligible for Medicaid or CHIP and eligible for APTC when the individual enrolls in a qualified health plan, the individual is treated as not eligible for Medicaid or CHIP for purposes of the premium tax credit for the duration of the period of coverage under the qualified health plan (generally, the rest of the plan year), even if the taxpayer's actual income for the tax year suggests that the individual may have been eligible for Medicaid or CHIP.

Accordingly, if a taxpayer was enrolled in both Medicaid coverage and in a qualified health plan for which APTC was paid for one or more months of the year for which the Marketplace determined that he or she was ineligible for Medicaid, the taxpayer can claim the PTC for these months, if otherwise eligible. The

Marketplace may periodically check state Medicaid data to identify consumers who may be dual-enrolled, and direct them to return to the Marketplace to discontinue their APTC. If you believe that the taxpayer may currently be enrolled in both Medicaid and a qualified health plan with advance credit payments, you should advise the taxpayer to contact the Marketplace immediately.

Taxpayers can qualify for PTC even though they are covered by limited coverage Medicaid, AmeriCorps or AfterCorps (for returning Peace Corps), or other coverage that is not MEC. Volunteers can generally rely on the Marketplace's determination when it has granted APTC.

Taxpayers have a limited time to obtain Medicare, during which time they remain eligible for PTC. A person who is eligible for Medicare loses eligibility for PTC even if he or she fails to enroll in Medicare. The loss of eligibility occurs the first day of the fourth full month after the person became eligible for Medicare. For example, a person who is enrolled in Marketplace coverage with APTC, but becomes Medicare-eligible on his 65th birthday on May 17, loses eligibility for PTC on September 1, the first day of the fourth full month after Medicare eligibility. See Publication 974, Premium Tax Credit (PTC), for details.

If APTC is being paid for coverage of an individual enrolled in a qualified health plan and the individual becomes eligible for government-sponsored coverage that is effective retroactively (such as Medicaid or CHIP), the individual will not be considered eligible for the government-sponsored coverage until the month after the date of approval. Taxpayers can get the PTC for Marketplace coverage until the first day of the calendar month after they are approved for the government-sponsored coverage.

A person is considered eligible for other MEC only if the person is eligible for MEC for every day of that month. For example, if a person does not become eligible for employer- or government-sponsored coverage until the 5th day of a month, he or she may be allowed a PTC for the month. The person should alert the Marketplace to the change and discontinue any APTC being paid for the Marketplace coverage.

Adele is single with no dependents. She works part-time and has no offer of employer-sponsored health coverage. She projects her income to be $17,500 for the year (roughly 150 percent of FPL), based on her earnings at the same job in the prior year. She enrolls in a qualified health plan in the Marketplace and is determined eligible for APTC.

Adele's place of employment was closed for two weeks, unexpectedly lowering the number of hours she worked. Her employer also didn't pay an end-of-year bonus that she anticipated. Adele's actual household income for the year was $16,000. This income would make her eligible for Medicaid under her state's eligibility rules. However, based on Adele's projection of income when she enrolled in Marketplace coverage, the Marketplace determined that she was not eligible for Medicaid. Therefore, Adele is treated as not eligible for Medicaid for the year and is eligible for the PTC.

How does the taxpayer get the APTC?

During enrollment, the taxpayer projects household income and family composition. The Marketplace verifies this information through various data sources, including prior year tax information, Social Security Administration data, and state-level wage data. Using all this information, the Marketplace estimates the amount of PTC a taxpayer will be able to claim. The estimated PTC is the maximum amount of APTC for which the taxpayer is eligible.

Taxpayers may choose to:

- Have some or all of the APTC paid to the insurance company to lower the taxpayer's share of monthly premiums; or
- Forego APTC, pay all the premiums out of pocket, and get all the benefit of the PTC when they file their tax return

The amount of APTC will appear on Form 1095-A.

How is the amount of PTC determined?

The amount of the PTC is based on a sliding scale. A taxpayer with household income at 200 percent of the FPL for the taxpayer's family size will generally get a larger credit to help cover the cost of insurance than a taxpayer with the same family size who has household income at 300 percent of the FPL. In other words, the higher the household income, the lower the amount of the credit. As explained earlier, FPL is based on tax family size.

The PTC is the sum of the credit amount for each month. The credit amount for a month is the lesser of two amounts: (1) the monthly premium for the plan or plans in which the taxpayer's family enrolled (enrollment premiums) and (2) the monthly premium for the taxpayer's applicable second lowest cost silver plan (SLCSP) minus the taxpayer's monthly contribution amount. This calculation is done on Form 8962. The applicable SLCSP premium is the premium for the second lowest cost silver plan that applies to the coverage family discussed earlier (the members of the taxpayer's tax family enrolled in Marketplace coverage and not eligible for other minimum essential coverage). If the SLCSP premium amount does not appear on Form 1095-A, or the SLCSP premium amount reported on Form 1095-A is incorrect because of a change in circumstances the Marketplace did not know about, the taxpayer must find the correct applicable SLCSP premium on either **www.healthcare.gov** (for taxpayers who enroll in coverage through a federally facilitated Marketplace), the website for the taxpayer's state-based Marketplace, or by calling the Marketplace customer service. If the taxpayer must allocate policy amounts with another taxpayer (because members of more than one tax family are enrolled in a single policy), the return is out of scope for the VITA/TCE programs.

A taxpayer's contribution amount is computed by the software as a percentage of the taxpayer's household income determined by multiplying the taxpayer's household income by the applicable figure (from the table in the instructions for Form 8962). The applicable figure is based on the FPL; the higher the FPL, the higher the percentage of household income that is used to compute the contribution amount.

The contribution amount is an annual amount because it is a percentage of household income, which is an annual amount. The monthly contribution amount is the contribution amount divided by 12. Taxpayers with no changes in enrollment premiums and applicable SLCSP premiums for all 12 months can do a single, annual calculation to compute their PTC.

Taxpayers who have a Form 1095-A showing changes in monthly amounts must do a monthly calculation to determine their PTC in Part II of Form 8962. Taxpayers who have changes in monthly amounts not shown on Form 1095-A must also do a monthly calculation to determine their PTC (for example, a taxpayer enrolled in a qualified health plan who became eligible for employer coverage during the year, but did not notify the Marketplace). See the Volunteer Resource Guide, Tab H, for instructions on completing Form 8962.

If taxpayers received the benefit of advance credit payments, they will reconcile the APTC with the amount of the actual PTC that is calculated on the tax return (more information on reconciliation is provided under How is the PTC claimed on the return, later).

The PTC is a refundable tax credit. If the amount of a taxpayer's net PTC (the excess of PTC over APTC) is more than the amount of a taxpayer's tax liability on the return, the taxpayer will receive the difference as a refund. If a taxpayer has no tax liability, all of the net PTC is paid to the taxpayer as a refund. If there is excess APTC (the excess of APTC over PTC), the taxpayer may be required to repay some or all of the excess.

What happens if income or family size changed during the year?

Part of the PTC calculation is the contribution amount, which will be higher at a higher household income level (and lowers the amount of the credit). The FPL is based on the state in which the taxpayer resided and family size. Therefore, a taxpayer's PTC for the year will differ from the APTC payment amount estimated by the Marketplace if the taxpayer's family size or household income as estimated at the time of enrollment is different from the family size or household income reported on the return.

The more the family size or household income differs from the projections used by the Marketplace to compute the APTC payments, the more significant the difference will be between the advance credit payments and the actual credit.

Taxpayers should notify the Marketplace about changes in circumstances when they happen, which allows the Marketplace to update the information used to determine the expected amount of the PTC and adjust the APTC payment amount. This adjustment decreases the likelihood of a significant difference between the advance credit payments and the actual PTC. Changes in circumstances that can affect the amount of the actual PTC include:

- Increases or decreases in household income
- Marriage
- Divorce
- Birth or adoption of a child
- Other changes in household composition
- Gaining or losing eligibility for government-sponsored or employer-sponsored health care coverage
- Change of address

If taxpayers are currently enrolled in Marketplace coverage and have an excess APTC repayment, they should contact the Marketplace now to adjust their APTC and avoid another repayment.

What documentation will taxpayers receive to claim the PTC?

By January 31 of the year following the year of coverage, the Marketplace will send Form 1095-A to taxpayers who purchased qualified health coverage insurance through the Marketplace. The Marketplace also reports this information to the IRS.

Use the information on Form 1095-A to compute the taxpayers' PTC on their tax returns and to reconcile the advance credit payments made on their behalf with the amount of the actual PTC on Form 8962. If Form 1095-A was lost or never received, the taxpayer must contact the Marketplace. These forms can be downloaded by taxpayers through their Marketplace account. Volunteers cannot prepare a return without this information and the return may reject if e-file is attempted without Form 8962.

How is the PTC claimed on the tax return?

Taxpayers who received the benefit of APTC payments must file a tax return even if they otherwise are not required to file. Remember, the PTC is only available to taxpayers who purchased health coverage through the Marketplace for themselves or a tax family member.

A taxpayer computes the amount of PTC on Form 8962 and reconciles it with the APTC payments for the year. If the PTC computed on the return is more than the APTC payments made on the taxpayer's behalf during the year, the difference will increase the refund or lower the amount of tax owed.

If the APTC payments are more than the PTC (excess APTC), some or all of the difference will increase the taxpayer's tax liability and result in either a smaller refund or a larger balance due. Taxpayers with household income below 400 percent of the FPL for their family size may be allowed a limitation on their excess APTC repayment. The limitation is based on the taxpayer's household income as provided in the repayment limitation table, which can be found in the Important Changes lesson in this publication and in the Volunteer Resource Guide, Tab H, Other Taxes, Payments, and Refundable Credits.

For taxpayers who use the Married Filing Separately filing status, the repayment limitation applies to the spouses separately based on the household income reported on each return. There are situations where the cap does not apply; for example, the repayment cap is not allowed for APTC paid on behalf of individuals not lawfully in the U.S. Refer to Instructions for Form 8962 and Publication 974 for additional

information. The repayment cap applies in all other situations in which a taxpayer's household income is below 400 percent of the applicable FPL and the applicable repayment cap amount is less than the taxpayer's excess APTC.

Taxpayers who chose to forego APTC will get all of the benefit of their PTC on their tax return. This will either increase their refund or lower the balance due.

The itemized deduction for health insurance premiums is net of PTC meaning that only the portion of the premiums that exceeds the PTC is deductible. For taxpayers who itemize their deductions, the deduction for health premiums is increased for any APTC repayment and decreased for additional PTC as shown on Form 8962.

For taxpayers who are self-employed claiming the self-employed health insurance adjustment to gross income, the calculation becomes circular and their returns are out of scope for VITA/TCE. Refer such taxpayers to a professional tax preparer or Publication 974.

Brandon is single with no dependents. When he enrolled through the Marketplace, Brandon was approved for APTC based on his projected household income. Brandon's Form 1095-A shows APTC of $1,486. Based on Brandon's actual modified AGI, he is eligible for a PTC of $500. Brandon's income is household income is at 310 percent of the FPL, so he is allowed a repayment limitation. Brandon must increase his tax liability by the lesser of the excess of his APTC over his PTC, $986, or the repayment limitation.

EXERCISES (continued)

Question 5: Pedro is retired and covered by Medicare. His wife Camilla is too young for Medicare. Both are U.S. citizens. Even though Pedro is on Medicare, can Camilla get a PTC if she enrolls in coverage through the Marketplace (and is otherwise eligible for a PTC)?

a. Yes

b. No

Question 6: You are completing the return for Antonio, who purchased health coverage through the Marketplace and received the benefit of APTC. In completing Form 8962, you note that Antonio's MAGI is 401 percent of the FPL and the calculation shows that he has to repay most of his APTC. Assuming that Antonio would be entitled to an IRA deduction if he made an IRA contribution, can Antonio reduce his MAGI for the PTC calculation even though the tax year has ended?

a. Yes

b. No

Question 7: Piper's income is 300 percent of the FPL for her family size. She purchased health insurance through her employer. Is Piper eligible to take the PTC for her coverage? ☐ Yes ☐ No

Question 8: Harry purchased insurance through the Marketplace. What form will he receive from the Marketplace to prepare his tax return?

a. Form 8962

b. Form 1095-A

c. Form W-2

Question 9: Roger's APTC is $2,500. He is single with no dependents, and lives in Mississippi. On Form 8962, he calculates an actual PTC of $1,000. His household income is over 300 percent of the FPL but under 400 percent of the FPL for a family size of one. Does the repayment limitation apply to Roger?

a. Yes

b. No

Question 10: Judy is single with no dependents. In December, Judy enrolled through the Marketplace in a qualified health plan for the following year. On July 14, Judy enlisted in the Army and was immediately eligible for government sponsored minimum essential coverage. For what period is Judy able to claim a PTC (if she meets all of the eligibility criteria)?

a. The entire tax year

b. January through June

c. January through July

d. Judy is not eligible for the PTC

What about unusual situations?

This lesson does not cover all the situations you may encounter. For situations listed below, consult the Volunteer Resource Guide, Tab H, Other Taxes, Payments, and Refundable Credits, instructions for Form 8962 and Publication 974.

What if taxpayers receive more than one Form 1095-A?

There is only one PTC calculation on Form 8962. Refer to the Volunteer Resource Guide, Tab H, Other Taxes, Payments, and Refundable Credits, for instructions on how to enter multiple Forms 1095-A in the software.

What if taxpayers must allocate policy amounts for a policy purchased through the Marketplace?

If a taxpayer is enrolled, or has a family member who is enrolled, in a policy with a person not in the taxpayer's tax family (a shared policy), the taxpayer may have to allocate the items on Form 1095-A (the enrollment premiums, the premium for the applicable SLCSP, and the advance credit payments) with another taxpayer (a shared policy allocation). The following taxpayers may have to do a shared policy allocation:

- Taxpayers who got divorced or legally separated during the tax year
- A taxpayer who claims as a dependent an individual enrolled in a policy with a member of another tax family
- A taxpayer who receives a Form 1095-A that includes an individual claimed as a dependent by another tax family
- A taxpayer who files a separate return from his or her spouse

Taxpayers allocate policy amounts on Form 8962, Part IV. Returns that require an allocation of policy amounts are out of scope for the VITA/TCE programs.

What about an individual the taxpayer enrolled who does not file a return and is not claimed as a dependent by anyone?

If an individual for whom APTC was paid neither files a tax return for the year the APTC was paid, nor is claimed as a dependent on a tax return for the year the APTC was paid, the taxpayer who indicated to the Marketplace at enrollment that the individual would be in the taxpayer's tax family for the year the APTC was paid must report the APTC paid for that individual's coverage. See the instructions for Form 8962 and Publication 974 for more information.

What if taxpayers get married during the year?

If taxpayers got married during the tax year and one or both spouses received the benefit of APTC payments for the pre-marriage months, the spouses may be eligible to use an alternative calculation to determine their excess APTC. The alternative calculation can be used to reduce excess APTC, but not to claim net PTC. See the instructions for Form 8962 for eligibility. If eligible, taxpayers will complete Form 8962, Part V, Alternative Calculation of Year of Marriage. This is out of scope for the VITA/TCE programs. If the taxpayers do not have excess APTC, they cannot use the alternative calculation and the return remains in scope.

What about individuals not lawfully present?

A PTC is not allowed for the coverage of an individual who is not lawfully present in the United States. All APTC paid for an individual not lawfully present who enrolls in a qualified health plan must be repaid. If a member of the family is not lawfully present and is enrolled in a qualified health plan with family members who are lawfully present for one or more months of the year, use the instructions in Publication 974 to find out how much APTC, if any, must be repaid. If all family members enrolled in a qualified health plan are not lawfully present, all APTC must be repaid. There is no repayment limitation on excess APTC attributable to the coverage of an individual not lawfully present in the United States. Refer to Publication 974.

Summary

The Affordable Care Act addresses health insurance coverage and financial assistance options for individuals and families, including the PTC.

Only taxpayers who purchase qualified health care coverage through the Marketplace for themselves, their spouse with whom they are filing jointly, or their dependents are allowed a PTC. Eligible taxpayers may choose to get the benefit of advance credit payments, the amount of which is based on their estimated PTC, to reduce their share of the cost of monthly premiums. Taxpayers who chose to forgo advance credit payments get all of the benefit of the PTC when they claim it on the tax return. The PTC is calculated and the advance credit payments are reconciled on Form 8962. Taxpayers will receive Form 1095-A from the Marketplace, which will contain the information necessary to complete Form 8962.

The PTC is claimed on Form 1040, Schedule 3. Any excess APTC that must be repaid is entered on Form 1040, Schedule 2.

Through 2025, a taxpayer’s required contribution is less than in prior years. Also, taxpayers with household income over 400% of the FPL may be allowed a PTC through 2025. Thus, more taxpayers who purchase their health coverage through the Marketplace will be able to claim PTC for these years.

What situations are out of scope for the VITA/TCE programs?

The following are out of scope for this lesson. While this list may not be all inclusive, it is provided for your awareness only.

- Self-employed health coverage deductions for taxpayers who are also allowed a PTC
- Form 8962 Part IV, Allocation of Policy Amounts, and Part V, Alternative Calculation for Year of Marriage
- If there is a code FF on Form W-2, Box 12 and the employee has a Marketplace policy and is otherwise eligible for PTC
- Individual Coverage Health Reimbursement Arrangement (ICHRA) with Marketplace coverage

EXERCISE Answers

Answer 1: b, No. Hank's income is below the filing threshold for a dependent with earned income so his parents will not include his MAGI in the Household Income for ACA purposes.

Answer 2: a, Yes. Hank's income is above the filing threshold for a dependent with earned income, so his parents will include his MAGI in the Household Income for ACA purposes.

Answer 3: b, No. Leana has her own household.

Answer 4: a. As Married Filing Separately, she could only claim PTC if she qualifies under the exception for abused or abandoned spouses.

Answer 5: a, Yes. Camilla is eligible for a PTC if she enrolls in coverage through the Marketplace (and is otherwise eligible).

Answer 6: a, Yes. Antonio can make a deductible IRA contribution up until the April due date of the return.

Answer 7: b, No. the coverage must have been purchased through the Marketplace.

Answer 8: b. Form 1095-A.

Answer 9: a, Yes. His applicable repayment cap amount is less than his excess APTC of $1,500.

Answer 10: c. Judy is eligible for the PTC from January through July.

Terms You May Need to Know

Applicable taxpayer (for purpose of premium tax credit) – A taxpayer must be an applicable taxpayer to claim the premium tax credit (PTC). Generally, for 2021 and 2022, an applicable taxpayer is one who has household income of at least 100 percent of the federal poverty line (FPL) for his or her family size. An individual who can be claimed as a dependent by another taxpayer and a taxpayer who is married at the end of the year but doesn't file a joint return cannot claim a PTC, although there are exceptions for head of household filers and victims of spousal abuse or abandonment.

See also: **Exception for household income below 100 percent of FPL and Exception for alien lawfully present in the United States.**

Coverage family – All members of the taxpayer's family who are enrolled in a qualified health plan and are not eligible for minimum essential coverage (other than coverage in the individual market). The members of the coverage family may change from month to month. A taxpayer is allowed a PTC only for qualified health insurance purchased for members of the coverage family.

Domestic abuse – Domestic abuse includes physical, psychological, sexual, or emotional abuse, including efforts to control, isolate, humiliate, and intimidate, or to undermine the victim's ability to reason independently. All the facts and circumstances are considered in determining whether an individual is abused, including the effects of alcohol or drug abuse by the victim's spouse. Abuse of the victim's child or any family member living in the household may constitute abuse of the victim. If the taxpayer is a victim of domestic abuse or abandonment and does not qualify to use Head of Household filing status, the taxpayer may be able to claim a premium tax credit if he or she files a return as Married Filing Separately and meets the exceptions as listed in Exception 2 of the married taxpayer definition later in this section. See Publication 974 for a list of documentation that the taxpayer should retain.

Employee safe harbor – If the Marketplace determines that, based on projected household income, an individual's employer coverage would be unaffordable for the year of coverage, the employer coverage is considered unaffordable for the employer's plan year even if the amount the employee must pay for the employer coverage does not exceed the applicable percentage of household income reported on the tax return.

Exception for alien lawfully present in the United States – A taxpayer with household income below 100 percent of the FPL can be an applicable taxpayer as long as the taxpayer, the taxpayer's spouse, or a dependent who enrolled in a qualified health plan is not a U.S. citizen but is lawfully present in the U.S. and not eligible for Medicaid because of immigration status.

Exception for household income below 100 percent of FPL – A taxpayer with household income below 100 percent of the FPL is an applicable taxpayer if all of the following requirements are met:

- The taxpayer, the taxpayer's spouse, or a dependent enrolled in a policy through a Marketplace
- The Marketplace estimated at the time of enrollment that the taxpayer's household income would be at least 100 percent of the FPL for the taxpayer's family size; and
- Advance credit payments were made for the coverage for one or more months of the year

Family/Family size – For the purposes of Form 8962, a taxpayer's tax family consists of the taxpayer (unless the taxpayer qualifies as a dependent of another taxpayer), the taxpayer's spouse if a joint return is filed (unless the spouse qualifies as a dependent of another taxpayer) and the individuals who qualify as dependents of the taxpayer and whom the taxpayer claims by putting the individual's name and TIN on the Form 1040 or Form 1040NR the taxpayer files for the year.

Family coverage – Health insurance that covers more than one individual.

FPL – Federal Poverty Line – An income amount considered poverty level for the year, adjusted for family size. Department of Health and Human Services (HHS) determines the federal poverty guideline amounts annually. The government adjusts the income limits annually for inflation. For purposes of the PTC, eligibility for a certain year is based on the most recently published guidelines as of the first day of open enrollment for the year of coverage. The FPL tables are in the Volunteer Resource Guide, Tab H, Other Taxes, Payments, and Refundable Credits.

Form 1095-A – Used to report certain information to the IRS about family members who enroll in a qualified health plan through the Marketplace. Form 1095-A is furnished to individuals to allow them to claim the premium tax credit, to reconcile the credit on their returns with advance payments of the premium tax credit (APTC), and to file an accurate tax return.

Form 1095-B – Used to report certain information to the IRS and to taxpayers about individuals who have minimum essential coverage.

Form 1095-C – Employers with 50 or more full-time employees, including full-time equivalent employees, use this form to report information about offers of health coverage and enrollment in health coverage for their employees.

Household income – Total of the modified adjusted gross income (MAGI) of the taxpayer (and spouse, if married filing a joint return) and the MAGI of all dependents required to file a federal income tax return because their income exceeds the filing threshold.

Individual market – The insurance market that provides private, individual (non-group) health insurance coverage to individuals who purchase health insurance on their own. This includes qualified health plans offered through the Marketplace. Each individual generally must pay the entire cost of the health insurance premium, but certain individuals are eligible for insurance premium subsidies for coverage purchased through the Marketplace.

MAGI – See Modified Adjusted Gross Income.

Marketplace – A governmental agency or nonprofit entity that makes qualified health plans available to individuals. The term "Marketplace" refers to state Marketplaces, regional Marketplaces, subsidiary Marketplaces, and a federally-facilitated Marketplace.

Married taxpayers (for purposes of the premium tax credit) – If a taxpayer is married at the end of the tax year, the taxpayer generally must file a joint return with his or her spouse to claim the premium tax credit unless the taxpayer meets one of the following two exceptions:

- Exception 1 (Head of Household filing status). The taxpayer may file a return as if he or she is unmarried and take the PTC if one of the following applies:
  - The taxpayer files a separate return from the taxpayer's spouse on Form 1040 because the taxpayer meets the requirements for married persons who live apart under Head of Household in the instructions for Form 1040.
  - The taxpayer files as Single on Form 1040NR because the taxpayer meets the requirements for married persons who live apart under Were You Single or Married? in the instructions for Form 1040NR.
- Exception 2. If taxpayer is a victim of domestic abuse or abandonment and does not qualify to use Head of Household filing status, the taxpayer may claim a premium tax credit if he or she files a return as Married Filing Separately and meets the following:
  - The taxpayer is living apart from his or her spouse at the time the taxpayer files the current year tax return.
  - The taxpayer is unable to file a joint return because he or she is a victim of domestic abuse or spousal abandonment.
  - The taxpayer checks the box on Form 8962 to certify that he or she is a victim of domestic abuse or spousal abandonment.

Minimum essential coverage (MEC) – Coverage under a government-sponsored program, an eligible employer-sponsored plan, a plan in the individual market, a grandfathered health plan, or other coverage recognized by the Department of Health and Human Services (HHS), in coordination with the Secretary of the Treasury, as minimum essential coverage.

Modified Adjusted Gross Income (MAGI) for PTC – MAGI is a taxpayer's adjusted gross income plus his or her untaxed foreign earned income, tax-exempt interest, and Social Security benefits not included in income. The taxpayer's MAGI is increased by the MAGI of a claimed dependent who is required to file a tax return because their income meets the filing threshold.

Premium tax credit (PTC) – A refundable tax credit for certain people who enroll in a qualified health plan offered through the Marketplace.

Qualified health plan – A health plan certified by the Department of Health and Human Services to be offered through the Marketplace. Plans in the Marketplace are offered in different categories: Bronze, Silver, Gold, and Platinum ("catastrophic" plans are also available to some people, but do not qualify for PTC and no Form 1095-A will be issued). See **www.healthcare.gov** for additional information about plan levels.

Required contribution for PTC – For individuals or families enrolled in Marketplace coverage, the required contribution amount is the amount of the taxpayers' household income the enrollees would be responsible for paying as their share of premiums each month if they enrolled in the applicable second lowest cost silver plan. It is not based on the amount of premiums the enrollees paid out of pocket during the year, but PTC will not be more than the premiums for the qualified health plan the taxpayer or the taxpayer's family members enroll in.

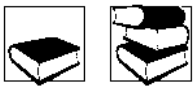
Second Lowest Cost Silver Plan (SLCSP) – The second lowest cost silver plan offered through the Marketplace for the rating area in which the taxpayer resides. A taxpayer who enrolled in a qualified health plan through the Marketplace will receive Form 1095-A from the Marketplace which will include the premium for the SLCSP. This figure is used on Form 8962 to calculate the amount of the premium tax credit that the taxpayer is allowed.

Self-only coverage – Health insurance that covers one individual.

Spousal abandonment – A taxpayer is a victim of spousal abandonment for a taxable year if, taking into account all facts and circumstances, the taxpayer is unable to locate his or her spouse after reasonable diligence. If taxpayer is a victim of domestic abuse or abandonment and does not qualify to use Head of Household filing status, the taxpayer may claim a premium tax credit if he or she files a return as Married Filing Separately and meets the exceptions as listed in Exception 2 of the **Married taxpayer** definition above. See Publication 974 for documentation that the taxpayer should retain.

Tax family – For the purposes of Form 8962, a taxpayer's tax family consists of the taxpayer (unless the taxpayer qualifies as a dependent of another taxpayer), the taxpayer's spouse if a joint return is filed (unless the spouse qualifies as a dependent of another taxpayer), and the individuals who qualify as dependents of the taxpayer and whom the taxpayer claims by putting the individual's name and TIN on the Form 1040 or Form 1040NR the taxpayer files for the year. The tax family does not include individuals a taxpayer can but does not claim as dependents.

Other Taxes



Introduction

This lesson covers the Other Taxes reported on the return. You will determine if taxpayers owe additional taxes, which can decrease a refund or increase a balance due.

Objectives

At the end of this lesson, using your resource materials, you will be able to:

- Identify the different types of other taxes on a return
- Determine if a taxpayer is liable for other taxes that are within scope of the VITA/TCE programs
- Determine how to report these additional taxes on the tax return and complete the applicable forms or schedules

What do I need?

- Form 13614-C
- Publication 4012
- Publication 17

Optional:

- Publication 1244
- Form 1040 Instructions
- Form 4137
- Form 5329 and Instructions
- Form 5405 and Instructions
- Form W-2
- Schedule SE

What are other taxes?

"Other taxes" are different from the income tax from the tax tables or figured using the Tax Computation Worksheet. They include, but are not limited to:

- Self-employment tax
- Social Security and Medicare taxes on tip income
- Additional taxes on IRAs and other qualified retirement plans
- Additional tax on taxable HSA distributions
- Repayment of first-time homebuyer credit

These amounts are usually calculated on their own form or schedule and entered on Form 1040, Schedule 2. The taxes are added after the nonrefundable credits are calculated; the nonrefundable credits do not reduce the other taxes.

Household employment taxes are also included in Other Taxes. However, this topic is beyond the scope of the VITA/TCE programs. Taxpayers who must file household employment taxes should be referred to a professional tax preparer.

Two additional taxes may apply to taxpayers with higher income. These are the additional Medicare tax on wages (Form 8959, Additional Medicare Tax) and the net investment income tax (Form 8960, Net Investment Income Tax Individuals, Estates, and Trusts). Taxpayers with income levels large enough to incur these taxes should be referred to a paid professional preparer.

Additional tax on early distributions from IRAs is covered under Basic certification if the additional tax applies. Advanced certification is required if exceptions to the additional tax apply and for other topics in this lesson. If an issue related to an Advanced-level topic arises at a volunteer site, be sure that a volunteer with required certification provides assistance.

Refer to the Premium Tax Credit lesson contained in this publication for information on the repayment of the advanced premium tax credit.

What is self-employment tax?

Self-employment (SE) tax is Social Security and Medicare taxes collected primarily from individuals who work for themselves. It is similar to the Social Security and Medicare taxes withheld from the pay of most wage earners except a self-employed individual pays both the employee part and what would be the employer part. Payments of SE tax contribute to the taxpayer's coverage under the Social Security system. Social Security coverage provides the taxpayer with retirement, disability, survivor, and hospital insurance (Medicare) benefits.

Who must pay self-employment tax?

SE tax must be paid if either of the following applies:

- The taxpayer had income as a church employee of $108.28 or more.
- The taxpayer receives net earnings from self-employment income in the amount of $400 or more (excluding church employee income).

The VITA/TCE programs' scope includes Schedule C, with limits.

Generally, taxpayers who are independent contractors or sole proprietors must file Schedule C and Schedule SE. Since taxes are not withheld from independent contractors' pay, it is the taxpayer's responsibility to pay income and SE tax. Taxpayers should make quarterly estimated tax payments during the year to pay these taxes.

The Social Security Administration uses the information from Schedule SE to figure a person's benefits under the Social Security program. Not reporting all of a taxpayer's self-employment income could cause their Social Security benefits to be lower when they retire.

This tax applies no matter how old the taxpayer is and even if they are already getting Social Security or Medicare benefits.

Self-employed taxpayers who receive tips should include the tips in gross receipts on Schedule C.

How do I complete Schedule SE?

Net Profit from Business was covered in an earlier lesson. When assisting a taxpayer with self-employment income, first complete Schedule C. Schedule SE is used to calculate the self-employment tax. The deductible part of the self-employment tax is reflected as an adjustment to income on Form 1040, Schedule 1. The adjustment to income is similar to the benefit that employers receive when they deduct their share of the Social Security and Medicare taxes as payroll taxes.

Self-employment tax is Social Security and Medicare taxes collected primarily from individuals who work for themselves, similar to the Social Security and Medicare taxes withheld from the pay of most wage earners.

The self-employment tax rate on net earnings is 15.3% (12.4% Social Security tax plus 2.9% Medicare tax).

The software automatically transfers the appropriate information from Schedule C to Schedule SE and calculates the self-employment tax and the adjustment for the deductible part of the self-employment tax.

Partial tax deferral for certain Schedule SE filers

Self-employed individuals may have deferred the employer portion of the Social Security tax on self-employment income earned from March 27, 2020 through December 31, 2020. Half of the deferred Social Security tax was due by December 31, 2021, and the remainder is due by January 3, 2023 unless paid earlier (the worksheet in the 2020 tax return shows the actual amounts deferred and when they are due). IRS mailed to affected taxpayers instructions, vouchers, and envelopes for the deferred payments. Refer taxpayers who have questions regarding payment of deferred tax to **www.irs.gov/newsroom/how-self-employed-individuals-and-household-employers-repay-deferred-social-security-tax**

Who does not pay self-employment tax?

Some professions do not have a requirement to pay the self-employment tax:

- Notaries public are not subject to the self-employment tax by law. Be sure to identify notaries on the input forms.
- Statutory employees have Social Security and Medicare tax withheld and do not have to pay the self-employment tax even though they report their income and expenses on Schedule C.

Enter the net profit from a notary's business on the SE Tax input screen so that SE tax is not computed.

What about taxes on unreported tip income?

All tip income is subject to federal income tax. However, tips of less than $20 per month that are not reported to the employer are not subject to Social Security and Medicare taxes.

Individuals who receive $20 or more per month in tips from any one job must report their tip income to their employer. The employer reports these tips as part of the wages on Form W-2, Box 1. The employer withholds Social Security and Medicare taxes and federal income tax on that income.

What about allocated tips?

An employer may "allocate" tips to an employee if the employee worked in a restaurant, cocktail lounge, or similar business and reported tips that were less than the employee's share of 8% of food and drink sales. If the employer allocates tips to employees, the amount is reported on Form W-2, Box 8, and included in income on Form 1040. Social Security and Medicare taxes are not withheld on allocated tips. The employee pays the Social Security and Medicare taxes by completing Form 4137, Social Security and Medicare Tax on Unreported Tip Income.

If the employee can show, using Publication 1244, Employee's Daily Record of Tips and Report to Employer, or some similar daily tip record, that the actual tips received are different from the allocated amount, then the actual amount is reported on Form 1040. The actual tips received are also reported on Form 4137 to calculate Social Security and Medicare taxes.

What about tips that the employee did not report to the employer?

If the employee received $20 or more in unreported cash and charge tips in any month from any job, the employee must report that income on Form 1040 and pay the Social Security and Medicare taxes on that income. But, if the employee received less than $20 in tips in any month from any job, they are not required to report them to the employer. However, these amounts do need to be included on Form 1040. They will not be subject to Social Security or Medicare taxes and you will need to indicate that on Form 4137.

See Volunteer Resource Guide, Tab D, Income, for instructions on reporting tip income. The software calculates Social Security and Medicare taxes on the tips based on your entries on the W-2 input and Form 4137 input. The software will also add unreported tips to Form 1040 as wages.

Carla waits tables at a café. Her employer reports all tips that customers add to their credit card tabs, but she leaves it up to Carla to keep track of her cash tips. Carla receives more than $20 per month in cash tips. Carla keeps a record but, because she doesn't report her cash tips to her employer, they are not included on her Form W-2. Carla includes the unreported tips as income on Form 1040. Carla also uses Form 4137 to calculate and pay the Social Security and Medicare taxes on those tips.

How do I figure and report these taxes?

As part of your interview, explain to taxpayers that sometimes people do not realize they owe taxes on tips they do not report to their employer. Also explain the taxes paid on those tips actually boost the taxpayer's future Social Security benefits.

To figure the tax, determine if during any month the taxpayer received $20 or more in tips that were not reported to the employer. Unreported tips are entered on the W-2 screen.

EXERCISES

Answers follow the lesson summary.

Question 1: Nancy had a summer job at a coffee hut. She made $18 in tips in May, $755 in June, $600 in July, and $45 in August. Until a co-worker told her, she didn't realize she had to report her tips to their employer. She then reported $1,000 in tips to her boss.

What amount of tips will Nancy have to add to her Form 1040 as wages?

a. $1,418

b. $1,000

c. $418

d. $18

Question 2: What amount of unreported tips does Nancy have to pay Social Security and Medicare taxes on when she files her tax return?

a. $1,418

b. $400

c. $45

d. $18

What about taxes on IRAs and other qualified retirement plans?

Traditional IRAs and other qualified plans allow individuals to defer paying taxes on contributions and earnings until the funds are distributed.

If the rules for contributions and distributions are not followed, additional taxes may be due. For example, the taxpayer must pay income tax plus an additional tax if any of the following apply:

- A distribution is taken before the individual reaches the age of 59½, is not rolled over into another qualified plan or IRA, and no exception applies
- Minimum distributions are not withdrawn when required - in scope for Tax-Aide
- Excess contributions are not withdrawn by the due date of the return including extensions — out of scope if an additional tax applies (either the 6% excess contribution or 10% early distribution)

If the taxpayer is under the age of 59½, earnings on excess contributions withdrawn by the due date of the return are early distributions and subject to the 10% additional tax. Refer to the Adjustments to Income lesson for more information.

The additional tax for each situation is outlined on Form 5329, Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts.

Only Parts I and IX of Form 5329 are in scope for Tax-Aide. These parts provide for the exceptions to the additional tax on part or all of the early distributions from IRAs or qualified pension plans and to request a waiver from the additional tax on excess accumulations (missed RMD). The other parts of Form 5329 are out of scope; refer taxpayers with these issues to a professional tax preparer.

Some exceptions apply only to IRA distributions, some apply only to distributions from a qualified retirement plan, and some exceptions apply to both IRA and retirement plan distributions. Refer to the Volunteer Resource Guide, Tab H for the list of exceptions.

Refer to the intake and interview sheet, Part III – Income, for the question regarding retirement income or payments from pensions, annuities, and/or IRA. If yes is checked, review any Form 1099-R that reports these payments to determine if the taxpayer is subject to the additional tax or qualifies for an exception.

If Form 1099-R correctly shows code 1 in Box 7 indicating an early distribution, the additional tax applies unless the taxpayer qualifies for an exception. In some circumstances, Form 5329 is not required. Tax software does this automatically based on entries on Form 1099-R.

Early distribution in case of birth or adoption of child

An IRA owner or a participant in a workplace-defined contribution plan, such as a 401(k) or 403(b) plan, can withdraw up to $5,000 for the birth or adoption of a child without incurring the usual 10% additional tax on early distributions. The distribution must be made within one year after the child is born or the adoption is finalized and cannot be from a defined benefit plan. Any time after receiving the distribution, the IRA owner or plan participant may generally recontribute any portion of the distribution as a rollover contribution to an eligible retirement plan, including an IRA.

A qualified distribution due to the birth or adoption of a child may be repaid at any time. An amended return is needed for the year of distribution to get a refund of taxes paid on a distribution that is repaid in a later year. A refund of taxes paid in the year of distribution is limited by statute, normally three years from the due date of the return. Refer to Pub 590-B for additional information.

Early distribution exception for public safety employees

Qualified public safety employees who receive distributions from a governmental defined benefit pension plan aren't subject to the additional tax on early distributions. Qualified public safety employees include those who provide police protection, firefighting services, or emergency medical services for a state or municipality, and who separated from service in or after the year they attained age 50.

For purposes of the exception, the definition of qualified public safety employees also includes federal law enforcement officers, federal customs and border protection officers, federal firefighters, air traffic controllers, nuclear materials couriers, members of the United States Capitol Police or Supreme Court Police, and diplomatic security special agents of the Department of State.

How do you complete Form 5329, Part I?

If an exception to the additional tax on early distributions applies, Form 5329, Part I, must be completed. Refer to the Volunteer Resource Guide, Tab H for the software entries and exception codes.

When the early distribution is from a SEP IRA and it is made within two years from when participation in the plan began, the addition to tax is computed using a rate of 25% instead of 10%. Such a distribution is designated by Code S in Box 7 of Form 1099-R.

Do not reduce medical expenses or education expenses eligible for a deduction or credit for the amounts used to reduce the addition to tax on an early distribution. This is not a double dip situation and is allowable.

Laura is 41 years old and received an early distribution from her 401(k) account. The volunteer determines that Laura paid for unreimbursed qualified medical expenses in excess of 7.5% of her AGI, which is more than the amount of her distribution. In this case Form 5329, Part I, would be completed. Laura would not have to pay the additional tax on this distribution. If Laura is itemizing deductions, she can claim the whole amount of her medical expenses even though she used the expenses to reduce the additional tax.

How do you complete Form 5329, Part IX?

Tax-Aide only: Part IX is in scope to remove the additional tax.

The rules to determine the amount of an RMD can be complex and best left to the taxpayer to work out with the trustee. If a taxpayer fails to take the RMD, an additional tax of 50% of the shortfall may apply.

The RMD is computed based on the value of all traditional IRAs, except inherited IRAs. Each inherited IRA is treated separately. Again, the trustee should determine the RMD amount for each inherited IRA. In order to request a failure-to-take-RMD waiver for any IRA, the taxpayer must take a catch-up distribution and this should be mentioned in the waiver request.

Recent IRS regulations clarify the rules for inherited IRAs where the decedent died in 2020 or 2021, which may result in a beneficiary's failure to take the RMD for 2021 or 2022. (COVID legislation provided that no RMD was required for 2020.) IRS has granted a blanket waiver of the additional tax for failures to take RMDs in these inherited IRA situations for 2021 or 2022 and has not indicated that a catch-up distribution is necessary for the missed RMD. For these situations, be sure refer to Notice 2022-53 in the waiver request.

Use Part IX of Form 5329 to request a waiver of the addition to tax for failure to take the required minimum distribution from an IRA. Refer to the Volunteer Resource Guide, Tab H, for specific software instructions.

What about the addition to tax on taxable HSA distributions?

If distributions are not repaid as a mistaken distribution, not rolled over, and not offset by qualified medical expenses, the amount withdrawn will be included in income and reported on Form 1040. HSA distributions included in income are subject to an additional 20% tax unless the account beneficiary:

- Died
- Became permanently and totally disabled
- Turned age 65

If one of these exceptions applies, it is claimed on Form 8889, Part II.

An HSA distribution that is rolled over to another HSA is not taxable and not subject to the additional 20% tax. See the Adjustments lesson.

What about repayment of the first-time homebuyer credit?

Certain situations may require the first-time homebuyer credit to be repaid and reported on Form 1040, Schedule 2. Review the Life Events section of the intake and interview sheet to determine if the taxpayer claimed the 2008 homebuyer credit and must pay back a portion of the credit each year.

If the taxpayer received the first-time homebuyer credit for a home purchased in 2008, generally they must repay the credit over a 15-year period in 15 equal installments. The repayment period began in 2010. However, if the home ceases to be the taxpayer's main home before the 15-year period is up, the taxpayer must repay all remaining annual installments.

The home ceases to be the main home if the taxpayer sells the home; converts the entire home to business or rental property; the home is destroyed, condemned, or disposed of under threat of condemnation; or the lender forecloses on the mortgage. There are certain exceptions to the repayment rule. See the general instructions for Form 5405 for details.

If the taxpayer dies, they do not have to repay the balance of the credit.

Special rules apply for taxpayers who filed a joint return for 2008 and claimed the first-time homebuyer credit. If the home is transferred to a spouse (or ex-spouse as part of a divorce), the spouse receiving the home is responsible for repaying the credit, unless an exception applies. Or if one of the spouses dies, their half of the remaining credit is forgiven and does not need to be paid back.

The credit is repaid by including it as additional tax on the return for the year the home ceases to be the taxpayer's main home. If the taxpayer is required to repay the credit, it is calculated on Form 5405 and reported on Form 1040, Schedule 2. Certain taxpayers who are repaying an installment of the credit claimed for homes purchased in 2008 are not required to file Form 5405. See Form 5405 Instructions for more information.

Summary

This lesson explained how to report Other Taxes on the return. Other taxes are not calculated using the income tax tables or the Tax Computation Worksheet. They include:

- Self-employment tax
- Social Security and Medicare taxes on unreported tip income
- Additional taxes on IRAs and other qualified retirement plans
- Additional tax on taxable HSA distributions
- Repayment of first-time homebuyer credit

What situations are out of scope for the VITA/TCE programs?

The following are out of scope for this lesson. While this list may not be all inclusive, it is provided for your awareness only.

- Employment taxes for household employees
- IRA minimum distributions not withdrawn when required
- Excess contributions to an IRA that are not withdrawn by the due date of the return including extensions if the excess contribution or early distribution addition to tax applies
- Distributions or excess contributions shown on parts II through VII of Form 5329 (only Parts I and IX are in scope for Tax-Aide)

- Distribution from an ABLE account that exceeds the qualified disability expenses
- Individuals subject to the additional Medicare tax on Form 8959
- Individuals subject to the net investment income tax on Form 8960

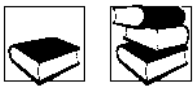
To gain a better understanding of the tax law, complete the practice return(s) for your course of study using the Practice Lab on L&LT.

EXERCISE Answers

Answer 1: c. Nancy's combined tips for May, June, July, and August were $1,418, and she reported only $1,000 to her employer. She needs to add $418 as wages on her tax return.

Answer 2: b. Nancy does not have to pay Social Security and Medicare taxes on the tips she received in May, because they amounted to less than $20 for the month.

Payments and Miscellaneous Refundable Credits



Introduction

This is one of several lessons that cover the total payments on the return, which includes payments, additional child tax credit, the refundable education credit, and the earned income credit. After finishing these lessons, you will be able to complete the appropriate lines and schedules of the taxpayer's return. This lesson covers income tax withholding, estimated tax payments, certain refundable credits, and other payments made by the taxpayer. Some of the credits will be entered on the appropriate lines of the return while some payments and credits may be entered on Schedule 3, Additional Credits and Payments.

Premium tax credit, additional child tax credit and the refundable education credit have already been covered. Earned income credit will be covered in the next lesson.

Objectives

At the end of this lesson, using your resource materials, you will be able to:

- Identify the following types of payments and credits that are applicable for most low- and moderate-income taxpayers:
  - Federal income tax withheld from Forms W-2, Wage and Tax Statement
  - Federal income tax withheld from Forms 1099
  - Estimated tax payments and amounts applied from the prior year's return
  - Amount paid with a request for an extension to file
  - Excess Social Security and tier 1 RRTA tax withheld
- Report these payments and credits correctly on the taxpayer's return

The information you obtain from the taxpayer's Intake/Interview & Quality Review Sheet will help you determine the payments and credits that should be reported. Refer to the Volunteer Resource Guide, Tab H, Other Taxes, Payments, and Refundable Credits, to identify and review the payments reported on a return.

What do I need?

- Form 13614-C
- Publication 4012
- Publication 17
- Form W-2
- Form 1040

Optional:

- Publication 505
- Form 1040 Instructions
- Form 1040-ES
- Forms 1099
- Form 4868
- Form 8962

How do I report federal income tax withheld?

The federal income tax system is a "pay as you go" system. That means tax is paid as income is earned or received during the year and is referred to as withholding credit.

Income tax is generally withheld from the following types of income:

- Salaries and wages
- Tips
- Taxable fringe benefits
- Sick pay
- Pensions and annuities
- 401(k) and IRA distributions
- Gambling winnings
- Unemployment compensation
- Certain federal payments such as Social Security benefits

If taxpayers have income tax withheld during the tax year, they will receive one of the following forms showing the amount withheld:

- Form W-2, Wage and Tax Statement
- Form W-2G, Certain Gambling Winnings
- One or more of several different types of Forms 1099

The amounts withheld are entered on the lines for federal income tax withheld.

The unintentional omission of withheld income tax is a common error. To avoid this mistake, review your input on each form to ensure all income taxes withheld are included before proceeding to the next one.

The total amount withheld from income is included on the return. If a paper return must be filed, attach all Forms W-2 and any Forms W-2G and Forms 1099 if tax was withheld.

Freda worked as a clerk and received a Form W-2 that reported federal income tax withholding of $1,000. She also received Form 1099-INT from her bank, which reflected federal income tax withholding of $50. The correct total withholding reported on her return would be $1,050 ($1,000 + $50).

Refer to prior lessons for:

- *Education Credits*
- *Child Tax Credit*
- *Premium Tax Credit*

When you enter information from the taxpayer's Form(s) W-2 and Form(s) 1099, including the federal income tax withheld, the tax software calculates the total and displays it on the appropriate line of the return.

What about estimated taxes and amounts applied from the prior year's return?

What are estimated tax payments?

Many taxpayers have income from self-employment, dividends, interest, capital gains, rent, and royalties. The "pay as you go" system also applies to this income. If the tax due on this income exceeds $1,000, estimated tax must be paid quarterly by the taxpayer. If estimated tax payments are not paid when they are required, a penalty could be imposed. This also applies if taxpayers do not have enough income tax withheld from their salary or wages. See the Refund and Amount of Tax Owed lesson for more information on estimated taxes.

Estimated tax is used to pay both income tax and self-employment tax, as well as other taxes and amounts reported on your tax return.

Where do I get this information?

Review the taxpayer's Intake/Interview & Quality Review Sheet to determine if they had income from sources such as self-employment or investments for which taxes may not have been withheld. If so, ask, "Did you pay estimated taxes to the IRS?" Be sure to note the dates and amounts of the payments on the intake and interview sheet and enter them into the software.

If taxpayers need more information about estimated taxes, refer them to Form 1040-ES, which includes instructions and a worksheet for computing the amount of estimated taxes they should pay. Forms can be obtained on IRS.gov.

If a taxpayer paid substantially more or less than required in estimated tax, encourage them to recalculate it. They can adjust their estimated tax payments by following the instructions and worksheet on Form 1040-ES. Taxpayers who are wage earners should use the IRS Tax Withholding Estimator to determine whether they need to update their withholding.

What about tax payments applied from a previous year?

Taxpayers who overpay their income taxes in one year can apply all or part of their overpayment to the next year's estimated tax by indicating the amount they want to apply.

Where do I get this information?

This information should be included in the taxpayer's Intake/Interview & Quality Review Sheet, but confirm by asking the taxpayer:

- Did last year's return show an overpayment?
- Did you apply any part of the overpayment to this tax year?

If the answer is "yes" to both questions, ask to see last year's tax return to document the amount of tax applied to this year's tax return. Add this amount on the applicable line on Form 1040.

For software entries to record current year estimated tax payments, go to the Volunteer Resource Guide, Tab K, Finishing the Return.

Taxpayer Interview and Tax Law Application

Let's see how our volunteer helped a taxpayer, Ernie, with his payments.

Sample Interview

Volunteer Says...	Ernie Responds...
The tax software added up all the income tax withheld from your Forms W-2 we entered earlier. I know you had a little self-employment income and I see you responded "yes" to the question on estimated tax payments on the intake and interview sheet. Is that correct?	Yes, I did.
Do you have a record of your payments, perhaps on a Form 1040-ES?	Yeah, here it is.
Good, you paid each quarter. We'll enter those payments. While we're here, did last year's return show an overpayment?	Yes, here it is: $150.
Did you apply any of that overpayment to this year's tax return?	Yes, all of it.
Okay, we'll enter that too. Now we show the total of the withholding from your Forms W-2, your estimated tax paid and the refund amount from last year's return applied to this year.	Good!

What about amounts paid with an extension to file?

Taxpayers can get an automatic six-month extension of time to file by submitting Form 4868, Application for Automatic Extension of Time To File U.S. Individual Income Tax Return. This form extends the time to file until October 15. This is only an extension to *file*, not an extension to *pay*. If taxpayers do not pay their taxes by April 15, they will owe interest and may be charged penalties.

If the April 15 or October 15 deadline falls on a Saturday, Sunday, or legal holiday, the deadline is the next business day.

Later, when taxpayers file their return, they report the payment made with Form 4868 on the applicable line on Form 1040, Schedule 3.

One of Bernice's Forms W-2 was lost in the mail. She requested a copy from her former employer, but it did not arrive by April 15. She filed for an extension, calculated the amount of taxes owed based on her final pay stub from that employer, and paid the $243 that was due. When she finally received her Form W-2, she filed her return and reported the $243 on the applicable line on Form 1040, Schedule 3.

How can taxpayers file the extension?

Taxpayers may file the extension electronically or on paper. The extension must be transmitted or mailed by the due date of the return. You can help taxpayers file for an extension using the tax software.

Go to the Volunteer Resource Guide, Tab M, Other Returns, to review the step-by-step procedures for filing for an extension or review the Completing the Return lesson for additional information.

What is excess Social Security and tier 1 RRTA tax withholding?

A taxpayer may have more than one employer and a combined income over the Social Security wage base. This means the taxpayer may have paid more in Social Security tax than is required. This excess amount is reported on the applicable line on Form 1040, Schedule 3, and is a refundable credit.

The software will calculate this automatically based on the amount entered for each Form W-2. Therefore, be sure the information from each Form W-2 is accurately entered.

How do I find the total payments?

Figuring the total tax payments is easy. Add the total amount of federal withholding, estimated tax payments and amount applied from prior year return, plus the other payments and refundable credits (which includes any amounts from Schedule 3).

The software totals all payments automatically.

Repayments of previously taxed income

When a taxpayer repays income that they included in a prior year's tax return of more than $3,000, the taxpayer may choose between a deduction in the year of repayment or a tax credit on the return of the year of repayment.

If choosing the deduction, it would be claimed in the same manner as the income was previously included:

- Schedule C if it was business income
- Schedule D/Form 8949 if it was a capital gain (same short or long term as originally reported)
- All other as a miscellaneous itemized deduction not subject to the 2% rule

If choosing the tax credit, it is computed on a with-and-without basis to measure the incremental tax that was paid in the prior year when the income was included. The credit is reported on Schedule 3, Line 13d (now supported in the tax software >Payments & Estimates > IRC 1341 Repayment Amount).

If taxes other than income taxes were paid on the previously included income, the taxpayer may be able to file a claim for refund using Form 843. Form 843 is beyond the scope of VITA/TCE Programs.

Repayments of more than $3,000 are out of scope. If the taxpayer repaid income of $3,000 or less, there is no deduction or credit.

State tax laws may differ.

Summary

Listing all the payments the taxpayer made during the year, and the taxpayer's refundable credits is critical to completing an accurate return. You must be able to identify the types of payments and credits that apply to each taxpayer when you are preparing their return.

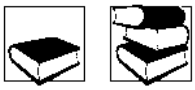
What situations are out of scope for the VITA/TCE programs?

The following is out of scope for this lesson. While this list may not be all inclusive, it is provided for your awareness only.

- Taxpayers who choose to claim any of the following credits:
  - Form 4136, Credit for Federal Tax Paid on Fuels
  - Form 2439, Notice to Shareholder of Undistributed Long-Term Capital Gains
  - Form 8839, Qualified Adoption Expenses
  - Credit for repayment of amounts included in income in a previous year (IRC 1341)

To gain a better understanding of the tax law, complete the practice return(s) for your course of study using the Practice Lab on L&LT.

Earned Income Credit (EIC)



Introduction

This lesson covers the earned income credit (EIC). There are several common errors associated with claiming this credit on the return. The Volunteer Resource Guide and the intake and interview sheet are critical tools in avoiding these mistakes.

Objectives

At the end of this lesson, using your resource materials, you will be able to:

- Determine if a taxpayer is eligible for the earned income credit
- Calculate the earned income credit

What do I need?

- Form 13614-C
- Publication 4012
- Publication 17
- Form 1040 and Instructions
- Form 8862

Optional:

- Publication 596
- Schedule EIC

What is the EIC?

The earned income credit (EIC) is a refundable tax credit for most people who work but do not earn high incomes. The purpose of the EIC is to reduce the tax burden and to supplement the wages of working families whose earnings are less than the maximums for their filing status. Eligible taxpayers can receive a refund with this credit, even if they have no filing requirement, owe no tax, and had no income tax withheld. All taxpayers and dependents must have valid Social Security numbers by the due date of the return (including extensions) to claim the credit. The refund for taxpayers claiming the EIC will not be issued prior to February 15.

The EIC can be a very valuable credit. The EIC was permanently expanded to allow families to claim credit for three or more children. The EIC amounts are adjusted for inflation every year.

The EIC is reported on its own line on the tax return.

How does a taxpayer qualify for the EIC?

There are general sets of rules for claiming the earned income credit:

- Rules for everyone
- Rules for taxpayers with a qualifying child
- Rules for taxpayers who do not have a qualifying child

What rules apply to everyone?

The taxpayer must meet all the rules to qualify for the earned income credit. Turn to the chart titled Summary of EIC Eligibility Requirements in the Volunteer Resource Guide, Tab I, Earned Income Credit. Review Part A, Rules for Everyone, and Part D, Earned Income and AGI Limitations.

Both earned income and adjusted gross income must be below the income limits in order for the taxpayer to qualify for the EIC. These amounts are adjusted for inflation every year. See the Important Changes lesson for this year's amounts.

The taxpayer, and spouse if MFJ, must have a principal place of abode in the United States for more than half the year. Be sure to indicate they are not eligible for EIC if the abode is outside the U.S. and they are using a U.S. address on their return so the software properly denies EIC.

Taxpayers can claim EIC who are married, not filing a joint return, had a qualifying child living with them for more than 1/2 the year and either lived apart from their spouse for the last 6 months of the year or are legally separated according to state law under legal separation agreement or a decree of separate maintenance and didn't live in the same household as the spouse at the end of the year. [Effective for tax years 2021 and later]

Individual Taxpayer Identification Numbers (ITINs) and Adoption Taxpayer Identification Numbers (ATINs) cannot be used when claiming the EIC. If a couple is filing a joint return,both spouses and all qualifying children must have an SSN that is valid for work by the due date of the return. Taxpayers cannot file an amended return retroactively for any year in which they did not have a valid Social Security number by the due date of the return (including extensions).

Singles and couples who have Social Security numbers can claim the credit, even if their children don't have SSNs. In this instance, they would get the smaller credit available to childless workers. In the past, these filers didn't qualify for the credit.

James and Jill are filing a joint return and both have valid SSNs. They have two daughters; Susie has a valid SSN and Sally has an ITIN. Only the daughter with the valid SSN may qualify the tax return for EIC.

There is a limit to the amount of investment income a person can receive and still qualify for the EIC. See the Volunteer Resource Guide, Tab I, Earned Income Credit, Summary of EIC Eligibility Requirements for the investment income limit. Investment income includes such items as taxable interest and dividends, tax-exempt interest, capital gain net income, and income from residential rental property.

What is "earned" income for EIC purposes?

Earned income includes wages, salaries, tips, and other taxable employee pay. Turn to the Earned Income Table in the Volunteer Resource Guide, Tab I, Earned Income Credit, for examples of earned income.

One type of payment considered earned income is "taxable long-term disability benefits received prior to minimum retirement age." Refer to the Retirement Income lesson earlier for additional information.

Volunteers using software must check the box in the Rollover or Disability section of the Form 1099-R input screen to report disability as wages. To review information on reporting disability income for a person under retirement age, go to the Volunteer Resource Guide, Tab D, Income.

What about combat pay?

Combat pay is never taxable to most soldiers. Members of the U.S. Armed Forces who served in a combat zone may elect to include their nontaxable combat pay in their earned income for the purposes of computing this credit. Doing this may increase or decrease the taxpayer's EIC. If the election is made, *all* of the nontaxable combat pay must be included. If both spouses filing a joint return have combat pay, they can individually choose to make the election on the tax return.

If a taxpayer has combat pay listed in Box 12 of Form W-2 marked with code Q, the software will determine if the combat pay should or should not be added to the taxpayer's income.

What about self-employment income?

Net earnings from self-employment are considered earned income. For most taxpayers within the scope of the VITA/TCE programs, “net earnings” for EIC purposes will be the amount reported as business income minus the deductible portion of the self-employment tax that is reported on Form 1040, Schedule 1.

Jeff’s self-employment income reported on Form 1040 is $2,000. The deductible portion of his self-employment tax, which is recorded on Schedule 1 of Form 1040, is $142.

His income for EIC purposes is $2,000 – $142 = $1,858.

Reminder: Nonwage income received for doing work (such as for side jobs or contract labor) is self-employment income, even for taxpayers who do not think of themselves as “self-employed.” **All self-employment income and expenses are required** to be reported on Schedule C, Profit or Loss from Business. Taxpayers not meeting the VITA/TCE programs’ scope limitations for filing Schedule C will need to seek the assistance of a professional tax preparer.

An IRS certified volunteer tax preparer must exercise due diligence when preparing or assisting in the preparation of, approving, and filing tax returns. Although a volunteer tax preparer may rely in good faith on information provided by the taxpayer without requiring documentation as verification, the tax preparer must ask questions if the information furnished appears to be incorrect, inconsistent, or incomplete.

What about household employee income?

Domestic employees such as housekeepers are only issued Form W-2 if their earnings are more than a certain amount. Refer to Publication 926, Household Employer’s Guide, for tax year amounts. Even if no W-2 is received, the income should be added to wages on Form 1040. This income should also be included when calculating
the EIC.

What about Medicaid waiver payments?

Certain Medicaid waiver payments (MWP) may be excluded from income under Notice 2014-7. Refer to the Wages, Interest, Etc. lesson for details. Even though excluded, these payments may be included in earned income if there is benefit from the inclusion. If both spouses earn Medicaid waiver payment income, each can make the election to include their MWP income as earned income for EIC purposes.

Earned income not qualifying for the EIC

One income item that is reported on Form W-2 but does not qualify as earned income for EIC purposes, is income received for work performed while an inmate in a penal institution.

A scholarship or fellowship grant that isn't reported to the taxpayer on a Form W-2 also isn't considered earned income for the EIC.

Generally, excluded income is not earned income for EIC purposes – an exception is made for Medicaid waiver payments as noted above. Refer to the Volunteer Resource Guide, Tab I, Earned Income Credit.

Income received for work while an inmate is in a penal institution must be entered in the Less Common Income, Other Compensation, then Prisoner Earned Income line in addition to the Form W-2 entries.

EXERCISES

Use the Summary of EIC Eligibility Requirements Chart in the Volunteer Resource Guide, Tab I, Earned Income Credit, to answer the following questions. Answers follow the lesson summary.

Question 1: A taxpayer without a qualifying child is filing as Married Filing Separately. Does this taxpayer qualify for the EIC?

a. Yes

b. No

Question 2: A taxpayer has interest income of $4,500. His earned income is only $7,000. He is single, has a valid Social Security number and is not the qualifying child of anyone else. Does he qualify for the EIC?

a. Yes

b. No

What are the rules for taxpayers with qualifying children?

The taxpayer can file Form 1040 to claim the EIC with a qualifying child. The taxpayer has a qualifying child for EIC purposes if the child meets **all** the tests outlined in the Volunteer Resource Guide, Tab I, Earned Income Credit. A short version of the rules is shown in Part B, Rules If You Have a Qualifying Child. A detailed version is on the next page of the Volunteer Resource Guide.

Jane, 31, and Todd, 33, have an 8-year-old daughter, Amanda. All are U.S. citizens and have valid SSNs. Jane and Todd have never been married. Jane and Amanda lived together all year in an apartment. Todd lived alone. Jane earned $15,000 working as a clerk in a clothing store. Todd is an assistant manager of a hardware store and earned $48,000. He paid over half Jane's rent and utilities, and also gave Jane extra money for groceries.

Todd does not pay any expenses or support for any other family member. Although Todd provided over half the cost of a home for Jane and Amanda, he cannot file Head of Household and he cannot claim the child for EIC, since Amanda did not live with him more than half the year. Jane cannot file as Head of Household either. Review the Filing Status for Head of Household rules in the Volunteer Resource Guide, Tab B, Starting a Return and Filing Status.

Jane is the only one who can claim Amanda as a qualifying child for EIC. Review the Earned Income Credit rules in the Volunteer Resource Guide, Tab I, Earned Income Credit.

For EIC purposes, a qualifying child does not have to be the taxpayer's dependent (unless the child is married). Specifically, there is no support test to be a qualifying child for EIC. Therefore, even if the child is not the taxpayer's dependent, the taxpayer may be able to claim the child for EIC if they meet the age, relationship and residency tests.

In the case of divorced or separated parents, the custodial parent (with whom the child lived for more than half the year) can qualify for the EIC regardless of whether or not they claim the child as a dependent. The noncustodial parent cannot qualify for EIC because the child did not live with them for more than half the year.

What are the rules for a qualifying child of more than one person?

A child who meets the conditions to be a qualifying child of more than one person can only be claimed by one taxpayer for the EIC.

Robyn is 25 years old. She and her 2-year-old son, Aiden, lived with Robyn's mother all year. Aiden has a valid Social Security number.

Using the EIC With a Qualifying Child Chart from the Volunteer Resource Guide, Tab I, Earned Income Credit, based on what we have learned so far about Robyn and her family:

Step 1 is YES

Step 2 is YES

Step 3 is YES

Step 4 is NO

Step 5 is YES

For Step 6, check to see if Aiden can be anyone else's qualifying child, for EIC purposes.

Who else lived in the house that is related to Aiden? Robyn's mother also lives with them. Go through the steps to see if Aiden can be a qualifying child for Robyn's mother.

If the taxpayer can't claim the EIC because the qualifying child is treated under the tiebreaker rules as the qualifying child of another person, the taxpayer may be able to take the EIC using a different qualifying child, or take the EIC if they qualify using the rules for people who don't have a qualifying child. See the Qualifying Child of More than One Person rules in the Volunteer Resource Guide, Tab I, Earned Income Credit.

What are the rules for taxpayers without qualifying children?

Taxpayers can claim the EIC without a qualifying child. Confirm that the taxpayer and spouse cannot be claimed as dependents by their parents or anyone else. Review the rules in the Volunteer Resource Guide, Tab I, Earned Income Credit, under Part C, Rules If You Don't Have a Qualifying Child.

Tom and Martha are a married couple. Tom is 66 and Martha is 58 years old. If all other rules are met, they would qualify for the EIC.

For a couple filing a joint return, only one taxpayer has to meet the age requirement.

Taxpayers turning 25 on January 1 are considered to be of age as of December 31. Taxpayers reaching the age of 65 on January 1 are still considered 64 as of December 31. Taxpayers in either of these situations whose return is rejected may need to file a paper return.

EXERCISES (continued)

Using the EIC charts in the Volunteer Resource Guide, determine if each of these taxpayers has a qualifying child or can claim the EIC. Each taxpayer and child has a valid Social Security number.

Question 3: Maureen's 20-year-old daughter, Angie, lived with her for eight months of the year. Angie is not married and is a full-time college student. Is Angie a qualifying child for the EIC?

a. Yes

b. No

Question 4: Three children live with Mira, who cares for them as her own: Twila, the 3-year-old daughter of Mira's cousin; Chez, Mira's newly adopted 2-year-old son from Europe, who has lived with Mira since November of the tax year; and Dwight, Mira's 20-year-old son, who attends community college part time. Which of them are qualifying children?

a. Twila

b. Chez

c. Dwight

d. None

Question 5: Margie's daughter, Aimee, turned 23 early in the tax year while attending college full time. Margie is filing as Head of Household. Margie has an AGI of $31,000. Assuming that she and her daughter pass all other tests, can Margie claim the EIC?

a. Yes

b. No

Question 6: Rob and Laura are divorced. Laura is the custodial parent for Dawn, who lived with her all year. Laura signed Form 8332, allowing Rob to claim Dawn as a dependent until she turns 18. Can Rob claim Dawn for the EIC?

a. Yes

b. No

Question 7: Jewel and her daughter lived with Jewel's brother, Emmitt all year. Jewel earns $20,000 and claims her daughter as the qualifying child for the EIC. Emmitt is 25 years old and earned $8,500. Is Emmitt able to claim the EIC for a taxpayer without a qualifying child?

a. Yes

b. No

Question 8: Larry is 35 years old and unmarried. Larry lives with his brother, Jeff, who is unmarried and totally and permanently disabled. Jeff receives disability income that is used to pay for more than half of his support. Can Larry claim Jeff as a qualifying child for EIC?

a. Yes

b. No

Tax-Aide only: *use the Qualifying Child or Relative Resource Tool to determine if the individual is a qualifying child or qualifying relative dependent and the benefits that may be claimed. It can be found in the Portal Library and/or ordered for delivery.*

How should I handle a taxpayer whose EIC was disallowed in a prior year?

The intake and interview sheet asks if the taxpayer was previously disallowed EIC or certain other refundable credits in a prior year because special rules apply. If the taxpayer answers “yes” to this question, refer to the Volunteer Resource Guide, Tab I, Earned Income Credit, Disallowance of Certain Credits.

Form 8862, Information to Claim Certain Credits After Disallowance, must be completed when required or the return will be rejected. The taxpayer should have received a notice from the IRS to file Form 8862 with their tax return.

If the taxpayer is denied EIC for the current tax year because of IRS disallowance, you will need to indicate that so the software does not compute the credit.

How is the correct EIC amount calculated?

The software computes EIC using worksheets and the Earned Income Credit tables. The EIC worksheets can be found in Publication 596, Earned Income Credit, or Form 1040 Instructions. The software completes Schedule EIC and EIC worksheets that can be reviewed with the taxpayer if they have questions about how EIC was computed.

When reviewing the Form 1040 Instructions, it is common to mistake the Tax Tables for the EIC tables. Double-check that the heading on the page you are using is “Earned Income Credit (EIC) Table.”

Class Exercise

A taxpayer is filing Head of Household and has one qualifying child. The earned income and AGI is $19,000. How much EIC is the taxpayer entitled to?

Turn to the first page of the EIC tables. Find the amount in the “At least - But less than” column. Find the correct filing status column: Single, head of household and qualifying surviving spouse, or in a separate column, married filing jointly. There are subcolumns for the number of qualifying children.

Summary

The earned income credit computation is based on filing status, number of qualifying children, earned income, and adjusted gross income. Certain individuals with no children may also qualify.

By using the intake and interview sheet, the EIC charts in the Volunteer Resource Guide and correctly entering the taxpayer’s data in the software, most of the errors that result from incorrectly computing the EIC can be avoided.

The EIC is entered on its own line of the return.

To gain a better understanding of the tax law, complete the practice return(s) for your course of study using the Practice Lab on L&LT.

EXERCISE Answers

Answer 1: b, No. In order to claim the credit as MFS, the taxpayer must have a qualifying child.

Answer 2: a, Yes. His investment income is below the threshold amount.

Answer 3: a, Yes. Daughter Angie meets all the eligibility tests to be a qualifying child.

Answer 4: d. None of the children under Mira's care are qualifying children for the EIC. Twila does not meet the relationship test, Chez does not meet the residency test, and Dwight does not meet the age test.

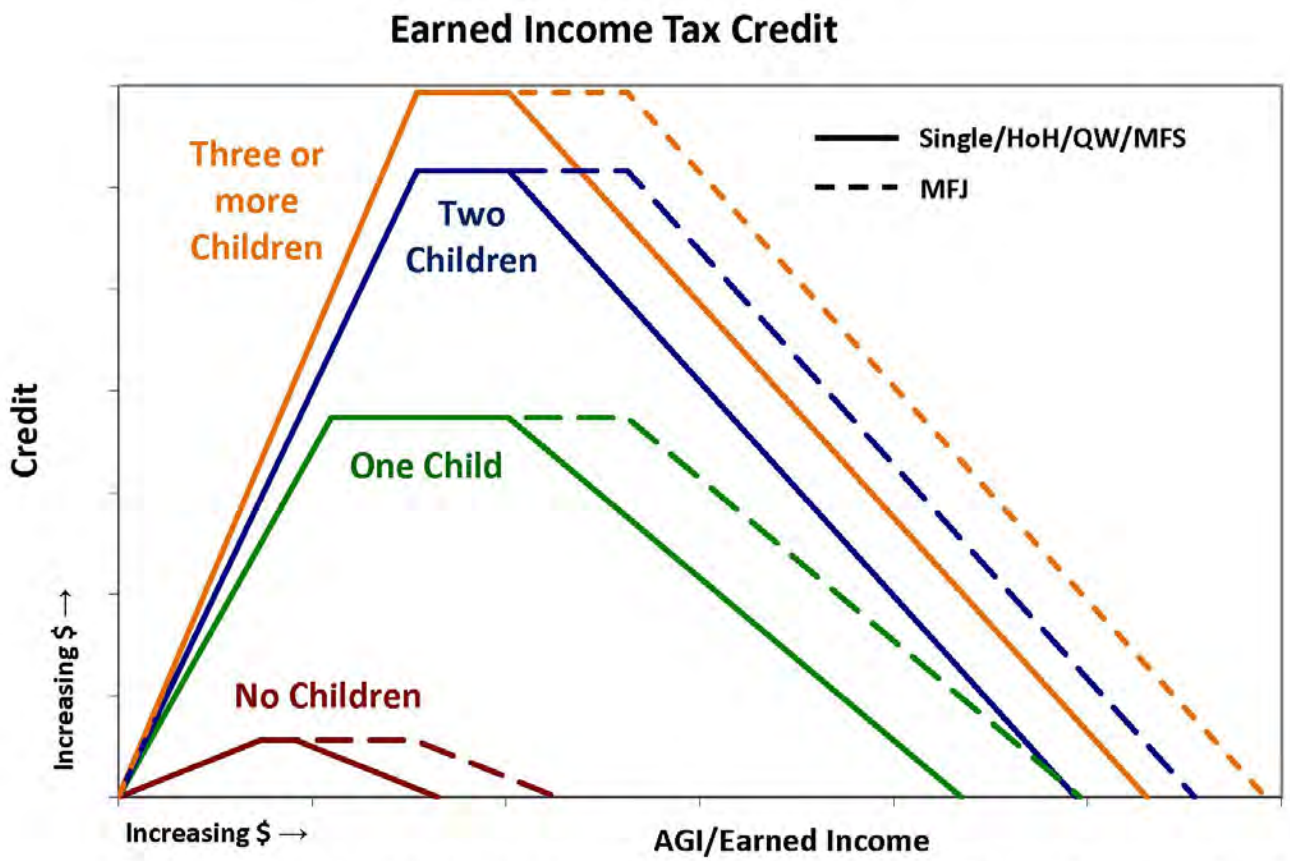
Answer 5: a, Yes. Margie meets the general eligibility requirements and Aimee meets the Qualifying Child rules.

Answer 6: b, No. While Rob can claim his daughter as a dependent, the daughter did not live with him for more than half the year, so she fails the residency test. Dawn is the qualifying child of Laura.

Answer 7: a, Yes. Jewel's daughter is not the qualifying child of Emmitt, but he can claim the EIC for a taxpayer without a qualifying child.

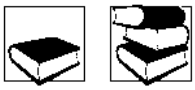
Answer 8: a, Yes, Jeff is Larry's qualifying child for EIC. Jeff is not Larry's dependent because he provides more than half of his own support; but the support test does not apply for EIC.

The following chart demonstrates how the earned income credit functions. Some earned income is needed to generate an EIC. If income is too high, the credit is reduced – maybe to zero.



The purpose of this chart is to show how the earned income credit changes with AGI/Earned income, number of children and filing status. It is not intended as a scalable reference document.

Refund and Amount of Tax Owed



Introduction

This lesson covers the Refund and Amount You Owe sections of the taxpayer's return. After completing this lesson, you will determine if taxpayers have overpaid (a refund is due) or have underpaid (balance is due to the government) their tax. This part of the return is a summary of the tax, credits, and payments.

Taxpayers may be entitled to a refund or owe tax. In either case, they have several choices on how to get their refund or pay the amount they owe. It is important that volunteers are familiar with those choices to better help taxpayers understand their refund and payment options. This is especially true because of the increase in the number of taxpayers coming in to VITA/TCE sites who owe tax for the first time and need guidance.

Feedback results indicate volunteers are less familiar with the procedures for payment options than the procedures for refund options. Be sure to identify the payment options available to taxpayers that are outlined in this lesson and in the Volunteer Resource Guide, Tab K, Finishing the Return.

To complete these sections of the taxpayer's return, you will need to confirm answers provided on the Intake/ Interview & Quality Review Sheet, regarding direct deposit and direct debit. Also, review the Volunteer Resource Guide, Tab K, Finishing the Return, which provides guidance on refunds and balance due returns.

Objectives

At the end of this lesson, using your resource materials, you will be able to:

- Identify the applicable section and lines of Form 1040 for the refund or amount owed
- Report the correct amount of refund or amount owed
- Identify the refund options available, including the purchase of savings bonds
- Describe the different payment options for the amount owed

Explain how to adjust the amount of tax withheld or make estimated tax payments to avoid underpayment of taxes

What do I need?

- Form 13614-C
- Publication 4012
- Publication 17
- Form 1040
- Form 1040-ES
- Form 8888
- Form W-4
- Form W-4P
- Form W-4R
- Form W-4S
- Form W-4V

Optional:

- Publication 505
- Publication 594
- Publication 4134
- Publication 5381
- Form 9465

How do I know if the taxpayer is due a refund?

The taxpayer's total tax and total tax payments already made, which includes refundable credits, appear on the applicable lines of Form 1040.

If the payments made exceed the amount of tax liability, the amount of the overpayment is shown on the applicable line in the Refund section of the Form 1040. This is the amount the taxpayer has overpaid.

If the amount of the tax liability exceeds the payments made, the amount owed appear in the Amount You Owe section of the Form 1040. This is the amount the taxpayer must pay to the IRS.

For taxpayers who are due a refund:

- *Advise taxpayers to check Where's My Refund? at* **www.irs.gov/refunds** *or download the IRS2Go app to check the status of their refund status for tax year 2019 or later. The taxpayer will need their Social Security number or ITIN, filing status, and the exact refund amount. Where's My Refund?will display the status of the refund 24 hours after e-filing a return for the current filing year, 3 or 4 days after filing a prior year return, or 4 weeks after mailing a paper return.*
- *Inform taxpayers of the split refund using Form 8888 (found in the e-file section of the tax software) and saving bond options*

What are the options for an overpayment?

Taxpayers can choose to:

- Apply any portion of their overpayment to the following tax year
- Receive all or part of their refund using direct deposit to any financial account that has a Routing Transit Number, such as a checking account, a savings account (including an IRA), or a prepaid debit card
- Receive all or part of their refund as a check
- Purchase Series I Savings Bonds

RALs, RACs, and Other Financial Products: You may be asked about Refund Anticipation Loans (RALs). A RAL is money borrowed by a taxpayer from a lender based on the taxpayer's anticipated income tax refund. A variation of a RAL is a Refund Anticipation Check (RAC). Financial Institutions also offer a variety of other financial products to taxpayers based on their refunds. Providers that assist taxpayers in applying for a RAL or other financial products have additional responsibilities and may be sanctioned by the IRS if they fail to adhere to the requirements. These financial products are out of scope for the VITA/TCE programs.

How do I apply part of the overpayment to the following year?

For taxpayers who want to apply a portion of the overpayment to next year's taxes, enter the amount to be applied to the following year on the applicable line. By entering an amount on this line, the taxpayer is electing to apply all or a portion of the current year's overpayment to next year's estimated tax.

The software shows the remaining amount to be refunded to the taxpayer on the amount to be refunded line.

How do I indicate that the entire refund should be sent to the taxpayer?

For taxpayers who want the entire refund sent to them, leave the line for amount applied to estimated tax blank or enter 0.

A field in the signature section of Form 1040 labeled Identity Protection PIN is designed to help prevent refunds from being issued to an identity thief. See the Course Introduction lesson for more information.

The tax software shows the entire refund amount on the amount to be refunded line.

What are a taxpayer's refund options?

Taxpayers may choose to have their refund deposited directly into their account at a bank, credit union, or other financial institution, into their TreasuryDirect account, or to a prepaid debit card, or to an IRA. Direct deposits are usually received within three weeks of return acceptance. Taxpayers may choose to have a refund check mailed to them. Refund checks are usually mailed within 6 to 8 weeks after the return is filed. In addition, taxpayers can request their refund be deposited directly into a TreasuryDirect online account to buy U.S. Treasury marketable securities and savings bonds will use the RTN of 051736158 and their TreasuryDirect account number. Refer to **usa.gov/3KvcP** for more information on direct deposit refunds to TreasuryDirect online accounts.

The taxpayer may decide toward the end of the return preparation process to allocate some or all of the refund to their IRA. Be sure to go back into the return and enter the contribution amount – the taxpayer may get additional benefit from the contribution through a deduction and/or the retirement savings credit.

Taxpayers who do not have a TreasuryDirect online account also have the option to purchase savings bonds with their federal income tax refunds. Additional details will be covered later in the lesson.

What are the benefits of direct deposit?

Encourage taxpayers to use direct deposit; direct deposit refunds are received faster than checks (usually within 10 to 21 days) and eliminate the possibility of a check being lost or stolen. Direct deposit is more convenient for the taxpayer and saves tax dollars because it costs less to process.

How do I enter the information for direct deposit?

Make sure taxpayers show you proof of their bank account and routing information, such as a check. Bank deposit slips are not a reliable source for routing numbers for direct deposit. Enter the account number from left to right, but omit spaces and symbols. The Volunteer Resource Guide, Tab K, Finishing the Return, Pointers for Direct Deposit of Refunds, includes a diagram showing where to find the Routing Transit Number (RTN) and Depositor Account Number (DAN) information on a check.

Direct deposit of a taxpayer's refund is to be made to an account (or accounts) only in the taxpayer's name. Advise taxpayers their refunds may only be deposited directly into their own accounts.

***Tax Software Hint:** For software entries, go to the Volunteer Resource Guide, Tab K, Finishing the Return, for software entries on direct deposit.*

If the routing and account numbers are not valid, the refund will be delayed 4–6 weeks. If the direct deposit is rejected, a check will automatically be mailed to the address on the return.

Can the refund be deposited into more than one account?

Taxpayers may choose to have their refund deposited in up to three accounts. For example, a person expecting a refund of $600 could choose to deposit $200 into a checking account, $300 into a savings account, and $100 into an IRA account.

Taxpayers' refunds should only be deposited directly into accounts that are in their own name, a spouse's name, or both if it's a joint account. No more than three electronic refunds can be deposited into a single financial account or prepaid debit card. Taxpayers who exceed the limit will receive an IRS notice and a paper refund.

Use Form 8888, Allocation of Refund (Including Savings Bond Purchases), to list the RTN and account number for each deposit. Form 8888 is not required if the refund is to be deposited into a single account. Go to the Volunteer Resource Guide, Tab K, Finishing the Return, for the software entries.

What if the taxpayer makes a mistake on the return that increases the amount of the refund?

E-filing a tax return avoids math errors and other common problems that can require adjustments to a return after it is filed. If an adjustment results in a larger refund than expected, the IRS adds the difference to the last account designated for direct deposit.

When an adjustment is made to a tax refund, the IRS sends a letter explaining any errors that resulted in the adjustment, as well as any changes made to the refund amount and the amount of each direct deposit.

What if the taxpayer makes a mistake on the return that decreases the amount of the refund?

If an adjustment results in a smaller than expected refund, the IRS uses a bottom-up rule and deducts the difference from the direct deposit amount designated for the last account shown on Form 8888. If the difference exceeds the amount designated for the last account, the IRS deducts the remainder from the amount designated to the next account, until the amount due is paid.

Joan's return shows a refund of $300 and she asks the IRS to split her refund among three accounts with $100 to each account. Due to an error, her refund is decreased by $150. The IRS will adjust her direct deposits as follows:

	Requested Direct Deposits	***Actual Direct Deposits***
Account 1	*$100*	*$100*
Account 2	*$100*	*$50*
Account 3	*$100*	*$0*

The IRS will apply this same bottom-up rule to adjust direct deposits for refund offsets for unpaid federal taxes or if the refundable credits portion of the taxpayer's refund is withheld pending further review. After the IRS review, if a refund is allowed, it will be direct-deposited in the account listed first on Form 8888.

Bill asks that his refund of $780 be deposited into three different accounts: $300 into Account 1, $300 into Account 2, and $180 into Account 3. However, Bill owes federal taxes of $290 on an earlier tax year, and after this is offset, only $490 remains to be direct deposited. Account 3 will receive $0, Account 2 will receive $190, and Account 1 will receive $300.

Melanie is due a refund of $1,000; $700 of the refund is an earned income credit (EIC). She asks that her refund be split into three different accounts: $500 into Account 1, $300 into Account 2, and $200 into Account 3. Melanie's EIC amount of $700 was held pending a review. So, $300 went to Account 1 and $0 went to Accounts 2 and 3. Later, when the IRS allowed her EIC refund amount, it was deposited into Account 1.

What happens if the taxpayer owes other debts like student loans or child support?

If the refund is decreased due to an offset to pay state income tax, child support, or certain federal nontax debts, such as student loans, then the decrease will be taken first from the account that appears first on the payment file received from the IRS. The IRS payment file orders accounts from the lowest to the highest routing number. If the debt exceeds the payment designated for the account that appears first on the payment file, the Treasury Department's Financial Management Service (FMS) will reduce the payment designated for the account that appears next.

What should I watch out for?

Double-check the RTN of the financial institution before the return is transmitted if:

- You are unfamiliar with the financial institution.
- The RTN is for a credit union that is payable through another financial institution. Taxpayers should contact their credit union for the correct RTN.
- If more than one account is selected for direct deposit, be sure that the amounts on Form 8888 equal the refund amount on Form 1040.

EXERCISES

Answers follow the lesson summary.

Question 1: Using direct deposit is one way to reduce the chance that a refund will be lost or stolen.

a. True

b. False

Question 2: When entering an account number for direct deposit, make sure to include all spaces and hyphens.

a. True

b. False

Financial institutions generally do not allow a joint refund to be deposited into an individual account. The IRS is not responsible if a financial institution refuses a direct deposit.

What do I need to know about the option to buy U.S. savings bonds with a federal tax refund?

Taxpayers have an opportunity to purchase U.S. savings bonds with their tax refunds. Volunteers should review these guidelines to promote this asset-building opportunity as part of the filing season.

Taxpayers' choices include the purchase of bonds for co-owners, such as children or grandchildren, and for beneficiaries, such as the parents of a child.

What are U.S. savings bonds?

U.S. savings bonds are savings instruments for individual savers issued by the U.S. Department of the Treasury. For purposes of this program, only Series I Savings Bonds are offered.

Series I Savings Bonds are sold at face value (a $50 bond costs $50), and grow in value for up to 30 years. The bonds can be purchased in denominations of $50, $100, $200, $500, $1,000. In any single calendar year, taxpayers can purchase up to $5,000 of paper savings bonds of any denomination through their income tax refund.

Series I Savings Bonds pay interest based on a combination of a fixed rate (which remains the same throughout the life of the savings bond) and a semiannual inflation rate, which is updated each May and November. Savings bonds accrue interest until redeemed or until they reach their final maturity in 30 years.

Savings bonds can be redeemed for principal and accrued earnings anytime after the first 12 months after date of purchase (or earlier if the taxpayer lives in an area affected by natural disaster.) Also, if a savings bond is redeemed within the first five years, the three most recent months' interest will be forfeited. After five years, no penalty will apply.

How can savings bonds be purchased at VITA/TCE sites?

Taxpayers can choose to save part or all of their refunds by requesting savings bonds on Form 8888. The specific details on how to purchase savings bonds with a federal tax refund are included in the Form 8888 Instructions.

In addition to the three direct deposits, taxpayers can allocate their refund to request up to three different savings bond registrations and receive a check. Form 8888 is divided into separate parts to reflect this.

- Part I: Complete this part for direct deposit of a portion of a refund to one or more accounts.
- Part II: Complete this part to buy paper bonds with part of a refund. In addition to making bond purchases for themselves, taxpayers can make bond purchases and add beneficiaries or co-owners, and make bond purchases for someone other than themselves.
- Part III: Complete this part if taxpayers wish to receive part of their refund by check.
- Part IV: Total allocation of refund. Add the amounts for each part together; they must equal the total refund amount.

The Form 8888 Instructions provide directions for the specific information to include on the form for the purchase of savings bonds.

Mary's tax return shows she is due a refund of $548.00. She wants to buy a $500 savings bond. Using Form 8888, Mary can purchase the savings bond and elect to deposit the remaining $48 into her checking account.

Refer to Purchase Savings Bonds in Tab K, Completing the Return of the Volunteer Resource Guide.

How does the taxpayer receive the savings bonds?

Taxpayers will receive the amount they designated by mail in the form of U.S. Series I Savings Bonds. However, if taxpayers make an error in figuring their refund, the bond request is not a multiple of $50, or the refund is offset for any reason, this option will not apply and the entire amount of the refund will be sent to taxpayers in the form of a check.

When will requested bonds not be issued?

Bonds will not be issued if any of the following apply:

- The bond request is not a multiple of $50.
- More than one name is entered on line 5b, 5c, 6b, or 6c.
- The refund is decreased because of a math error.
- The refund is offset for any reason.

Instead, the **entire** refund will be sent to the taxpayer in the form of a check.

If an error is made on the return and the amount of the refund is increased, the additional amount will be sent to the taxpayer in the form of a check.

Whom does the taxpayer contact if the savings bonds are not received?

The first step is to check the status of the refund by going to the "Where's My Refund"at **www.irs.gov/refunds** or calling 1-800-829-1954. It can take up to three weeks to send the savings bonds to the taxpayer's mailing address after the IRS has processed the portion of the refund not used to buy savings bonds. Taxpayers can contact the Treasury Retail Securities Site online or at 1-844-284-2676 to inquire about the status of the savings bonds.

For additional information, refer to Form 8888 or go to **www.irs.gov**.

How do I know if an amount is owed?

Taxpayers who owe money on their returns are often afraid and do not know what to do next. This is a good opportunity to advise the taxpayers of the various options for payment.

The software automatically calculates the amount that is owed when the payment total is less than the amount of tax.

Explain to taxpayers that the tax return will be filed now and that they should submit their payment of taxes due no later than April 15 (or the next business day if April 15 falls on Saturday, Sunday, or a legal holiday). Remind taxpayers that filing an extension of time to file does not extend the time for payment.

To avoid a failure-to-file penalty, taxpayers with an amount owed must file their return by the due date even if they cannot pay the full amount with the return.

What forms of payment are acceptable?

The payment options are:

- Check or money order submitted with Form 1040-V, Payment Voucher
- Electronic funds withdrawal
- Credit card (fees may apply)
- Electronic Federal Tax Payment System (EFTPS)
- IRS Direct Pay
- Cash at a retail partner

Taxpayers should not mail cash with their returns. They must go to a retail partner such as Dollar General, Family Dollar, CVS Pharmacy, Walgreens, Pilot Travel Centers, 7-Eleven, Speedway, Kum & Go, Royal Farms, Go Mart and Kwik Trip. Refer to **www.irs.gov/payments/pay-with-cash-at-a-retail-partner** *for additional information.*

Form 1040-V includes instructions and a table of IRS addresses if the taxpayer wants to mail a check or money order.

Go to the Volunteer Resource Guide, Tab K, Finishing the Return, to review the information on balance due returns. Be sure to read this reference and refer to it when preparing a return that has an amount owed.

Taxpayers can check the balance owed on their account by creating an account on IRS.gov or by requesting an account transcript at **www.irs.gov/payments/view-your-tax-account***.*

Taxpayers can use the IRS2Go app on their mobile device to access their account and make a payment.

What if the taxpayer cannot pay?

If taxpayers state that they cannot pay, first advise them to file the return and pay as much as they can with the return. This will reduce penalty and interest charges. Once they receive a notice, they can pay the remaining amount in full or choose another payment option if more time is needed.

Taxpayers who cannot pay the full amount owed, shown on Form 1040 in the Amount You Owe section, may use one of the following options:

- Request a short-term payment plan of up to 180 days using the Online Payment Agreement Application (OPA) or calling. No fee is charged, but interest and penalties are charged on payments after the April due date.
- Monthly installment payments (established online using OPA or file Form 9465, Installment Agreement Request). A fee is charged for this option, in addition to interest and penalties. The fee is less with OPA. Taxpayers may qualify for waiver or reimbursement.
- Referral to Low-Income Taxpayer Clinics (LITC). Services are offered for free or a small fee.

Any amount of tax owed that is not paid by the April due date is subject to penalties and interest. Taxpayers who cannot pay should choose the option that is the least costly. For example, the 180-day short-term plan option has no user fee. Print extra vouchers for taxpayers who need to send in multiple payments or they can make their payments using DirectPay on IRS.gov or the IRS2Go app.

Taxpayers who can show they will have a substantial financial difficulty if they pay their tax on the due date are considered to have an undue hardship. Such taxpayers can request an extension of time to pay by filing Form 1127, Application for Extension of Time for Payment of Tax Due to Undue Hardship, by the due date of the return. Remember, undue hardship is more than an inconvenience.

How do I handle Form 9465, Installment Agreement Request?

The following outlines key information related to an installment agreement.

- Taxpayers who owe can immediately establish an installment agreement online, using the Online Payment Agreement Application (OPA). Taxpayers can also use OPA to agree to a short-term payment plan up to 180 days. With OPA, there is no need to complete Form 9465. For more information, go to **www.irs.gov/payments/online-payment-agreement-application**.
- If the return is being filed electronically, Form 9465 can also be included with the e-filed return. Refer to the Volunteer Resource Guide, Tab K, Finishing the Return.
- When filing a paper return, Form 9465 should be completed and attached to the front of the return before mailing. The processing fee charged is higher if Form 9465 is used.

- If taxpayers already have an installment agreement with the IRS, they may be able to add the current year's amount owed to the same agreement. Taxpayers in this situation should contact the IRS directly at 1-800-829-1040 or complete Form 9465 reflecting the balance of all amounts (prior and current year amounts) and indicate the new total monthly payment. Submit Form 9465 electronically with the return.
- If the request is granted, the taxpayers must pay an installment agreement user fee. The amount of the fee varies depending on whether the agreement was setup online or the taxpayer agreed to pay by direct debit. If the taxpayers' income is below certain limits, they may qualify for a reduced or waived fee. Taxpayers can also request a reduced user fee by completing Form 13844, Application for Reduced User Fee for Installment Agreement. Taxpayers can obtain Form 13844 at irs.gov or by calling the IRS forms number at 1-800-829-3676. The fee for establishing an installment agreement using OPA is lower.
- If the IRS approves the agreement, a notice is issued that provides details of the agreement and requests the user fee at that time.
- If the total amount due is more than $25,000, there are additional requirements. Refer to Form 9465 instructions.

Some low-income taxpayers may qualify for a modification of user fee requirements. The IRS will waive or reimburse user fees associated with installment agreements for taxpayers who earn less than 250% of the federal poverty rate. For details, see User fee waivers and refunds on IRS.gov.

What is an Offer in Compromise?

An offer in compromise (OIC) allows taxpayers to settle tax debt for less than the full amount owed. It may be a legitimate option if a taxpayer cannot pay their full tax liability or doing so creates a financial hardship. IRS will consider the unique set of facts and circumstances:

- Ability to pay
- Income
- Expenses
- Asset equity

There is a nonrefundable application fee ($205) although low-income taxpayers qualify to waive the application fee for an OIC if their AGI is at or below 250% of the federal poverty level. Assisting a taxpayer with an OIC is out of scope for the VITA/TCE Programs. Taxpayers can access additional information on irs.gov and in the Form 656-B Offer in Compromise Booklet.

Where can I refer taxpayers for other options to resolve tax-related matters?

Low-Income Taxpayer Clinics (LITCs) are independent from the IRS and Taxpayer Advocate Service (TAS). LITCs represent taxpayers whose income is below a certain level and who need to resolve tax problems with the IRS. LITCs can represent taxpayers in audits, appeals, and tax collection disputes before the IRS and in court. In addition, LITCs can provide information about taxpayer rights and responsibilities in different languages for individuals who speak English as a second language. Services are offered for free or a small fee. For more information or to find an LITC, see the LITC page at **www.taxpayeradvocate.irs.gov/about-us/low-income-taxpayer-clinics-litc/** or **Publication 4134, Low Income Taxpayer Clinic List**. This publication is available online at IRS.gov or by calling the IRS at 1-800-829-3676.

Under the Taxpayer First Act, programs funded by IRS grants are encouraged to refer taxpayers when appropriate to an LITC. As mentioned above, LITCs can provide help with many issues that VITA volunteers might identify in their work with taxpayers. LITC staff may also be a resource to VITA Quality Reviewers or preparers in helping with the interpretation of tax law. Ideally, tax preparation programs and LITCs will share information and discuss how best to make a referral to provide the best possible service to our taxpayers. LITCs are encouraged to refer taxpayers to free preparation options such as VITA and TCE by the LITC Program Office.

EXERCISES (continued)

Question 3: For which of the following will the taxpayer be charged a convenience fee?

- **a.** Direct deposit of a refund
- **b.** Electronic funds withdrawal of a tax payment
- **c.** Using a credit card to make a tax payment
- **d.** Using a personal check to make a tax payment

Taxpayer Interview and Tax Law Application

Seymour's Form 1040 shows his total tax is $450. His tax payments come to just $200. Therefore, Seymour owes $250.

Sample Interview

Volunteer Says...	Seymour Responds...
The amount of tax you owe is $250. You can either mail in a check or money order with the payment voucher, use electronic funds withdrawal, IRS Direct Pay, use cash at a retail partner, or call in a credit card payment. You'll have to pay an additional convenience fee for using a credit card.	Hmm. How does electronic funds withdrawal work? Does it come out of my account right away?
No, we can designate the date that the debit will occur, any time up to April 15. I would just need to see proof of account to verify your bank account information so I can include the routing and account numbers in your electronic return.	And there's no charge?
Right. And it saves you the trouble of mailing in the voucher with your payment.	Sounds good to me. But I don't have my checking account information with me. Maybe I should just mail in my payment.
You can do that too. Here's Form 1040-V, which has been completed for you. Make your check or money order payable to "United States Treasury." If it's not already printed on the check, make sure it shows your name, address and daytime phone number. Also, print your Social Security number and "[year] Form 1040" on the front of your check. Then mail the payment with the voucher. I'll get the mailing address for you.	That doesn't seem too hard.
Just make sure it gets postmarked by the due date. I can e-file your tax return right now, but it's up to you to make sure you send in your payment on time. Or, you can just go to IRS.gov and use DirectPay -- you'll need to enter your routing number and account number. It's safer and quicker than mailing a check.	Thank you for your help. I will make sure the payment is made on time.

How is the estimated tax penalty calculated?

The estimated tax penalty is calculated on Form 2210, Underpayment of Estimated Tax by Individuals, Estates, and Trusts, and reported on the applicable line in Form 1040, Amount You Owe section. While completion of Form 2210 is out of the scope of the VITA/TCE programs, it is important for volunteers to have an awareness of the estimated tax penalty provisions.

What is the estimated tax penalty?

Generally, taxpayers may owe a penalty for underpayment of estimated tax if they did not pay enough tax, either through withholding or by making estimated tax payments.

In most cases, taxpayers must make estimated tax payments if they expect to owe at least $1,000 in tax (after subtracting withholding and credits) and their withholding and credits will be less than the smaller of:

- 90 percent of the tax shown on the current tax return or
- 100 percent of the tax shown on the prior year's tax return (110 percent for certain higher-income taxpayers; see Form 1040-ES)

An estimated tax penalty may apply if the taxpayer does not make estimated tax payments as required.

There are special situations when a taxpayer will not have to pay a penalty. See Form 2210 Instructions or Publication 17 for more information.

Mark's total tax is $1,657 for the current tax year. His withholding is $417. He owes $1,240. His prior year's tax was $2,000. Mark will probably be charged an estimated tax penalty because the amount he owes is over $1,000 and his withholding and credits are less than 90 percent of his current year tax or 100 percent of his prior year tax.

Do I have to calculate the estimated tax penalty?

Because Form 2210 is complicated, leave the estimated tax penalty line blank on Form 1040. This will not prevent the IRS from calculating the penalty if it is due. Let the taxpayer know that a penalty may be owed, and if so, the IRS will send a notice.

Form 2210 is no longer included with the estimated tax penalty notice. Refer taxpayers who need assistance with Form 2210 to a professional tax preparer.

EXERCISES (continued)

Question 4: Dion's total tax liability is $1,044. After withholding, she owes $640. This means Dion might have to pay a penalty for underpayment of estimated tax.

a. True

b. False

How can taxpayers make sure the correct amount of tax is withheld?

There are several ways to pay taxes during the year to avoid having a balance due when the return is filed. Depending on the taxpayer's situation, here are some suggestions:

- Taxpayers whose income is mostly from wages, pensions, unemployment, or some investment income (such as interest on U.S. bonds) can adjust their withholding
- Taxpayers whose income is mostly from self-employment or investments can make or increase their estimated tax payments
- A combination of increased withholding and estimated tax payments may work best for some taxpayers

Recipients of wages, annuity, pension, or certain other deferred compensation payments use these forms to tell payers the correct amount of federal income tax to withhold: Form W-4, Employee's Withholding

Certificate, and if applicable, Form W-4P, Withholding Certificate for Periodic Pension or Annuity Payments, Form W-4R, Withholding Certificate for Nonperiodic Payments and Eligible Rollover Distributions, or Form W-4V, Voluntary Withholding Request. Each form includes the following types of information the payer uses to figure the taxpayer's correct withholding:

- Marital status (married taxpayers may request the payer to withhold at a higher rate to avoid underwithholding)
- Qualifying children or other dependents
- Other income, deductions and any additional amount to be withheld
- Qualification of exempt status

The amount of tax the employer withholds from the taxpayer's wages depends on:

- The amount of pay the taxpayer earns
- How often the taxpayer is paid
- The taxpayer's information entered on Form W-4

When should taxpayers submit a revised Form W-4 to their employer?

The taxpayers may submit a new Form W-4 whenever they want to increase or decrease the withholding amount.

Life events such as a change in marital status, birth of a child, or purchase of a home will change adjustments, deductions, and credits on the tax return. These taxpayers should submit a revised Form W-4 to their employer.

Refer to Form W-4 instructions to see the applicable lines a taxpayer must complete to revise Form W-4.

In some situations, getting the right amount withheld is difficult if:

- The taxpayers are married and both work
- The taxpayers have more than one job
- The tax law regarding deductions or credits changes

Publication 17, Tax Withholding and Estimated Tax chapter, has more information on this topic. Taxpayers can go to the **Tax Withholding Estimator** to help calculate the correct withholding.

Mary claimed her son as a dependent on this year's return. Mary will not be able to claim her son as a dependent on next year's return. Due to the change in Mary's tax situation, she uses the Tax Withholding Estimator to help determine the appropriate amount of withholding and submits an updated Form W-4 to her employer.

John works two full-time jobs. He reviews his withholding and realizes he will not have enough tax withheld. He gives his employer a revised Form W-4 to increase his withholding so he will not owe money when he files his return.

How do taxpayers request an increase or decrease in withholding for other income payments?

Taxpayers can use the following withholding forms to request a change in their withholding on other types of income.

- Form W-4P, Withholding Certificate for Periodic Pension or Annuity Payments
- Form W-4S, Request for Federal Income Tax Withholding from Sick Pay
- Form W-4V, Voluntary Withholding Request (generally used for certain government payments, including Form SSA-1099)
- Form W-4R, Withholding Certificate for Nonperiodic Payments and Eligible Rollover Distributions

Refer to the Volunteer Resource Guide, Tab K, Finishing the Return, for guidance on helping taxpayers avoid a balance due. Advise taxpayers to use the **Tax Withholding Estimator** *to check their withholding for next year. If they need to adjust the amount withheld, suggest they submit a revised Form W-4, and if appropriate, help them complete the revised Form W-4.*

When should the taxpayer make estimated tax payments?

Estimated tax is the amount a taxpayer expects to owe for the tax year after deducting any tax credits or federal withholding. Taxpayers with significant income that is not subject to withholding (such as interest, dividends, capital gains, or self-employment income) will often find they need to make estimated tax payments.

The decision tree in Publication 17, Your Federal Income Tax for Individuals, and Publication 505, Tax Withholding and Estimated Taxes, can help determine if the taxpayer should make estimated tax payments. See the Payments and Miscellaneous Refundable Credits lesson for more information.

Maria is retired, and her only income is from a pension and some investments. She had no withholding and is not eligible for any tax credits. When you complete her return this year, she has a balance due of $1,300. Maria should begin making estimated payments, since her balance due next year will be more than $1,000, and she has no withholding. If Maria does not want to make estimated payments, she could submit Form W-4P to request withholding from her pension instead.

How is estimated tax figured?

Use Form 1040-ES, Estimated Tax for Individuals, to compute the amount of estimated tax that should be paid over the year. This form includes worksheets to help taxpayers estimate their income and tax liability for the year. The current year's tax return can be used as a starting point, but any anticipated changes should also be taken into account. Taxpayers may also have to adjust their payments during the tax year if a change in income or the tax law will affect their tax liability.

For additional information on estimated tax payments, refer to the Volunteer Resource Guide, Tab K, Finishing the Return.

How can I avoid common errors?

Double and triple-check the routing number and account number for direct deposit and electronic funds withdrawal. Have the taxpayers compare the numbers entered on the return to their checks or other account information. If an error is made in the bank information, taxpayers must work with the bank to resolve any misdirected funds.

Summary

Refunds

If the payments made exceed the amount of tax, then the amount of the overpayment is entered on the overpaid line in the Refund section of Form 1040.

Taxpayers can choose to apply any portion of their overpayment to the following tax year or receive their refund as a check or direct deposit. Direct deposits can be split among as many as three different accounts by using Form 8888.

For direct deposit of the refund, select Direct Deposit as the Federal Return type on the e-File page. Enter the Routing Transit Number (RTN) and Depositor Account Number (DAN) in the Taxpayer Bank Account Information section of the e-File page. Use a check as proof of account.

Taxpayers can use their federal tax refund to buy U.S. savings bonds for themselves or others, such as children or grandchildren. They do not need to have a bank account or an existing account with the Treasury Department.

Review Form 8888 for more information about splitting a refund and the purchase of savings bonds. Form 8888 can be downloaded from **www.irs.gov**.

Amount Owed

If the payment total is less than the amount of tax owed, then the balance due amount is shown on the applicable line in the Amount You Owe section of Form 1040. Form 1040-V, which is used for mail-in tax payments, will also be prepared if the direct debit option is not selected.

Taxpayers are often very anxious if they owe tax on their return. Take the time to provide the various payment options to taxpayers in this situation.

Explain to taxpayers that the tax return can be electronically filed now but that they should submit their payment of taxes by the due date of the return. They can pay with a check or money order, with Form 1040-V, electronic funds withdrawal, credit card, Direct Pay, or cash at a retail partner. They can download the IRS2Go app to make payments through a mobile device.

Taxpayers who are unable to pay may request an additional 180 days to pay, or complete Form 9465 for an installment agreement. This request can be made with an e-filed return, or by using the Online Payment Agreement feature on IRS.gov.

Interest and penalties are charged on amounts not paid by the due date of the return. There are fees associated with certain payment options.

Estimated Tax Penalty

If it appears taxpayers may owe an estimated tax penalty, let them know the IRS will calculate the penalty and send a bill. Completion of Form 2210 is out of scope. Refer taxpayers who need assistance with Form 2210 to a professional tax preparer.

Adjusting Tax Withholding

Advise taxpayers who did not have enough tax withheld to submit a revised Form W-4 (to their employer), Form W-4P, Form W-4R (to a pension or IRA payer), Form W-4S (to a sick-pay payer), or Form W-4V (to certain governmental payers). Use the **Tax Withholding Estimator** to calculate the correct withholding amount.

Taxpayers with significant income that is not subject to withholding (such as interest, dividends, capital gains, or self-employment income) may find they need to make estimated tax payments. Use Form 1040-ES, Estimated Tax for Individuals, to compute the amount of estimated tax that should be paid over the year.

What situations are out of scope for the VITA/TCE programs?

The following is out of scope for this lesson. While this list may not be all inclusive, it is provided for your awareness only.

- Form 2210, Underpayment of Estimated Tax by Individuals, Estates, and Trusts
- Offers in Compromise

To gain a better understanding of the tax law, complete the practice return(s) for your course of study using the Practice Lab on L&LT.

EXERCISE Answers

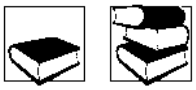
Answer 1: a, True. Direct deposit is safer since there is no check to be lost or stolen.

Answer 2: b, False. Enter the account number from left to right, leaving out all spaces and special characters.

Answer 3: c. The credit card processor covers its costs by assessing a “convenience fee” to taxpayers using this system. Taxpayers will be advised of the amount of this fee when they call the interactive voice response system.

Answer 4: b, False. The tax Dion owes is less than $1,000, so she does not have to pay a penalty.

Completing the Return



Introduction

In this lesson, you will receive insights and information for concluding your interview with the taxpayer and completing the return.

Using the tools discussed in the Volunteer Resource Guide, Tab K, Finishing the Return, share the following with the taxpayers:

- What to file when a taxpayer moves
- When tax returns are due
- Getting an extension of time to file
- Which records/documents they should keep and why
- What documentation is maintained at the site – why, how long, etc.
- What they need to know and do if they overpaid their taxes (such as submitting a new Form W-4 to their employer to reduce the amount of withholding). See the Refund and Amount of Tax Owed lesson for additional information.
- What they need to know and do if they owe additional taxes (e.g., payment due date, estimated tax payments, and submitting a new Form W-4 to increase withholding). See the Refund and Amount of Tax Owed lesson for additional information.

These are important tasks to accomplish after the tax return is completed, quality reviewed, and ready to be filed. The way that you conclude the interview can impact taxpayers' attitudes toward the taxpaying experience and their satisfaction with the volunteer tax return assistance program. It can also make next year's tax preparation easier for taxpayers and the volunteer who assists them.

Objectives

At the end of this lesson, using your resource materials, you will be able to:

- Determine where to file a return when a taxpayer moves
- Determine when a return should be filed
- Assist with getting an extension of time to file a return
- Assemble the taxpayer's copy of the tax return
- Identify the records the site maintains
- Explain to taxpayers which records they should maintain
- End the interview

What do I need?

- Publication 4012
- Publication 17
- Publication 730
- Form 1040-V

Optional*:*

- Form 8332
- Form 8879
- Form 9465
- Form 8822

What action should be taken when a taxpayer moves?

Taxpayers who changed their mailing address during the year should notify the IRS of the change on Form 8822, Change of Address, or use their new address when they file a tax return, give an oral notification or signed written statement to the IRS, or update their address with the U.S. Postal Service (USPS).

Taxpayers who move after filing a tax return should fill out and mail Form 8822 to the IRS service center based on the state where their returns were previously filed. The service centers' addresses are listed on page 2 of the form.

EXERCISES

ANSWERS are after the lesson summary.

Question 1: Tony, who is due a refund, filed his tax return from his home address in Florida on March 12. On March 30 he was transferred to Puerto Rico. Where should Tony submit his Form 8822, Change of Address?

a. To the IRS service center for Florida

b. To the IRS service center for Puerto Rico

c. Either of the above

When should taxpayers file their returns?

Most individual tax returns cover a calendar year, January through December. Calendar-year taxpayers who live in the United States or Puerto Rico should file their individual tax returns by the April due date of the following year.

Taxpayers who have a balance due can pay by check, money order, electronic funds withdrawal, or credit card.

If April 15 falls on a weekend or holiday, then the due date is the next business day.

If the postal service does not deliver to the taxpayer's street address and the taxpayer has a post office box, enter the post office box number on the line for the present home address.

What are the extension requirements for taxpayers within the U. S.?

Taxpayers can receive extensions of time to file their returns. Different rules apply to taxpayers who live in the U.S. and those who live outside the U.S.

The IRS will charge interest on taxes not paid by the due date, even if an extension of time to file is granted. The only exception is when the combat zone extension applies. See Military Finishing and Filing the Return, later.

How does a taxpayer get an automatic extension?

Taxpayers living in the United States can receive an automatic six-month extension of time to file their federal tax returns.

To get the automatic extension, taxpayers must file Form 4868, Application for Automatic Extension of Time To File U.S. Individual Income Tax Return, by the due date for their tax return (usually April 15). Calendar-year taxpayers who take the extension will have until October 15 to file their tax return.

There are three ways to request an automatic extension of time to file a U.S. individual income tax return.

- *e-File Form 4868.*
- *Pay all or part of the estimated income tax due using Direct Pay, Electronic Federal Tax Payment System (EFTPS), or a credit or debit card. See "How to Make a Payment" on page 3 of Form 4868.*
- *File a paper Form 4868 with payment (optional).*
- *See Form 4868 for details.*

What are the extension requirements for taxpayers outside the U.S. and Puerto Rico?

Extension requirements for taxpayers living outside the United States and Puerto Rico differ from those who live inside the U.S. Refer to the Military Finishing and Filing the Return lesson for taxpayers who live outside the United States and Puerto Rico.

Will the taxpayer owe interest and/or penalties?

Although taxpayers are not required to pay the amount they estimate as due, Form 4868 does not extend the time to pay their taxes. *If taxpayers do not pay the amount due by the regular due date, they will owe interest.*

In addition, taxpayers may be charged a late-payment penalty if the amount of tax paid before the due date (from withheld taxes or estimated tax payments) is less than 90% of the actual tax owed.

If Form 4868 is filed late, the IRS will inform the taxpayer that the request was denied.

For more details on penalties, refer to filing information in Publication 17.

EXERCISES (continued)

Question 2: True or False? Interest is charged on the balance remaining after the due date of the return.

a. True

b. False

Question 3: Which of the following calendar-year taxpayers can receive an automatic six-month extension?

a. Avery, who filed Form 4868 in February and chose to have the IRS figure his taxes

b. Benton, who filed Form 4868 on April 15 and did not pay any portion of a balance due

c. Calvin, who filed Form 4868 on April 20 and included a tax payment that was over 90% of what he owed

d. None of the above

How does the taxpayer file the return after obtaining a filing extension?

When the tax return is actually filed, any payment that was submitted with Form 4868 should be entered on the applicable line for amounts paid with extension on Form 1040, Schedule 3.

For instructions on filing an extension using the tax software, go to the Volunteer Resource Guide, Tab M, Other Returns.

What is the Third Party Designee?

For taxpayers who want to allow a friend, family member, or another person to discuss their tax return with the IRS, the "Yes" box of the Third Party Designee area of the return can be checked. You may see this situation in the case of an individual going overseas or elderly parents who wish to have their adult child handle their affairs. You will also need to enter the name, phone number, and any five numbers the designee chooses as their Personal Identification Number (PIN).

Volunteer preparers must never be designated as a third party designee. See Publication 17 for information on what the taxpayer is authorizing when designating a third party designee.

What are the rules for filing a return for decedents?

The personal representative must file the final income tax return for the year of death and any returns not filed for preceding years. If anyone other than the surviving spouse is filing the return, Form 1310, Statement of Person Claiming Refund Due a Deceased Taxpayer, must be filed. A surviving spouse may have to file the returns for the decedent.

To make a claim, the decedent's representative must file:

- A tax return for each year a tax return has not yet been filed
- Form 1040X for each year an income tax return has already been filed.

If an individual died after the tax year, but before the return for that year was filed, the return for the tax year is not the final return; it is a regular return. The return for the year the taxpayer died will be the final tax return.

Bob died in February 2019. His 2018 tax return – due on April 15, 2019 – is not the final tax return. The final tax return would be the 2019 Form 1040, filed in 2020.

The final tax return is due at the same time the decedent's return would have been due had the death not occurred.

For software entries related to filing a decedent's return, go to the Volunteer Resource Guide, Tab K, Finishing the Return.

For information on signing a joint return if one spouse has died or cannot sign the return, see Publication 17 Index, keyword: Signatures.

A person claiming a refund for a deceased taxpayer who is not the spouse must file Form 1310, Statement of Person Claiming Refund Due a Deceased Taxpayer.

What is the Global Carryforward Consent Form?

The last page of the Intake/Interview & Quality Review Sheet is Form 15080, Consent to Disclose Tax Return Information to VITA/TCE Tax Preparation Sites, also called the global carryforward consent. When the taxpayer consents (both taxpayer and spouse must consent if MFJ), the software will pre-populate the next year's return with information that facilitates completing the next year's return, such as employer information from Forms W-2, payer data from Forms 1099, and capital loss carryforwards. The carryforward information will be available to any VITA/TCE site in the next year only. Signing the consent does not enable any site to access the prior year's return — only the site that processed the original return has access to the prior year's return.

How do I prepare the taxpayer's copy of the tax return?

Volunteer tax assistance sites use tax software to create and e-file tax returns. Even so, taxpayers must retain paper copies of their returns. Follow the steps in the Volunteer Resource Guide, Tab K, Finishing the Return, to prepare the taxpayer's copy. In general:

1. Use tax software to print the entire return, including all forms, schedules, and attachments, including any consent forms the taxpayer may have signed
2. Make sure the taxpayer names and Social Security numbers are correct

3. Assemble the taxpayer's copy:
   - Start with Form 1040 on top
   - Place each form, schedule, and attachment in the proper sequence, based on the sequence number shown in the upper right corner of the form
4. Show the taxpayers the printed copy of the tax return, verifying once more the name, SSN, ITIN, address, filing status, dependents, income, expenses, deductions, credits, payments, and tax refund or balance due

Who keeps the records?

What forms should taxpayers keep?

Taxpayers must keep records to prove their income and expenses. If they own a home or investments, their records should contain information needed to calculate the basis of the property.

Advise taxpayers to keep a copy of the following documents for at least three years:

- Form 1040 with all forms, schedules, and attachments.
- All other tax-related documents, including Forms W-2 and 1099.
- If applicable:
  - Form 8332, Release/Revocation of Release of Claim to Exemption for Child by Custodial Parent
  - Power of Attorney
- For e-file returns, taxpayers must also keep a copy of the signed Form 8879, IRS e-file Signature Authorization.

If Publication 730, Important Tax Records Envelope, or an alternative is available, place the return and supporting documents into that envelope.

Advise taxpayers to bring the tax records envelope to the site next year.

What tax return data will the site keep?

The site will keep the following data confidential and in a secure location until December 31 of the current year:

- A master backup disk containing all electronically transmitted returns unless the site is using an internet-based software.
- A master backup disk containing all electronically transmitted IRC 7216, Consent to Disclose and Consent to Use Notices, and Global Carry Forward Consent unless the site is using an internet based software.

The site is no longer required by IRS to retain signed copies of Form 8879.

How do I close the contact?

Before seeing taxpayers off:

- Ask taxpayers, "Do you have any questions before you leave?"
- If the taxpayer is expecting a refund, provide instructions about how to check on the refund status at irs.gov "Where's my Refund?"
- If the taxpayer has a balance due on the current or prior year return, provide information about various payment options and due dates.
- Advise taxpayers how to get answers to questions that may come up later.

- Encourage taxpayers to consider volunteering if they seem interested in learning more about tax preparation. Provide them with contact information or take their contact information, depending on your site's procedures.
- Ensure that you have the contact information needed to reach taxpayers in case there are any problems with e-filing the return.
- Thank taxpayers for using the service.
- Remind the taxpayer to take all of their tax records with them.

What other resources exist to assist taxpayers?

Low Income Taxpayer Clinics (LITC) assist low income individuals who have a tax dispute with the IRS, and provide education and outreach to individuals who speak English as a second language (ESL).

LITCs can represent taxpayers before the IRS or in court on audits, appeals, tax collection matters, and other tax disputes. Services are provided for free or for a small fee.

Although LITCs receive partial funding from the IRS, LITCs, their employees, and their volunteers are completely independent of the IRS.

Taxpayers whose incomes are below a certain level may be eligible for assistance (generally not to exceed 250% of the federal poverty level). For more information about LITCs, taxpayers can visit **https://taxpayeradvocate.irs.gov/about/litc**.

Does the taxpayer have to do anything else?

Give taxpayers a brief explanation of how the e-file process works:

- The Site Coordinator or designee transmits all the e-file returns.
- Taxpayers who change their mailing address during the year should notify the IRS of the change on Form 8822, Change of Address, use their new address when filing their tax return, send a signed written statement or call, or through updating their address with the U.S. Postal Service (USPS).
- The Site Coordinator or designee receives an acknowledgment for each successful e-file, or a reject notice if there was a problem with the electronic file. The most common problem is a name or Social Security number that does not match IRS records.
- If the e-file is rejected, the Site Coordinator or designee will contact the taxpayer to resolve the problem, if necessary.
- If the return is not being e-filed, taxpayers must mail the signed copy of the tax return, along with copy B of all Forms W-2 and any Forms 1099 with withholding. Taxpayers who are filing a state return may need another copy of the return and Forms W-2. Make sure taxpayers know the correct address for mailing the return(s). Advise taxpayers that the return must be postmarked by the April filing due date.

Summary

Properly completing a return, including a good quality review by a second certified volunteer, is essential before a return is filed.

Concluding the interview properly ensures that taxpayers have a complete record of the return, understand what will happen next, and know how to get answers to questions that come up later. If you handle the interview well, it can help taxpayers develop a more positive attitude toward the tax experience, which can foster greater accuracy in returns and timeliness in filing.

You should know how to complete and assemble the tax return and how to end the interview. The taxpayers should leave with instructions on:

- Which records the site is maintaining
- Which tax records they should maintain
- The additional action the taxpayer needs to take and the timeline for such action, such as when the return is put on extension

To gain a better understanding of the tax law, complete the practice return(s) for your course of study using the Practice Lab on L&LT.

EXERCISES Answers

Answer 1: a. Because he already filed his return from his previous address, Tony should submit Form 8822 to the service center for his previous address.

Answer 2: a, True. If the tax is paid after the regular due date, interest is charged from the regular due date to the date the tax is paid.

Answer 3: b. To get the extension, taxpayers must file Form 4868 by the return's due date. They do not have to pay their tax when submitting Form 4868, but they will owe interest on any tax not paid by the due date.

Military Finishing and Filing the Return

Introduction

This lesson will help you address special filing concerns of members of the U.S. Armed Forces. To do this you need to determine where and when to file a federal tax return, who qualifies for a deadline extension, and who qualifies for special tax benefits.

Objectives

At the end of this lesson, using your resource materials, you will be able to:

- Identify the special tax filing concerns of members of the Armed Forces
- Describe the extensions to file that are available for members of the Armed Forces
- Determine the effect on taxes of being in a combat zone
- Identify the tax forgiveness provisions related to military or terrorist actions

What do I need?

- Form 13614-C
- Publication 4012
- Publication 3
- Publication 17
- Form 1040
- Form 2848
- Form 4868
- Form 8822

Optional:

- Form 1040 Instructions

Where and when should members of the Armed Forces file their returns?

Where should members of the military file their returns?

Members of the Armed Forces should send their federal returns to the service center based on where they currently live. Refer to the Form 1040 Instructions for the appropriate address.

The address may be different depending on whether the taxpayer encloses a payment or if the military member is stationed overseas with an APO or FPO address.

Many military facilities have a Volunteer Income Tax Assistance center that will e-file tax returns.

Sergeant Kane, who is stationed in Maine but whose permanent home address is in California, should send her federal return to the service center for Maine.

When should members of the military file their returns?

Special rules apply to members of the Armed Forces in combat zones as discussed below. All other members of the Armed Forces are subject to the normal rules of when to file a return as discussed in the Completing the Return lesson.

What action should be taken when a member of the Armed Forces moves?

Taxpayers who changed their mailing address during the year should notify the IRS of the change on Form 8822, Change of Address, or use their new address when they file a tax return, give an oral notification or signed written statement to the IRS, or update their address with the U.S. Postal Service (USPS).

Taxpayers who move after filing a tax return should fill out and mail Form 8822 to the IRS service center based on the state where their returns were previously filed. The service centers' addresses are listed on page 2 of the form.

What do members of the Armed Forces need to know about getting a refund or having an amount of tax owed on their returns?

Members of the Armed Forces you assist may be entitled to a refund or owe tax. In either case they have several choices on how to get their refund or pay the amount they owe. It is important that volunteers are familiar with those choices to better help taxpayers understand their refund and payment options. This information was covered in the Refund and Amount of Tax Owed lesson. Refer to this lesson to review these options.

See Publication 3, Armed Forces Tax Guide, which is a helpful resource for those assisting members of the Armed Forces.

What are the extension requirements for taxpayers outside the U.S. and Puerto Rico?

Extension requirements for taxpayers living outside the United States and Puerto Rico differ from those who live inside the U.S.

Who qualifies for an automatic two-month extension?

U.S. citizens and resident aliens are allowed an automatic two-month extension to file their return if they are:

- Living outside the U.S. and Puerto Rico on the due date of the return, and their main place of business or assigned post of duty is outside the U.S. and Puerto Rico
- Members of the Armed Forces on duty outside of the U.S. and Puerto Rico on the due date of the tax return

Although calendar-year taxpayers in this situation don't have to file or pay until June 15, they will owe interest charged from the April due date to the date the tax is paid. Form 4868 is not required to obtain this automatic two-month extension to file.

Traveling outside the United States and Puerto Rico on the due date does not qualify the taxpayer for an automatic two-month extension.

What must taxpayers attach to their return?

Taxpayers using the automatic two-month extension must attach a statement to their return stating that they meet the requirements previously discussed in the section "Who qualifies for an automatic two-month extension" above.

What is the extension rule for married taxpayers?

For married taxpayers who file jointly, only one spouse needs to meet the requirements to take advantage of the automatic extension to June 15.

For married taxpayers who file separately, only the spouse who meets the requirements qualifies for the automatic extension. If both spouses meet the requirements, each may take advantage of the extension.

How can a taxpayer request an additional extension?

Taxpayers who live outside the U.S. and Puerto Rico and whose main place of business or assigned tour of duty is outside the U.S. and Puerto Rico can also request an additional extension by filing Form 4868 by the automatic extension date of June 15 and checking the "out of the country" and a U.S. citizen or resident box.

The due date will then be extended to **October 15**.

EXERCISES (continued)

Question 1: Which of the following calendar-year taxpayers has until June 15 to file a tax return? (Select all that apply.)

a. Weston, who files a joint return with his wife, Sheila. She was stationed in the Philippines from January through May, and they paid their taxes by credit card on April 2.

b. Lilly, who lives in Mexico from January through April working for a company, returning to her main business in Texas on May 1.

c. Dwayne, who was stationed in South Korea from July 1 through January 31.

d. None of the above.

Question 2: Pvt. Franklin, a U.S. citizen, is a calendar-year taxpayer. What would the due date be for him to file a return if his assigned tour is in Puerto Rico?

a. April 15

b. June 15

c. June 16

How should the IRS be notified about combat zone service?

The IRS works with the Department of Defense to identify taxpayers who are serving in a combat zone. This may allow the IRS to suspend compliance actions, such as audits or enforced collections, until 180 days after the taxpayer has left the zone.

Taxpayers qualifying for such combat zone relief may also notify the IRS directly of their status through a special e-mail address: **combatzone@irs.gov**. They should provide name, stateside address, date of birth, and date of deployment to the combat zone. They should not include any Social Security numbers in an e-mail. This notification may be made by the taxpayer, spouse, or authorized agent or representative.

The IRS cannot provide tax account information by e-mail. The IRS will send responses to any questions about the taxpayer's account by regular mail to the address on record for the person, within two business days. The IRS may provide general answers to questions regarding the status of individual combat zone updates via e-mail.

What are the tax options for combat zone participants?

For members of the Armed Forces serving in a combat zone or qualified hazardous duty area, the deadline for filing tax returns, paying taxes, filing claims for refunds, and taking other actions with the IRS is automatically extended.

The deadline for taking action with the IRS is extended 180 days after the later of:

- The last day in a combat zone/qualified hazardous duty area
- The last day of any continuous hospitalization for injury from service in a combat zone or qualified hazardous duty area

In addition to the 180-day extension, the deadline is also extended by the number of days that were left to take the action with the IRS when the taxpayer entered a combat zone (or began performing qualifying service outside the combat zone). For example, the taxpayer has 3 1/2 months (Jan. 1 - April 15) to file the tax return. Any days left in this period when the taxpayer entered the combat zone (or the entire 3 1/2 months if they entered it before the beginning of the year) are added to the 180 days.

Generally, spouses of individuals who served in a combat zone are entitled to the same deadline extension. There are two exceptions:

- Any tax year beginning more than two years after the date the area ceases to be a combat zone
- Any period the qualifying individual is hospitalized in the U.S. for injuries incurred in a combat zone

In these instances, the extension does not apply to a spouse.

Captain Chloe Maple, a resident of Maryland, entered a combat zone on December 1, 2016. She remained there through March 31, 2018, when she departed for the United States. She wasn't injured and didn't return to the combat zone. The deadlines for filing Captain Maple's 2016, 2017, and 2018 returns are figured as follows:

- ***The 2016 tax return**. The deadline is January 14, 2019. This deadline is 289 days (180 plus 109) after Captain Maple's last day in the combat zone (March 31, 2018). The 109 additional days are the number of days in the 3 1/2 month filing period that were left when she entered the combat zone (January 1–April 18, 2017).*
- ***The 2017 tax return**. The deadline is January 13, 2019. The deadline is 288 days (180 plus 108) after Captain Maple's last day in the combat zone (March 31, 2018). The 108 additional days are the number of days in the 3 1/2 month filing period that were left when she entered the combat zone (January 1–April 18, 2018).*
- ***The 2018 tax return**. The deadline isn't extended because the 180-day extension period after March 31, 2018, plus the number of days left in the filing period when she entered the combat zone (107) ends on January 12, 2019, which is before the due date for her 2018 return (April 17, 2019).*

Publication 3 provides additional information for combat zone extension of deadlines.

EXERCISES (continued)

Question 3: If a member of the Armed Forces served in a combat zone from December 30, 2017 through May 31, 2019 and was not injured, the deadline for filing a 2017 tax return would be extended by how many days?

Request Publication 3 if you prepare returns at a military site. There are many special provisions that apply to service personnel and this publication is a valuable reference.

What are other tax options for combat zone participants?

Other situations that count as time served in a combat zone or qualified hazardous duty area are:

- Missing status such as missing in action or prisoner of war time counts as time served
- Support personnel including Red Cross, accredited correspondents, and civilian personnel acting under the direction of the Armed Forces
- Hospitalization outside the U.S. and up to five years of hospitalization in the U.S. as a result of an injury while serving in a combat zone or a contingency operation

When can taxes be deferred?

Reservists called to active duty and enlistees in the Armed Forces might qualify for a deferral of taxes owed if they can show that their ability to pay taxes was affected by their military service. The Service Members Civil Relief Act provides this benefit. The act covers active duty members of the military services and commissioned officers of the uniformed services.

What are rules for deferment?

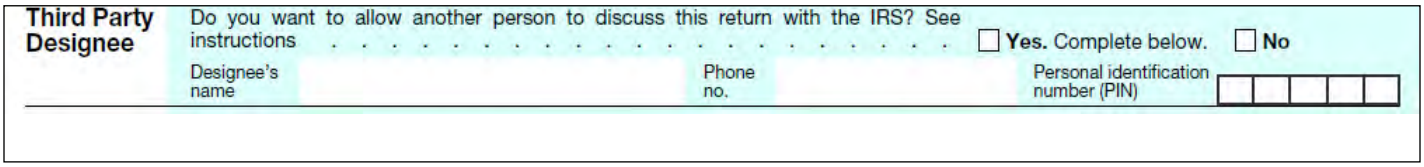
The deferral is not automatic; a taxpayer must apply for it. A taxpayer must have received a notice of tax due, or have an installment agreement with the IRS, before applying for the deferral. When applying, the taxpayer must:

- Be performing military service, and
- Show how the member's ability to pay the income tax has been materially affected by military service

The IRS will review each request and advise the taxpayer in writing of its decision. The service member will then be allowed up to 180 days after termination or release from military service to pay the tax. If the tax is paid in full by the end of the deferral period, no interest or penalty will be charged for that period.

Can other parties assist with a tax return?

If a taxpayer wants a third party designee to discuss a tax return with the IRS, the "Yes" box in the Third Party Designee area of the return must be checked. Also, the taxpayer must provide the designee's name, phone number, and any five numbers the designee chooses as a personal identification number. **Volunteers may not be named as a "Third Party Designee."**



Form 2848, Power of Attorney and Declaration of Representative, may also be used to grant authority to an individual to represent the taxpayer before the IRS and to receive tax information. If the return is e-filed, a copy of Form 2848 must be attached to Form 8453, U.S. Individual Income Tax Transmittal Form for an IRS e-file Return, and mailed to the IRS. Form 2848 can also be faxed to the IRS; see the Where to File Chart in the Form 2848 instructions.

Use caution when allowing a representative to sign for someone. See Signatures in the Filing Information chapter in Publication 17 for more information.

If it is not possible to obtain a signature for a joint return from a spouse serving in a combat zone, a signed authorization to act on the taxpayer's behalf can be accepted. The IRS also accepts a written statement explaining that the spouse is serving in a combat zone. The statement must be signed by the spouse who is not serving in a combat zone and attached to the return.

What are the tax forgiveness provisions for military decedents?

Special tax-forgiveness provisions apply to individuals who die:

- While serving in a combat zone, or from wounds, disease, or other injury incurred while serving in a combat zone
- As a result of wounds or injuries incurred in a terrorist or military action while working for the U.S. government

Only the decedent's part of the joint income tax liability is eligible for the refund or tax forgiveness.

The forgiveness applies to:

- The tax year death occurred and
- Any earlier tax year in the period beginning with the year before the year in which the wounds or injury occurred

Any forgiven tax liability that has already been paid, will be refunded.

In addition, any unpaid taxes for years ending before the member began service in a combat zone will be forgiven, and any of those taxes that are paid after the date of death will be refunded.

The tax forgiveness provision also applies to those taxpayers serving outside the combat zone if the service:

- Was in direct support of military operations in the zone and
- Qualified the member for special military pay for duty subject to hostile fire, imminent danger, and/or terrorist actions

EXERCISES (continued)

Question 4: Army Private Shiloh Kane died in 2019 of wounds incurred in a terrorist attack in 2017. For what tax years are Private Kane's income tax liabilities forgiven?

a. 2016 through 2017

b. 2017 through 2019

c. 2016 through 2019

What are the rules for filing a return for decedents?

The personal representative must file the final income tax return for the year of death and any returns not filed for preceding years. If anyone other than the surviving spouse is filing the return, Form 1310, Statement of Person Claiming Refund Due a Deceased Taxpayer, must be filed. Refer to the Completing the Return lesson regarding rules for returns for decedents.

Summary

This lesson identified special filing concerns for members of the U.S. Armed Forces.

- Members of the Armed Forces should send their federal returns to the service center for where they currently live.
- Most taxpayers who live in the U.S. or Puerto Rico should file their individual tax returns by April 15, unless that date falls on a weekend or holiday.
- Taxpayers who changed their mailing address should notify the IRS of the change on Form 8822, Change of Address, or use their new address when they file a tax return, give an oral notification or signed written statement to the IRS, or update their address with the U.S. Postal Service (USPS).
- The extension rules vary depending on whether the taxpayer lives in the U.S. or outside the U.S.
- The taxpayer, spouse, authorized agent, or representative can notify the IRS about combat zone service by sending an email to **combatzone@irs.gov**. Social Security numbers should not be included in the email.

- For members of the Armed Forces serving in a combat zone or Qualified Hazardous Duty Area, deadlines for taking action with the IRS are automatically extended until 180 days plus up to 3 1/2 months if the taxpayer entered the combat zone before the beginning of the year from the time the member leaves the combat zone/qualified hazardous duty area.
- The income tax liability of a member of the Armed Forces is forgiven if a member dies as a result of service in a combat zone or from a terrorist or military action outside the U.S.
- The terrorist or military action forgiveness also applies to an individual who is a U.S. employee at death and dies from wounds or injuries incurred in a terrorist or military action regardless of where the action occurred.

To gain a better understanding of the tax law, complete the practice return(s) for your course of study using the Practice Lab on L&LT.

EXERCISE Answers

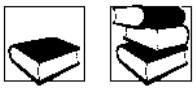
Answer 1: a. For Weston and Sheila, who file jointly, only one spouse needs to meet the requirements to take advantage of the automatic extension. In scenario B, Lilly does not qualify for the two-month automatic extension since her main place of business is Texas. In scenario C, Dwayne does not qualify for the automatic two-month extension because he was back in the U.S. on the due date.

Answer 2: a. April 15. Taxpayers who live and/or assigned in the U.S. or Puerto Rico should file their individual tax returns by April 15, unless that date falls on a weekend or holiday.

Answer 3: The deadline for filing the 2017 tax return is 180 days plus the number of days remaining for the Armed Forces member to take action after entering the combat zone. The deadline for 2017 is extended 288 days (180 plus 108) after leaving the combat zone. The 108 additional days are the number of days in the 3-1/2 month filing period that were left when the taxpayer entered the combat zone on December 30 (January 1 - April 18, 2018).

Answer 4: c. His income tax liability is forgiven for all tax years from 2016 through 2019

Amended and Prior Year Returns



Introduction

This lesson will help you determine how to amend a federal income tax return regardless of where the original return was prepared. In addition, this lesson provides guidance on preparing prior year returns for the previous three years, provided the taxpayer has the applicable required information. The site may prepare returns beyond the three previous years if taxpayers have the required information for those years.

If a taxpayer requests your help in filing an amended return, first confirm the original return is within the scope of the VITA/TCE programs. Ask the taxpayer what errors or omissions they wish to correct, and examine the return and any IRS correspondence carefully to determine if the original return is, in fact, incorrect.
To amend a return, tax preparation software must be used to complete Form 1040-X, Amended U.S. Individual Income Tax.

Objectives

At the end of this lesson, using your resource materials, you will be able to:

- Identify when it is appropriate to prepare an amended return, Form 1040-X
- Determine the time limits for filing Form 1040-X
- Identify how to assemble and submit Form 1040-X
- Provide guidance when preparing prior year returns
- Identify when it is appropriate to file a prior year return

What do I need?

- Form 13614-C
- Publication 4012
- Publication 17
- Form 1040-X
- Form 1040-X Instructions

Optional:

- Form 1040 Instructions
- Form 8379

When is an amended return required?

Taxpayers should file amended returns using Form 1040-X to correct any errors or omissions on a return they have already filed.

An exclusion of unemployment compensation of up to $10,200 was allowed for individuals for tax year 2020. In most cases, the IRS automatically redetermined the correct taxable amount of unemployment compensation and the correct tax. However, if as a result of the excluded unemployment compensation, taxpayers now qualify for deductions or credits not claimed on their original return, they should file an amended return. For example, if the taxpayer did not claim the Earned Income Tax Credit (EITC) on their originally filed return because the AGI was too high, but the exclusion allowed for unemployment compensation now reduces the AGI, the taxpayer should file an amended return to claim the credit if now eligible.

An amended return is not always required when the original return has an error. For example, the IRS will usually correct a math error on a return, or they will write the taxpayer and request a missing schedule or form. In these cases, do not amend the return. If taxpayers receive a notice from the IRS, refer them to the contact person and telephone number on the notice.

Before preparing an amended return, be sure you have any and all IRS changes to the originally filed return.

File an amended return if taxpayers:

- Received another Form W-2, a corrected Form W-2, or another income statement that was not reported on the original return
- Received an additional Form 1099 (such as unemployment compensation) or a corrected Form 1099 that was not reported on the original return
- Claimed dependents, deductions or credits they should not have claimed
- Did not claim dependents, deductions or credits they could have claimed, or
- Should have used a different filing status

If the federal return has to be amended, often the state return must also be amended.

Two weeks after Bernard's current-year tax return was filed, he received another Form W-2 in the mail. The volunteer tax preparer reviews Bernard's file to be sure the Form W-2 wasn't included on the original return. The volunteer then helps Bernard prepare Form 1040-X to include the additional Form W-2 on the current-year return.

After the due date of the original return, a taxpayer can change from Married Filing Separately to Married Filing Jointly, but cannot change from Married Filing Jointly to Married Filing Separately. However, an executor may be able to make this change for a deceased spouse. Refer to Publication 17 for more information.

Is an amended return needed for injured spouse situations?

When a joint return is filed and only one spouse owes a past due amount such as child support, an education loan, or prior year's taxes, the spouse who is not obligated for the debt can be considered an "injured spouse." The couple should have filed Form 8379, Injured Spouse Allocation, with their original return. If they did not file Form 8379, and one of them qualifies as an injured spouse, file Form 8379 by itself. Do not attach the form to Form 1040-X.

However, if the couple is filing Form 1040-X for an additional refund not associated with the original injured spouse claim, and they do not want the injured spouse's portion of the overpayment to be applied to the offset against the spouse, then complete and attach another Form 8379 to Form 1040-X. See Publication 17, Form 8379, and Form 1040-X Instructions for further information.

How do I start?

To file an amended return, you need a copy of the original return and the information that needs to be changed.

- Begin by researching and verifying the change requested by the taxpayer. Review the Intake/Interview & Quality Review Sheet with the taxpayer **and** use the Volunteer Resource Guide and Publication 17 to make sure that what the taxpayer wants to change is correct.
- Ask probing questions, using the interview techniques and tools discussed in the Volunteer Resource Guide, to get all the facts before preparing Form 1040-X. Ask taxpayers if they have received any correspondence from the IRS making changes to the original return and all the reasons, they want to amend the return. When amending a return, it is important to correct all known errors, regardless of whether correcting the error increases or decreases a refund or balance due.

What is Form 1040-X?

Look at the format of Form 1040-X, page 1; there are three columns:

- Column A is used to show the **original** or **IRS adjusted figures** from the original return or previous amendment
- Column C is used to show the entries that would have been made on the original return if it had been done correctly
- The differences between the figures in columns A and C are shown in column B (Net change)

Amended returns can be prepared using tax software. However, only tax year 2019 and later can be amended and filed electronically using Form 1040-X if the return was originally e-filed. If the original return was paper filed, the amended return will also have to be paper filed.

Part I, Exemptions and Dependents (on page 2), is used only if the taxpayer is increasing or decreasing the number of dependents claimed on the return being amended.

Part II, Presidential Election Campaign Fund, is used to make a $3 donation to the fund for you (or your spouse) if you did not do so on your original return.

Part III, Explanation of Changes, must be used to explain specific changes being made on the return and the reasons for each change.

Explanations should be easily understood and clearly point out that the taxpayer qualifies for the change. For example, “taxpayer received another W-2 after they filed original return,” or “taxpayer qualifies to claim child care expenses of $600 for their 10-year-old dependent child, Form 2441 attached,” or “taxpayer meets the qualifications to file as Head of Household instead of Married Filing Separately.”

Taxpayers can easily check the status of a Form 1040-X, Amended U.S. Individual Income Tax Return, using the **Where’s My Amended Return?** *tool. It’s available in English and Spanish, and tracks the status of the amended return for the current year and up to three prior years.*

Taxpayers can obtain a free transcript of their original or amended return from the last three years using the IRS2Go phone app or completing Form 4506T or Form 4506T-EZ, Request for Transcript of Tax Return. To get a copy of the original return, complete and mail Form 4506, Request for a Copy of Tax Return, to the appropriate IRS office listed on the form. There is a charge to receive a copy of the original return.

What are the time limits to file amended returns for refunds?

There is a statute of limitations on refunds being claimed on amended returns. In general, if a refund is expected on an amended return, taxpayers must file the return within three years of the due date of the original return, or within two years after the date they paid the tax, whichever is later. An original return filed before the due date (without regard to extensions) is considered filed on the due date.

Robert’s 2015 tax return was due April 15, 2016. He filed it on March 20, 2016. He amends the 2015 return, expecting the correction to result in a refund. If he gets it postmarked on or before April 15, 2019, it will be within the three-year limit, and the return will be accepted. But if the amended 2015 return is postmarked after April 15, 2019, it will fall outside the three-year period and he will not receive the refund.

There are a few exceptions to the three-year limit. For example, a taxpayer has a longer period of time to claim a loss on a bad debt or worthless security, or for a foreign tax credit or deduction. The exceptions are explained in more detail in Publication 17 and the Form 1040-X Instructions. If you think the taxpayer may qualify for an exception to the three-year time limit, refer them to a professional tax preparer.

What if taxpayers are due a refund on their amended return?

If the amended return indicates the taxpayer is due a refund, be sure to advise that:

- Before filing the amended return, the taxpayer should allow time for the original return to be processed.
- The taxpayer can cash the original refund check, if any, while waiting for any additional refund.
- Interest may be paid on claims not processed within 45 days of the due date of the return.
- Generally, it takes 8-16 weeks to process an amended tax return.

What if the taxpayer owes money on the amended return?

If the amended current year return indicates the taxpayer owes money, file Form 1040-X and instruct the taxpayer to pay the amount by the April due date to avoid interest and penalties.

Taxpayers who cannot pay the balance in full by the April due date should file the return on time anyway. Encourage taxpayers to pay as much as they can on time, because the IRS will calculate and bill for interest on the amount of tax owed. Refer to the Volunteer Resource Guide, Tab K, Finishing the Return, for more information on payment options.

Refer taxpayers to the Form 1040-X Instructions for information they must include on their check or money order.

EXERCISES

Answers are after the lesson summary.

Question 1: John e-filed his 2015 Form 1040 on March 29, 2016. John found an error on the 2015 return and mailed an amended 2015 return on April 15, 2019. Is this too late to qualify for the refund?

a. Yes

b. No

Question 2: Brenda discovers an error on her timely-filed 2015 tax return. Correction of this error would result in a refund. She mails an amended return on May 6, 2019. Is this too late for Brenda to claim a refund?

a. Yes

b. No

How do I complete the amended return using tax software?

Volunteer tax preparers can amend returns regardless of where the original return was prepared, using tax software. Remember to follow the interview process and use the research tools to prepare an accurate return.

For software entries, go to Volunteer Resource Guide, Tab M, Other Returns, to review the step-by-step procedures for preparing Form 1040-X.

A refund on an amended return cannot be direct deposited. A paper check will be mailed to the taxpayer.

How do I assemble and submit Form 1040-X?

What should be attached when the return cannot be e-filed?

Remember, Form 1040-X should be prepared using tax software. However, only 2019 or later tax years can be e-filed and only when the original return was e-filed. Once the amended return is complete, follow these steps to assemble the return for mailing and for the taxpayers' records:

1. Print two copies of the federal amended return, Form 1040-X, from the tax software, and if there is a state return, two copies of that form: one for the taxpayers' records and one to mail.
2. Attach any forms or schedules needed to support the changes. Make sure the reason for amending the return is explained on Form 1040-X, Part III.
3. Attach all additional or corrected Form(s) W-2 or Form(s) 1099 that the taxpayers received after filing their original return. Be sure you have included any additional federal income tax withheld in the Payments section of Form 1040-X.
4. Have the taxpayer (and spouse if Married Filing Jointly) sign and date Form 1040-X and the state return.

Attach all affected forms and schedules when amending a return, otherwise IRS will send the amended return back to the taxpayer unprocessed (but do not include the original or revised Form 1040).

Explain that normal processing time for an amended return is generally 8-16 weeks. Also tell the taxpayers that, if they owe money and are not paying the balance due by the original due date of the return, the IRS will send a bill that will include any interest or penalty amounts.

Who can prepare prior year returns?

Tax-Aide Counselors must be certified for the prior year to prepare such prior year return or amended return. Taxpayers seeking assistance outside the scope of the VITA/TCE programs should be referred to a professional tax preparer.

SPEC may be able to support sites that have the resources, motivation and ability to go back as many years as needed, while maintaining quality standards.

VITA/TCE sites are encouraged, but not required to prepare prior year returns.

If a taxpayer requests return preparation assistance for returns older than three years or if the site is unable to prepare prior year returns, refer the taxpayer to a professional tax preparer to complete the prior year returns.

What technical resources are required?

If your site chooses to prepare prior year returns, the Site Coordinator should be aware of the requirements. The SPEC Relationship Managers and **Prior Year Forms and Instructions** on IRS.gov are critical resources for administrative and technical resources.

The Partner and Volunteer Resource Page at **www.irs.gov/individuals/partner-and-volunteer-resource-center** *includes hot topics for partners and volunteers.*

At a minimum, the following tools are required:

- Prior year tax preparation software
- Reference material, including Publications 17 and the Volunteer Resource Guide (available in the tax software) and volunteer quality alerts/volunteer tax alerts at **www.irs.gov/individuals/quality-and-tax-alerts-for-irs-volunteer-programs**.
- A current year Form 13614-C must be completed for each prior year return and will be used to determine the scope and certification level of each return.

Prior year tax form instructions and publications are also available on IRS.gov for reference. If your site does not have the necessary tools to prepare prior year returns, seek guidance from your Site Coordinator.

The **Interactive Tax Assistant (ITA)** *is an online tool that provides consistent answers to many current and prior year tax law questions using a probe and response process. ITA is available on IRS.gov.*

How do I file a prior year return?

Tax returns for the two most current prior years can be filed electronically. Older prior year returns must be mailed by taxpayers to the appropriate IRS address listed in the Volunteer Resource Guide, Tab P, Partner Resources. Also, see the information about balance due returns in Tab K, Finishing the Return, of the same guide.

Summary

In the VITA/TCE programs, you can help taxpayers prepare amended or prior year tax returns provided the site offers this service. Use the interview process and research tools to prepare accurate amended returns.

Amended returns should be filed to correct any error or omission that is within scope.

Additional notes:

- A refund on an amended or prior year return cannot be direct deposited; a check is mailed to the taxpayer.
- If you are amending the federal return, you usually have to amend the state return.
- Volunteers may only prepare returns within the scope of the VITA/TCE programs and only if the tax issues come within the volunteer's current level of training and certification.
- If a taxpayer requests return preparation assistance for returns older than three years or if the site is unable to prepare prior year returns, refer the taxpayer to a professional tax preparer to complete the prior year returns.

What situations are out of scope for the VITA/TCE programs?

The following is out of scope for this lesson. While this list may not be all inclusive, it is provided for your awareness only.

- Taxpayers who may qualify for an exception to the three-year time limit for filing an amended return for a refund

To gain a better understanding of the tax law, complete the practice return(s) for your course of study using the Practice Lab on L&LT.

EXERCISE Answers

Answer 1: b. No, it is not too late. Returns filed before the due date are considered filed on the due date of the return. Therefore, John's amended return was filed within the three-year period allowed for refunds.

Answer 2: a. Yes, it is too late. The postmark must be three years from the due date of the return. The IRS will disallow Brenda's amended return requesting a refund because it was filed more than three years after the due date of the original return.

Appendix: Premium Tax Credit Exercises

Introduction

The purpose of the following examples is to give volunteers an opportunity to practice completing forms and worksheets associated with the Premium Tax Credit (PTC). Adequate information is provided to prepare simple tax returns with various health insurance coverage scenarios that you may encounter. Following each scenario are screen shots from the tax preparation software that will allow you to check your work. Note: This publication is posted before software and most tax forms are finalized.

Reminders

- All taxpayer names, addresses and Social Security numbers provided in the scenarios are fictitious.
- When entering Social Security numbers (SSNs), replace the Xs as directed, or with any four digits of your choice.
- Use employer identification number (EIN) 622-00-XXXX for all W-2s.
- Complete tax return and intake sheet information is not provided. For the purposes of these exercises, you can ignore incomplete or missing information, or enter sample information of your choice.
- Use your city, state, and ZIP code when completing any forms, unless the notes state otherwise.
- For the purposes of the premium tax credit calculations on Form 8962, use “Other 48 states” so your calculations will match the provided answers.
- For all scenarios, assume that the identity and Social Security cards were checked for all individuals on the intake sheet.

Scenario 1 – Premium Tax Credit with APTC

Interview Notes

- Sheryl Graves has two children she claims as dependents, Trina and Travis, who live with her all year.
- She divorced in 2015. Sheryl pays all the costs of keeping up the home. Their SSNs are:
  - Sheryl: 605-00-XXXX
  - Trina: 606-00-XXXX
  - Travis: 607-00-XXXX
- Sheryl’s mother, Monique Floyd, also lives with her. Sheryl provides over half of Monique’s support and claims her as a dependent. Monique’s SSN is 608-00-XXXX. Her only income for the tax year is $4,500 received from Social Security and she was covered by Medicare all year.
  - Sheryl’s Form W-2 shows:
  - Box 1 = $36,429
  - Box 2 = $1,026
- Sheryl had no other income or deductions.
- Sheryl’s employer does not offer health insurance coverage. She purchased qualified health care coverage for herself and her children through the Marketplace. They were covered for the entire year. Sheryl received the benefit of advance payments of the premium tax credit to help with the cost of her insurance premiums.

Directions

Review the interview notes, complete the volunteer sections of the intake sheet, and start a new return using the Practice Lab. Enter the SSN, filing status, personal information, dependents, and income. Then complete the following steps:

1. Select the Health Insurance section and answer all the questions pertaining to Sheryl and her family.
2. Compare your result to the screen shots on the following pages.

Sheryl's intake sheet, page 1, with the volunteer section completed:

Form **13614-C** (October 2022)

Department of the Treasury - Internal Revenue Service

Intake/Interview & Quality Review Sheet

OMB Number 1545-1964

You will need:
- **Tax Information such as Forms W-2, 1099, 1098, 1095.**
- **Social security cards or ITIN letters for all persons on your tax return.**
- **Picture ID (such as valid driver's license) for you and your spouse.**

- **Please complete pages 1-4 of this form.**
- **You are responsible for the information on your return. Please provide complete and accurate information.**
- **If you have questions, please ask the IRS-certified volunteer preparer.**

Volunteers are trained to provide high quality service and uphold the highest ethical standards.
To report unethical behavior to the IRS, email us at wi.voltax@irs.gov

Part I – Your Personal Information (If you are filing a joint return, enter your names in the same order as last year's return)

1. Your first name: SHERYL	M.I.	Last name: GRAVES	Best contact number: YOUR PH #	Are you a U.S. citizen? ☒ Yes ☐ No
2. Your spouse's first name	M.I.	Last name	Best contact number	Is your spouse a U.S. citizen? ☐ Yes ☐ No

3. Mailing address: 321 MARTIN ROAD	Apt #	City: YOUR CITY	State: YS	ZIP code: YOUR ZIP

4. Your Date of Birth: 06/17/1979	5. Your job title: CLERK	6. Last year, were you: b. Totally and permanently disabled ☐ Yes ☒ No	a. Full-time student ☐ Yes ☒ No	c. Legally blind ☐ Yes ☒ No
7. Your spouse's Date of Birth	8. Your spouse's job title	9. Last year, was your spouse: b. Totally and permanently disabled ☐ Yes ☐ No	a. Full-time student ☐ Yes ☐ No	c. Legally blind ☐ Yes ☐ No

10. Can anyone claim you or your spouse as a dependent? ☐ Yes ☒ No ☐ Unsure

11. Have you, your spouse, or dependents been a victim of tax related identity theft or been issued an Identity Protection PIN? ☐ Yes ☒ No

12. Provide an email address (optional) (this email address will not be used for contacts from the Internal Revenue Service)

Part II – Marital Status and Household Information

1. As of December 31, 2022, what was your marital status?
- ☐ Never Married
- ☐ Married
- ☒ Divorced
- ☐ Legally Separated
- ☐ Widowed

(This includes registered domestic partnerships, civil unions, or other formal relationships under state law)
a. If Yes, Did you get married in 2022? ☐ Yes ☐ No
b. Did you live with your spouse during any part of the last six months of 2022? ☐ Yes ☐ No
Date of final decree: 4/27/2010
Date of separate maintenance decree:
Year of spouse's death:

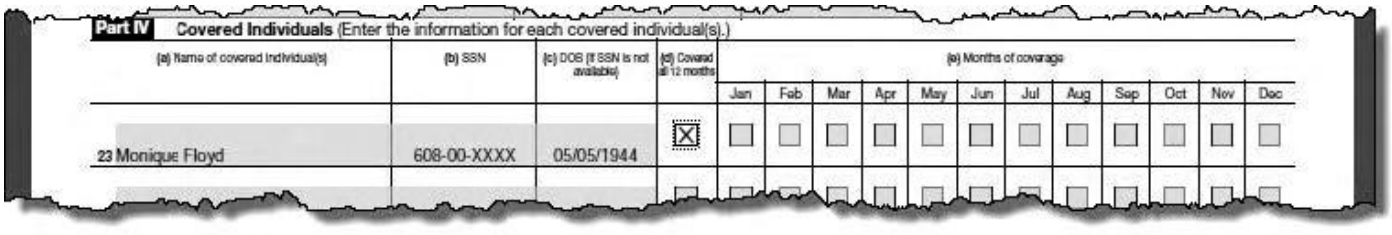
2. List the names below of:
- **everyone** who lived with you last year (other than your spouse)
- **anyone** you supported but did not live with you last year

If additional space is needed check here ☐ and list on page 3

									To be completed by a Certified Volunteer Preparer				
Name (first, last) Do not enter your name or spouse's name below (a)	Date of Birth (mm/dd/yy) (b)	Relationship to you (for example: son, daughter, parent, none, etc) (c)	Number of months lived in your home last year (d)	US Citizen (yes/no) (e)	Resident of US, Canada, or Mexico last year (yes/no) (f)	Single or Married as of 12/31/22 (S/M) (g)	Full-time Student last year (yes/no) (h)	Totally and Permanently Disabled (yes/no) (i)	Is this person a qualifying child/relative of any other person? (yes/no)	Did this person provide more than 50% of his/her own support? (yes,no,n/a)	Did this person have less than $4,400 of income? (yes,no,n/a)	Did the taxpayer(s) provide more than 50% of support for this person? (yes/no/n/a)	Did the taxpayer(s) pay more than half the cost of maintaining a home for this person? (yes/no)
TRINA GRAVES	3/1/2001	Daughter	12	YES	YES	S	YES	NO	NO	NO	YES	YES	YES
TRAVIS GRAVES	12/25/2002	Son	12	YES	YES	S	YES	NO	NO	NO	YES	YES	YES
MONIQUE FLOYD	5/5/1944	Mother	12	YES	YES	S	NO	NO	NO	NO	YES	YES	YES

Catalog Number 52121E www.irs.gov Form **13614-C** (Rev. 10-2022)

Monique Floyd's Form 1095-B:



Part IV **Covered Individuals** (Enter the information for each covered individual(s).)

(a) Name of covered individual(s)	(b) SSN	(c) DOB (If SSN is not available)	(d) Covered all 12 months	(e) Months of coverage: Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
23 Monique Floyd	608-00-XXXX	05/05/1944	X												

Form 1095-A Health Insurance Marketplace Statement

Form **1095-A**

Department of the Treasury
Internal Revenue Service

Health Insurance Marketplace Statement

Do not attach to your tax return. Keep for your records.
Go to *www.irs.gov/Form1095A* for instructions and the latest information.

☐ VOID
☐ CORRECTED

OMB No. 1545-2232

2022

Part I Recipient Information

1 Marketplace identifier XXXXX	**2** Marketplace-assigned policy number XXXXXXXX	**3** Policy issuer's name XXXXXXXXXXXXXXXXXXXXXX	
4 Recipient's name SHERYL GRAVES		**5** Recipient's SSN 605-00-XXXX	**6** Recipient's date of birth 06/17/1979
7 Recipient's spouse's name		**8** Recipient's spouse's SSN	**9** Recipient's spouse's date of birth
10 Policy start date 01/01/2022	**11** Policy termination date 12/31/2022	**12** Street address (including apartment no.) 321 MARTIN RD	
13 City or town YOUR CITY	**15** State YS	Country and ZIP or foreign postal code YOUR ZIP	

June 20

Part II Covered Individuals

	A. Covered individual name	B. Covered individual SSN	C. Covered individual Date of birth	D. Coverage start date	E. Coverage termination date
16	SHERYL GRAVES	605-00-XXXX	06/17/1979	01/01/2022	12/31/2022
17	TRINA GRAVES	606-00-XXXX	03/01/2001	01/01/2022	12/31/2022
18	TRAVIS GRAVES	607-00-XXXX	12/25/2002	01/01/2022	12/31/2022
19					
20					

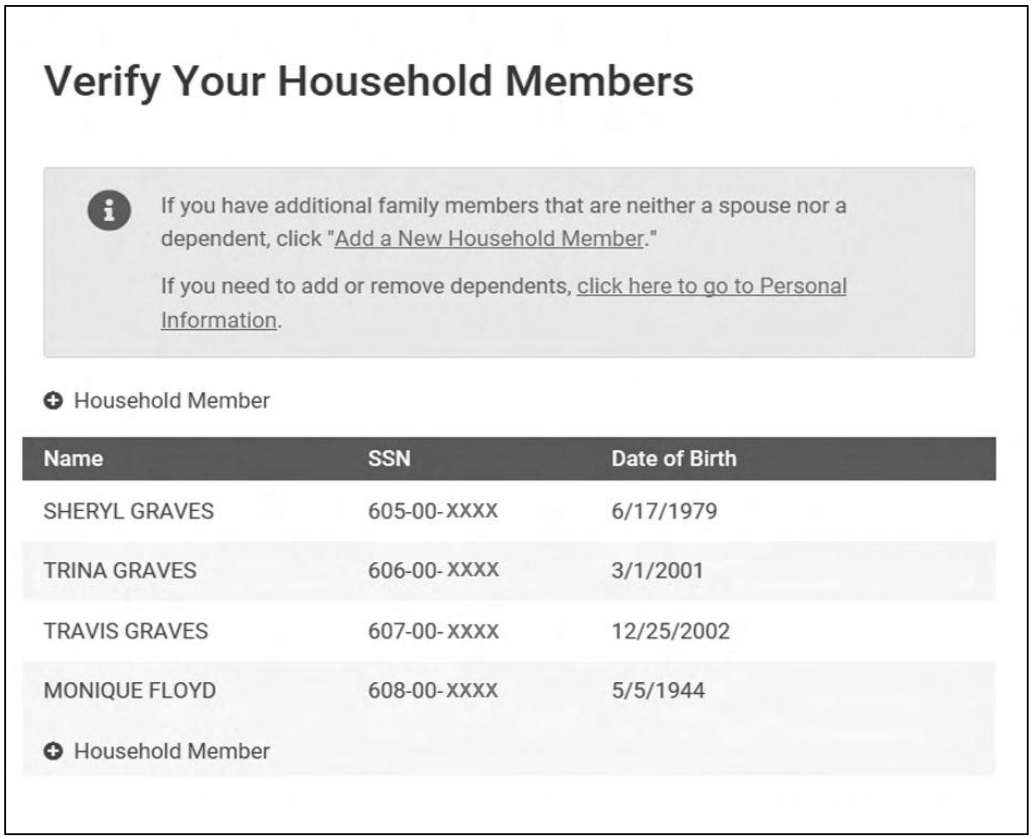
Part III Coverage Information

Month	A. Monthly enrollment premiums	B. Monthly second lowest cost silver plan (SLCSP) premium	C. Monthly advance payment of premium tax credit
21 January	$587.00	$744.00	$492.00
22 February	$587.00	$744.00	$492.00
23 March	$587.00	$744.00	$492.00
24 April	$587.00	$744.00	$492.00
25 May	$587.00	$744.00	$492.00
26 June	$587.00	$744.00	$492.00
27 July	$587.00	$744.00	$492.00
28 August	$587.00	$744.00	$492.00
29 September	$587.00	$744.00	$492.00
30 October	$587.00	$744.00	$492.00
31 November	$587.00	$744.00	$492.00
32 December	$587.00	$744.00	$492.00
33 **Annual Totals**	$7044.00	$9,288.00	$5,904.00

For Privacy Act and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 60703Q Form **1095-A** (2022)

Scenario 1 - TaxSlayer ACA Responses

Sheryl's completed Health Insurance section is shown below.



Directions: Enter the information from Sheryl's Form 1095-A:

Advanced Premium Tax Credit (1095-A)

Are you required to repay all of the APTC received? In most cases, the answer is NO. ONLY answer YES if you were not considered lawfully present in the U.S. or you meet the Health Coverage Tax Credit criteria. Note: We will automatically calculate a full repayment of APTC when MAGI is greater than 400 percent of Federal Poverty Line.

- ○ Yes
- ◉ No

Is your household income below 100% of the Federal poverty line, and do you meet all of the requirements under either "Estimated household income at least 100% of the Federal poverty line" or "Alien lawfully present in the United States"?

- ◉ Yes
- ○ No

Do all Forms 1095-A include coverage for January through December, with no changes in monthly amounts?

- ◉ Yes
- ○ No

Please enter your annual Advance Premium Tax Credi information

Premium Amount (Form 1095-A, line 33A)

$ 7044

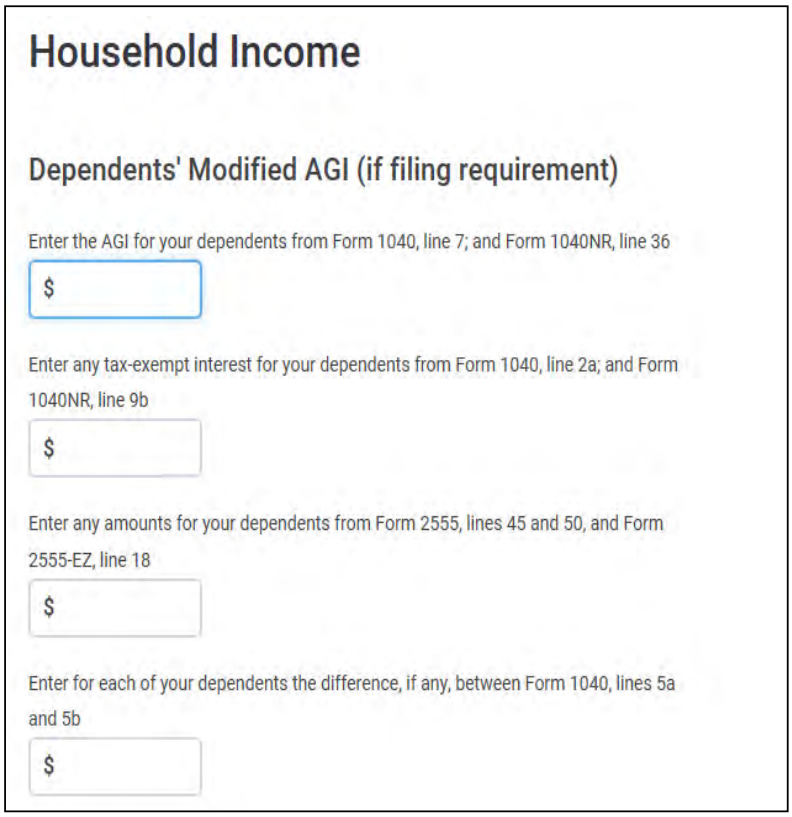
Annual Premium Amount of SLCSP (Form 1095-A, line 33B)

$ 9288

Annual Advance Payment of PTC (Form 1095-A, line 33C)

$ 5904

Directions: You do not need to enter an amount for the dependents' modified AGI because none of Sheryl's dependents were required to file a return.



Scenario 1: Results –

Form 8962, Premium Tax Credit (PTC)

Form **8962**

Department of the Treasury
Internal Revenue Service

Premium Tax Credit (PTC)

► **Attach to Form 1040, 1040-SR, or 1040-NR.**
► **Go to *www.irs.gov/Form8962* for instructions and the latest information.**

OMB No. 1545-0074

2021

Attachment Sequence No. **73**

Name shown on your return	Your social security number
SHERYL GRAVES	605-00-XXXX

A. If you, or your spouse (if filing a joint return), received, or were approved to receive, unemployment compensation for any week beginning during 2021, check the box. See instructions . . . . . ► ☐

B. You cannot take the PTC if your filing status is married filing separately unless you qualify for an exception. See instructions. If you qualify, check the box ► ☐

Part I Annual and Monthly Contribution Amount

1	Tax family size. Enter your tax family size. See instructions			1	4
2a	Modified AGI. Enter your modified AGI. See instructions	2a	36,429		
b	Enter the total of your dependents' modified AGI. See instructions	2b	0		
3	Household income. Add the amounts on lines 2a and 2b. See instructions			3	36,429
4	Federal poverty line. Enter the federal poverty line amount from Table 1-1, 1-2, or 1-3. See instructions. Check the appropriate box for the federal poverty table used. **a** ☐ Alaska **b** ☐ Hawaii **c** ☑ Other 48 states and DC			4	26,500
5	Household income as a percentage of federal poverty line (see instructions)			5	137 %
6	Reserved for future use				
7	Applicable figure. Using your line 5 percentage, locate your "applicable figure" on the table in the instructions			7	.0000
8a	Annual contribution amount. Multiply line 3 by line 7. Round to nearest whole dollar amount	8a	0	**b** Monthly contribution amount. Divide line 8a by 12. Round to nearest whole dollar amount	8b 0

Part II Premium Tax Credit Claim and Reconciliation of Advance Payment of Premium Tax Credit

9 Are you allocating policy amounts with another taxpayer or do you want to use the alternative calculation for year of marriage? See instructions.
☐ **Yes.** Skip to Part IV, Allocation of Policy Amounts, or Part V, Alternative Calculation for Year of Marriage. ☑ **No.** Continue to line 10.

10 See the instructions to determine if you can use line 11 or must complete lines 12 through 23.
☑ **Yes.** Continue to line 11. Compute your annual PTC. Then skip lines 12–23 and continue to line 24. ☐ **No.** Continue to lines 12–23. Compute your monthly PTC and continue to line 24.

Annual Calculation	(a) Annual enrollment premiums (Form(s) 1095-A, line 33A)	(b) Annual applicable SLCSP premium (Form(s) 1095-A, line 33B)	(c) Annual contribution amount (line 8a)	(d) Annual maximum premium assistance (subtract (c) from (b); if zero or less, enter -0-)	(e) Annual premium tax credit allowed (smaller of (a) or (d))	(f) Annual advance payment of PTC (Form(s) 1095-A, line 33C)
11 Annual Totals	7,044	9,288	0	9,288	7,044	5,904

Monthly Calculation	(a) Monthly enrollment premiums (Form(s) 1095-A, lines 21–32, column A)	(b) Monthly applicable SLCSP premium (Form(s) 1095-A, lines 21–32, column B)	(c) Monthly contribution amount (amount from line 8b or alternative marriage monthly calculation)	(d) Monthly maximum premium assistance (subtract (c) from (b); if zero or less, enter -0-)	(e) Monthly premium tax credit allowed (smaller of (a) or (d))	(f) Monthly advance payment of PTC (Form(s) 1095-A, lines 21–32, column C)
23 December						

24	Total premium tax credit. Enter the amount from line 11(e) or add lines 12(e) through 23(e) and enter the total here	24	7,044
25	Advance payment of PTC. Enter the amount from line 11(f) or add lines 12(f) through 23(f) and enter the total here	25	5,904
26	Net premium tax credit. If line 24 is greater than line 25, subtract line 25 from line 24. Enter the difference here and on Schedule 3 (Form 1040 or 1040-SR), line 9, or Form 1040-NR, line 65. If line 24 equals line 25, enter -0-. Stop here. If line 25 is greater than line 24, leave this line blank and continue to line 27	26	1,140

Repayment of Excess Advance Payment of the Premium Tax Credit

...ater than line 24, subtract line 24 from line 25. Enter the differen...

Column C of Form 1095-A is entered on Form 8962, Column F.

Scenario 1 - Form 1040, Schedule 3, Additional Credits and Payments :

Part II Other Payments and Refundable Credits

9	Net premium tax credit. Attach Form 8962	9	1,140

Scenario 2 – Premium Tax Credit with APTC for Part-Year Coverage

Interview Notes

- Charles and Shay Baldwin are married with two dependent children, Nathaniel and Karly, who live with them all year. Their SSNs are:
  - Charles: 609-00-XXXX
  - Shay: 610-00-XXXX
  - Nathaniel: 611-00-XXXX
  - Karly: 612-00-XXXX
- Charles' Form W-2 shows:
  - Box 1 = $33,500
  - Box 2 = $1,820
- Shay's W-2 shows:
  - Box 1 = $17,750
  - Box 2 = $1,153
- Charles' and Shay's employers do not offer health insurance coverage. Charles enrolled in a plan through the Marketplace that covered him, Shay, and both children with an effective date of March 1. He selected the second lowest cost silver plan. They received the benefit of advance payments of the premium tax credit for their coverage. During the year, Charles received an unexpected raise in pay. They did not notify the Marketplace. The family has no other income or deductions.

Directions

Review the interview notes, complete the volunteer sections of the intake sheet, and start a new return using the Practice Lab. Enter the SSNs, filing status, personal information, dependents, and income. Then complete the following steps:

1. Select the Health Insurance section and answer all the questions pertaining to Charles, Shay, and their family.
2. Compare your result to the screen shots on the following pages.

Page 1 of the intake sheet with volunteer entries:

Form **13614-C** (October 2022)	Department of the Treasury - Internal Revenue Service **Intake/Interview & Quality Review Sheet**	OMB Number 1545-1964

You will need:
- **Tax Information such as Forms W-2, 1099, 1098, 1095.**
- **Social security cards or ITIN letters for all persons on your tax return.**
- **Picture ID (such as valid driver's license) for you and your spouse.**

- **Please complete pages 1-4 of this form.**
- **You are responsible for the information on your return. Please provide complete and accurate information.**
- **If you have questions, please ask the IRS-certified volunteer preparer.**

Volunteers are trained to provide high quality service and uphold the highest ethical standards.
To report unethical behavior to the IRS, email us at wi.voltax@irs.gov

Part I – Your Personal Information (If you are filing a joint return, enter your names in the same order as last year's return)

1. Your first name: CHARLES	M.I.	Last name: BALDWIN	Best contact number: YOUR PHONE #	Are you a U.S. citizen? ☒ Yes ☐ No
2. Your spouse's first name: SHAY	M.I.	Last name: BALDWIN	Best contact number	Is your spouse a U.S. citizen? ☒ Yes ☐ No

3. Mailing address: 775 BANKS STREET	Apt #	City: YOUR CITY	State: YS / ZIP code: YOUR ZIP

4. Your Date of Birth: 12/3/1981	5. Your job title: CUSTOMER SERVICE REP	6. Last year, were you: b. Totally and permanently disabled ☐ Yes ☒ No	a. Full-time student ☐ Yes ☒ No; c. Legally blind ☐ Yes ☒ No
7. Your spouse's Date of Birth: 6/10/1985	8. Your spouse's job title: CASHIER	9. Last year, was your spouse: b. Totally and permanently disabled ☐ Yes ☒ No	a. Full-time student ☐ Yes ☒ No; c. Legally blind ☐ Yes ☒ No

10. Can anyone claim you or your spouse as a dependent? ☐ Yes ☒ No ☐ Unsure

11. Have you, your spouse, or dependents been a victim of tax related identity theft or been issued an Identity Protection PIN? ☐ Yes ☒ No

12. Provide an email address (optional) (this email address will not be used for contacts from the Internal Revenue Service)

Part II – Marital Status and Household Information

1. As of December 31, 2022, what was your marital status?
- ☐ Never Married (This includes registered domestic partnerships, civil unions, or other formal relationships under state law)
- ☒ Married
  - a. If Yes, Did you get married in 2022? ☐ Yes ☒ No
  - b. Did you live with your spouse during any part of the last six months of 2022? ☒ Yes ☐ No
- ☐ Divorced — Date of final decree
- ☐ Legally Separated — Date of separate maintenance decree
- ☐ Widowed — Year of spouse's death

2. List the names below of:
- **everyone** who lived with you last year (other than your spouse)
- **anyone** you supported but did not live with you last year

If additional space is needed check here ☐ and list on page 3

Name (first, last) Do not enter your name or spouse's name below (a)	Date of Birth (mm/dd/yy) (b)	Relationship to you (for example: son, daughter, parent, none, etc) (c)	Number of months lived in your home last year (d)	US Citizen (yes/no) (e)	Resident of US, Canada, or Mexico last year (yes/no) (f)	Single or Married as of 12/31/22 (S/M) (g)	Full-time Student last year (yes/no) (h)	Totally and Permanently Disabled (yes/no) (i)	**To be completed by a Certified Volunteer Preparer:** Is this person a qualifying child/relative of any other person? (yes/no)	Did this person provide more than 50% of his/her own support? (yes,no,n/a)	Did this person have less than $4,400 of income? (yes,no,n/a)	Did the taxpayer(s) provide more than 50% of support for this person? (yes/no/n/a)	Did the taxpayer(s) pay more than half the cost of maintaining a home for this person? (yes/no)
NATHANIEL BALDWIN	4/4/2004	Son	12	YES	YES	S	YES	NO	NO	NO	YES	YES	YES
KARLY BALDWIN	4/29/2006	Daughter	12	YES	YES	S	YES	NO	NO	NO	YES	YES	YES

The amount shown for APTC is for illustrations purposes. APTC cannot be more than the policy cost.

Form 1095-A Health Insurance Marketplace Statement

Form **1095-A**

Department of the Treasury
Internal Revenue Service

Health Insurance Marketplace Statement

Do not attach to your tax return. Keep for your records.
Go to *www.irs.gov/Form1095A* for instructions and the latest information.

☐ VOID
☐ CORRECTED

OMB No. 1545-2232

2022

Part I Recipient Information

1 Marketplace identifier: XXXX	**2** Marketplace-assigned policy number: XXXXX	**3** Policy issuer's name: XXXXXXXXXXXXXXXXXXXX	
4 Recipient's name: CHARLES BALDWIN		**5** Recipient's SSN: 609-00-XXXX	**6** Recipient's date of birth: 12/03/1981
7 Recipient's spouse's name: SHAY BALDWIN		**8** Recipient's spouse's SSN: 610-00-XXXX	**9** Recipient's spouse's date of birth: 06/10/1985
10 Policy start date: 03/01/2022	**11** Policy termination date: 12/31/2022	**12** Street address (including apartment no.): 775 BANKS ST	
13 City or town: YOUR CITY	14. State or province: YS	**15** Country and ZIP: YOUR ZIP	

Part II Covered Individuals

	A. Covered individual name of birth	B. Covered individual SSN	C. Covered individual Date of Birth	D. Coverage start date dat	E. Coverage termination date
16	CHARLES BALDWIN	609-00-XXXX	12/03/1981	03/01/2022	12/31/2022
17	SHAY BALDWIN	610-00-XXXX	06/10/1985	03/01/2022	12/31/2022
18	NATHANIEL BALDWIN	611-00-XXXX	04/04/2004	03/01/2022	12/31/2022
19	KARLY BALDWIN	612-00-XXXX	04/29/2006	03/01/2022	12/31/2022
20					

Part III Coverage Information

Month	A. Monthly enrollment premiums	B. Monthly second lowest cost silver plan (SLCSP) premium	C. Monthly advance payment of premium tax credit
21 January			
22 February			
23 March	$789.00	$789.00	$800.00
24 April	$789.00	$789.00	800.00
25 May	$789.00	$789.00	$800.00
26 June	$789.00	$789.00	$800.00
27 July	$789.00	$789.00	$800.00
28 August	$789.00	$789.00	$800.00
29 September	$789.00	$789.00	$800.00
30 October	$789.00	$789.00	$800.00
31 November	$789.00	$789.00	$800.00
32 December	$789.00	$789.00	$800.00
33 **Annual Totals**	$7890.00	$7890.00	$8,000.00

For Privacy Act and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 60703Q Form **1095-A** (2022)

Scenario 2 - TaxSlayer ACA Responses

Charles and Shay's completed Health Insurance section is shown below. Indicate that Charles, Shay, Nathaniel, and Karly all had qualified health care coverage purchased through the Marketplace from March through December:

Health Insurance Questionnaire

Did you purchase health insurance via HealthCare.gov or a State Marketplace? *

- (•) Yes
- ( ) No

Verify Your Household Members

If you have additional family members that are neither a spouse nor a dependent, click "Add a New Household Member."

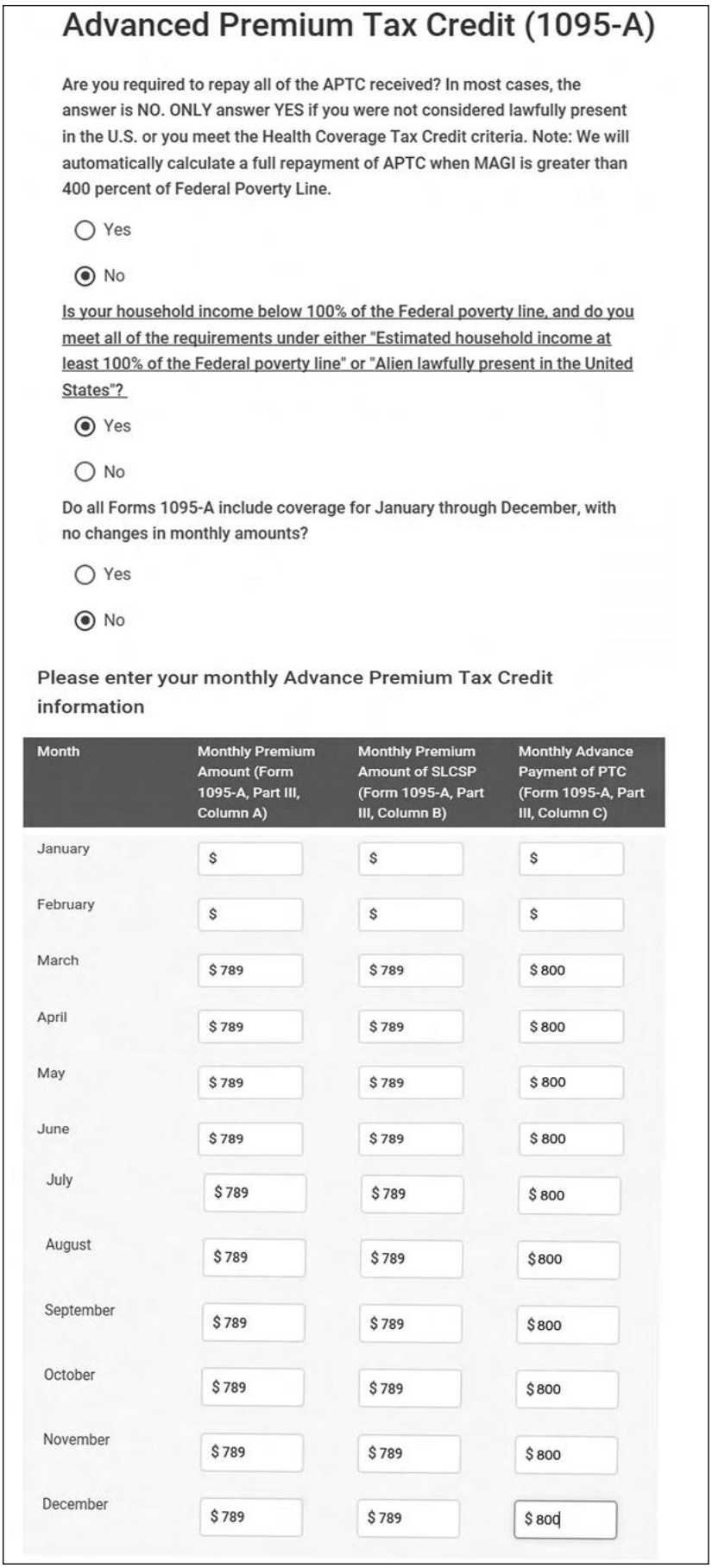
If you need to add or remove dependents, click here to go to Personal Information.

⊕ Household Member

Name	SSN	Date of Birth
CHARLES BALDWIN	609-00-XXXX	12/3/1981
SHAY BALDWIN	610-00-XXXX	6/10/1985
NATHANIEL BALDWIN	611-00-XXXX	4/4/2004
KARLY BALDWIN	612-00-XXXX	4/29/2006

⊕ Household Member

Directions: Enter the information from the Form 1095-A:



Advanced Premium Tax Credit (1095-A)

Are you required to repay all of the APTC received? In most cases, the answer is NO. ONLY answer YES if you were not considered lawfully present in the U.S. or you meet the Health Coverage Tax Credit criteria. Note: We will automatically calculate a full repayment of APTC when MAGI is greater than 400 percent of Federal Poverty Line.

- ○ Yes
- ◉ No

Is your household income below 100% of the Federal poverty line, and do you meet all of the requirements under either "Estimated household income at least 100% of the Federal poverty line" or "Alien lawfully present in the United States"?

- ◉ Yes
- ○ No

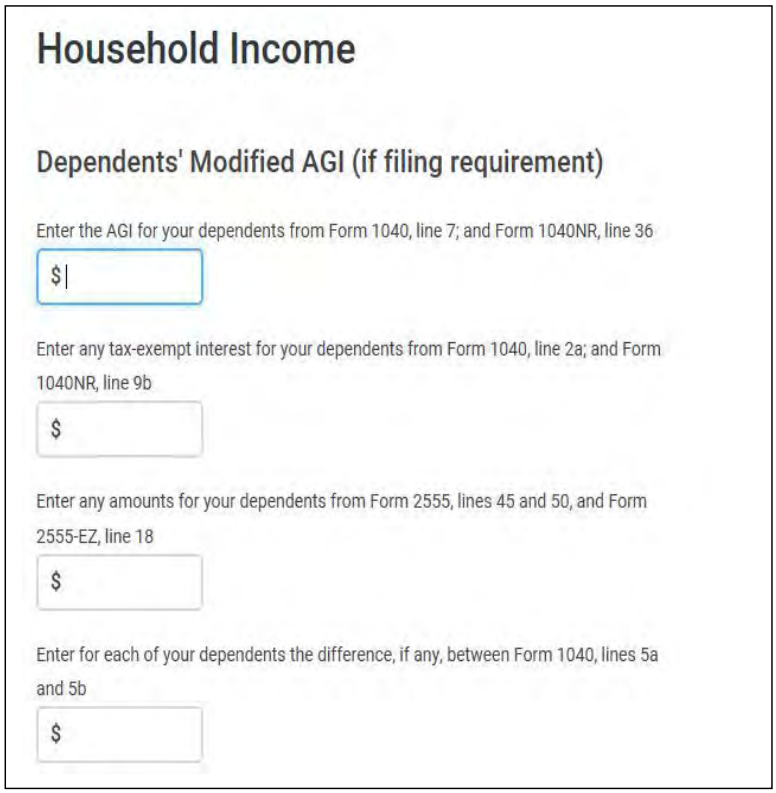
Do all Forms 1095-A include coverage for January through December, with no changes in monthly amounts?

- ○ Yes
- ◉ No

Please enter your monthly Advance Premium Tax Credit information

Month	Monthly Premium Amount (Form 1095-A, Part III, Column A)	Monthly Premium Amount of SLCSP (Form 1095-A, Part III, Column B)	Monthly Advance Payment of PTC (Form 1095-A, Part III, Column C)
January	$	$	$
February	$	$	$
March	$ 789	$ 789	$ 800
April	$ 789	$ 789	$ 800
May	$ 789	$ 789	$ 800
June	$ 789	$ 789	$ 800
July	$ 789	$ 789	$ 800
August	$ 789	$ 789	$ 800
September	$ 789	$ 789	$ 800
October	$ 789	$ 789	$ 800
November	$ 789	$ 789	$ 800
December	$ 789	$ 789	$ 800

The dependents did not have any income or filing requirement.



Scenario 2 - Results

Scenario 2 - Form 8962, Premium Tax Credit

See Parts 1, 2, and 3 of Charles and Shay's completed Form 8962 below. Part 3 of Form 8962 reconciles advance payments of the premium tax credit.

In this case, Charles failed to report an increase in pay to the Marketplace. This resulted in an excess advance premium tax credit repayment. This excess will decrease their refund or increase their balance due. Charles should have reported his change in income to the Marketplace so they could have adjusted his advance credit payments for the remainder of the coverage year. Note that his repayment is capped because the income is under 200% of the Federal Poverty Line.

See illustration of Form 8962, Premium Tax Credit, on the following page.

Scenario 2 - Form 8962 Premium Tax Credit (PTC)

Form **8962**

Department of the Treasury
Internal Revenue Service

Premium Tax Credit (PTC)

► **Attach to Form 1040, 1040-SR, or 1040-NR.**
► **Go to *www.irs.gov/Form8962* for instructions and the latest information.**

OMB No. 1545-0074

20**XX**

Attachment Sequence No. **73**

Name shown on your return	Your social security number
CHARLES BALDWIN	609-00-XXXX

A. If you, or your spouse (if filing a joint return), received, or were approved to receive, unemployment compensation for any week beginning during 2021, check the box. See instructions . . . . . ► ☐

B. You cannot take the PTC if your filing status is married filing separately unless you qualify for an exception. See instructions. If you qualify, check the box ► ☐

DRAFT AS OF November 8, 2021 DO NOT FILE

Part I Annual and Monthly Contribution Amount

1	Tax family size. Enter your tax family size. See instructions			1	4
2a	Modified AGI. Enter your modified AGI. See instructions	2a	51,250		
b	Enter the total of your dependents' modified AGI. See instructions	2b			
3	Household income. Add the amounts on lines 2a and 2b. See instructions			3	51,250
4	Federal poverty line. Enter the federal poverty line amount from Table 1-1, 1-2, or 1-3. See instructions. Check the appropriate box for the federal poverty table used. **a** ☐ Alaska **b** ☐ Hawaii **c** ☑ Other 48 states and DC			4	26,500
5	Household income as a percentage of federal poverty line (see instructions)			5	195 %
6	Reserved for future use				
7	Applicable figure. Using your line 5 percentage, locate your "applicable figure" on the table in the instructions			7	.0180
8a	Annual contribution amount. Multiply line 3 by line 7. Round to nearest whole dollar amount	8a	923		
	b Monthly contribution amount. Divide line 8a by 12. Round to nearest whole dollar amount			8b	77

Part II Premium Tax Credit Claim and Reconciliation of Advance Payment of Premium Tax Credit

9 Are you allocating policy amounts with another taxpayer or do you want to use the alternative calculation for year of marriage? See instructions.
☐ **Yes.** Skip to Part IV, Allocation of Policy Amounts, or Part V, Alternative Calculation for Year of Marriage. ☑ **No.** Continue to line 10.

10 See the instructions to determine if you can use line 11 or must complete lines 12 through 23.
☐ **Yes.** Continue to line 11. Compute your annual PTC. Then skip lines 12–23 and continue to line 24.
☑ **No.** Continue to lines 12–23. Compute your monthly PTC and continue to line 24.

Annual Calculation	**(a)** Annual enrollment premiums (Form(s) 1095-A, line 33A)	**(b)** Annual applicable SLCSP premium (Form(s) 1095-A, line 33B)	**(c)** Annual contribution amount (line 8a)	**(d)** Annual maximum premium assistance (subtract (c) from (b); if zero or less, enter -0-)	**(e)** Annual premium tax credit allowed (smaller of (a) or (d))	**(f)** Annual advance payment of PTC (Form(s) 1095-A, line 33C)
11 Annual Totals						
Monthly Calculation	**(a)** Monthly enrollment premiums (Form(s) 1095-A, lines 21–32, column A)	**(b)** Monthly applicable SLCSP premium (Form(s) 1095-A, lines 21–32, column B)	**(c)** Monthly contribution amount (amount from line 8b or alternative marriage monthly calculation)	**(d)** Monthly maximum premium assistance (subtract (c) from (b); if zero or less, enter -0-)	**(e)** Monthly premium tax credit allowed (smaller of (a) or (d))	**(f)** Monthly advance payment of PTC (Form(s) 1095-A, lines 21–32, column C)
12 January						
13 February						
14 March	789	789	77	712	712	800
15 April	789	789	77	712	712	800
16 May	789	789	77	712	712	800
17 June	789	789	77	712	712	800
18 July	789	789	77	712	712	800
19 August	789	789	77	712	712	800
20 September	789	789	77	712	712	800
21 October	789	789	77	712	712	800
22 November	789	789	77	712	712	800
23 December	789	789	77	712	712	800

24	Total premium tax credit. Enter the amount from line 11(e) or add lines 12(e) through 23(e) and enter the total here	24	7,120
25	Advance payment of PTC. Enter the amount from line 11(f) or add lines 12(f) through 23(f) and enter the total here	25	8,000
26	Net premium tax credit. If line 24 is greater than line 25, subtract line 25 from line 24. Enter the difference here and on Schedule 3 (Form 1040), line 9. If line 24 equals line 25, enter -0-. Stop here. If line 25 is greater than line 24, leave this line blank and continue to line 27	26	

Part III Repayment of Excess Advance Payment of the Premium Tax Credit

27	Excess advance payment of PTC. If line 25 is greater than line 24, subtract line 24 from line 25. Enter the difference here	27	880
28	Repayment limitation (see instructions)	28	650
29	Excess advance premium tax credit repayment. Enter the smaller of line 27 or line 28 here and on Schedule 2 (Form 1040), line 2	29	650

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 37784Z Form **8962** (2021)

Scenario 2 - Form 1040, Schedule 2, Additional Taxes

Part I	Tax		
1	Alternative minimum tax. Attach Form 6251	1	
2	Excess advance premium tax credit repayment. Attach Form 8962	2	650
3	Add lines 1 and 2. Enter here and include on Form 1040 or 1040-SR, line 12b	3	

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Link & Learn Taxes

Link & Learn Taxes is web-based training designed specifically for VITA/TCE volunteers. Each volunteer's ability to prepare complete and accurate returns is vital to the credibility and integrity of the program. Link & Learn Taxes, as part of the complete volunteer training kit, provides the path to achieving this high level of quality service.

Link & Learn Taxes and Publication 4012, VITA/TCE Volunteer Resource Guide, work together to help volunteers learn and practice.

Link & Learn Taxes for 2022 includes:

- Access to all VITA/TCE courses
- Easy identification of the VITA/TCE courses with the course icons
  - As you progress through a lesson, the content for Basic, Advanced, Military, or International will dis play, depending on the level of certification you selected
- PowerPoint presentations that can be customized to fit your classroom needs
- VITA/TCE Central to provide centralized access for training materials and reference links
- The Practice Lab
  - Gives volunteers practice with an early version of the IRS-provided tax preparation software
  - Lets volunteers complete test practice problems
  - Lets volunteers prepare test scenario returns for the test/retest

Go to **www.irs.gov,** type "Link & Learn" in the Keyword field and click Search. You'll find a detailed overview and links to the courses.

FSA (Facilitated Self Assistance) empowers taxpayers to prepare their own returns with the assistance of a certified volunteer. Taxpayers complete their own returns using interview-based software supplied by leaders in the tax preparation industry. Volunteers assist taxpayers with tax law questions.

Virtual VITA/TCE model includes any site where face-to-face activities are not used during the tax preparation process. That is, the intake specialist, IRS-tax law certified preparer (who prepares the return) and/or the quality reviewer are not face-to-face with the taxpayer. By incorporating this flexibility partners can provide taxpayers with more convenient locations to file their taxes.

For more information contact your SPEC Relationship Manager to see if you should start a FSA or Virtual VITA site in your community.

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Your online resource for volunteer and taxpayer assistance

Partner and Volunteer Resource Center

www.irs.gov/Individuals/Partner-and-Volunteer-Resource-Center

- What's Hot!
- Site Coordinator's Corner

Quality and Tax Alerts for IRS Volunteer Programs

www.irs.gov/individuals/quality-and-tax-alerts-for-irs-volunteer-programs

- Volunteer Tax Alerts

Volunteer Training Resources

www.irs.gov/Individuals/Volunteer-Training-Resources

Outreach Connection

www.irs.gov/Individuals/Outreach-Corner

Interactive Tax Assistant (ITA)

www.irs.gov/help/ita

Online Services and Tax Information for Individuals

www.irs.gov/Individuals

Plan

- Tax Withholding (Paycheck Checkup)
- When to File
- Recordkeeping
- Choosing a Tax Professional
- Get Answers to Your Tax Questions Online
- Year-round Tax Planning is for Everyone, Publication 5349

Tools

- View Your Tax Account
- Get Your Transcript
- Where's My Refund?

File

- IRS Free File
- How to File
- Filing Past Due Returns
- Correcting Your Tax Return
- Social Security Benefit Statement

Pay

- Tax Withholding
- Estimated Taxes
- Options for Paying Your Taxes
- How to Choose a Payment Option
- Understanding Your IRS Notice or Letter
- What to Do If You Can't Pay

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