



Department  
of the  
Treasury

**Internal  
Revenue  
Service**

# Your Federal Income Tax

**For Individuals**

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For use in  
preparing

**1996**

Returns



Department  
of the  
Treasury

Internal  
Revenue  
Service

# Your Federal Income Tax

## For Individuals

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All material in this publication may be reprinted freely. A citation to *Your Federal Income Tax (1996)* would be appropriate.

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

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

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

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

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

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## Introduction

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

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

credit and the advance earned income credit.

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

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

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

- Lists of where to report certain items listed on information documents,
- List of mailing addresses for where to file returns,
- List of recorded tax information topics (Tele-Tax), and

- List of phone numbers for calling the IRS.

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

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

You can get free IRS publications and forms. Call 1-800-TAX-FORM(1-800-829-3676) or use the order form in the back of this publication. Many public libraries also have reference sets of these publications that you can use.

If you have access to a personal computer and a modem, you can also get many forms and publications electronically. See *How To Get Forms, Publications, and Other Information* in the back of this publication for more details.

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

Internal Revenue Service  
Technical Publications  
Branch (T:FP:P)  
Washington, DC 20224

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

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## IRS Customer Service Standards — 1996 Progress Report

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**Easier filing.** To make it easier for you to meet your tax obligations, we have expanded opportunities for simplified return filing and payment of taxes through our electronic filing, joint Federal-state filing, TeleFile, and electronic payment programs. **In 1996**, IRS received 14.9 million electronically filed individual returns and schedules compared to 11.8 million in 1995. This included 2.8 million returns through TeleFile, the first totally paperless way for you to file a Federal income tax return. We expanded the number of states participating in the Federal-state electronic filing program from 29 to 31. IRS also received over \$374 billion in electronic payments.

**Access to information.** You will have convenient access to tax law and account information. Tax information will be available by fax and through the Internet. Our pre-recorded tax information will be available 24 hours a day, 7 days a week, and access to refund status information will be available 16 hours a day each business day. Telephone assistance provided by our representatives will be available 10 hours

each business day. **During 1996**, we assisted over 104 million taxpayers by providing pre-recorded tax information, refund status information, and telephone assistance from our representatives. In addition, taxpayers had 24 hour access to over 600 forms and publications and over 148 tax topics on the Internet. Taxpayers downloaded almost 3 million of these products using the Internet and over 300,000 using the IRS electronic bulletin board. Over 100,000 information orders have been filled by fax. There were over 80 million accesses on the IRS Home Page on the Internet.

**Accuracy.** Our goal is to answer your questions and process your tax returns accurately. **In 1996**, we achieved an accuracy rate of 93% in answering tax law and account questions. Our accuracy rate for processing tax refunds was 99.6%.

**Prompt refunds.** If you file a complete and accurate tax return and you are due a refund, your refund will be issued within 21 days if you file electronically and within 40 days if you file a

paper return. (Your refund may be delayed if your return is selected for further review.) **In 1996**, refunds were issued on time for all complete and accurate returns. Refunds based on electronically filed returns were issued, on average, within 16 days and for paper returns, the average was 38 days.

**Initial contact resolution.** Our goal is to satisfactorily resolve all your issues the first time you contact the IRS. **In 1996**, we met that goal 80% of the time. We will continue our efforts to address all of your issues and improve the level of our service in 1997.

**Canceling penalties.** If you provide sufficient and accurate information to our tax assistants but are given and reasonably rely on an incorrect answer, we will cancel related penalties.

**Resolving problems.** If you have a problem that has not been resolved through normal processes, you may contact our Problem Resolution Office. A caseworker will contact you within 1 week and will work with

you to resolve the issue. **During 1996**, over 355,000 cases were referred and taxpayers were contacted within 1 week of referral 89.5% of the time.

**Simpler forms.** We will make tax forms and instructions simpler and easier for you to use. We made some changes this year but we want your ideas for improvements. Please e-mail, call, or write to us. You can e-mail us through the IRS Internet Home Page (<http://www.irs.us-treas.gov>). You can call us and leave a recorded message 24 hours a day, 7 days a week at 1-800-829-9043. Or, you can write to the Tax Forms Committee, Western Area Distribution Center, Rancho Cordova, CA 95743-0001. **For 1996**, you will be able to request direct deposit of your refund on your tax return rather than on a separate form. More sole proprietors will be eligible to file the Schedule C-EZ. In addition, several items which appeared on the 1995 Forms 1040 and 1040A have been eliminated. ■

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## Important Changes for 1996

This section summarizes important tax changes that took effect in 1996. These changes are discussed in more detail throughout this publication.

Changes are also discussed in Publication 553, *Highlights of 1996 Tax Changes*.

**Penalty due to new law waived.** You will not have to pay a penalty for underpaying either of the first two installments of your 1996 estimated tax if you underpaid because of provisions in the Small Business Job Protection Act of 1996. See Chapter 5.

**Credit for diesel-powered highway vehicles.** The credit allowed to purchasers of diesel-powered highway vehicles has been repealed. If you purchased a diesel-powered highway vehicle after August 20, 1996, you are not entitled to the special credit. See Chapter 36.

**Death benefit exclusion repealed.** The exclusion from gross income for the first \$5,000 of employer-provided death benefits is repealed for decedents dying after August 20, 1996. See Chapters 11 and 13.

**Employer-provided educational assistance benefits.** The exclusion from gross income for up to \$5,250 of qualified employer-provided educational assistance benefits was extended retroactively to apply to tax years beginning after 1994 and before June 1, 1997. The exclusion does not apply to expenses for graduate-level courses beginning after June 30, 1996. For more information, including how you can claim these benefits for 1995 and 1996, get Publication 508, *Educational Expenses*.

**Savings bonds used for education.** The amount of income you can have before the exclusion of interest from certain Series EE U.S. Savings bonds is phased out increased for 1993 through 1996. If your excludable interest from savings bonds was reduced or eliminated in 1993, 1994, or 1995, you may be entitled to a refund. See *Modified adjusted gross income limit* under *Education Savings Bonds Program* in Chapter 8.

**Donations of appreciated stock.** The special rule allowing a deduction for the full fair market value of qualified appreciated stock given to certain private foundations is reinstated, but only for contributions made after June 30, 1996, and before June 1, 1997. See Publication 526, *Charitable Contributions*.

**Damages for nonphysical injuries or sickness or punitive damages.** Generally, amounts received after August 20, 1996, as damages for nonphysical injuries or sickness or as punitive damages are taxable. See Chapter 13.

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

**New rule to recover the tax-free portion of certain annuity distributions.** For qualified annuities that start after November 18, 1996, you must use a simpler formula to recover your basis (investment) in the annuity. See Chapter 11.

**State tuition programs.** Effective for tax years ending after August 20, 1996, distributions from a qualified state tuition program are taxable only to the extent they are more than the amount contributed to the program. See Publication 525, *Taxable and Nontaxable Income*.

**Unearned income of minor children taxed on parent's return.** The amounts involved in the election to claim a child's unearned income on the parent's return have been increased. The maximum amount of a minor child's interest and dividend income that a parent may be able to report on his or her own return (rather than filing a return for the minor child) has been raised from less than \$5,000 to less than \$6,500. See Chapter 32 for details.

**Taxpayer identification numbers needed for all dependents and for all qualifying persons for the child and dependent care credit.** Unless the child was born in December 1996, you must provide the taxpayer identification number (generally the social security number) for each dependent and each qualifying person for the child and dependent care credit. If a taxpayer identification number is incorrect or missing, the exemption and the credit may not be allowed. See Chapter 3 for exemptions and Chapter 33 for the child and dependent care credit.

**Taxpayer identification numbers for aliens.** If you, your dependent, or your qualifying child is a nonresident or resident alien who does not have — and is not eligible to get — a social security number (SSN), file Form W-7 with the IRS to apply for an individual taxpayer identification number (ITIN). You enter this number on your tax return wherever the SSN is requested, and you use it for tax purposes only. An ITIN does not entitle you to the earned income credit, social security benefits, or change your employment or immigration status under U.S. law. See Chapter 1 for more information.

**Earned income credit.** The maximum amount of earned income credit you can receive has increased. The maximum amount of income you can earn and still get the earned income credit has also increased. Generally, persons with investment income of more than \$2,200 cannot claim the earned income credit. For more information, including how to figure the amount of your credit, see Chapter 35.

**Social security numbers needed for the earned income credit.** Unless the child was born in December 1996, you must provide the social security number of each qualifying child to claim the earned income credit. If a social security number is incorrect or missing from Schedule EIC, the credit may not be allowed. See Chapter 35 for details.

**Who must file.** Generally, the amount of income you can have before you must file a return has been increased. See Chapter 1.

**Higher exemption amount.** For 1996, you are allowed a \$2,550 deduction for each exemption to which you are entitled. However, your exemption amount could be phased out if you have high income. See Chapter 3.

**Standard deduction.** For most people, the standard deduction has increased. Because of this increase, it may benefit you to take the standard deduction for 1996 even though you itemized deductions in past years. See Chapter 21.

**Limit on itemized deductions.** Some of your itemized deductions may be limited if your adjusted gross income is more than a certain dollar amount. For 1996, the amount is \$117,950 (\$58,975 if you are married filing separately). See Chapter 22.

**Alaska Permanent Fund dividends.** If you otherwise qualify to file Form 1040A or 1040EZ, you can report Alaska Permanent Fund dividends on line 12 of Form 1040A or line 3 of Form 1040EZ. See Chapter 1.

**Service in hazardous duty area or combat zone.** Tax benefits are available to those who participated in Operation Joint Endeavor (Bosnia and Herzegovina, Croatia, and Macedonia) after November 20, 1995, and to those who served in the Persian Gulf area combat zone. For information, see Publication 3, *Armed Forces Tax Guide*.

**Standard mileage rate increased.** For 1996, the standard mileage rate for the cost of operating your car is 31 cents a mile for all business miles. The rate is 10 cents a mile for medical and moving expenses. See Chapter 28 for business expenses, Chapter 29 for educational expenses, Chapter 23 for medical expenses, and Chapter 19 for moving expenses.

**Self-employment tax.** The maximum net earnings subject to the social security tax portion of self-employment tax (12.4%) has increased to \$62,700. All net earnings of at least \$400 (\$108.28 for church employees) are subject to the Medicare tax portion (2.9%). Use Schedule SE (Form 1040) to figure the tax

due. For more information, see Publication 533, *Self-Employment Tax*.

**Social security and Medicare taxes.** The maximum wages subject to social security tax (6.2%) has increased to

\$62,700. All wages are subject to Medicare tax (1.45%).

**Direct deposit of refund.** You can ask to have your refund deposited directly into your account (at a bank or other financial institution) by completing the appropriate lines on your tax form.

There is no additional form to attach. See Chapter 1.

to your questions about the forms. ■

**Phone numbers for income statements.** The W-2 and 1099 forms you receive for 1996 should include a telephone number you can call to get answers

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## Important Changes for 1997

This section highlights important tax changes that take effect in 1997 and that could affect your estimated tax payments for 1997. More information on these and other changes can be found in Publication 553, *Highlights of 1996 Tax Changes*.

**Adoption tax credit.** You may be able to claim a tax credit for qualified adoption expenses. The credit can be as much as \$5,000 for each child (\$6,000 for a child with special needs).

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

**Voluntary withholding.** You can have federal income tax withheld from your unemployment compensation and certain federal payments you receive. Complete Form W-4V, *Voluntary Withholding Request*, and give it to the payer.

**IRA for spouse.** A married couple filing a joint return can contribute up to \$2,000 to each of their IRAs, even if one spouse had little or no income. See Chapter 18.

**IRA withdrawals to pay medical expenses and medical insurance.** You generally pay a 10% penalty if you withdraw funds from your IRA before a certain age. However, you may not have to pay the penalty if the withdrawals are used to pay unreimbursed medical expenses that are more than 7½% of your adjusted gross income.

If you lose your job, you may be able to withdraw funds from your IRA without paying the 10% penalty if the withdrawals are not more than the amount paid for medical insurance for you and your family.

**Self-employed health insurance deduction.** If you are self-employed, the part of your health insurance premiums you can deduct increases to 40%.

**Medical savings accounts.** Certain persons who are covered under a high deductible health plan may be able to participate in a medical savings account program. You would then be able to deduct up to \$1,462.50 (\$3,375 for family coverage) a year for contributions to a medical savings account, even if you do not itemize your deductions. Proceeds from this account would be used to pay unreimbursed medical expenses.

**Medical expenses for long-term care.** You generally can include in your medical expenses the costs of qualified long-term care services. These costs include all or part of the premiums for qualified long-term care insurance.

**Life insurance paid before death of insured.** Certain payments received under a life insurance contract on behalf of a terminally or chronically ill individual (an accelerated death benefit) can be excluded from your income.

**Long-term care insurance and benefits.** Long-term care insurance contracts issued after 1996 generally are treated as accident and health insurance contracts. If you receive long-term care insurance benefits from your employer, you generally will not include them in your income. Long-term care insurance contracts are ones that only provide certain coverage for the care of chronically ill individuals under the care of licensed health care practitioners.

**Suspension of the 15% tax on excess distributions.** The 15% tax on distributions over \$150,000 has been suspended for distributions made from IRAs and qualified plans after 1996 and before the year 2000.

**Energy conservation subsidies.** The exclusion from gross income of any subsidy provided by a public utility to a customer for the purchase or installation of an energy conservation measure is available only for dwelling units. ■

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## Important Reminders

Listed below are important reminders and other items that may help you file your 1996 tax return. Many of these items are explained in more detail later in this publication.

**Foreign source income.** If you are a U.S. citizen with income from sources outside the United States (foreign income), you must report all such income on your tax return unless it is exempt by U.S. law. This is true whether you reside inside or outside the United States and whether or not you receive a

Form W-2 or 1099 from the foreign payer. This applies to earned income (such as wages and tips) as well as unearned income (such as interest, dividends, capital gains, pensions, rents and royalties).

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

**Social security taxes for household employees.** If you

pay a domestic employee (such as a nurse, babysitter or housekeeper) cash wages of \$1,000 or more to work in your home, you generally will have to pay social security and Medicare taxes. You pay these taxes with your income tax return, but wages paid to students under 18 are exempt. As a household employer, you will need an employer identification number (EIN) for the Forms W-2 and Schedule H that you must file. For more information, see Publication 926, *Household Employer's Tax Guide*.

**Estimated tax and withholding.** If you must make estimated tax payments or are subject to tax withholding, you have the option of including any expected employment taxes when figuring your estimated tax payments or how much you want withheld from your pay. For more information, see Publication 505, *Tax Withholding and Estimated Tax*.

**Earned income credit with your pay.** If a qualifying child lives with you and you expect to qualify for the earned income

credit in 1997, you may be able to receive part of the credit in each paycheck. See Chapter 35.

**Receipts for business expenses.** You must have receipts for amounts that are \$75 or more for certain business expenses. See Chapter 28.

**Lump-sum distributions.** You may be able to figure the tax on a lump-sum distribution under the 5-year tax option even if the plan participant was born after 1935. For more information, see Chapter 11.

**Forms W-2 and 1099.** You should receive your 1996 Form W-2, *Wage and Tax Statement*, and your Forms 1099 by January 31, 1997. If you have not received them by January 31, ask your employer or payer for them. If you still do not receive them by February 15, call the IRS number for your area listed in your tax form instruction booklet.

Even if you do not receive these income statements, you must still report your earnings. If you lose your copy of Form W-2 or 1099, or if it is incorrect, ask your employer or payer for a new one.

**Faster ways to file your return.** The IRS offers fast, accurate ways to file your tax return information.

**Electronic filing.** You can have your return filed electronically instead of mailing it to the IRS. You can have your refund deposited directly into your checking or savings account, and in many states, you can file your federal and state tax returns electronically at the same time.

**On-line filing.** If you have a computer, a modem and the necessary software, you can file your tax return from home using an IRS-accepted on-line service company or transmitter.

**TeleFile.** If you have a touch-tone phone and are filing Form 1040EZ, you may be able to file your tax return over the phone. You can only use TeleFile if you receive a TeleFile package in the mail and meet the requirements explained in it.

**1040PC returns.** You can use a personal computer to prepare a 1040PC return. The return has fewer pages because the computer only prints lines on which you make an entry. You can get tax preparation software that includes the 1040PC print

option from a computer store; it is *not* available from the IRS.

For more details on these fast filing methods, see Chapter 1.

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

**Free tax help.** The IRS provides free tax information and services throughout the year, and there are approximately 100 publications available. Publication 910, *Guide to Free Tax Services*, describes the publications and the free tax information services you can receive.

If you have access to a personal computer and a modem, you can also get many forms and publications electronically. See *How To Get Forms, Publications, and Other Information* in the back of this book for details.

**Tele-Tax.** This telephone service provides recorded tax information on about 150 topics. Tele-Tax can also tell you the status of your refund. In addition to listening to the Tele-Tax topics by phone, you can also have them faxed to you. See *What Is Tele-Tax?* in your tax form instruction booklet.

**Telephone help.** IRS representatives are available to answer your tax questions by telephone. If, after reading the tax form instructions and IRS tax publications, you are not sure how to fill out your return, or you have a question about an IRS notice, you can call the IRS number for your area. These numbers are listed in your tax form instruction booklet, which also gives the hours of operation. You will not be charged for the call unless your phone company charges you for local calls.

**TTY/TDD equipment.** If you have access to TTY/TDD equipment, you can call 1-800-829-4059 with your tax questions or to order forms and publications. See your tax form instruction booklet for the hours of operation.

**Written tax questions.** You can send your written tax questions to your IRS District Director. You should get an answer in about 30

days. If you do not have the address, you can get it by calling the IRS number for your area that is listed in your tax form instruction booklet.

**Assistance with your return.** Assistants are available in many IRS offices throughout the country to help you prepare your own return. An assistant will explain a Form 1040EZ, Form 1040A, or Form 1040 with Schedules A and B to you and other taxpayers in a group setting. At many of these offices, you can also file your tax return electronically. (See Chapter 1 for information on electronic filing.) To find the location of the IRS office nearest you, look in the phone book under "United States Government, Internal Revenue Service."

If you want help with your tax return, you should bring in your tax package, Forms W-2 and 1099, and any other information (such as a copy of last year's return) that will help the assistant to help you.

At most IRS offices you can also get tax forms, publications, and help with questions about IRS notices or bills.

**Videotaped instructions.** Videotaped instructions for completing your tax return are available in either English or Spanish at many libraries.

**Braille tax materials.** Braille tax materials are available for review from Regional Libraries for the Visually Impaired in conjunction with the National Library Service for the Blind and Physically Handicapped. To locate your nearest library, write to the National Library Service for the Blind and Physically Handicapped, Library of Congress, 1291 Taylor St., NW, Washington, DC 20542.

Braille materials currently available for review include this publication, Publication 334, *Tax Guide for Small Business*, and Forms 1040, 1040A, and 1040EZ and their instructions.

**Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE).** Free help from volunteers is available in most communities. After completing IRS training, these volunteers help prepare basic tax returns for taxpayers with special needs, including persons with disabilities, the elderly, non-English-speaking people, and low-

income people. At many of these offices, you can file your tax return electronically. (See Chapter 1 for information on electronic filing.) Call the IRS telephone number for your area for the location of the volunteer assistance site near you.

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

**Check the name and social security number (SSN) on your tax form.** If either the name or SSN on your tax form does not agree with your social security card, your refund may be delayed or you may not receive credit for your social security earnings. If your Form W-2, Form 1099, or other tax document shows an incorrect SSN or name, notify your employer or the form-issuing agent. If the name or number on your social security card is incorrect, call the Social Security Administration at 1-800-772-1213.

**Rounding off.** It is easier to complete your tax return if you round off all money amounts. This means that you drop amounts under 50 cents. For example, \$25.32 becomes \$25.00. You increase amounts that are 50 cents or more to the next dollar so that, for example, \$25.50 becomes \$26.00.

If you do round off, do so for all amounts on your return. However, if you have to add two or more amounts to figure the total to enter on a line, include cents when adding the amounts and round off only the total.

**Records and receipts.** Do not send in records, receipts, or canceled checks with your tax return. Keep your records available so that you can produce them if the amounts you claim on your return are ever questioned.

You generally should keep records that support items of income or deductions on a return for 3 years from the date the return was filed or two years from the date the tax was paid, whichever is later.

You should keep records that relate to the cost of property as long as they are important in figuring its basis. See Chapter 1.

**Filing reminders.** Before you file your return, be sure you do all of the following.

- Make sure the information on all Forms W-2 you receive is correct.
- Put all income, deductions, credits, and tax items on the correct lines.
- Check your social security numbers or ITINs. Incorrect or missing numbers for you, your spouse, or your dependents may delay your refund.
- Use the correct chart or worksheet if you take the standard deduction.
- Use the correct column in the Tax Table or the appropriate Tax Rate Schedule.
- Check your math carefully.
- Sign and date your return and enter your occupation. On a joint return both husband and wife must sign.
- If you received a tax return package with a peel-off label showing your address, transfer the label to your return and make any necessary corrections to it. Use the label from your federal tax return package and not the one that came with your state tax return. Using the label helps us identify your account, saves processing time, and speeds refunds.
- If you are married filing a joint return and did not get a label, or you are married filing a separate return, enter your spouse's social security number in the spaces provided on your tax form.
- Attach all Forms W-2 to the left margin of the front page of your return.
- Attach all forms and schedules in attachment sequence number order. See Chapter 1.
- Send your check or money order for the amount you owe. Write your social security number, name, address, daytime telephone number, form number and tax year on your

check or money order. Use Form 1040-V, *Payment Voucher*, to send your payment, and put it loose in the mailing envelope.

**Note.** If you pay the first installment of your 1997 estimated tax at the same time you file your 1996 return, **do not** send it with your return. Use a separate check or money order and mail it in a separate envelope to the address for your area given in the instructions for Form 1040-ES, *Estimated Tax for Individuals*.

**Death of taxpayer.** If a taxpayer died before filing a required return, the taxpayer's personal representative must file and sign a return for that person. A personal representative can be an executor, administrator, or anyone who is in charge of the taxpayer's property. If a joint return is filed, the surviving spouse must also sign it. If no personal representative has been appointed, see Chapter 4.

**Copy of return.** Keep a copy of your tax return. It may be helpful in amending a filed return or preparing future returns. You can ask the IRS for a copy of a prior year tax return or a transcript of tax account information. See Chapter 1.

**Gift to reduce the public debt.** You can make a voluntary gift to reduce the public debt. To do so, make a check payable to *Bureau of the Public Debt*. You can send it to:

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

Or, you can enclose the check with your 1996 income tax return when you file. See Chapter 1.

**Where to file.** If an envelope addressed to the IRS came with your 1996 return, please use it to mail your return, and be sure to use enough postage. If you do not have it, or if you moved during the year, mail your return to the address listed for your area under *Where Do I File?* in your tax form instruction booklet.

**File on time — even if you cannot pay.** If you do not have the money to pay the amount you owe on your return, you should file your return on time and pay what you can. The IRS will bill

you for the balance due, plus interest if the balance is not paid by the due date. You may also have to pay a failure-to-pay penalty.

If you do not file your return by the due date, you will have to pay interest on the amount you owe, and you may have to pay a failure-to-pay penalty plus interest on the penalty. You may also have to pay a failure-to-file penalty, plus interest. See Chapter 1.

**Installment agreement.** If you cannot pay the full amount due with your return, you may ask to make monthly installment payments. See Chapter 1.

**Amended return.** If you find changes in your income, deductions, or credits after you mail your return, file Form 1040X, *Amended U.S. Individual Income Tax Return*, to change the return you already filed. See Chapter 1.

**Penalties.** Certain "accuracy" penalties can be imposed, including the penalties for negligence and for substantial understatement of income tax. There are also penalties for failing to provide a social security number and for fraud. See Chapter 1.

**Address change.** If you move, be sure to notify the IRS using Form 8822, *Change of Address*. Mail it to the Service Center where you filed your last return. Addresses for the Service Centers are on the back of the form.

If you move after you file your return and you are expecting a refund, also notify the post office serving your old address. This will help to forward your check to your new address.

**Refund information.** You can use Tele-Tax to find out the status of your refund by telephone. (However, electronically filed return refund information may not be on your area's Tele-Tax system.) For details on how to use this service, see *What Is Tele-Tax?* in your tax form instruction booklet.

**Refund checks.** Be sure to cash your refund check soon after you receive it. Checks not cashed within 12 months of the date of the check will be canceled. See Chapter 1.

**Refund more or less than expected.** If you receive a check for a refund you are not entitled

to, or for an overpayment that should have been credited to estimated tax, do not cash the check. Call the IRS number for your area.

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

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

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

**Do you want more or less tax withheld in 1997?** If your 1996 refund is large and you want to have less tax withheld from your pay, you should get Form W-4, *Employee's Withholding Allowance Certificate*, from your employer. Complete Form W-4 claiming any additional allowances you are entitled to, and return the form to your employer. If you owe a large amount of tax this year, you may need to give your employer a completed Form W-4 claiming fewer allowances or asking for an additional amount to be withheld from each paycheck. See Chapter 5.

**Estimated tax.** Tax changes for 1997 may affect whether you must make estimated tax payments and the amount of your payments. Generally, you must make estimated tax payments if you expect to owe at least \$500 and you expect your withholding and credits to be less than the smaller of (1) 90% of the tax shown on your 1997 return or (2) 100% of the tax shown on your 1996 return. However, certain taxpayers may not be able to use 100% of their 1996 tax to figure their 1997 estimated tax payments. See Chapter 5.

**Unresolved tax problems.** The Problem Resolution Program is for taxpayers who have been unable to resolve their problems with the IRS. If you have a tax problem you cannot clear up through normal channels, write to your local IRS District Director or call your local

IRS office and ask for Problem Resolution assistance. If you have access to TTY/TDD equipment, you can call 1-800-829-4059 to ask for help from Problem Resolution.

This office cannot change the tax law or technical decisions. But it can help you clear up problems that resulted from previous contacts.

For more information about the Problem Resolution Program, get Publication 1546, *How to use the Problem Resolution Program of the IRS*.

**Privacy Act and paperwork reduction information.** The Privacy Act of 1974 and the

Paperwork Reduction Act of 1980 say that when we ask you for information we must first tell you what our legal right is to ask for the information, why we are asking for it, how it will be used, what could happen if we do not receive it, and whether your response is voluntary, required to

obtain a benefit, or mandatory under the law. A complete statement on this subject can be found in your tax form instruction booklet. ■

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# Part One.

## The Income Tax Return

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

### 1.

## Filing Information

### Important Changes for 1996

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

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

**Social security number for dependent.** You must provide the social security number (SSN) of each dependent you claim, regardless of the dependent's age. But you do not need to provide an SSN for a child born in December of 1996. For more information, see *Social Security Number*, under *How Do I Prepare My Return?* later.

**Alaska Permanent Fund dividends.** A dividend from the Alaska Permanent Fund can now be reported on Form 1040A, line 12, or Form 1040EZ, line 3, as well as on Form 1040, line 21. Please see Chapter 13 for more information about this income.

**Service in hazardous duty area or combat zone.** You are allowed additional time to take care of tax matters if you are a member of the Armed Forces who served in the Persian Gulf Area combat zone, or a qualified hazardous duty area (Bosnia and Herzegovina, Croatia, or Macedonia) in the former Yugoslavia, or if you are not a member of the Armed Forces but served in the combat zone or hazardous duty area in support of the Armed Forces. You are allowed additional time for filing your tax returns, paying your taxes, and filing claims for refunds. See *Individuals Serving in Combat Zone*, later, under *When Do I have To File?*

**Taxpayer identification number for aliens.** If you, or your dependent is a non-resident or resident alien who does not have—and is not eligible to get—a social security number, file **Form W-7** with the IRS to apply for an Individual Taxpayer Identification Number (ITIN). You enter this number wherever the SSN is requested, and you use it for tax purposes only.

For more information on an ITIN:

- For you or your dependent, see *Social Security Number* under *How Do I Prepare My Return?*
- For your qualifying child, see *Social security number* under *Who Can Claim the Credit* in Chapter 35.

### Important Reminders

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

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

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

**Electronic filing.** You may want to take advantage of filing your return electronically instead of on a paper form. Electronic filing can shorten the time for processing returns to within 3 weeks. See *Electronic Filing*, later, under *Does My Return Have To Be On Paper?*

**Computerized returns.** You may want to prepare your return on a personal computer. This return, called a 1040PC return, can be processed faster and more accurately than the regular tax return. Whenever this chapter refers to Form 1040, it generally also includes a 1040PC return. See *Computerized Returns*, later, under *Does My Return Have To Be On Paper?* for more information.

## Introduction

This chapter discusses:

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

## Do I Have To File a Return?

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

- Individuals—In General
  - Surviving Spouses, Executors, Administrators, or Legal Representatives
  - U.S. Citizens Living Outside the U.S.
  - Residents of Puerto Rico
  - Individuals With Income From U.S. Possessions
- Dependents
- Children Under Age 14
- Self-Employed Persons
- Aliens

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



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

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

## Individuals—In General

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

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

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

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

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

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

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

**Age.** If you are 65 or older at the end of the year, you generally can have a higher amount of gross income than other taxpayers before you must file. See *Table 1-1*. You are considered 65 on the day before your 65th birthday. For example, if your 65th birthday was on January 1, 1997, you are considered 65 for 1996.

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

You must file a final return for a decedent (a person who died) if:

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

For more information on rules for decedents, see Chapter 4.

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

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

## Residents of Puerto Rico

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

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

**Table 1-1. 1996 Filing Requirements for Most Taxpayers**

To use this table, first find your marital status at the end of 1996. Then, read across to find your filing status and age at the end of 1996. You must file a return if your gross income was at least the amount shown in the last column.			
Gross income means all income you received in the form of money, goods, property, and services that is not exempt from tax, including any gain on the sale of your main home (even if you may exclude or postpone part or all of the gain). When using this table, do not count social security benefits as gross income unless you are married filing a separate return and lived with your spouse at any time in 1996. (If you must count the benefits, see <i>Married filing separately and living with spouse</i> under <i>Are Any of Your Benefits Taxable?</i> in Chapter 12 for the amount of social security benefits to count.)			
Also, see <i>Table 1-2</i> and <i>Table 1-3</i> for other situations when you must file.			
Marital Status	Filing Status	Age*	Gross Income
Single (including divorced and legally separated)	Single	under 65 65 or older	\$6,550 \$7,550
	Head of household	under 65 65 or older	\$8,450 \$9,450
Married with a child and living apart from your spouse during the last 6 months of 1996	Head of household	under 65 65 or older	\$8,450 \$9,450
		Married, joint return	under 65 (both spouses) 65 or older (one spouse) 65 or older (both spouses)
Married and living with your spouse at end of 1996 (or on the date your spouse died)	Married, separate return	any age	\$2,550
	Married, not living with your spouse at the end of 1996 (or on the date your spouse died)	Married, joint or separate return	any age
Widowed before 1996 and not remarried in 1996		Single	under 65 65 or older
	Head of household		under 65 65 or older
	Qualifying widow(er) with dependent child	under 65 65 or older	\$9,250 \$10,050

\* If you were age 65 on January 1, 1997, you are considered to be age 65 at the end of 1996.

## Individuals With Income From U.S. Possessions

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

## Dependents

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

**Responsibility of parent.** If a dependent child with taxable income cannot file an income tax return, a parent, guardian, or other legally responsible person must file it for the child. If the child cannot sign the return, the filer must sign the child's name followed by the words "By (signature), parent (or guardian) for minor child."

A child is liable for his or her own tax. But if a child's income tax is not paid, the parent or guardian is liable for the tax on the child's salaries and wages, but not for any tax on any other income of the child.

**Child's income.** Amounts a child earns by performing services are his or her gross income. This is true even if under local law the child's parents have the right to the earnings and may actually have received them.

## Children Under Age 14

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

## Self-Employed Persons

You are self-employed if you:

- Carry on a trade or business as a sole proprietor.

- Are an independent contractor.
- Are a member of a partnership.
- Are in business for yourself in any other way.

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

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

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

**Gross income.** For purposes of the filing requirements, your gross income includes all income you receive in the form of money, goods, property, and services that is not exempt from tax. This includes the gross income amount on line 7 of Schedule C (Form 1040), *Profit or Loss From Business*, or line 1 of Schedule C-EZ (Form 1040), *Net Profit From Business*.

**Net earnings of \$400 or more.** You must file a tax return if you had net earnings of \$400 or more from self-employment. This applies regardless of your age.

Net earnings from self-employment are figured on line 4 of Schedule SE (Form 1040), Section A or line 4c of Schedule SE (Form 1040), Section B.

**Minimum amount.** You must have \$400 or more of net earnings from self-employment to be subject to self-employment tax. If your net earnings are less than \$400, you do not have to pay the tax, unless you had church employee income of \$108.28 or more.

**Self-employment tax.** Self-employment tax is comparable to the social security and Medicare tax withheld from an employee's wages.

The combined self-employment tax rate for 1996 is 15.3%. The 15.3% rate is a total of 12.4% for social security and 2.9% for Medicare. Use **Schedule SE** (Form 1040), *Self-Employment Tax*, to figure your tax. Attach it to Form 1040. A copy of this schedule is shown in Chapter 39.

**Maximum amount.** No more than \$62,700 of your combined wages, tips, and net earnings in 1996 is subject to any combination of the 12.4% social security part of self-employment tax, social security tax, or railroad retirement (tier 1) tax.

However, all of your net earnings from self-employment in 1996 are subject to the 2.9% Medicare part of self-employment tax.

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

**Table 1-2. 1996 Filing Requirements for Dependents**  
See Chapter 3 to find out if someone can claim you as a dependent.

<p>If your parent (or someone else) can claim you as a dependent, and any of the situations below applies to you, you must file a return. (See <i>Table 1-3</i> for other situations when you must file.)</p> <p>In this table, <b>earned income</b> means salaries, wages, tips, and professional fees. It also includes taxable scholarship and fellowship grants (see <i>Scholarship and Fellowship Grants</i> in Chapter 13).</p> <p><b>Unearned income</b> is investment-type income such as interest, dividends, and capital gains. It also includes unemployment compensation, taxable social security benefits, pensions, annuities, and distributions of unearned income from a trust.</p> <p><b>Caution:</b> If your gross income was \$2,550 or more, you generally cannot be claimed as a dependent unless you were under age 19 or a full-time student under age 24. For details, see <i>Gross Income Test</i> in Chapter 3.</p>
<p><b>Single dependents</b>—Were you either age 65 or older or blind?</p> <p><input type="checkbox"/> <b>No.</b> You must file a return if any of the following apply.</p> <ul style="list-style-type: none"> <li>• Your unearned income was \$1 or more, and the total of that income plus your earned income was more than \$650.</li> <li>• You had no unearned income, and your earned income was more than \$4,000.</li> </ul> <p><input type="checkbox"/> <b>Yes.</b> You must file a return if any of the following apply.</p> <ul style="list-style-type: none"> <li>• Your earned income was more than \$5,000 (\$6,000 if 65 or older <b>and</b> blind),</li> <li>• Your unearned income was more than \$1,650 (\$2,650 if 65 or older <b>and</b> blind),</li> <li>• Your gross income was more than:             <ol style="list-style-type: none"> <li>1) The larger of \$650 or your earned income (up to \$4,000), plus</li> <li>2) \$1,000 (\$2,000 if 65 or older <b>and</b> blind).</li> </ol> </li> </ul>
<p><b>Married dependents</b>—Were you either age 65 or older or blind?</p> <p><input type="checkbox"/> <b>No.</b> You must file a return if any of the following apply.</p> <ul style="list-style-type: none"> <li>• Your gross income was at least \$5 and your spouse files a separate return on Form 1040 and itemizes deductions.</li> <li>• You had no unearned income, and your earned income was more than \$3,350,</li> <li>• Your unearned income was \$1 or more, and the total of that income plus your earned income was more than \$650.</li> </ul> <p><input type="checkbox"/> <b>Yes.</b> You must file a return if any of the following apply.</p> <ul style="list-style-type: none"> <li>• Your earned income was more than \$4,150 (\$4,950 if 65 or older <b>and</b> blind),</li> <li>• Your unearned income was more than \$1,450 (\$2,250 if 65 or older <b>and</b> blind),</li> <li>• Your gross income was more than:             <ol style="list-style-type: none"> <li>1) The larger of \$650 or your earned income (up to \$3,350), plus</li> <li>2) \$800 (\$1,600 if 65 or older <b>and</b> blind).</li> </ol> </li> </ul>

a wholly owned instrumentality of a foreign government, and if your work is exempt from social security and Medicare taxes, you must pay self-employment tax on earnings from services performed in the United States.

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

**Employees of churches.** You will have to pay self-employment tax if:

- 1) You work for a church or a qualified church-controlled organization that elected exemption from social security and Medicare taxes,
- 2) You receive \$108.28 or more from the church or organization as its employee (other than as a minister or a member of a religious order), and
- 3) You have not elected to be exempt from social security taxes as a member of a qualifying religious sect.

See Publication 533, *Self-Employment Tax*, for more information.

## Aliens

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

The rules used to determine if you are a resident or nonresident alien are discussed in Publication 519, *U.S. Tax Guide for Aliens*.

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

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

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

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

## Who Should File



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

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

## Which Form Should I Use?

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

### Form 1040EZ

Form 1040EZ is the simplest form to use.

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

- Your filing status is single or married filing jointly.

- You (and your spouse if married filing a joint return) were under age 65 on January 1, 1997, and not blind at the end of 1996.
- You do not claim any dependents.
- Your taxable income is less than \$50,000.
- Your income is only from wages, salaries, tips, unemployment compensation, Alaska Permanent Fund dividends, taxable scholarship and fellowship grants, and taxable interest of \$400 or less.
- You did not receive any advance earned income credit (EIC) payments.
- If you were a nonresident alien at any time in 1996, your filing status is married filing jointly.
- You do not owe any household employment taxes on wages you paid to a domestic employee.

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

**Table 1-3. Other Situations When You Must File a 1996 Return**

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

1. You owe any special taxes, such as:

- Social security or Medicare tax on tips you did not report to your employer. (See Chapter 7.)
- Uncollected social security, Medicare, or railroad retirement tax on tips you reported to your employer. (See Chapter 7.)
- Uncollected social security, Medicare, or railroad retirement tax on your group-term life insurance. (See Chapter 31.)
- Alternative minimum tax. (See Chapter 31.)
- Tax on a qualified retirement plan, including an individual retirement arrangement (IRA). (See Chapter 18.)
- Tax from recapture of investment credit or a low-income housing credit you claimed in a previous year. (See the instructions for Form 4255, *Recapture of Investment Credit*, or Form 8611, *Recapture of Low-Income Housing Credit*.)
- Recapture tax on the disposition of a home purchased with a federally-subsidized mortgage. (See Chapter 16.)
- Recapture of the qualified electric vehicle credit. (See Chapter 36.)

2. You received any advance earned income credit (EIC) payments from your employer. This amount should be shown in box 9 of your Form W-2. (See Chapter 35.)

3. You had net earnings from self-employment of at least \$400. (See “Self-Employed Persons.”)

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

## Form 1040A

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

### You can use Form 1040A if:

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

If you file Form 1040A, you can claim estimated tax payments for 1996 and the exclusion of interest from Series EE U.S. savings bonds issued after 1989.

If you do not meet all of the above requirements, you cannot use Form 1040A. For example, you may want to claim itemized deductions, which you cannot claim on Form 1040A. Check the list under *Form 1040* to see if you must use Form 1040.

## Form 1040

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

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

### You must use Form 1040 if:

- Your taxable income is \$50,000 or more.
- You itemize your deductions.

- You received or paid accrued interest on securities transferred between interest payment dates.
- You received nontaxable dividends or capital gain distributions.
- You have to complete Part III of Schedule B (Form 1040) because:

You were a grantor of, or transferor to, a foreign trust that existed during 1996, or

At any time during the year you had an interest in, or signature or other authority over, a bank, securities, or other financial account in a foreign country. **Note:** If the combined value of the foreign account(s) is \$10,000 or less during all of 1996, or if the account(s) was with a U.S. military banking facility operated by a U.S. financial institution, you may be able to use Form 1040A or Form 1040EZ.

- You had income that cannot be reported on Form 1040EZ or Form 1040A. This includes gain from the sale of your home or other property, barter income, alimony income, taxable refunds of state and local income taxes, and self-employment income (including farm income).
- You sold or exchanged capital assets or business property.
- You claim adjustments to gross income for moving expenses, the deduction for self-employment tax, payments for self-employed health insurance, payments to a Keogh or SEP plan, the penalty on early withdrawal of savings, alimony paid, certain required repayments of supplemental unemployment benefits, jury pay turned over to your employer, qualified performing artists' expenses, or other allowable adjustments to income.
- Your Form W-2 shows uncollected employee tax (social security and Medicare tax) on tips or group-term life insurance in box 13. See Chapter 7.
- You received \$20 or more in tips in any one month, and you did not report all of these tips to your employer. See Chapter 7.
- You must pay tax on self-employment income. See Schedule SE (Form 1040), *Self-Employment Tax*.
- You have to recapture an investment credit, a low-income housing credit, a qualified electric vehicle credit, or an Indian employment credit you claimed in a previous year.
- You have to recapture tax on the disposition of a home purchased with a federally-subsidized mortgage. See Chapter 16.
- You have to pay tax on an excess golden parachute payment.
- You claim credits against your tax for any of the following:
  - Mortgage interest credit
  - Foreign tax credit

Any general business credit  
Credit for prior year minimum tax  
Credit for fuel from a nonconventional source  
Credit for federal tax on fuels  
Qualified electric vehicle credit  
Regulated investment company credit

- You file any of the following:

Form 2119, *Sale of Your Home* (when filed in the year of sale)  
Form 2555, *Foreign Earned Income*  
Form 2555-EZ, *Foreign Earned Income Exclusion*  
Form 4563, *Exclusion of Income for Bona Fide Residents of American Samoa*  
Form 4970, *Tax on Accumulation Distribution of Trusts*  
Form 4972, *Tax on Lump-Sum Distributions* (See Chapter 11.)  
Form 5329, *Additional Taxes Attributable to Qualified Retirement Plans (Including IRAs), Annuities, and Modified Endowment Contracts*  
**Note:** If you are filing Form 1040 solely because you have to file Form 5329, do not file Form 1040, you only have to file Form 5329. (See Chapters 11 and 18.)  
Form 8271, *Investor Reporting of Tax Shelter Registration Number*  
Form 8814, *Parents' Election To Report Child's Interest and Dividends*

## When Do I Have To File?

April 15, 1997, is the due date for filing your 1996 income tax return if you use a calendar year. For a quick view of due dates for filing a return with or without an extension of time to file (discussed later), see *Table 1-4*.

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

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

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

postmarked certified mail receipt is evidence that the return was delivered.

**Private delivery services.** In addition to the United States Postal Service, private delivery services (to be designated by the IRS) can be used to meet the timely mailing as timely filing and paying rule (for example, to send your tax return to the IRS). When this publication was printed, no private delivery had been designated. When they are, the IRS will make every effort to publicize the information.

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

**Nonresident alien.** If you are a nonresident alien and earn wages that are subject to U.S. income tax withholding, your 1996 U.S. income tax return ( Form 1040NR or Form 1040NR-EZ) is due by:

- April 15, 1997, if you use a calendar year, or
- The 15th day of the 4th month after the end of your fiscal year if you use a fiscal year.

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

- June 16, 1997, if you use a calendar year, or
- The 15th day of the 6th month after the end of your fiscal year, if you use a fiscal year.

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

**Filing for a decedent.** If you must file a final return as an executor, administrator, legal representative, or surviving spouse of a taxpayer who died during the year (a decedent), the income tax return is due by the 15th day of the 4th month after the end of the deceased taxpayer's normal tax year. In most cases, for a 1995 return, this will be April 15, 1997. See *Final Return for the Decedent* in Chapter 4.

## Extensions of Time To File

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

- Outside the United States, or
- Serving in a combat zone or a qualified hazardous duty area.

These rules are discussed separately.

**Form 4868.** If you are not able to file your 1996 return by the due date, you may be able to get an automatic 4-month extension of time to file. To get the automatic extension, you must file Form 4868, *Application for Automatic Extension of Time To File U.S. Individual Income Tax Return*.

Table 1-4. **When to File Your 1996 Return** (For U.S. citizens and residents who file returns on a calendar year)

	For Most Taxpayers	For Certain Taxpayers Outside the U.S.
<b>No extension requested</b>	April 15, 1997	June 16, 1997
<b>Form 4868 filed (1st extension)</b>	August 15, 1997	August 15, 1997
<b>Form 2688 filed after filing Form 4868 (2nd extension)</b>	October 15, 1997	October 15, 1997

**Example.** If your return is due on April 15, 1997, you will have until August 15, 1997, to file.

**Caution: You may not be eligible.** If you want the IRS to figure your tax, you cannot use the automatic extension of time to file. If you are under a court order to file by the regular due date, you also cannot use the automatic extension of time to file.

**When to file.** You must file Form 4868 by April 15, 1997. If you are filing a fiscal year return, file Form 4868 by the regular due date for your return. You can file Form 1040EZ, Form 1040A, or Form 1040 any time before the 4-month extension period ends.

**Time to pay not extended.** An extension of time to file is not an extension of time to pay. You must make an accurate estimate of your tax for 1996 and send any necessary payment with your Form 4868. If you find you cannot pay the full amount due with Form 4868, you can still get the extension. You will owe interest on the unpaid amount.

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

Interest and penalties are assessed (charged) from the original due date of the return, which, for most taxpayers, is April 15, 1997.

**When you file your return.** Enter any payment you made with Form 4868 on line 55, Form 1040. If you file Form 1040EZ or Form 1040A, include any payment you made with Form 4868 in your total payments on line 9 of Form 1040EZ or line 29d of Form 1040A. Also write "Form 4868" and the amount paid in the space to the left of line 9 or line 29d.

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

You can apply for an extension beyond the 4-month extension either by a letter to the IRS or by filing **Form 2688**, *Application*

*for Additional Extension of Time To File U.S. Individual Income Tax Return*. You should request the extension early so that, if refused, you still will be able to file on time. Except in cases of undue hardship, Form 2688 or a request by letter will not be accepted until you have first used Form 4868 to get an automatic 4-month extension. Form 2688 or your letter will not be considered if you file it after the extended due date.

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

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

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

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

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

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

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

### Individuals Outside the U.S.

You are allowed an automatic 2-month extension (until June 16, 1997, if you use a calendar year) to file your 1996 return and pay any federal income tax that is due if you are a U.S. citizen or resident and on the regular due date of your return (April 15, 1997, if you use a calendar year):

- 1) You are living outside of the United States and Puerto Rico, and your main place of business or post of duty is outside the United States and Puerto Rico, **or**
- 2) You are in military or naval service on duty outside the United States and Puerto Rico.

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

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

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

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

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

**Extensions beyond 2 months.** If you are unable to file your return within the automatic 2-month extension period, you may be able to get an additional 2-month extension of time to file your return, for a total of 4 months. You must file Form 4868 by the end of the automatic extension period (usually June 16, 1997) to get this additional 2-month extension.

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

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

**No further extensions.** An extension of more than 6 months will generally not be granted. However, if you are outside the

United States and meet certain tests, you may be granted a longer extension. See *When To File and Pay* in Publication 54 for more information.

### Individuals Serving in Combat Zone

If you served in the Armed Forces in the Persian Gulf Area combat zone, or in a qualified hazardous duty area (Bosnia and Herzegovina, Croatia, or Macedonia) in the former Yugoslavia, the deadline for filing your tax return, paying any tax that you may owe, and filing a claim for refund is automatically extended. The deadline is also extended if you served in the combat zone or in a qualified hazardous duty area in support of the Armed Forces, even though you were not a member of those forces. This category includes Red Cross personnel, accredited correspondents, and civilians under the direction of the Armed Forces in support of the Armed Forces.

For purposes of the deadline extension, the Persian Gulf Area became a combat zone on August 2, 1990, and Bosnia and Herzegovina, Croatia, and Macedonia became a qualified hazardous duty area on November 21, 1995. See Publication 3 for more information on these and other benefits.

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

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

In addition to the 180 days, your deadline is also extended by the number of days you had left to file when you entered the Persian Gulf Area combat zone or qualified hazardous duty area. For example, you have 3½ months (January 1 – April 15, 1997) to file your 1996 tax return. Any days of this 3½-month period that are left when you entered the combat zone or qualified hazardous duty area (or the entire 3½ months if you entered the combat zone or qualified hazardous duty area before January 1, 1997) are added to the 180 days to find the end of your time extension for filing your 1996 return.

## How Do I Prepare My Return?

This section explains how to get ready to fill in your tax return, including when to report your income and expenses. It also explains how to complete certain sections of the form. You may find *Table 1-5* helpful when you prepare your return.

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

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

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

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

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

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

**Tax help on videotape.** A videotape of tax return instructions is available in either English or Spanish at participating libraries.

Table 1-5. **6 Steps for Preparing Your Return**

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

## When Do I Report My Income and Expenses?

You must figure your taxable income on the basis of a tax year. A “tax year” is an

annual accounting period used for keeping your records and reporting your income and expenses. You must account for your income and deductions in a way that clearly shows your taxable income. The way you do this is called an accounting method. This section explains which accounting periods and methods you can use.

## Accounting Periods

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

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

**Changing your accounting period.** If you want to change your accounting period, you generally must get permission from the IRS. Use **Form 1128, Application To Adopt, Change, or Retain a Tax Year**. Form 1128 must be filed by the 15th day of the second calendar month of the requested accounting period. The new period cannot be used until you receive approval from IRS. A fee is charged to request a change in your accounting period.

**Example.** Last year, you were an employee and filed your income tax return on a calendar year basis. On July 1 this year you quit your job and open your own repair shop. For business reasons, you want to file your income tax return on a fiscal year basis from July 1 to June 30. To change your accounting period, complete and send Form 1128 by August 15.

**Additional information.** For more information on accounting periods, see Publication 538, *Accounting Periods and Methods*.

## Accounting Methods

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

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

**Constructive receipt.** You constructively receive income when it is credited to your account, or is set apart in any way that makes it available to you. You do not need

to have physical possession of it. For example, interest credited to your bank account on December 31, 1996, is taxable income to you in 1996 if you could have withdrawn it in 1996 (even if the amount is not entered in your passbook or withdrawn until 1997).

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

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

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

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

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

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

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

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

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

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

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

**Changing your accounting method.** Once you have chosen your accounting method, you ordinarily cannot change it without the permission of the IRS. However, you can choose a different method for each business you have when you report income from it for the first time.

**Example.** You work for a salary and use the cash method to report that income on your tax return. You open a gift shop and continue to work for a salary. Even though you use the cash method for your salary, you can use an accrual method for reporting income from your gift shop.

**How to change.** If you want to change your accounting method, get Form 3115, *Application for Change in Accounting Method*. In general, Form 3115 must be filed within 180 days after the beginning of the year of change. A fee is charged to request a change in your accounting method.

**Additional information.** For more information on accounting methods, get Publication 538.

## Social Security Number

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

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

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

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

**Exception.** You do not need to provide an SSN for a child born in December of 1996.

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

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

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

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

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

**Nonresident alien spouse.** If your spouse is a nonresident alien and you file a joint or separate return, your spouse must have either an SSN or an Individual Taxpayer Identification Number (ITIN). If your spouse is not eligible to get an SSN, see the next discussion.

**Individual taxpayer identification number (ITIN) for aliens.** The IRS will issue you an ITIN if you are a nonresident or resident alien and you do not have and are not eligible to get a social security number (SSN). **To apply for an ITIN**, file **Form W-7** with the IRS. See *How To Get Forms, Publications, and Other Information*, at the end of this publication, to find out how to get the form. It usually takes about 30 days to get an ITIN. Enter this number on your tax return wherever your SSN is requested, and use it for tax purposes only. An incorrect or missing taxpayer identification number may increase your tax or reduce your refund.

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



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

**Penalty for not providing social security number.** If you do not include your SSN or the SSN of your spouse or dependent as required, you may have to pay a

penalty. See the discussion on *Penalties*, later, for more information.

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

## Presidential Election Campaign Fund

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

## Rounding Off Dollars

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

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

**Example.** You receive two W-2 forms: one showing wages of \$5,000.55 and one showing wages of \$18,500.73. On Form 1040, line 7, you would enter \$23,501 (\$5,000.55 + \$18,500.73 = \$23,501.28) instead of \$23,502 (\$5,001 + \$18,501).

## Additional Schedules

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

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

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

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

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

- Schedule A to itemize your deductions.
- Schedule B to report over \$400 in interest or dividends (including capital gain and nontaxable distributions), to answer the foreign accounts and foreign trusts questions, or to report interest or dividend income (even if \$400 or less) if certain conditions apply. Those conditions are listed under *How To Report Interest Income* in Chapter 8.
- Schedule C or Schedule C-EZ to report profit or loss subject to self-employment tax from a business you operated or a profession you practiced as a sole proprietor, and to report wages and expenses you had as a statutory employee.
- Schedule D to report capital gains and losses.
- Schedule E to report income or loss from rental real estate, royalties, partnerships, estates, trusts, S corporations, and REMICs (residual interests).
- Schedule EIC to take the earned income credit.
- Schedule F to report farm income and expenses.
- Schedule H to figure employment taxes on cash wages you paid to a household employee.
- Schedule R to take the credit for the elderly or the disabled.
- Schedule SE to figure self-employment tax.

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

- 1) You received more than \$400 in either interest or dividends, or
- 2) You had a foreign account or were the grantor of, or transferor to, a foreign trust.

If you checked **Yes** to the question on line 11a, Part III of Schedule B, you must file Form TD F 90-22.1, *Report of Foreign Bank and Financial Accounts*, by June 30, 1997, with the Department of the Treasury at the address shown on the form. Form TD F 90-22.1 is not a tax return, so do not attach it to your Form 1040. Be sure to file your Form 1040 with the IRS. You can get Form TD F 90-22.1 by using the order blank at the end of this publication.

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

**Assembling your return.** Attach all forms and schedules behind Form 1040 in order of the "Attachment Sequence Number" shown in the upper right corner of the form or schedule. Put forms without an attachment sequence number next. Then arrange all other statements or attachments

in the same order as the forms and schedules they relate to and attach them last. Do not attach items unless required to do so.

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

## Signatures

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

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

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

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

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

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

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

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

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

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

**Power of attorney.** A return signed by an agent in any of these cases must have a

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

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

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

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

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

## Refunds

When you complete your return, you will determine if you paid more income tax than you owed. If so, you can get a refund of the amount you overpaid or, if you file Form 1040 or Form 1040A, you can choose to apply all or part of the overpayment to your next year's (1997) estimated tax.



*If you choose to have a 1996 overpayment applied to your 1997 estimated tax, you cannot change your mind and have any of it refunded to you after the due date of your 1996 return.*

You cannot have your overpayment applied to your 1997 estimated tax if you file Form 1040EZ.

Follow the instructions in your tax forms package to complete the entries to claim your refund and/or to apply your overpayment to your 1997 estimated tax.



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



*The IRS may not accept direct deposit requests if the refund claimed differs by more than \$50 from what the IRS computes. Nor will there be direct deposit of refunds into foreign bank accounts. Direct deposit cannot be*

*used when filing a prior year return or for filing a joint return for a spouse who died during 1996. Also, direct deposit will not occur if the name on the tax return and bank account do not match. If the direct deposit cannot be done, the IRS will send a check instead.*

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

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

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

## Amount You Owe

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

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



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

## Interest

You will have to pay interest on any tax you owe that is not paid by the due date of your return. Interest is charged even if you get an extension of time for filing.



*If you choose to have the IRS figure your tax for you, interest cannot start earlier than the 31st day after the IRS sends you a bill. For information on this choice, see Tax Figured by IRS in Chapter 31.*

**Interest on penalties.** Interest is charged on the failure-to-file penalty, the accuracy-related penalty, and the fraud penalty from the due date of the return (including extensions) to the date of payment. Interest on other penalties starts on the date of notice and demand, but is not charged on penalties paid within 10 days from the date of the notice.

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

officer or employee of the IRS in performing a ministerial act. This is a procedural or mechanical act that occurs during the processing of a taxpayer's case.

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

## How To Pay

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

For example, if you file Form 1040 for 1996 and you owe additional tax, show your name and address, social security number, daytime telephone number, and *1996 Form 1040* on the front of your check or money order. If you file an amended return (Form 1040X) for 1995 and you owe tax, show your name and address, social security number, daytime telephone number, and *1995 Form 1040X* on the front of your check or money order.

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

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

**Payment voucher.** If you have a balance due on line 62 of your 1996 Form 1040 and you receive **Form 1040-V, Payment Voucher**, use it to send us your payment. This will help us process your payment more accurately and efficiently. Follow the instructions that come with the form.

**Estimated tax payments.** Do not include any estimated tax payment in your check or money order that is payment for your 1996 income tax return. Mail the estimated tax payment separately to the address shown in the Form 1040-ES instructions. The address for mailing estimated tax payments is different from the address for sending your tax return.

**Waiver of estimated tax penalty.** If you underpaid your 1996 estimated tax, you may be eligible for a waiver of the penalty for the underpayment. See Chapter 5.

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

## Installment Agreement

If you cannot pay the full amount due with your return, you may ask to make monthly installment payments. However, you will be charged interest and may be charged a late payment penalty on the tax not paid by April 15, 1997, even if your request to pay in installments is granted. If your request is

granted, you must also pay a fee. To limit the interest and penalty charges, pay as much of the tax as possible with your return. But before requesting an installment agreement, you should consider other less costly alternatives, such as a bank loan.

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

## Gift To Reduce the Public Debt

You can make a contribution (gift) to reduce the public debt. If you wish to do so, make a **separate** check payable to *Bureau of the Public Debt*. You can send it to the Bureau of the Public Debt, Department G, Washington, DC 20239-0601. Or, you can enclose the check in the envelope with your income tax return. Please do not add this gift to any tax you owe. If you owe tax, include a separate check for the tax payable to *Internal Revenue Service*.

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

## Peel-Off Address Label

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

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

The coding on the label is used by the IRS in processing your return. The label helps to correctly identify your account. It also saves processing costs and speeds up processing so that refunds can be issued sooner.

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

**Correcting the label.** Make necessary name and address changes on the label. If you have an apartment number that is not shown on the label, please write it in. If you and your spouse file a joint return and maintain separate homes, choose one address to enter on your return. If the label is for a joint return and the social security numbers are not listed in the same order as

the first names, change the numbers to show the correct order. If your social security number is not correct, or if you changed your name, see the discussion under *Social Security Number*, earlier.

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

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

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

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

- 1) City,
- 2) Province or state,
- 3) Foreign postal code, and
- 4) Name of foreign country.

**Do not** abbreviate the name of the country.

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## Where Do I File?

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

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

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

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

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## Does My Return Have To Be On Paper?

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

- 1) Electronic filing,
- 2) On-line filing,
- 3) TeleFile (filing by telephone), and
- 4) Computerized returns (the 1040PC return, which is prepared on a personal computer and generally has fewer pages than a conventional return).

## Electronic Filing

You may be able to have your return filed electronically instead of on a paper form. Millions of taxpayers filed electronically last year. Most individuals can file electronically, whether their return shows a balance due or a refund.

Tax returns can be electronically filed through tax preparers, through a company that will transmit your return to the IRS, with your personal computer using an IRS-accepted on-line service company or transmitter, and through many IRS walk-in offices offering taxpayer assistance. Check your telephone book for tax preparers and other companies offering this service. If you plan to go to an IRS walk-in office, call 1-800-829-1040 for the site nearest you.

For this discussion, “preparer” includes transmitters, on-line service providers, and any other electronic filers the IRS accepted to file returns under the Electronic Filing Program.

For more information on electronic filing, a recorded message is available on the Tele-Tax system. The Tele-Tax number for your area is listed in your tax forms package.

**Benefits.** *Table 1-6* lists the benefits of electronic filing. Electronic filing uses automation to replace most of the manual steps needed to process paper returns. As a result, processing for electronic returns is faster and more accurate. However, errors on the return or problems with its transmission can delay processing.

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

Electronic filing does not affect your chances of an IRS examination of your return.

**Balance due.** If you have a balance due with your return, you must pay it by April 15, 1996 to avoid penalties and interest. Mail your payment with either:

- 1) The **Form 1040-V, Payment Voucher**, included in some tax forms packages (or provided by your preparer), or
- 2) The tear-off stub from the appropriate payment reminder notice.

**Refunds.** If you file a complete and accurate return, your refund will be issued within 21 days. However, some refunds may be temporarily delayed as a result of compliance checks. These checks make sure

**Table 1-6. Benefits of Filing Electronically**

<b>Accuracy</b>	<ul style="list-style-type: none"> <li>• Computer program quickly catches mistakes before they become problems</li> </ul>
<b>Acknowledgement</b>	<ul style="list-style-type: none"> <li>• IRS advises the preparer (or other transmitter) who filed your return that it has been accepted for processing</li> </ul>
<b>File Now, Pay Later</b>	<ul style="list-style-type: none"> <li>• File early and pay the balance due by April 15</li> </ul>
<b>Refunds</b>	<ul style="list-style-type: none"> <li>• Normally issued within 3 weeks</li> </ul>
<b>Simultaneous Federal/State Filing</b>	<ul style="list-style-type: none"> <li>• File both federal and state returns with the IRS at the same time (see <i>Federal/State electronic filing</i> for a list of participating states)</li> </ul>

that returns are filed accurately and that the refund is correctly determined.

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

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

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

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

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

**Federal/State electronic filing.** In most states, you can file an electronic state return simultaneously with your federal return.

For more information, check with your local IRS office, state tax agency, or tax preparer.

**Form 8453.** Your preparer will ask you to sign Form 8453, *U.S. Individual Income Tax Declaration for Electronic Filing*. Both spouses must sign if a joint return is being filed. Your preparer will file the form with the IRS. Your signature on the form:

- Certifies that the information on Form 8453 is correct and corresponds to the information on your return,
- Authorizes your preparer to file your return electronically,
- Authorizes the IRS to tell your preparer it has received your return, whether it has accepted or rejected your return for

processing, and the reason for rejection, if applicable, and

- Authorizes the IRS, if you elect direct deposit, to deposit your refund directly into your checking or savings account.

Your preparer will give you the required preparer-signed copy of your return, including a copy of the completed Form 8453. This material is for your records. Do not mail this copy to the IRS; if you do, your refund may be delayed.

**Refund inquiries.** The IRS will notify your preparer of the date your electronic return was accepted for processing. If you do not receive your refund within 3 weeks after the return was accepted by IRS, you can call Tele-Tax Automated Refund Information. The Tele-Tax number for your area is listed in your tax forms package. Before you call Tele-Tax, please have the following information from your return available:

- 1) The first social security number shown on the return,
- 2) Your filing status, and
- 3) The exact amount of your refund.

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

If Tele-Tax has no information on your return, contact your preparer for the date IRS accepted your return. If your return was accepted more than 3 weeks ago, contact your local IRS office. Explain that you filed your return electronically and that Tele-Tax has no information on it. Also, provide the first social security number shown on your return and the date the IRS accepted your return.

## On-Line Filing

If you have a computer, a modem, and the necessary software, you can file your own return electronically from home. To do this,

you must use an IRS-accepted on-line service company or transmitter. Contact one if you want more information about this way of filing. They will charge you a small fee if you use their services to file this way.

You may also be able to use your computer and modem to download and print tax forms, instructions, and publications. See *How To Get Forms, Publications, and Other Information* in the back of this publication for details.

## TeleFile, the File-By-Phone System

If you receive a TeleFile tax package, you may be able to file your Form 1040EZ information over the phone. Your filing status must be single or married filing jointly with no dependents, you must have a touch-tone phone, and you must meet the other requirements explained in the TeleFile package.

To use TeleFile, you must first fill in lines A, B, C, and D (and lines E, F, and G if you elect direct deposit of your refund), on the TeleFile Worksheet. Then call the number listed in the TeleFile tax package. Use your touch-tone phone to enter the information requested. TeleFile will then figure your tax and will tell you the amount of your refund or the amount you owe. Before you hang up, the system will give you a confirmation number that assures you your return has been accepted and filed. You will not have to mail any forms to the IRS.

The call takes about 10 minutes. If you are due a refund, you should get it within 3 weeks.

You can use TeleFile only if you receive the special TeleFile tax package in the mail from the IRS. You cannot order it. If you are eligible to use TeleFile, IRS sends you the package automatically.

## Computerized Returns

Almost anyone who files a tax return (Form 1040, 1040A, or 1040EZ) can now file a 1040PC return instead. You prepare a 1040PC return on a personal computer.

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

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

If you file a 1040PC return and are getting a refund, you can have the refund deposited directly to your checking or savings account.

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

## What Happens After I File?

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

## What Records Should I Keep?

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

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

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

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

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

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

applies to you. See Chapter 14 for information on basis.

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

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

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

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

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

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

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

## Interest on Refunds

If you are due a refund, you may also be entitled to receive interest on your overpayment. The interest rates are adjusted quarterly.

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

Accepting a refund check does not change your right to claim an additional refund and interest. File your claim within the applicable period of time. See *Amended*

*Returns and Claims for Refund*, later. If you do not accept a refund check, no more interest will be paid on the amount of the overpayment included in the check.

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

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

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

## Offset Against Debts

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

**Joint return and injured spouse.** When a joint return is filed and only one spouse is obligated to pay past-due child and spousal support or a federal debt, the spouse who is not obligated for the debt can be considered an *injured spouse*. An injured spouse can obtain a refund for his or her share of the overpayment that would otherwise be used to pay the past-due amount.

To be considered an injured spouse, you must:

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

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

## Change of Address

If you move, always notify in writing the Internal Revenue Service Center where you filed your last return, or the Chief, Taxpayer

Service Division, in your local IRS district office. You can use **Form 8822**, *Change of Address*, to notify us of your new address. If you move after filing your return and you are expecting a refund, also notify the post office servicing your old address. This will help to forward your check to your new address (unless you chose direct deposit of your refund).

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

## Past-Due Refund

If you do not get your refund within 6 weeks after filing your return, call Tele-Tax. For details on how to use this telephone service, see *What Is Tele-Tax?* in your tax forms package. Please wait 6 weeks after filing your 1996 tax return before using this service. However, see *Electronic Filing*, earlier, for information about refund inquiries when you file an electronic return.

## What If I Made a Mistake?

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

## Amended Returns and Claims for Refund

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

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

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

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

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

income and the amount you owe or your refund.

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

If you overpaid tax, you can have all or part of the overpayment refunded to you, or you can apply all or part of it to your 1996 estimated tax. If you choose to get a refund, it will be sent separately from any refund shown on your original return.

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

File a separate form for each tax year involved.

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

If the last day for claiming a credit or refund is a Saturday, Sunday, or legal holiday, the claim is considered timely if it is filed on the next business day.

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

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

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

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

**Example 1.** You made estimated tax payments of \$500 and got an automatic extension of time to August 15, 1993, to file your 1992 income tax return. When you filed your return on that date, you paid an additional \$200 tax. On August 15, 1996, you filed an amended return and claimed a refund of \$700. Because you filed your

claim within 3 years after you filed your return, you can get a refund of up to \$700, the tax paid within the 3 years plus the 4-month extension period immediately before you filed the claim.

**Example 2.** The situation is the same as in Example 1, except you filed your return on October 31, 1993, 2½ months after the extension period ended. You paid an additional \$200 on that date. On October 26, 1996, you filed an amended return and claimed a refund of \$700. Although you filed your claim within 3 years from the date you filed your original return, the refund was limited to \$200, the tax paid within the 3 years plus the 4-month extension period immediately before you filed the claim. The estimated tax of \$500 paid before that period cannot be refunded or credited.

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

**Example.** You filed your 1992 tax return on April 15, 1993. You paid taxes of \$500. On November 4, 1994, after an examination of your 1992 return, you had to pay an additional tax of \$200. On May 3, 1996, you file a claim for a refund of \$300. However, because you filed your claim more than 3 years after you filed your return, your refund will be limited to the \$200 you paid during the 2 years immediately before you filed your claim.

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

- A bad debt (see *Nonbusiness Bad Debts* in Chapter 15).
- A worthless security (see *Worthless securities* in Chapter 15).
- Foreign tax paid or accrued (see Publication 514, *Foreign Tax Credit for Individuals*).
- Net operating loss carryback (see Publication 536, *Net Operating Losses*).
- Carryback of certain business tax credits (see Publication 334, *Tax Guide for Small Business*).
- A claim based on an agreement with the Service extending the period for assessment of tax.
- An injured spouse claim (see *Offset Against Debts*, earlier).

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

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

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

You are filing a claim for a credit or refund based solely on contested income tax or on estate tax or gift tax issues considered in your previously examined returns, and

You want to take your case to court instead of appealing it within the IRS.

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

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

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

Also, your refund may be reduced by amounts you owe for past-due child support or debts to another federal agency. The IRS will notify you if this happens. The refund procedures discussed in this chapter will not be available to you to get back the reduction. However, if you are the spouse of a person who owes past-due amounts for these obligations and the reduced refund relates to an overpayment on a joint return, you may be able to get a refund of your share of the overpayment before or after it is used to pay the past-due amount. See *Offset Against Debts*, earlier.

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

## Penalties

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

### Civil Penalties

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

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

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

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

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

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

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

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

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

date, the minimum penalty is the smaller of \$100 or 100% of the unpaid tax.

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

- 1) You underpay your tax because of either “negligence” or “disregard” of rules or regulations, or
- 2) You substantially understate your income tax.

The penalty is equal to 20% of the underpayment.

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

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

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

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

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

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

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

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

*Internal Revenue Bulletin* that involve the same or similar circumstances as yours.

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

In cases of substantial understatement only, items that meet the requirements of Revenue Procedure 95-55 (or later update) are considered adequately disclosed on your return without filing Form 8275.

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

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

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

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

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

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

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

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

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

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

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

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

## Criminal Penalties

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

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

## 2.

# Filing Status

## Introduction

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

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

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

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

If you file Form 1040 or Form 1040A, indicate your filing status by checking the appropriate box on lines 1 through 5.

There are different tax rates for different filing statuses. To determine your correct amount of tax, use the column in the Tax Table or Tax Rate Schedule in your forms package that applies to your filing status.

## Useful Items

You may want to see:

### Publication

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

## Marital Status

In general, your filing status depends on whether you are considered unmarried or married.

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

**Divorced persons.** State law governs whether you are married, divorced, or legally separated under a decree of separate maintenance. If you are divorced under a final decree by the last day of the year, you are considered unmarried for the whole

year. If you obtain a divorce in one year for the sole purpose of filing tax returns as unmarried individuals, and at the time of divorce you intended to and did remarry each other in the next tax year, you and your spouse must file as married individuals.

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

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

**Married persons.** You and your spouse may be able to file a joint return, or you may file separate returns. You are considered married for the whole year if on the last day of your tax year you are either:

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

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

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

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

**Married persons living apart.** If you live apart from your spouse and meet certain tests, you may be **considered unmarried**. Therefore, you may file as head of household even though you are not divorced or legally separated. If you qualify

to file as head of household instead of as married filing separately, your standard deduction will be higher. Also, your tax may be lower, and you may be able to claim the earned income credit. See *Head of Household*, later.

## Single

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

Your filing status may be single if you were widowed before January 1, 1996, and did not remarry in 1996. However, you may be able to use another filing status that will give you a lower tax. See *Head of Household* and *Qualifying Widow(er) With Dependent Child* to see if you qualify.

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

## Married Filing Jointly

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

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

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

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

**Divorced persons.** If you are divorced under a final decree by the last day of the

year, you are considered unmarried for the whole year and may not choose married filing jointly as your filing status.

## Filing a Joint Return

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

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

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

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

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

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

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

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

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

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

**Divorced taxpayer.** You may be held jointly and individually responsible for any

tax, interest, and penalties due on a joint return filed before your divorce. This responsibility applies even if your divorce decree states that your former spouse will be responsible for any amounts due on previously filed joint returns.

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

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

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

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

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

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

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

## Married Filing Separately

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

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

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

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

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

## Separate Returns

Special rules apply if you file a separate return.

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

### If you file a separate return:

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

**Individual retirement arrangements (IRAs).** You may not be able to deduct contributions to your IRA if either you or your spouse was covered by an employer retirement plan, you and your spouse file separate returns, and you lived together during the year. See *Deductible Contributions* in Chapter 18.

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

### Joint Return After Separate Returns

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

If you or your spouse (or both of you) files a separate return, you may change to a joint return any time within 3 years from the due date of the separate return or returns. This does not include any extensions. A separate return includes a return filed by you or your spouse claiming married filing separately, single, or head of household filing status. For tax years beginning on or before July 30, 1996, if the amount paid on your separate returns is less than the total tax shown on the joint return, you must pay the additional tax due on the joint return when you file it. For tax years beginning after July 30, 1996, you do not have to pay the additional tax as a condition to filing the joint return.

### Separate Returns After Joint Return

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

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

### Head of Household

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



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

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

### Considered Unmarried

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

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

the dependent under a pre-1985 divorce or separation agreement.

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

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

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

### Qualifying Person

Each of the following individuals is considered a qualifying person.

- 1) Your child, grandchild, stepchild, or adopted child who is:
  - a) Single. This child does not have to be your dependent. However, a foster child must be your dependent. See Chapter 3 for more information on dependents.
  - b) Married. This child must qualify as your dependent. However, if your married child's other parent claims him or her as a dependent under the special rules for a *Noncustodial parent* discussed in Chapter 3 under *Support Test for Divorced or Separated Parents*, the child does not have to be your dependent.

If the qualifying person is a child but not your dependent, enter that child's name in the space provided on line 4 of Form 1040 or Form 1040A.

- 2) Any relative listed below whom you claim as a dependent.

Parent	Brother-in-law
Grandparent	Sister-in-law
Brother	Son-in-law
Sister	Daughter-in-law
Stepbrother	
Stepsister	If related by blood:
Stepmother	Uncle
Stepfather	Aunt
Half brother	Nephew
Half sister	Niece
Mother-in-law	
Father-in-law	

You are related by blood to an uncle or aunt if he or she is the brother or sister of your mother or father.

You are related by blood to a nephew or niece if he or she is the child of your brother or sister.

**Note.** A dependent can qualify only one taxpayer to use the head of household filing status for any tax year.

**Dependents.** If the person you support is required to be your dependent, you do not qualify as a head of household if you can only claim the exemption under a multiple support agreement. See *Multiple Support Agreement* in Chapter 3.

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

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

**Temporary absences.** You are considered to occupy the same household despite the temporary absence due to special circumstances of either yourself or the other person. Temporary absences due to special circumstances include those due to illness, education, business, vacation, and military service. It must be reasonable to assume that you or the other person will return to the household after the temporary absence, and you must continue to maintain a household in anticipation of the return.

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

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

## Keeping Up a Home

You are keeping up a home only if you pay more than half of the cost of its upkeep. You may determine whether you paid more

than half of the cost of keeping up a home by using the *Cost of Maintaining a Household* worksheet, shown later.

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

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

**State AFDC (Aid to Families with Dependent Children).** State AFDC payments you use to keep up your home do not count as amounts you paid. They are amounts paid by others that you must apply against the total cost of keeping up your home to figure if you paid more than half.

### Cost of Maintaining a Household

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

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

## Qualifying Widow(er) With Dependent Child

If your spouse died in 1996, you may use married filing jointly as your filing status for 1996 if you would otherwise qualify. The year of death is the last year for which you can file jointly with your deceased spouse. See *Married Filing Jointly*, earlier.

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

filing status for 2 years following the year of death of your spouse. For example, if your spouse died in 1995, and you have not remarried, you may be able to use this filing status for 1996 and 1997.

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

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

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

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

**Example.** John Reed's wife died in 1994. John has not remarried. He has continued during 1995 and 1996 to keep up a home for himself and his dependent child. For 1994 he was entitled to file a joint return for himself and his deceased wife. For 1995 and 1996 he may file as qualifying widower with a dependent child. After 1996 he can file as head of household if he qualifies.

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

### 3.

## Personal Exemptions and Dependents

### Important Changes for 1996

**Social security number for dependents.** You must provide the social security number of **any** person you claim as a dependent regardless of the dependent's age. However, a social security number is not required for 1996 for a child born during December of 1996.

**Taxpayer identification numbers for aliens.** If your dependent is a resident or nonresident alien who does not have — and is not eligible to get — a social security number (SSN), file Form W-7 with the IRS to apply for an individual taxpayer identification number (ITIN). Enter this number on your return wherever the dependent's SSN is requested. Use it for tax purposes only.

**Exemption amount.** The amount you can deduct as an exemption has increased from \$2,500 in 1995 to \$2,550 in 1996.

**Exemption phaseout.** You will lose all or part of the benefit of your exemptions if your adjusted gross income goes above a certain level. In 1996, the income level ranges from \$88,475 (for married filing separately) to \$176,950 (for married filing jointly) depending upon your filing status. See *Phaseout of Exemptions*, later.

### Introduction

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

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

Exemptions reduce your taxable income. Generally, you can deduct \$2,550 for each exemption you claim in 1996. How

you claim an exemption on your tax return depends on which form you file.

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

If you file Form 1040A or Form 1040, follow the instructions for the form. The total number of exemptions you can claim is the total in the box on line 6d. Also complete line 21 (Form 1040A) or line 36 (Form 1040) by multiplying the total number of exemptions shown in the box on line 6d by \$2,550.

**Note.** If your adjusted gross income is \$88,475 or more, see *Phaseout of Exemptions*, later.

### Useful Items

You may want to see:

#### Form (and Instructions)

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

## Exemptions

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

### Personal Exemptions

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

#### Your Own Exemption

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

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

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

#### Your Spouse's Exemption

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

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

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

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

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

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

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

### Exemptions for Dependents

You are allowed one exemption for each person you can claim as a dependent. This is called a dependency exemption.

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

**Child born alive.** If your child was born alive during the year, and the dependency tests are met, you may take the full exemption. This is true even if the child lived only for a moment. Whether your child was born alive depends on state or local law. There must be proof of a live birth shown by an official document, such as a birth certificate. You may not claim an exemption for a still-born child.

**Death of dependent.** If your dependent died during the year and otherwise qualified as your dependent, you can take his or her exemption.

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

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

**Dependency tests.** The following five tests must be met for you to claim a dependency exemption for a person:

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

## Member of Household or Relationship Test

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

**Temporary absences.** You are considered to occupy the same household despite the temporary absence due to special circumstances of either yourself or the other person. Temporary absences due to special circumstances include those due to illness, education, business, vacation, and military service.

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

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

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

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

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

A son or daughter of your brother or sister

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

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

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

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

However, if a state, one of its political subdivisions, or a tax-exempt child-placing agency makes payments to you as a foster parent, you may not take the child as your dependent. Your expenses are incurred on behalf of the agency that made payments to you. Expenses you incur in excess of nontaxable payments you receive are allowed as charitable contributions. You may deduct these contributions on Schedule A (Form 1040) if you itemize deductions. If you receive taxable payments, your expenses may be deductible as business expenses. See *Foster-care providers* under *Income Not Taxed* in Chapter 13 and *Foster parents* in Chapter 26.

**Cousin.** Your cousin will meet this test only if he or she lives with you as a member of your household for the entire year. A cousin is a descendant of a brother or sister of your father or mother and does not qualify under the relationship test.

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

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

## Citizenship Test

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

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

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

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

## Foreign students' place of residence.

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

## Joint Return Test

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

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

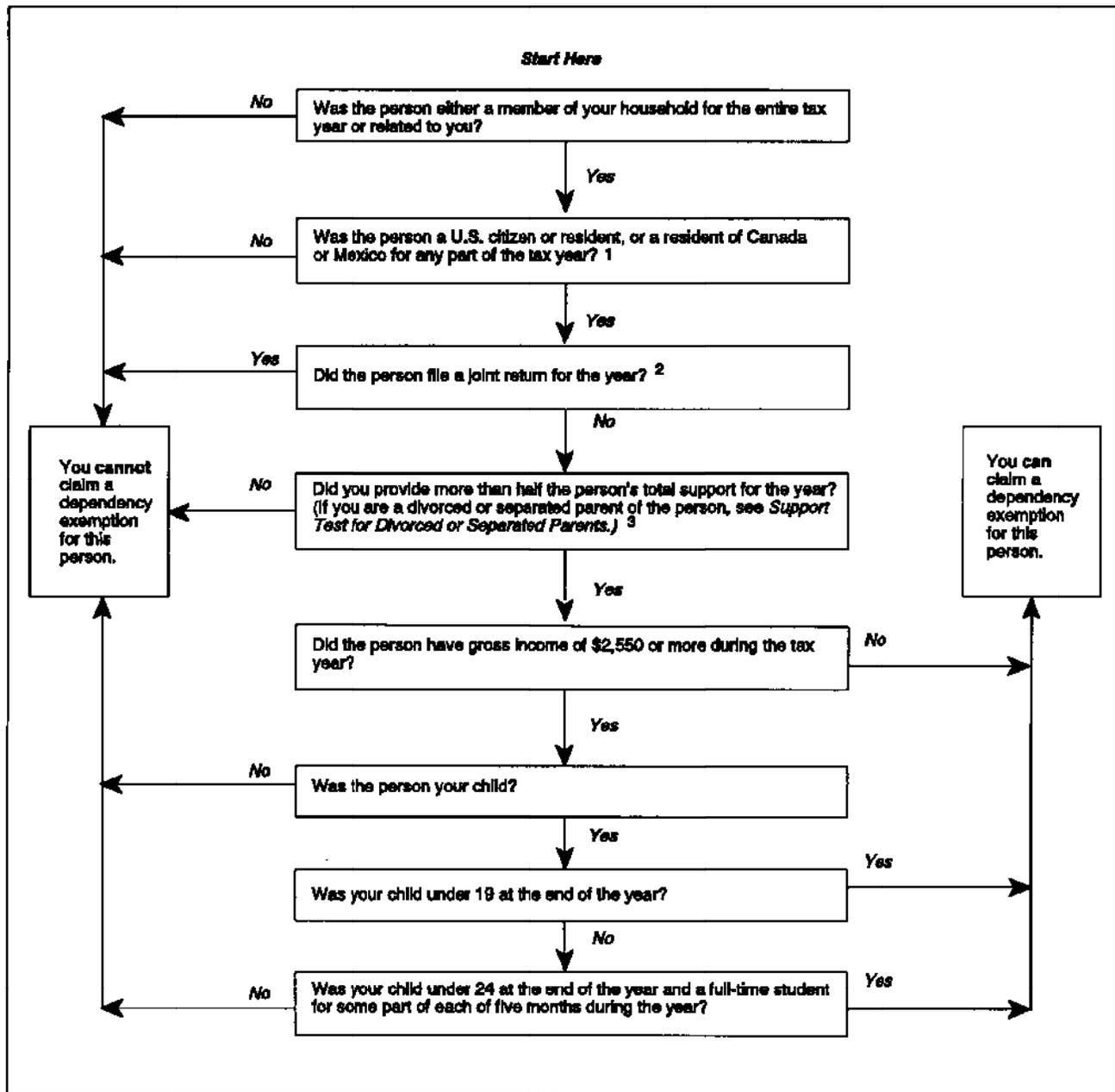
**Exception.** The joint return test does not apply if a joint return is filed by the dependent and his or her spouse merely as a claim for refund and no tax liability would exist for either spouse on the basis of separate returns.

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

## Gross Income Test

Generally, you may not take an exemption for a dependent if that person had gross income of \$2,550 or more for the year. This test does not apply if the person is your child and is either under age 19, or a student under age 24, as discussed later.

**Figure 3-A. Can You Claim a Dependency Exemption?**



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

<sup>2</sup> If neither the person nor the person's spouse is required to file a return but they file a joint return to claim a refund of tax withheld, you may answer "no" to this question.

<sup>3</sup> Answer "yes" to this question if you meet the multiple support requirements under *Multiple Support Agreement*.

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

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

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

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

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

Gross income also includes all unemployment compensation and certain scholarship and fellowship grants. Scholarships received by degree candidates that are used for tuition, fees, supplies, books, and

equipment required for particular courses are not included in gross income. For more information, see Chapter 13.

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

For this gross income test, gross income does not include income received by a permanently and totally disabled individual at a sheltered workshop. The availability of medical care must be the main reason the individual is at the workshop. Also,

the income must come solely from activities at the workshop that are incident to this medical care. A sheltered workshop is a school operated by certain tax-exempt organizations, or by a state, a U.S. possession, a political subdivision of a state or possession, the United States, or the District of Columbia, that provides special instruction or training designed to alleviate the disability of the individual.

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

**Child under 19.** If your child is under 19 at the end of the year, the gross income test does not apply. Your child may have any amount of income and still be your dependent if the other dependency tests are met.

**Example.** Marie Grey, 18, earned \$2,700. Her father provided more than half her support. He can claim her as a dependent because the gross income test does not apply and the other dependency tests were met.

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

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

- 1) A full-time student at a school that has a regular teaching staff, course of study, and regularly enrolled body of students in attendance, or
- 2) A student taking a full-time, on-farm training course given by a school described in (1) above or a state, county, or local government.

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

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

**Example.** James Clay, 22, attends college as a full-time student. During the summer, James earned \$2,700. If the other dependency tests are met, his parents can take the exemption for James as a dependent.

#### **Vocational high school students.**

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

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

## **Support Test**

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

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

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

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

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

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

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

#### **Armed Forces dependency allotments.**

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

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

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

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

**Example 1.** You provide \$2,000 toward your mother's support during the year. She has taxable income of \$600, nontaxable social security benefit payments of \$1,800, and tax-exempt interest of \$200. She uses all these for her support. You cannot claim your mother as a dependent because the \$2,000 you provide is not more than half of her total support of \$4,600.

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

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

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

#### **Support provided by the state (AFDC, food stamps, housing, etc.).**

Benefits provided by the state to a needy person, such as AFDC (Aid to Families with Dependent Children) generally are considered to be used for support. However, payments based on the needs of the recipient will not be considered as used entirely for that person's support if it is shown that part of the payments were not used for that purpose.

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

## **Total Support**

To figure if you provided more than half of the support of a person, you must first determine the total support provided for that

person. Total support includes amounts spent to provide food, lodging, clothing, education, medical and dental care, recreation, transportation, and similar necessities.

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

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

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

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

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

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

If you are considered to provide the total lodging, determine the fair rental value of the room the person uses, or a share of the fair rental value of the entire dwelling if

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

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

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

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

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

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

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

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

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

**Example 1.** You buy a \$200 power lawn mower for your 13-year-old child. The child is given the duty of keeping the lawn

trimmed. Because a lawn mower is ordinarily an item you buy for personal and family reasons that benefits all members of the household, you cannot include the cost of the lawn mower in the support of your child.

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

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

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

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

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

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

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

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

## Do Not Include in Total Support

The following items are not included in total support:

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

<b>Income</b>	
1) Did the person you supported receive any income, such as wages, interest, dividends, pensions, rents, social security, or welfare? (If yes, complete lines 2, 3, 4, and 5)	<input type="checkbox"/> Yes <input type="checkbox"/> No
2) Total income received	\$
3) Amount of income used for support	\$
4) Amount of income used for other purposes	\$
5) Amount of income saved	\$
(The total of lines 3, 4, and 5 should equal line 2)	
<b>Expenses for Entire Household</b> (where the person you supported lived)	
6) Lodging (Complete item a or b)	
a) Rent paid	\$
b) If not rented, show fair rental value of home. If the person you supported owned the home, include this amount in line 20.	\$
7) Food	\$
8) Utilities (heat, light, water, etc. not included in line 6a or 6b)	\$
9) Repairs (not included in line 6a or 6b)	\$
10) Other. Do not include expenses of maintaining home, such as mortgage interest, real estate taxes, and insurance.	\$
11) Total household expenses (Add lines 6 through 10)	\$
12) Total number of persons who lived in household	
<b>Expenses for the Person You Supported</b>	
13) Each person's part of household expenses (line 11 divided by line 12)	\$
14) Clothing	\$
15) Education	\$
16) Medical, dental	\$
17) Travel, recreation	\$
18) Other (specify)	\$
19) Total cost of support for the year (Add lines 13 through 18)	\$
20) Amount the person provided for own support (line 3, plus line 6b if the person you supported owned the home)	\$
21) Amount others provided for the person's support. Include amounts provided by state, local, and other welfare societies or agencies. Do not include any amounts included on line 2.	\$
22) Amount you provided for the person's support (line 19 minus lines 20 and 21)	\$
23) 50% of line 19	\$
If line 22 is more than line 23, you meet the support test for the person. If the person meets the other dependency tests, you may claim an exemption for that person. If line 23 is more than line 22, you may still be able to claim an exemption for that person under a multiple support agreement. See <i>Multiple Support Agreement</i> in this chapter.	

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

support of the child who receives them.

### Multiple Support Agreement

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

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

**Example 1.** You, your sister, and your two brothers provide the entire support of

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

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

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

## Support Test for Divorced or Separated Parents

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

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

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

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

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

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

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

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

**Example 2.** You and your former spouse provided your child's total support for 1996. You had custody of your child under your 1992 divorce decree, but on August 31, 1996, a new custody decree granted custody to your former spouse. Because you had custody for the greater part of the year, you are considered to have provided more than half of your child's support.

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

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

**Example.** Under the terms of your 1982 divorce decree, your former spouse has custody of your child. The decree specifically states that you are entitled to the exemption. You provide at least \$600 in child support during the calendar year. You

are considered to have provided more than half of the child's support.

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

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

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

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

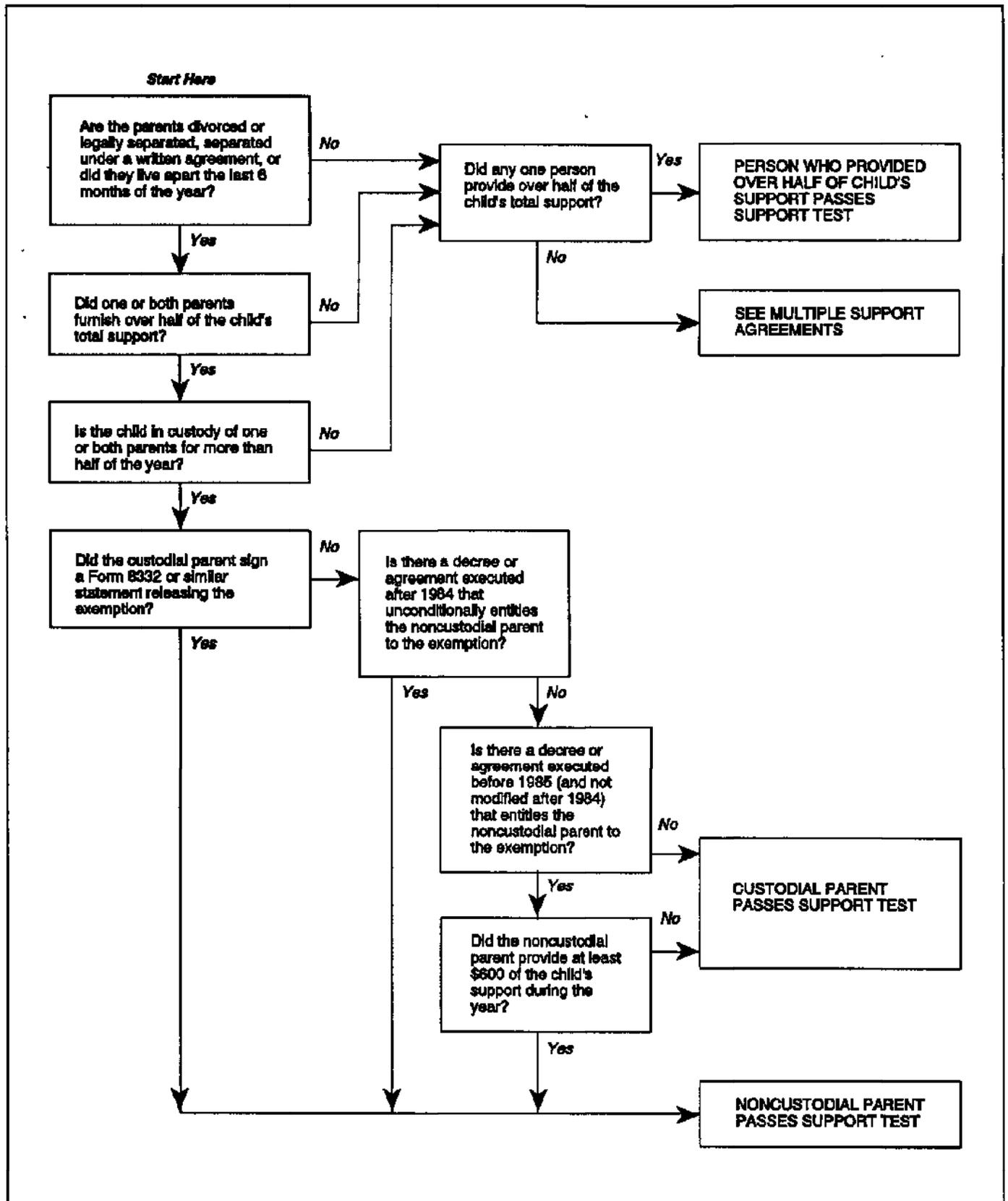
**Child support.** All child support payments actually received from the noncustodial parent are considered used for the support of the child.

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

**Back child support.** Even if you owed child support for an earlier year, your payments are considered support for the year paid, up to the amount of your required child support for that year. If the support payments are more than the amount required for this year, any payment for an earlier year is not support provided by the noncustodial parent for either the earlier year or for this year. It is to repay the custodial parent for amounts paid for the support of the children in an earlier year.

**Example.** Under your divorce decree, you must pay \$400 a month to your former spouse for the support of your two children. Last year you paid \$4,000 instead of \$4,800 ( $\$400 \times 12$  months) due for the year. This year, if you pay the full amount, the entire \$4,800 is considered support that you provided. If you also pay any part

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



of the \$800 you owe from last year, that amount is not included as support provided by you in either year.

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

**Example.** You are divorced. During the entire year, you and your child live with your mother in a house she owns. The fair rental value of the lodging provided by your mother for your child is \$1,000. The home provided by your mother is not included in the amount of support you provide.

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

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

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

## Phaseout of Exemptions

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

Filing Status	AGI Level Which Reduces Exemption Amount
Married filing separately	\$ 88,475
Single	117,950
Head of household	147,450
Married filing jointly	176,950
Qualifying widow(er)	176,950

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

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

## Social Security Number for Dependents

You must list the social security number (SSN) of **any** person you claim as a dependent (except a child born during December of 1996) in column (2) of line 6c of your Form 1040 or Form 1040A. If your dependent was born in December of 1996 and does not have an SSN, enter "12/96" in column (2).

You do not need an SSN for a child who was born in 1996 and died in 1996. Write "Died" in column (2) of line 6c of your Form 1040 or Form 1040A.



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

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

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

It usually takes about 2 weeks to get an SSN. If you do not have a required SSN by the April 15 filing date, you can file Form 4868 for an extension of time to file.

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

It usually takes about 30 days to get an ITIN.

An ITIN is for tax purposes only. It does not entitle your dependent to social security benefits or change your dependent's employment or immigration status under U.S. law.

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

# 4.

## Decedents

### Introduction

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

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

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

### Useful Items

You may want to see:

#### Publication

- 559** Survivors, Executors, and Administrators

#### Form (and Instructions)

- 56** Notice Concerning Fiduciary Relationship
- 1310** Statement of Person Claiming Refund Due a Deceased Taxpayer
- 4810** Request for Prompt Assessment Under Internal Revenue Code Section 6501(d)

## Personal Representatives

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

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

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

**Personal representative.** In general, an executor and an administrator perform the

same duties and have the same responsibilities. For simplicity, the term personal representative will be used throughout this chapter to refer to these "appointed" representatives and to representatives who are not appointed, but are in charge of a decedent's property.

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

### Duties

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

The personal representative must also:

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

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

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

## Final Return for the Decedent

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

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

**Determining income and deductions.** The method of accounting used by the decedent generally determines what income

you must include and what deductions you can take on the final return. Generally, individuals use one of two **methods of accounting:** cash or accrual.

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

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

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

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

**Example.** Roberta Russell died on February 5, 1997, before filing her 1996 tax return. Her personal representative must file her 1996 tax return as well as her final tax return for 1997.

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

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

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

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

**Example 1.** John Stone died in early 1996. He was survived by his wife Jane. His final joint return included the required information as shown in the illustration of the top of Form 1040.

DECEASED

JOHN S. STONE

FEBRUARY 28, 1996

Form 1040 U.S. Individual Income Tax Return 1996

Department of the Treasury—Internal Revenue Service
For the year Jan. 1—Dec. 31, 1996, or other tax year beginning 1996, ending 19 OMB No. 1545-0074

Label

(See page 11.) Use the IRS label. Otherwise, please print or type.

Form with fields for first name and initial, last name, social security number, spouse's social security number, address (LP 765-00-4321, JOHN S & JANE M STONE, 1992 OAK ST, SHERIDAN WY 82801), and city/town/post office/state/ZIP code.

Fields for social security numbers and instructions for finding line instructions on pages 2 and 3.

Presidential Election Campaign

Do you want \$3 to go to this fund? If a joint return, does your spouse want \$3 to go to this fund? Yes/No checkboxes.

Filing Status

1 Single
2 Married filing joint return (even if only one had income)

63 Estimated tax penalty. Also include on line 62 63

Sign Here

Keep a copy of this return for your records.

Declaration of preparer and signature area with fields for Your signature, Date, Your occupation, Spouse's signature, Date, Spouse's occupation.

Paid Preparer's Use Only

Preparer's signature, Date, Check if self-employed, Preparer's social security no., Firm's name, EIN, ZIP code.

Printed on recycled paper

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

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

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

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

Claiming a refund. Generally, a person who is filing a return for a decedent and

claiming a refund must file Form 1310, with the return.

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

Appointed personal representative. If you are a court appointed or certified personal representative filing Form 1040, Form 1040A, or Form 1040EZ for the decedent, you also do not have to file Form 1310, but you must attach to the return a copy of the court certificate showing your appointment. If the certificate does not include your address, be sure that your address is shown on the return. See Filing the return, earlier.

Example. Joe Brown died on January 14, 1997, before filing his 1996 tax return. On April 4, 1997, you are appointed the personal representative for Joe's estate, and you file his Form 1040 for 1996 showing a refund due. You do not need to attach Form 1310 to claim the refund, but you must attach to his return a copy of the court

certificate to show that you are the appointed personal representative of Joe's estate.

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

You can mail the decedent's final income tax return to the Internal Revenue Service Center for the area where you live.

Request for prompt assessment of tax. As the personal representative for the decedent's estate, you must see to it that any additional taxes that the decedent may owe are paid. The IRS usually has 3 years after the filing of a return to charge any additional tax that may be due. Returns filed before the due date are treated as filed on the due date.

You can shorten the time that the IRS has to charge the decedent's estate any additional tax by requesting a prompt assessment of the decedent's income taxes. This request reduces the time the IRS has to charge any additional tax from 3 years from the date the return is filed to 18 months from the date the IRS receives the request. This may permit a quicker settlement of the tax responsibilities of the estate and earlier distribution of the decedent's assets, such as money and property, to the beneficiaries.

You can make the request for any tax year still subject to additional tax charges, even if the return was filed before the decedent's death.

**Note.** Requesting this prompt assessment will not shorten the time the IRS has to charge any additional tax if it can be charged beyond the 3 years from the date the return was filed or due. For example, additional tax can still be charged because of a substantial understatement of income or if a fraudulent return was filed.

**How to request.** You can use **Form 4810, Request for Prompt Assessment Under Internal Revenue Code Section 6501(d)**, for making this request. If Form 4810 is not used, you must clearly indicate that you are requesting a prompt assessment under section 6501(d) of the Internal Revenue Code and specify the year(s) involved. You must file the request separately from any other document. Address your request to the District Director and send it to the IRS office where the decedent's return was filed.

**Joint return.** Generally, the personal representative and the surviving spouse can file a joint return for the decedent and the surviving spouse. However, the surviving spouse alone can file the joint return if:

- 1) The decedent did not file a return for that year, and
- 2) No personal representative is appointed before the due date for filing the return of the surviving spouse.

This also applies to the return for the preceding year if the decedent died after the close of the preceding tax year and before the due date for filing that return. The final joint return must show the decedent's income before death and the surviving spouse's income for the entire year.

If the surviving spouse remarried before the end of the year in which the decedent died, a final joint return with the deceased spouse cannot be filed. The filing status of the deceased spouse is then married filing separately.

**Change to joint return.** If a separate return was filed by or for the decedent, and the due date for filing that return has expired, that return can be changed to a joint return only by the personal representative on behalf of the decedent. The surviving spouse must also agree to the change. A

surviving spouse cannot change a separate return to a joint return if no personal representative has been appointed.

**Change to separate return.** If the surviving spouse files a joint return with the decedent and a personal representative is later appointed by the court, the personal representative can change the joint return election. The personal representative has one year from the due date of the return filed by the surviving spouse, to change the election by filing a separate return for the decedent.

If a separate return is filed for the decedent, the joint return then becomes the separate return of the surviving spouse. The decedent's items are excluded, and the tax liability of the surviving spouse is refigured.

## How To Report Certain Income

This section explains how to report certain types of income on the final return. The rules on income discussed in the other chapters of this publication also apply to a decedent's final return. See Chapters 6 through 17, if they apply.

### Interest and Dividend Income (Forms 1099)

Payers of interest and dividends report amounts on Forms 1099 using the name and identification number of the person to whom the account is payable. After a person's death, the Forms 1099 must reflect the new owner's (the estate's or beneficiary's) name and identification number. As the personal representative, you must furnish this information to the payers.

For example, if an interest-bearing account becomes part of the estate, you must provide the estate's name and employer identification number (EIN) to the payer so that the Form 1099-INT, *Interest Income*, can reflect the correct payee information. If the interest-bearing account is transferred to a surviving joint owner, you must provide the survivor's name and taxpayer identification number (TIN) to the payer.

You should receive Forms 1099 for the decedent that report amounts of interest and dividends earned prior to death. The estate or beneficiary should receive separate Forms 1099 that report the amounts earned after death and that are payable to them.

If you receive Forms 1099 that include both income earned before the date of death (reportable on the decedent's final return) and income earned after the date of death (reportable by the estate or other recipient), then you will need to request new Forms 1099. You should contact the payers to ask them for corrected Forms 1099 that properly identify the recipient of the income (by name and identification number) and the correct amounts.

## Capital Loss

A capital loss sustained by a decedent during his or her last tax year can be deducted only on the final return filed for the decedent. The capital loss limits discussed in Chapter 17 still apply in this situation. The loss cannot be deducted by the estate or carried over to following years.

## Business Income

This section discusses some of the business income which may have to be included on the final return.

**Partnership income.** If the decedent was a partner, his or her death generally does not close the partnership's tax year. See *Closing of tax year under Tax Year* in Publication 541, *Partnerships*.

If the partnership year ends with the death of a partner, see *Deceased partner under Distributive Share in Year of Disposition* in Publication 541.

As the personal representative, you must **include** on the final return the decedent's share of partnership income for the **partnership's tax year that ends within or with the decedent's last tax year** (year ending on the date of death).

**Do not include** on the final return the decedent's share of partnership income for a **partnership's tax year that ends after the date of death**. In this case, partnership income earned up to and including the date of death is **income in respect of the decedent**, which is discussed later in this chapter. Income earned after the date of death to the end of the partnership's tax year is income to the estate or successor in interest (beneficiary).

**Example.** The XYZ Partnership and all the partners use a calendar year as their tax year. One of the partners dies on June 10. The decedent's share of the partnership income from January 1 through June 10 is income in respect of a decedent. The share of partnership income after June 10 is income to the estate or beneficiary.

**S corporation income.** If the decedent was a shareholder in an S corporation, you must include on the final return the decedent's share of S corporation income for the corporation's tax year that ends within or with the decedent's last tax year (year ending on the date of death). The final return must also include the decedent's pro rata share of the S corporation's income for the period between the end of the corporation's last tax year and the date of death.

The income for the part of the S corporation's tax year after the shareholder's death is income to the estate or other person who has acquired the stock in the S corporation.

**Self-employment income.** You must include on the final return the self-employment income that the decedent actually or

constructively received or accrued, depending on the decedent's accounting method. For self-employment tax purposes only, the decedent's self-employment income will include the decedent's distributive share of a partnership's income or loss through the end of the month in which death occurred. For more information on how to compute the decedent's self-employment income, see Publication 533, *Self-Employment Tax*.

## Deductions, Credits, and Exemptions

Generally, the rules for deductions, credits, and exemptions that apply to individuals also apply to the decedent's final income tax return. On the final return, claim deductible items that were paid before the decedent's death (or accrued, if the decedent reported deductions on an accrual method).

### Deductions

All of the deductions that are discussed in this publication also apply to the final return as long as the decedent was eligible for the deduction at the time of death.

You can generally choose to claim itemized deductions or the standard deduction on the final return. See *Standard deduction*, later, for instances when you cannot choose the standard deduction or when the amount of the standard deduction may be limited.

If you have a choice, you should figure the amount of the decedent's itemized deductions before you decide whether to itemize or claim the standard deduction to be sure that you are using the method that gives you the lower tax.

**Itemized deductions.** If the total of the decedent's itemized deductions are more than the decedent's standard deduction, the federal income tax will generally be less if you claim itemized deductions on the final return. See Chapters 23 through 30 for the types of expenses that are allowed as itemized deductions.

**Note.** The amount you can deduct for most itemized deductions is limited if adjusted gross income is more than \$117,950 (\$58,975 if married filing separately). See Chapter 22 for more information.

**Medical costs.** If you itemize deductions on the final return, you may be able to deduct medical expenses of the decedent even though they were not paid before the date of death. See *Decedents* in Chapter 23 for an explanation of how this election can be made.

**Unrecovered investment in pension.** If the decedent was receiving a pension or annuity and died without a surviving annuitant, you can take a deduction on the decedent's final return for the amount of the decedent's investment in the pension or

annuity contract that remained unrecovered at death. The deduction is a miscellaneous itemized deduction that is not subject to the 2% of adjusted gross income limit. See Chapter 30.

**Standard deduction.** You can generally claim the full amount of the standard deduction on the decedent's final return. However, you cannot use the standard deduction if the surviving spouse files a separate return and itemizes deductions. In that event, you must also itemize deductions on the decedent's final return.

The amount of the standard deduction for a decedent's final return is the same as it would have been had the decedent continued to live. However, if the decedent was not 65 or older at the time of death, the higher standard deduction for age cannot be claimed.

If another taxpayer can claim the decedent as a dependent, the amount you can claim for the decedent's standard deduction may be limited. See Chapter 21 for more information on how to determine the amount of the standard deduction.

### Credits

Any of the tax credits that are discussed in this publication also apply to the final return if the decedent was eligible for the credits at the time of death. These credits are discussed in Chapters 33 through 36 of this publication.

### Tax withheld and estimated payments.

There may have been income tax withheld from the decedent's pay, pensions, or annuities before death, and the decedent may have paid estimated income tax. To get credit for these tax payments, you must claim them on the decedent's final return. For more information, see *Credit for Withholding and Estimated Tax* in Chapter 5.

### Exemptions

You can claim the full amount of the personal exemption on the decedent's final return unless the decedent can be claimed as a dependent by another taxpayer. In that case, the decedent's own exemption amount on the final return is zero. See Chapter 3 for more information on this limit and on other dependency exemptions that may be allowed on the final return.

## Tax Effect on Others

This section contains information about the effect of an individual's death on the income tax liability of others: the survivors (including the widow or widower), the beneficiaries, and the estate. Any survivor or beneficiary should coordinate the filing of his or her own tax return with the personal representative handling the decedent's estate. The personal representative can coordinate filing status, exemptions, income, and deductions so that the final return and

the income tax returns of the survivors, beneficiaries, and estate are all filed correctly.

## Survivors

If you are a survivor, you may qualify for certain benefits when filing your own income tax return. This section addresses some issues that may apply to you.

**Inherited property.** Property received as a gift, bequest, or inheritance is not included in your income. However, if the property you receive in this manner later produces income, such as interest, dividends, or rentals, then that income is taxable to you. If the gift, bequest, or inheritance you receive is the income from property, that income is taxable to you.

If you inherited the right to receive income in respect of the decedent, see *Income in Respect of the Decedent*, later.

**Joint return by surviving spouse.** A surviving spouse may be able to file a joint return with the decedent for the year of death as long as the survivor has not remarried before the end of that year. See *Joint return*, earlier.

If there is a dependent child, the surviving spouse may also be entitled to use the standard deduction amount and the tax rates that apply to joint returns for the 2 following years. See *Qualifying Widow(er) With Dependent Child* in Chapter 2 for information on how to qualify.

**The decedent as a dependent.** If the decedent qualified as your dependent for the part of the year before death, you can claim the full exemption amount for the dependent on your tax return.

## Income in Respect of the Decedent

All gross income that the decedent had a right to receive and that is not properly includible on the decedent's final return is called income in respect of the decedent. Instead of being reported on the final return of the decedent, the income is included, for the tax year when received, in the gross income of:

- 1) The decedent's estate, if the estate acquires the right to receive the income from the decedent,
- 2) The person who acquires the right to the income directly from the decedent without going through the estate, or
- 3) Any person to whom the estate properly distributes the right to receive the income.

**Example 1.** Thornton Jones owned and operated an orchard, and he used the cash method of accounting. He sold and delivered \$2,000 worth of fruit to a customer, but he did not receive payment

before his death. When the estate was settled, payment had still not been made, and the estate gave the right to receive the payment to his niece. When she collects the \$2,000, she must include it in her income. It is not reported on the final return of the decedent nor on the estate's income tax return.

**Example 2.** If, in Example 1, Thornton Jones had used the accrual method of accounting, the income from the fruit sale must be included on his final return. Neither his estate nor his niece will report the income when the money is later paid.

**Example 3.** Mary Smith was entitled to a large salary payment at the time of her death. It was to be paid in five yearly payments. Her estate, after collecting two payments, distributes the right to the remaining payments to you, the beneficiary. None of the payments would be included on the decedent's final return. The estate must include in its gross income, as income in respect of the decedent, the two payments it received. You must include in your gross income each of the three remaining payments as you receive them.

**Transferring your right to income.** If you transfer your right to receive income in respect of a decedent, you must include in your income the larger of:

- 1) The amount you receive for the right, or
- 2) The fair market value of the right at the time of the transfer. Fair market value is defined in Chapter 14 under *Other Basis*.

**Giving your right to income as a gift.** If you give your right to receive income in respect of a decedent as a gift, you must include in your gross income the fair market value of the right at the time you make the gift.

**Type of income.** The character, or type, of income that you receive in respect of a

decedent is generally the same as it would have been had the decedent continued to live and had received it. For example, if the income would have been a long-term capital gain to the decedent, it will be a long-term capital gain to you.

**Interest on certificates of deposit (CDs).** Interest on CDs that is not received by the date of death but that is earned between the date of the last interest payment and the date of death is interest income in respect of the decedent. Interest income earned on the account after the decedent's death that becomes payable on CDs after death is not income in respect of a decedent. Such interest is ordinary income that belongs to the respective recipients and must be included in their gross income.

**Installment payments.** If the decedent had sold property using the installment method and you receive the right to collect the payments after the date of death, the payments you collect are income in respect of the decedent. You will use the same gross profit percentage that the decedent used to figure the part of each payment that represents profit. Include in your income the same profit the decedent would have included had death not occurred. See Publication 537, *Installment Sales*, for more information on the installment method.

**Sale or exchange.** If you sell or exchange an installment obligation that you received from a decedent, the rules explained in Publication 537 for figuring the gain or loss on the disposition will apply. However, your basis in the obligation is the same as the decedent's basis, adjusted for all installment payments you received before the sale or exchange.

**Other income.** For examples of other income situations concerning decedents, see *Specific Types of Income in Respect of a Decedent* in Publication 559.

## Deductions in Respect of the Decedent

Deductions in respect of the decedent are items, such as business expenses, income-producing expenses, interest, and taxes, for which the decedent was liable, but which are not deductible on the decedent's final income tax return. When paid, these expenses may be deducted by:

- 1) The estate, or
- 2) If the estate is not liable for the expenses, the person who, because of the decedent's death, acquired the decedent's property subject to that liability.

**Federal estate tax deduction.** Income that a decedent had a right to receive is included in the decedent's gross estate and is subject to estate tax. This income in respect of a decedent is also taxed when received by the estate or beneficiary. However, an income tax deduction is allowed to the person (or estate) receiving the income. If you must include in your gross income an amount of income in respect of a decedent, then you can claim a deduction for part of any estate tax paid. The deduction must be claimed in the same tax year that the income is included in your gross income.

You can claim the deduction only as a miscellaneous itemized deduction on Schedule A (Form 1040). This deduction is not subject to the 2% limit on miscellaneous itemized deductions as discussed in Chapter 30.

If the income is capital gain income, then in figuring the maximum capital gain tax or any net capital loss limitation, the amount of the gain must be reduced, but not below zero, by the amount of any estate tax deduction attributable to such gain.

For more information, see *Estate Tax Deduction* in Publication 559.

## 5.

# Tax Withholding and Estimated Tax

## Important Changes for 1996

You should consider the items in this section when figuring any underpayment penalty for 1996.

**Penalty due to new law waived.** You will not have to pay a penalty for underpaying either of the first two installments of 1996 estimated tax if you underpaid because of provisions in the Small Business Job Protection Act of 1996. Provisions in that Act that could have caused your underpayment are:

- 1) Repeal of the \$5,000 death benefit exclusion in the case of employees dying after August 20, 1996 (see Chapter 13 for more information about the exclusion),
- 2) Changes in the taxation of certain punitive damages and damages that are not for physical injuries or sickness (see Chapter 13 for more information),
- 3) A change in the taxation of annuities that started after November 18, 1996 (see Chapter 11),
- 4) Denial of an exemption and the child and dependent care credit for any individual (except a child born in December 1996) whose taxpayer identification number is not included on your return (see Chapter 3 for information about exemptions or Chapter 33 for information about the credit),
- 5) Repeal of the diesel-powered highway vehicle credit for vehicles bought after August 20, 1996 (see Chapter 36),
- 6) A rule that lets a parent choose to report a child's 1996 interest and dividend income on the parent's 1996 return only if that income was less than \$6,500 (increased from \$5,000 in 1995) (see Chapter 32),
- 7) Clarification that distributions from a qualified state tuition program may be taxable to the extent they are more than the amount contributed to the program,
- 8) Clarification that newspaper distributors and certain fishing crew members are not employees and so must pay self-employment tax,
- 9) A new rule for S corporation stock inherited from an individual who died after August 20, 1996,

- 10) Changes to the income forecast method of depreciation, generally for property placed in service after September 13, 1995, and
- 11) Changes in rules for certain foreign trusts.

For more information about these provisions, see the chapter indicated or see Publication 553, *Highlights of 1996 Tax Changes*.

**Excess social security or railroad retirement tax withholding.** You will have excess social security or tier 1 railroad retirement tax withholding for 1996 only if your wages from two or more employers were more than \$62,700. See *Credit for Excess Social Security Tax or Railroad Retirement Tax Withheld* in Chapter 36.

## Important Changes for 1997

You should consider the items in this section when you figure your estimated tax or how much income tax you want withheld from your pay for 1997. For more information on these and other tax changes, see Publication 553, *Highlights of 1996 Tax Changes*.

**Withholding from unemployment compensation.** Beginning in 1997, you can choose to have income tax withheld from any unemployment compensation you get. See *Unemployment Compensation under Withholding*, later, for more information.

**Withholding from social security and other federal payments.** Beginning in 1997, you can choose to have income tax withheld from certain federal payments you get. These payments include social security benefits and tier 1 railroad retirement benefits. For more information, see *Social Security and Other Federal Payments under Withholding*, later.

**New adoption tax credit.** Beginning in 1997, you may be able to claim a credit for qualified adoption expenses. The credit is limited to \$5,000 for each child (\$6,000 in certain cases for a child with special needs). Depending on your income, the credit may be reduced or eliminated.

**New exclusion for employer-provided adoption assistance payments.** Beginning in 1997, you may not have to include in income certain amounts you received for qualified adoption expenses from your employer's adoption assistance program. This also applies to expenses incurred by your employer under this type of program for your adoption of a child. The amount you do not have to include in income is limited to \$5,000 for each child (\$6,000 in certain cases for a child with special needs). Depending on your income, this amount may be reduced or eliminated.

**Increase in deduction for self-employed health insurance.** The part of your health insurance premiums you can deduct if you are self-employed has increased to 40% for 1997.

**Increase in deduction for spousal IRAs.** If certain requirements are met, you may contribute as much as \$2,000 to your IRA and as much as another \$2,000 to a spousal IRA. Some or all of these amounts may be deductible. For 1996, the total amount you could contribute and deduct to both was limited to \$2,250.

**Medical expenses for long-term care.** Beginning in 1997, you generally can include in your medical expenses the costs of qualified long-term care services. You can also include premiums for qualified long-term care insurance, but only up to certain limits.

**Long-term care insurance.** Beginning in 1997, amounts your employer pays to provide you with qualified long-term care insurance are not taxed to you, unless the coverage is through a flexible spending or similar arrangement.

Benefits you receive under a qualified long-term care insurance contract generally are not taxed. But, in some cases, the amount not taxed is limited.

**Medical savings accounts.** You may be able to deduct up to \$1,462.50 (\$3,375 for family coverage) a year for contributions to a medical savings account in 1997, even if you do not itemize your deductions. You must be covered under a high deductible health plan and meet certain other requirements.

**Deduction for donation of appreciated stock to private foundation.** The special rule allowing a deduction for the full fair market value of qualified appreciated stock given to certain private foundations will not apply to contributions made after May 31, 1997.

**SIMPLE retirement plans.** Beginning in 1997, your employer may be eligible to adopt a Savings Incentive Match Plan for Employees (SIMPLE) retirement plan. If your employer establishes a SIMPLE plan for 1997, you may be able to have your employer contribute a certain percentage of your compensation to the plan each pay period (totaling up to \$6,000 for 1997). Your employer must make a matching contribution on your behalf. You do not have to pay income tax on these contributions or on the plan's earnings until they are distributed. Self-employed individuals can also participate in a SIMPLE plan.

**Accelerated death benefits not taxed.** Beginning in 1997, certain payments received under a life insurance contract on

the life of a terminally or chronically ill individual before the individual's death (accelerated death benefits) are not taxed if certain requirements are met. The tax-free amount is limited in some cases. Amounts received for the sale or assignment of these benefits to certain qualified viatical settlement providers are also tax-free, subject to a limit in some cases.

**Changes to business-related provisions.** A number of changes in the law affect businesses for 1997. These include:

- 1) An increase in the maximum section 179 deduction to \$18,000 (from \$17,500 in 1996).
- 2) A new work opportunity tax credit that is 35% of the qualified first-year wages, generally up to \$6,000, paid or incurred during the year to certain members of targeted groups who begin working for you after September 30, 1996, and before October 1, 1997.
- 3) An extension of the credit for increasing certain research activities, generally for amounts paid or incurred after June 30, 1996, and before June 1, 1997. (But you cannot use the extension of this credit when figuring your 1997 estimated tax.)

**Personal exemption.** For 1997, the personal exemption amount for you, your spouse, and each dependent has increased to \$2,650.

**Phaseout of personal exemptions.** Your deduction for personal exemptions is reduced by 2% for each \$2,500 (\$1,250 if you are married filing separately), or part of that amount, by which your adjusted gross income is more than an amount based on your filing status. The amounts for 1997 are:

Single	\$121,200
Married filing jointly or qualifying widow(er)	181,800
Married filing separately	90,900
Head of household	151,500

**Standard deduction.** Individuals who do not itemize deductions have an increased standard deduction for 1997. For more information, see Publication 505, *Tax Withholding and Estimated Tax*.

**Reduction of itemized deductions.** For 1997, certain itemized deductions are reduced by 3% of the amount of your adjusted gross income that is more than \$121,200 (\$60,600 if you are married filing separately). The reduction cannot be more than 80% of your affected deductions. Itemized deductions subject to the reduction are those other than medical expenses, investment interest, casualty and

theft losses, or gambling losses. This reduction does not apply when computing alternative minimum tax, nor does it apply to estates or trusts.

## Important Reminders

**Employment taxes on household employees.** If you must make estimated tax payments or are subject to tax withholding anyway, you have the option of including any expected employment (social security, Medicare, and federal unemployment) taxes for household employees when figuring your estimated tax or how much tax you want withheld from your pay for 1997. When figuring your estimated tax or how much tax you want withheld for 1998, you **must** include any expected employment taxes for household employees.

See Publication 926, *Household Employer's Tax Guide*, for other rules that apply to these employment taxes.

**Estimated tax payments — exception to use of prior year's tax.** Certain taxpayers (other than farmers and fishermen) must use 110% of their 1996 tax to figure their 1997 required annual payment of estimated tax. See Chapter 2 of Publication 505 if your 1996 adjusted gross income was more than \$150,000 (more than \$75,000 if you were married filing separately).

**Underpayment penalty.** The same rule applies to the underpayment penalty for 1996. See Chapter 4 of Publication 505.

**Claiming withholding and estimated tax payments.** When you file a federal income tax return, be sure to take credit for all federal income tax and excess social security or railroad retirement taxes withheld from your salary, wages, pensions, etc., and any backup withholding shown on Forms 1099. Also take credit for all estimated tax payments you made for that year. For example, all estimated tax payments made for 1996 should be claimed on the tax return you file for the 1996 tax year. You should file a return and claim these credits even if you do not owe tax. See *Credit for Withholding and Estimated Tax*, later in this chapter.

## Introduction

This chapter discusses how to pay your tax as you earn or receive income during the year. In general, the federal income tax is a pay-as-you-go tax. There are two ways to pay as you go:

- **Withholding.** If you are an employee, your employer probably withholds income tax from your pay. Tax may also be withheld from certain other income — including pensions, bonuses, commissions, and gambling winnings. In each case, the amount withheld is paid

to the Internal Revenue Service (IRS) in your name.

- **Estimated tax.** If you do not pay your tax through withholding, or do not pay enough tax that way, you might have to pay estimated tax. People who are in business for themselves generally will have to pay their tax this way. You may have to pay estimated tax if you receive income such as dividends, interest, rent, and royalties. Estimated tax is used to pay not only income tax, but self-employment tax and alternative minimum tax as well.

This chapter explains both of these methods. In addition, it explains:

- **Credit for withholding and estimated tax.** When you file your 1996 income tax return, take credit for all the income tax withheld from your salary, wages, pensions, etc., and for the estimated tax you paid for 1996.
- **Underpayment penalty.** If you did not pay enough tax during the year either through withholding or by making estimated tax payments, you may have to pay a penalty. The IRS usually can figure this penalty for you. See *Underpayment Penalty*, near the end of this chapter.

## Useful Items

You may want to see:

### Publication

- 505** Tax Withholding and Estimated Tax
- 553** Highlights of 1996 Tax Changes
- 919** Is My Withholding Correct for 1997?

### Form (and Instructions)

- W-4** Employee's Withholding Allowance Certificate
- W-4P** Withholding Certificate for Pension or Annuity Payments
- W-4S** Request for Federal Income Tax Withholding From Sick Pay
- W-4V** Voluntary Withholding Request
- 1040-ES** Estimated Tax for Individuals
- 2210** Underpayment of Estimated Tax by Individuals, Estates, and Trusts

## Withholding

This chapter discusses withholding on these types of income:

- Salaries and wages
- Tips

- Taxable fringe benefits
- Sick pay
- Pensions and annuities
- Gambling winnings
- Unemployment compensation
- Certain federal payments.

This chapter explains in detail the rules for withholding tax from each of these types of income. The discussion of salaries and wages includes an explanation of how to complete a Form W-4.

This chapter also covers backup withholding on interest, dividends, and other payments.

## Salaries and Wages

Income tax is withheld from the pay of most employees. Your pay includes bonuses, commissions, and vacation allowances, in addition to your regular pay. It also includes reimbursements and other expense allowances paid under a nonaccountable plan. See *Supplemental Wages*, later.

**Military retirees.** Military retirement pay is treated in the same manner as regular pay for income tax withholding purposes, even though it is treated as a pension or annuity for other tax purposes.

**Household workers.** If you are a household worker, you can ask your employer to withhold income tax from your pay. Tax is withheld only if you want it withheld and your employer agrees to withhold it. If you do not have enough income tax withheld, you may have to make estimated tax payments, as discussed later under *Estimated Tax*.

**Farmworkers.** Income tax is generally withheld from your cash wages for work on a farm unless your employer:

- 1) Pays you cash wages of less than \$150 during the year, and
- 2) Has expenditures for agricultural labor totaling less than \$2,500 during the year.

If you receive either cash wages not subject to withholding or noncash wages, you can ask your employer to withhold income tax. If your employer does not agree to withhold tax, or if not enough is withheld, you may have to make estimated tax payments, as discussed later under *Estimated Tax*.

### Amount Withheld

The amount of income tax your employer withholds from your regular pay depends on two things:

- 1) The amount you earn, and
- 2) The information you give your employer on **Form W-4**.

Form W-4 includes three types of information that your employer will use to figure your withholding:

- 1) Whether to withhold at the single rate or at the lower married rate,
- 2) How many withholding allowances you claim (each allowance reduces the amount withheld), and
- 3) Whether you want an additional amount withheld.

If your income is low enough that you will not have to pay income tax for the year, you may be exempt from withholding. See *Exemption From Withholding*, later.

**Note.** You must specify a filing status and a number of withholding allowances on Form W-4. You cannot specify only a dollar amount of withholding.

**New job.** When you start a new job, you must fill out Form W-4 and give it to your employer. Your employer should have copies of the form. If you later need to change the information you gave, you must fill out a new form.

If you work only part of the year (for example, you start working after the beginning of the year), too much tax may be withheld. You may be able to avoid overwithholding if your employer agrees to use the part-year method. See *Part-year method* in Chapter 1 of Publication 505 for more information.

**Changing your withholding.** Events during the year may change your marital status or the exemptions, adjustments, deductions, or credits you expect to claim on your return. When this happens, you may need to give your employer a new Form W-4 to change your withholding status or number of allowances.

You **must** give your employer a new Form W-4 within 10 days after:

- 1) Your divorce, if you have been claiming married status, or
- 2) Any event that decreases the number of withholding allowances you can claim.

Generally, you can submit a new Form W-4 at any time you wish to change the number of your withholding allowances for any other reason.

**Changing your withholding for 1998.** If events in 1997 will decrease the number of your withholding allowances for 1998, you must give your employer a new Form W-4 by December 1, 1997. If the event occurs in December 1997, submit a new Form W-4 within 10 days.

**Cumulative wage method.** If you change the number of your withholding allowances during the year, too much or too little tax may have been withheld for the period before you made the change. You may be

able to compensate for this if your employer agrees to use the cumulative wage withholding method for the rest of the year. You must ask in writing that your employer use this method.

To be eligible, you must have been paid for the same kind of payroll period (weekly, biweekly, etc.) since the beginning of the year.

**Checking your withholding.** After you have given your employer a Form W-4, you can check to see whether the amount of tax withheld from your pay is too little or too much. See *Getting the Right Amount of Tax Withheld*, later. If too much or too little tax is being withheld, you should give your employer a new Form W-4 to change your withholding.

**Note.** You cannot give your employer a payment to cover withholding for past pay periods. Nor can you give your employer a payment for estimated tax.

### Completing Form W-4

The following discussions explain how to complete your Form W-4.

**Marital status (line 3).** There is a lower withholding rate for married people who can use the tax rates for joint returns. Everyone else must have tax withheld at the higher single rate.

You must claim **single** status if either of the following applies.

- 1) **You are single.** If you are divorced, or separated from your spouse under a court decree of separate maintenance, you are considered single.
- 2) **You are married, but you are neither a citizen nor a resident of the United States,** or your spouse is neither a citizen nor a resident of the United States. However, if one of you is a citizen or a resident, you can choose to have the other treated as a resident. You can then file a joint return and claim married status on your Form W-4. See *Nonresident Spouse Treated as a Resident* in Chapter 1 of Publication 519, *U.S. Tax Guide for Aliens*, for more information.

You can claim **married** status if either of the following applies.

- 1) **You are married and neither you nor your spouse is a nonresident alien.** You are considered married for the whole year even if your spouse died during the year.
- 2) **You expect to be able to file your return as a qualifying widow or widower.** You usually can use this filing status if your spouse died within the previous 2 years and you provide a home for your dependent child. However, you must file a new Form W-4 showing your filing status as single by December 1 of the last year you are

eligible to file as a qualifying widow or widower. See *Qualifying Widow(er) With Dependent Child* in Chapter 2.

Some married people find that they do not have enough tax withheld at the married rate. This can happen, for example, when both spouses work. To avoid this, you can choose to have tax withheld at the higher single rate (even if you qualify for the married rate). Also, you can fill out the *Two-Earner/Two-Job Worksheet*.

**Withholding allowances (line 5).** The more allowances you claim on Form W-4, the less income tax your employer will withhold. You will have the most tax withheld if you claim "0" allowances. The number of allowances you can claim depends on:

- 1) How many exemptions you can take on your tax return,
- 2) Whether you have income from more than one job,
- 3) What deductions, adjustments to income, and credits you expect to have for the year, and
- 4) Whether you will file as head of household.

If you are married, it also depends on whether your spouse also works and claims any allowances on his or her own Form W-4. If you both work, you should figure your combined allowances on one Form W-4 worksheet. You then should divide the allowances among the Forms W-4 you each file with every employer. See *Two jobs*, later.

**Form W-4 worksheets.** Form W-4 has worksheets to help you figure how many withholding allowances you can claim. The worksheets are for your own records. Do not give them to your employer.

You do not have to use the worksheets if you use a more accurate method of figuring the number of withholding allowances. See *Alternative method of figuring withholding allowances* under *Completing Form W-4 and Worksheets* in Chapter 1 of Publication 505 for more information.

**Two jobs.** If you have income from two jobs at the same time, complete only one set of Form W-4 worksheets. Then split your allowances between the Forms W-4 for each job. You cannot claim the same allowances with more than one employer at the same time. You can claim all your allowances with one employer and none with the other, or divide them in any other way you wish.

If both you and your spouse are employed and you expect to file a joint return, figure your withholding allowances using your combined income, adjustments, deductions, exemptions, and credits. Use only one set of worksheets. You can divide your total allowances in any way you wish, but you cannot claim an allowance that your spouse also claims.

If you and your spouse expect to file separate returns, figure your allowances separately based on your own individual income, adjustments, deductions, exemptions, and credits.

**Personal Allowances Worksheet.** Use the *Personal Allowances Worksheet* on page 1 of Form W-4 to figure your withholding allowances for exemptions. Add the special allowance for only one job, the allowance for head of household status, and the allowance for the child and dependent care credit (if they apply) to your total allowances.

**Only one job (worksheet line B).** You can claim an additional withholding allowance if any of the following apply.

- 1) You are single, and you have only one job at a time.
- 2) You are married, you have only one job at a time, and your spouse does not work.
- 3) Your wages from a second job or your spouse's wages (or the total of both) are \$1,000 or less.

**Head of household (worksheet line E).** You can claim one additional withholding allowance if you expect to file as head of household on your tax return. To find out whether you qualify, see *Head of Household* in Chapter 2.

**Child and dependent care credit (worksheet line F).** You can claim one additional withholding allowance if you expect to have at least \$1,500 of qualifying child or dependent care expenses that you plan to claim a credit for on your tax return. For information on this credit, see Chapter 33.

Instead of using line F, you can choose to figure allowances for the child and dependent care credit (and other credits you expect to claim on your return) as explained next.

**Deductions and Adjustments Worksheet.** Fill out this worksheet to adjust the number of your withholding allowances for deductions, adjustments to income, and tax credits. The *Deductions and Adjustments Worksheet* is on page 2 of Form W-4. Chapter 1 of Publication 505 explains this worksheet.

**Two-Earner/Two-Job Worksheet.** You may need to complete this worksheet if you have two jobs or a working spouse. You should also use this worksheet to figure additional withholding if you expect to owe an amount other than income tax, such as self-employment tax.

**For more information about Form W-4** and a filled-in example, see Chapter 1 of Publication 505.

## Getting the Right Amount of Tax Withheld

In most situations, the tax withheld from your pay will be close to the tax you figure on your return if:

- 1) You accurately complete all the Form W-4 worksheets that apply to you, and
- 2) You give your employer a new Form W-4 when changes occur.

But because the worksheets and withholding methods do not account for all possible situations, you may not be getting the right amount withheld. This is most likely to happen in the following situations.

- 1) You are married and both you and your spouse work.
- 2) You have more than one job at a time.
- 3) You have nonwage income, such as interest, dividends, alimony, or self-employment income.
- 4) You will owe additional amounts with your return, such as self-employment tax.
- 5) Your withholding is based on obsolete Form W-4 information for a substantial part of the year.
- 6) Your earnings are more than \$150,000 if you are single or \$200,000 if you are married.

To make sure you are getting the right amount of tax withheld, get Publication 919. It will help you compare the total tax to be withheld during the year with the tax you can expect to figure on your return. It also will help you determine how much, if any, additional withholding is needed each payday to avoid owing tax when you file your return. If you do not have enough tax withheld, you may have to make estimated tax payments, as explained under *Estimated Tax*, later.

## Rules Your Employer Must Follow

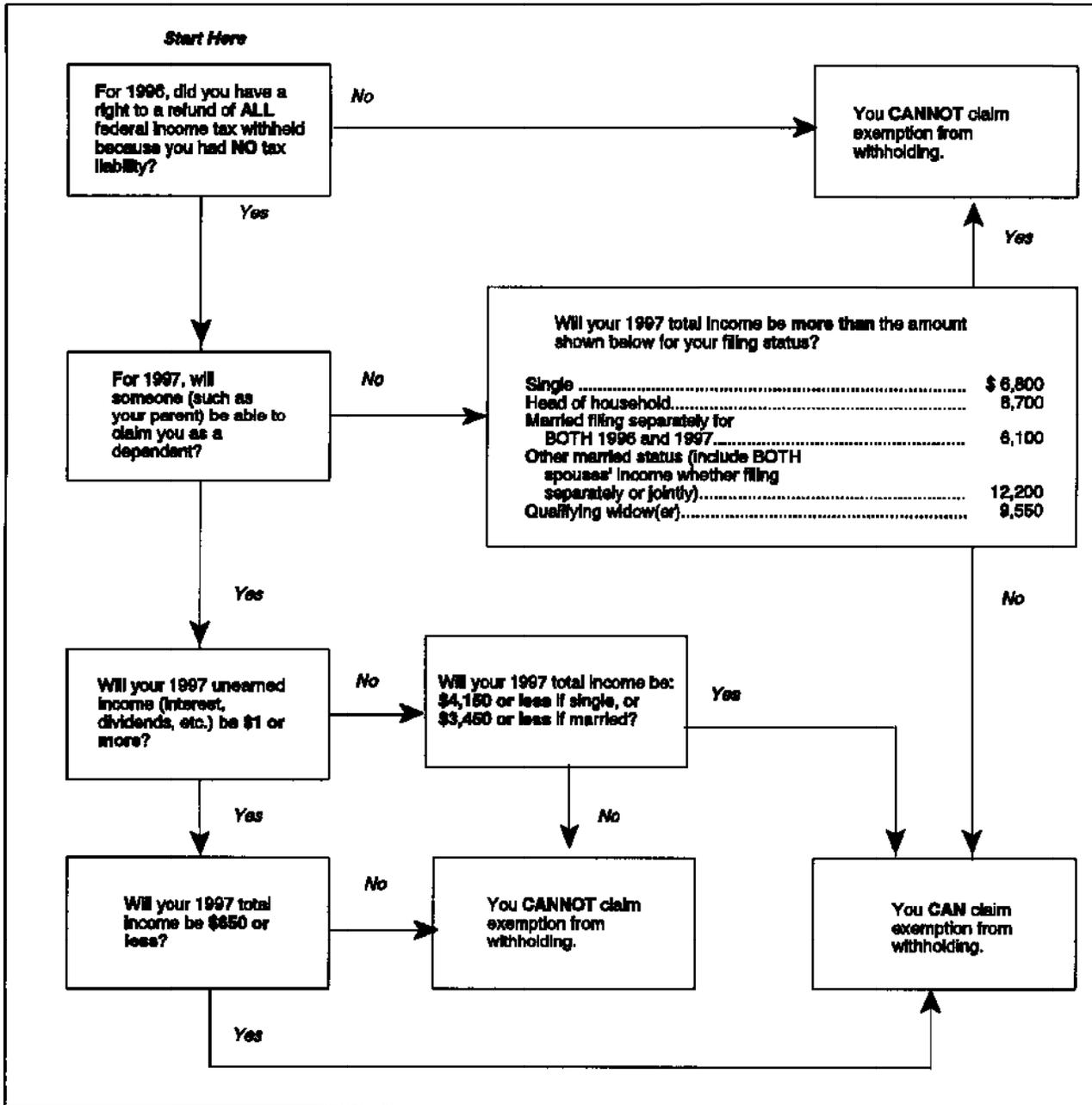
The following are some of the withholding rules that can affect how you fill out your Form W-4 and how you handle problems that may arise. For other rules, see *Rules Your Employer Must Follow* in Chapter 1 of Publication 505.

**New Form W-4.** When you start a new job, your employer should give you a Form W-4 to fill out. Your employer will use the information you give on the form to figure your withholding, beginning with your first payday.

If you later fill out a new Form W-4, your employer can put it into effect as soon as it is practical to do so. The deadline for putting it into effect is the start of the first payroll period ending 30 or more days after you turn it in.

**Figure 5-A. Exemption From Withholding on Form W-4**

**NOTE:** Do not use this chart if you are 65 or older or blind, or if you will itemize your deductions or claim dependents or tax credits. Instead, see the discussions in this chapter under *Exemption From Withholding*.



**No Form W-4.** If you do not give your employer a completed Form W-4, your employer must withhold at the highest rate—as if you were single and claimed no allowances.

**Repaying withheld tax.** If you find you are having too much tax withheld because you did not claim all the withholding allowances you are entitled to, you should give your employer a new Form W-4. Your employer cannot repay you any of the tax withheld under your old Form W-4.

However, if your employer has withheld more than the correct amount of tax for the Form W-4 you have in effect, you do not have to fill out a new Form W-4 to have your withholding lowered to the correct amount. Your employer can repay you the amount that was incorrectly withheld. If you are not repaid, you will receive credit on your tax return for the full amount actually withheld.

**Exemption From Withholding**

If you claim exemption from withholding, your employer will not withhold federal income tax from your wages. The exemption applies only to income tax, not to social security or Medicare tax.

You can claim exemption from withholding for 1997 only if **both** the following situations apply.

- 1) For 1996 you had a right to a refund of all federal income tax withheld because you had no tax liability.

- 2) For 1997 you expect a refund of all federal income tax withheld because you expect to have no tax liability.

Use *Figure 5–A* in this chapter to help you decide whether you can claim exemption. Do not use the chart if you are 65 or older or blind or if you will itemize deductions or claim dependents or tax credits on your 1997 return. These situations are discussed later.

**Student.** If you are a student, you are not automatically exempt. See Chapter 1 to see if you must file a return. If you work only part time or only during the summer, you may qualify for exemption from withholding.

**Example 1.** You are a high school student and expect to earn \$2,500 from a summer job. You do not expect to have any other income during 1997, and your parents will be able to claim you as a dependent on their tax return. You worked last summer and had \$375 federal income tax withheld from your pay. The entire \$375 was refunded when you filed your 1996 return. Using *Figure 5–A*, you find that you **can** claim exemption from withholding.

**Example 2.** The facts are the same as in Example 1, except that you have a savings account and expect to have \$20 interest income in 1997. Using *Figure 5–A*, you find that you **cannot** claim exemption from withholding because your unearned income will be \$1 or more and your total income will be more than \$650.

**Age 65 or older or blind.** If you are 65 or older or blind, use one of the worksheets in Chapter 1 of Publication 505, under *Exemption From Withholding*, to help you decide whether you can claim exemption from withholding. Do not use either of those worksheets if you will itemize deductions or claim dependents or tax credits on your 1997 return—see the following discussion instead.

**Itemizing deductions or claiming dependents or tax credits.** If you had no tax liability for 1996 and you will itemize your deductions or claim dependents or tax credits on your 1997 return, use the 1997 Estimated Tax Worksheet in Form 1040–ES (or see Chapter 2 of Publication 505) to figure your 1997 expected tax liability. You can claim exemption from withholding only if your total expected tax liability (line 13c of the worksheet) is zero.

**Claiming exemption.** To claim exemption, you must give your employer a Form W–4. Write “EXEMPT” on line 7.

Your employer must send the IRS a copy of your Form W–4 if you claim exemption from withholding and your pay is expected to usually be more than \$200 a week. If it turns out that you do not qualify for exemption, the IRS will send both you and your employer a written notice.

If you claim exemption, but later your situation changes so that you will have to pay income tax after all, you must file a new Form W–4 within 10 days after the change. If you claim exemption in 1997, but you expect to owe income tax for 1998, you must file a new Form W–4 by December 1, 1997.

**An exemption is good for only one year.** You must give your employer a new Form W–4 by February 15 each year to continue your exemption.

## Supplemental Wages

Supplemental wages include bonuses, commissions, overtime pay, and certain sick pay. Your employer or other payer of supplemental wages may withhold income tax from these wages at a flat rate of 28%. The payer can also figure withholding using the same method used for your regular wages.

Also see *Sick Pay*, later.

**Expense allowances.** Reimbursements or other expense allowances paid by your employer under a nonaccountable plan are treated as supplemental wages.

Reimbursements or other expense allowances paid under an accountable plan that are more than your proven expenses are treated as paid under a nonaccountable plan. However, this does not apply if you return the excess payments within a reasonable period of time.

For more information about accountable and nonaccountable expense allowance plans, see *Reimbursements* in Chapter 28.

## Penalties

You may have to pay a penalty of \$500 if:

- 1) You make statements or claim withholding allowances on your Form W–4 that reduce the amount of tax withheld, and
- 2) You have no reasonable basis for those statements or allowances at the time you prepare your Form W–4.

There is also a criminal penalty for willfully supplying false or fraudulent information on your Form W–4 or for willfully failing to supply information that would increase the amount withheld. The penalty upon conviction can be either a fine of up to \$1,000 or imprisonment for up to one year, or both.

These penalties will apply if you deliberately and knowingly falsify your Form W–4 in an attempt to reduce or eliminate the proper withholding of taxes. A simple error — an honest mistake — will not result in one of these penalties. For example, a person who has tried to figure the number of withholding allowances correctly, but claims seven when the proper number is six, will not be charged a W–4 penalty.

## Tips

The tips you receive while working on your job are considered part of your pay. You must include your tips on your tax return on the same line as your regular pay. However, tax is not withheld directly from tip income, as it is from your regular pay. Nevertheless, your employer will take into account the tips you report when figuring how much to withhold from your regular pay.

See Chapter 7 for information on reporting your tips to your employer. For more information on the withholding rules for tip income, see Publication 531, *Reporting Tip Income*.

**How employer figures amount to withhold.** The tips you report to your employer are counted as part of your income for the month you report them. Your employer can figure your withholding in either of two ways:

- 1) By withholding at the regular rate on the sum of your pay plus your reported tips, or
- 2) By withholding at the regular rate on your pay plus an amount equal to 28% of your reported tips.

**Not enough pay to cover taxes.** If your regular pay is too low for your employer to withhold all the tax (including social security tax, Medicare tax, or railroad retirement tax) due on your pay plus your tips, you may give your employer money to cover the shortage.

If you do not give your employer money to cover the shortage, your employer will first withhold as much social security tax, Medicare tax, or railroad retirement tax as possible, up to the proper amount, and then withhold income tax up to the full amount of your pay. If not enough tax is withheld, you may have to make estimated tax payments. When you file your return, you also may have to pay any social security tax, Medicare tax, or railroad retirement tax your employer could not withhold.

**Allocated tips.** Your employer should not withhold income tax, social security tax, Medicare tax, or railroad retirement tax on any allocated tips. Withholding is based only on your pay plus your **reported tips**. Your employer should refund to you any incorrectly withheld tax. See *Tip Allocation* in Chapter 7 for more information.

## Taxable Fringe Benefits

The value of certain noncash fringe benefits you receive from your employer is considered part of your pay. Your employer generally must withhold income tax on these benefits from your regular pay for the period the benefits are paid or considered paid.

For information on taxable fringe benefits, see *Fringe Benefits* under *Employee Compensation* in Chapter 6.

Your employer can choose not to withhold income tax on the value of your personal use of a car, truck, or other highway motor vehicle provided by your employer. Your employer must notify you if this choice is made.

For more information on withholding on taxable fringe benefits, see Chapter 1 of Publication 505.

## Sick Pay

“Sick pay” is a payment to you to replace your regular wages while you are temporarily absent from work due to sickness or personal injury. To qualify as “sick pay,” it must be paid under a plan to which your employer is a party.

If you receive sick pay from your employer or an agent of your employer, income tax must be withheld just as it is from your regular pay.

However, if you receive sick pay from a third party who is not acting as an agent of your employer, income tax will be withheld only if you choose to have it withheld. See *Form W-4S*, later.

If you receive payments under a plan in which your employer does not participate (such as an accident or health plan where you paid all the premiums), the payments are not sick pay and usually are not taxable.

**Union agreements.** If you receive sick pay under a collective bargaining agreement between your union and your employer, the agreement may determine the amount of income tax withholding. See your union representative or your employer for more information.

**Form W-4S.** If you choose to have income tax withheld from sick pay paid by a third party, such as an insurance company, you must fill out *Form W-4S, Request for Federal Income Tax Withholding From Sick Pay*. Its instructions contain a worksheet you can use to figure the amount you want withheld. They also explain restrictions that may apply.

Give the completed form to the payer of your sick pay. The payer must withhold according to your directions on the form.

If you do not request withholding on *Form W-4S*, or if you do not have enough tax withheld, you may have to make estimated tax payments. If you do not pay enough estimated tax or have enough income tax withheld, you may have to pay a penalty. See *Who Must Make Estimated Tax Payments and Underpayment Penalty*, later in this chapter.

## Pensions and Annuities

Income tax usually will be withheld from your pension or annuity distributions, unless you choose not to have it withheld. This rule applies to distributions from:

- 1) An individual retirement arrangement (IRA),
- 2) A life insurance company under an endowment, annuity, or life insurance contract,
- 3) A pension, annuity, or profit-sharing plan,
- 4) A stock bonus plan, and
- 5) Any other plan that defers the time you receive compensation.

The amount withheld depends on whether you receive payments spread out over more than one year (periodic payments), within one year (nonperiodic payments), or as an eligible rollover distribution (EDR). You cannot choose not to have income tax withheld from an EDR.

**More information.** For more information on taxation of annuities and distributions (including eligible rollover distributions) from qualified retirement plans, see Chapter 11. For information on IRAs, see Chapter 18. For more information on withholding on pensions and annuities, including a discussion of *Form W-4P, Withholding Certificate for Pension or Annuity Payments*, see *Pensions and Annuities* under *Withholding* in Chapter 1 of Publication 505.

## Gambling Winnings

Income tax is withheld from certain kinds of gambling winnings. The amount withheld is 28% of the proceeds paid (the amount of your winnings minus the amount of your bet).

Gambling winnings of more than \$5,000 from the following sources are subject to income tax withholding:

- 1) Any sweepstakes, wagering pool, or lottery, and
- 2) Any other wager, if the proceeds are at least 300 times the amount of the bet.

It does not matter whether your winnings are paid in cash, in property, or as an annuity. Winnings not in money are taken into account at their fair market value.

Gambling winnings from bingo, keno, and slot machines are not subject to income tax withholding. If you receive gambling winnings not subject to withholding, you may need to make estimated tax payments. (See *Estimated Tax*, later.)

If you do not pay enough tax through withholding or estimated tax payments, you may be subject to a penalty. (See *Underpayment Penalty*, later.)

**Form W-2G.** If a payer withholds income tax from your gambling winnings, you should receive a *Form W-2G, Certain Gambling Winnings*, showing the amount you won and the amount withheld.

**Reporting your winnings.** Report your winnings on line 21 of *Form 1040*. Report

the tax withheld on line 52 of *Form 1040*. Gambling losses are deductible only to the extent that they offset gambling winnings. You must use Schedule A of *Form 1040* to deduct your losses and to deduct state tax withholding.

## Unemployment Compensation

Beginning in 1997, you can choose to have income tax withheld from any unemployment compensation you get. To make this choice, you will have to fill out *Form W-4V, Voluntary Withholding Request*, (or a similar form provided by the payer) and give it to the payer. The amount withheld will be 15% of each payment.

Unemployment compensation is taxable. So, if you do not have income tax withheld, you may have to make estimated tax payments. See *Estimated Tax*, later.

If you do not pay enough tax either through withholding or estimated tax, you may have to pay a penalty. See *Underpayment Penalty*, later, for information.

## Social Security and Other Federal Payments

Beginning in 1997, you can choose to have income tax withheld from certain federal payments you receive. These payments are:

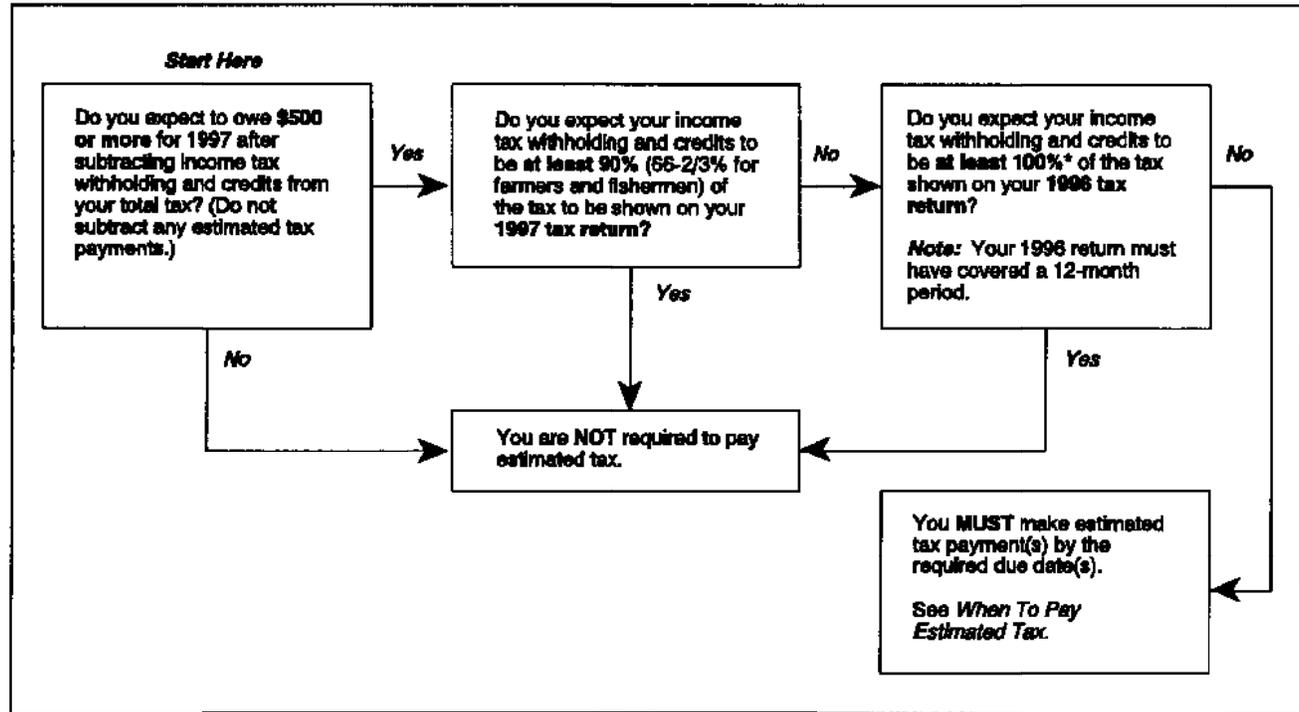
- 1) Social security benefits,
- 2) Tier 1 railroad retirement benefits,
- 3) Commodity credit loans included in your gross income, and
- 4) Payments you received under the Agricultural Act of 1949, or title II of the Disaster Assistance Act of 1988, as amended, because:
  - a) Your crops were destroyed or damaged by drought, flood, or any other natural disaster, or
  - b) You were unable to plant crops because of a natural disaster described in (a).

To make this choice, you will have to fill out *Form W-4V, Voluntary Withholding Request*, (or a similar form provided by the payer) and give it to the payer. You can choose to have 7%, 15%, 28%, or 31% of each payment withheld.

The payments in (1) and (2) are partly taxable in certain cases. The payments in (3) and (4) are fully taxable. So, if you do not choose to have income tax withheld, you may have to make estimated tax payments. See *Estimated Tax*, later. If you do not pay enough tax either through withholding or estimated tax, you may have to pay a penalty. See *Underpayment Penalty*, later, for information.

**More information.** For more information about the tax treatment of social security and railroad retirement benefits, see Chapter 12. Get Publication 225, *Farmer's Tax*

**Figure 5-B. Do You Have To Pay Estimated Tax?**



\*110% if less than two-thirds of your gross income for 1996 and 1997 is from farming or fishing and your 1996 adjusted gross income was more than \$150,000 (\$75,000 if your filing status for 1997 is married filing a separate return)

Guide, for information about the tax treatment of commodity credit loans or crop disaster payments.

### Backup Withholding

Banks and other businesses that pay you certain kinds of income must file an information return (Form 1099) with the IRS. The information return shows how much you were paid during the year. It also includes your name and taxpayer identification number (TIN). Your TIN generally is either a social security number or an employer identification number.

These payments generally are not subject to withholding. However, "backup" withholding is required in certain situations. And, backup withholding can apply to most kinds of payments that are reported on Form 1099.

Payments made to you are subject to backup withholding at a flat 31% rate in the following situations.

- 1) You do not give the payer your TIN in the required manner.
- 2) The IRS notifies the payer that the TIN you gave is incorrect.
- 3) You are required, but fail, to certify that you are not subject to backup withholding.
- 4) The IRS notifies the payer to start withholding on interest or dividends because you have underreported interest or dividends on your income tax return. The IRS will do this only after it has mailed you four notices over at least a 120-day period.

See *Backup Withholding* in Chapter 1 of Publication 505 for more information.

**Penalties.** There are civil and criminal penalties for giving false information to avoid backup withholding. The civil penalty is \$500. The criminal penalty, upon conviction, is a fine of up to \$1,000, or imprisonment of up to one year, or both.

### Estimated Tax

Estimated tax is the method used to pay tax on income that is not subject to withholding. This includes income from self-employment, interest, dividends, alimony, rent, gains from the sale of assets, prizes, and awards. You also may have to pay estimated tax if the amount of income tax being withheld from your salary, pension, or other income is not enough. To figure and pay estimated tax, use **Form 1040-ES, Estimated Tax for Individuals**.

Estimated tax is used to pay both income tax and self-employment tax, as well as other taxes and amounts reported on your tax return. If you do not pay enough tax through withholding or by making estimated tax payments, you may be charged a penalty. If you do not pay enough by the due date of each payment period (see *When To Pay Estimated Tax*, later), you may be charged a penalty even if you are due a refund when you file your tax return. For information on when the penalty applies, see *Underpayment Penalty*, later.

### Who Must Make Estimated Tax Payments

If you had a tax liability for 1996, you may have to pay estimated tax for 1997.

**General rule.** You must make estimated tax payments for 1997 if you expect to owe at least \$500 in tax for 1997 after subtracting your withholding and credits, and you expect your withholding and credits to be less than the smaller of:

- 1) 90% of the tax to be shown on your 1997 tax return, or
- 2) 100% of the tax shown on your 1996 tax return. Your 1996 tax return must cover all 12 months.

**Note.** If all your 1997 income will be subject to income tax withholding, you probably do not need to make estimated tax payments.

**Exceptions.** There are exceptions to the general rule if you are a farmer or fisherman or your 1996 adjusted gross income was more than \$150,000 (\$75,000 if your filing status for 1997 is married filing separately). See *Figure 5-B* and Chapter 2 of Publication 505 for more information.

**To whom the rules apply.** The estimated tax rules apply to:

- U.S. citizens and residents,
- Residents of Puerto Rico, the Virgin Islands, Guam, the Commonwealth of the Northern Mariana Islands, and American Samoa, and
- Nonresident aliens.

**Aliens.** Resident and nonresident aliens have to make estimated tax payments. Resident aliens should follow the rules in this chapter unless noted otherwise. Nonresident aliens should get **Form 1040-ES(NR), U.S. Estimated Tax for Nonresident Alien Individuals**.

**Avoiding estimated tax.** If, in addition to income not subject to withholding, you also receive salaries or wages, you can avoid having to make estimated tax payments by asking your employer to take more tax out of your earnings. To do this, file a new Form W-4 with your employer.

**No tax liability last year.** You do not have to pay estimated tax for 1997 if you meet all three of the following conditions:

- 1) You had no tax liability for your 1996 tax year,
- 2) You were a U.S. citizen or resident for the whole year, and
- 3) Your 1996 tax year covered a 12-month period.

You had no tax liability for 1996 if your total tax (defined later under *Required annual payment*) was zero or you did not have to file an income tax return.

**Married taxpayers.** To figure whether you must make estimated tax payments for 1997, apply the rules discussed here to your 1997 separate estimated income. If you can make joint estimated tax payments, you can apply these rules on a joint basis.

You and your spouse can make joint payments of estimated tax even if you are not living together.

You and your spouse cannot make joint estimated tax payments if you are separated under a decree of divorce or separate maintenance. Also, you cannot make joint estimated tax payments if either spouse is a nonresident alien or if you have different tax years.

Whether you and your spouse make joint estimated tax payments or separate payments will not affect your choice of filing a joint tax return or separate returns for 1997.

**1996 separate returns and 1997 joint return.** If you plan to file a joint return with your spouse for 1997, but you filed separate returns for 1996, your 1996 tax is the total of the tax shown on your separate returns. You filed a separate return for 1996 if you filed as single, head of household, or married filing separately.

**1996 joint return and 1997 separate returns.** If you plan to file a separate return for 1997, but you filed a joint return with your spouse for 1996, your 1996 tax is your share of the tax on the joint return. You file a separate return for 1997 if you file as single, head of household, or married filing separately. To figure your share, first figure the tax both you and your spouse would have paid had you filed separate returns for 1996 using the same filing status as for 1997. Then multiply your joint tax liability by the following fraction:

$$\frac{\text{Your separate tax liability}}{\text{Both spouses' separate tax liabilities}}$$

**Example.** Joe and Heather filed a joint return for 1996 showing taxable income of \$48,000 and a tax of \$8,234. Of the \$48,000 taxable income, \$40,000 was Joe's and the rest was Heather's. For 1997, they plan to file married filing separately. Joe figures his share of the tax on the 1996 joint return as follows:

Tax on \$40,000 based on a separate return	\$ 8,601
Tax on \$8,000 based on a separate return	<u>1,204</u>
Total	\$ 9,805
Joe's portion of total (\$8,601 ÷ \$9,805)	88%
Joe's share of joint return tax (\$8,234 × 88%)	<u>\$ 7,246</u>

## How To Figure Estimated Tax

To figure your estimated tax, you must figure your expected adjusted gross income, taxable income, and taxes and credits for the year.

When figuring your 1997 estimated tax, it may be helpful to use your income, deductions, and credits for 1996 as a starting point. Use your 1996 federal tax return as a guide. You will also need Form 1040-ES to figure and pay your estimated tax. You must make adjustments both for changes in your own situation and for recent changes in the tax law. For 1997, there are several important changes in the law. These changes are discussed under *Important Changes for 1997* at the beginning of this chapter.

Form 1040-ES includes a worksheet to help you figure your estimated tax. Keep the worksheet for your records.

For complete information and examples on how to figure your estimated tax for 1997, see Chapter 2 of Publication 505.

**Expected adjusted gross income.** Your expected adjusted gross income for 1997 is your expected total income minus your expected adjustments to income. Include all the income you expect to receive during the year, even income that is subject to withholding. However, do not include income that is tax exempt. Be sure to subtract all the adjustments to income you expect to take on your 1997 tax return. If you are using your 1996 return as a guide and filed Form 1040,

your adjustments for 1996 were on lines 23a-30. If you filed Form 1040A, your 1996 adjustments were on lines 15a-15c. When estimating your 1997 adjustments, include any allowable contributions to a medical savings account.

If you expect to receive social security benefits, you can use *Worksheet 2.1* in Chapter 2 of Publication 505 to figure your expected taxable benefits.

If you are self-employed, you can use *Worksheet 2.2* in Chapter 2 of Publication 505 to figure your deduction for one-half your expected self-employment tax.

**Expected taxable income.** Reduce your expected adjusted gross income by either your expected itemized deductions or your standard deduction and by a \$2,650 deduction for each exemption. For information on the 1997 standard deduction amounts and a possible limit on your itemized deductions, see Publication 505 or the instructions for Form 1040-ES.

**Expected taxes and credits.** After you have figured your expected taxable income, figure your expected income tax. Use the 1997 Tax Rate Schedules in Publication 505 or in the Form 1040-ES instructions. See Chapter 32 for the special tax computation to use for a child under age 14 who has more than \$1,300 of investment income.

Add your expected additional taxes from Form 8814, *Parents' Election To Report Child's Interest and Dividends*, and Form 4972, *Tax on Lump-Sum Distributions*. Subtract your expected credits. If you are using your 1996 return as a guide and filed Form 1040, your total credits for 1996 were shown on line 43. If you filed Form 1040A, your total credits for 1996 were on line 24c. When estimating your 1997 credits, include any allowable adoption tax credit. If your credits are more than your taxes, use "-0-" as the result.

Add your expected self-employment tax and other taxes (see Chapter 2 of Publication 505). "Other taxes" are those shown on lines 46 and 48 of the 1996 Form 1040, plus any advance earned income credit payments on line 49 and any write-in amounts on line 51 (other than recapture of a federal mortgage subsidy and any uncollected social security, Medicare, or railroad retirement tax). If you filed a 1996 Form 1040A, your only "other taxes" were any advance earned income credit payments on line 26.

Finally, subtract your expected earned income credit and fuel tax credit (from Form 4136). The result is your expected total tax for 1997.

**Required annual payment.** You figure the total amount you must pay for 1997 through withholding and estimated tax payments on lines 14a through 14c of the 1997 Estimated Tax Worksheet. The result is your required annual payment. It is the **smaller** of:

- 1) 90% of your total expected tax for 1997, or

2) 100% of the total tax shown on your 1996 return. (Your 1996 tax return must cover all 12 months.)

**Exceptions.** If you are a farmer or fisherman, or your 1996 adjusted gross income was more than \$150,000 (\$75,000 if your filing status for 1997 is married filing a separate return), your required annual payment may be different. See *Required Annual Payment* in Chapter 2 of Publication 505.

**Total tax for 1996.** Your 1996 total tax on Form 1040 is the amount on line 51 reduced by the total of the amounts on lines 47, 50, and 54, any credit from Form 4136 included on line 57, any recapture of a federal mortgage subsidy and any uncollected social security, Medicare, or railroad retirement tax included on line 51, and any tax from Form 5329 (other than the tax on early distributions) included on line 48. On Form 1040A, it is line 28 reduced by the total of the amounts on lines 27 and 29c. On Form 1040EZ, it is line 10 reduced by line 8.

**Total estimated tax payments.** Figure the total amount you must pay for 1997 through estimated tax payments on lines 15 and 16 of the 1997 Estimated Tax Worksheet. Subtract your expected withholding from your required annual payment. You usually must pay this difference in four equal installments. (See *When To Pay Estimated Tax and How To Figure Each Payment*, later.)

If your total expected tax on line 13c, minus your expected withholding on line 15, is less than \$500, you do not need to make estimated tax payments.

**Withholding.** Your expected withholding for 1997 includes the income tax you expect to be withheld from all sources (wages, pensions and annuities, etc.). It also includes excess social security and railroad retirement tax you expect to be withheld from your wages.

For information on excess social security or tier 1 railroad retirement tax withholding for 1997, see Publication 505.

## When To Pay Estimated Tax

For estimated tax purposes, the year is divided into four payment periods. Each period has a specific payment due date. If you do not pay enough tax by the due date of each of the payment periods, you may be charged a penalty even if you are due a refund when you file your income tax return. The following chart gives the payment periods and due dates for estimated tax payments.

<u>For the period:</u>	<u>Due date:</u>
Jan. 1* through Mar. 31	April 15
April 1 through May 31	June 15

June 1 through Aug. 31    September 15  
 Sept. 1 through Dec. 31    January 15 next year\*\*

\*If your tax year does not begin on January 1, see *Fiscal year taxpayers*, later.

\*\*See *January payment*, later.

**Saturday, Sunday, holiday rule.** If the due date for making an estimated tax payment falls on a Saturday, Sunday, or legal holiday, the payment will be on time if you make it on the next day that is not a Saturday, Sunday, or legal holiday. For example, a payment due Sunday, June 15, 1997, will be on time if you make it by Monday, June 16, 1997.

**January payment.** If you file your 1997 return by February 2, 1998, and pay the rest of the tax you owe, you do not need to make your estimated tax payment that would be due on January 15, 1998.

**Fiscal year taxpayers.** If your tax year does not start on January 1, your payment due dates are:

- 1) The 15th day of the 4th month of your fiscal year,
- 2) The 15th day of the 6th month of your fiscal year,
- 3) The 15th day of the 9th month of your fiscal year, and
- 4) The 15th day of the 1st month after the end of your fiscal year.

You do not have to make the last payment listed above if you file your income tax return by the last day of the first month after the end of your fiscal year and pay all the tax you owe with your return.

## When To Start

You do not have to make estimated tax payments until you have income on which you will owe the tax. If you have income subject to estimated tax during the first payment period, you must make your first payment by the due date for the first payment period. You can pay all your estimated tax at that time, or you can pay it in four installments. If you choose to pay in installments, make your first payment by the due date for the first payment period. Make your remaining installment payments by the due dates for the later periods.

**No income subject to estimated tax during first period.** If you first have income subject to estimated tax during a later payment period, you must make your first payment by the due date for that period. You can pay your entire estimated tax by the due date for that period, or you can pay it in installments by the due date for that period and the due dates for the remaining periods. The following chart shows when to make installment payments:

If you first have income on which you must pay estimated tax:	Make a	Make later
	payment by:	installments by:
Before April 1	April 15	June 15 September 15 January 15 next year*
After March 31 and before June 1	June 15	September 15 January 15 next year*
After May 31 and before Sept. 1	September 15	January 15 next year*
After August 31	January 15 next year*	(None)

\*See *January payment*, and *Saturday, Sunday, holiday rule* under *When To Pay Estimated Tax*, earlier.

**Change in estimated tax.** After making your first estimated tax payment, changes in your income, adjustments, deductions, credits, or exemptions may make it necessary for you to refigure your estimated tax. Pay the unpaid balance of your amended estimated tax by the next payment due date after the change or in installments by that date and the due dates for the remaining payment periods.

**How much to pay to avoid penalty.** To determine how much you should pay by each payment due date, see *How To Figure Each Payment*, next. If the earlier discussions of *No income subject to estimated tax during first period* or *Change in estimated tax* apply to you, you may need to read the explanation of the *Annualized Income Installment Method*, later, to avoid a penalty.

## How To Figure Each Payment

You should pay enough estimated tax by the due date of each payment period to avoid a penalty for that period. If you do not pay enough each payment period, you may be charged a penalty even if you are due a refund when you file your tax return. See *Underpayment Penalty*, later in this chapter.

## Regular Installment Method

If you must pay estimated tax beginning with the payment due April 15, 1997, you can figure your required payment for each period by dividing your total estimated tax payments (line 16 of the 1997 Estimated Tax Worksheet) by 4. Use this method only if your required annual payment stays the same throughout the year.

If you do not receive your income evenly throughout the year, your required estimated tax payments may not be the same for each period. See *Annualized Income Installment Method*, later.



**Amended estimated tax.** If you refigure your estimated tax during the year, or if your first payment is due after April 15, 1997, figure your required payment for each remaining payment period using the following worksheet.

1. Amended total estimated tax payments ..... \_\_\_\_\_
2. Multiply line 1 by:
  - .50 if next payment is due June 16, 1997.
  - .75 if next payment is due September 15, 1997.
  - 1.00 if next payment is due January 15, 1998. .... \_\_\_\_\_

3. Estimated tax payments for all previous periods ..... \_\_\_\_\_
4. **Next required payment:** Subtract line 3 from line 2 and enter the result (but not less than zero) here and on your payment-voucher for your next required payment ..... \_\_\_\_\_

If the payment on line 4 is due January 15, 1998, **stop here.** Otherwise, go on to line 5.

5. Add lines 3 and 4 ..... \_\_\_\_\_
6. Subtract line 5 from line 1 and enter the result (but not less than zero) ... \_\_\_\_\_
7. **Each following required payment:** If the payment on line 4 is due June 16, 1997, enter one-half of the amount on line 6 here and on the payment-vouchers for your payments due September 15, 1997, and January 15, 1998. If the amount on line 4 is due September 15, 1997, enter the full amount on line 6 here and on the payment-voucher for your payment due January 15, 1998 ..... \_\_\_\_\_

**Example.** Early in 1997, Mayra figures her estimated tax is \$1,800. She makes estimated tax payments on April 15 and June 16 of \$450 each ( $\$1,800 \div 4$ ).

On July 10, she sells investment property at a gain. Her refigured estimated tax is \$3,600. Her required estimated tax payment for the third payment period is \$1,800, figured as follows.

1. Amended total estimated tax payments ..... \$3,600
2. Multiply line 1 by:
  - .50 if next payment is due June 16, 1997.
  - .75 if next payment is due September 15, 1997.
  - 1.00 if next payment is due January 15, 1998. .... 2,700
3. Estimated tax payments for all previous periods ..... 900
4. **Next required payment:** Subtract line 3 from line 2 and enter the result (but not less than zero) here and on your payment-voucher for your next required payment ..... \$1,800

If the payment on line 4 is due January 15, 1998, **stop here.** Otherwise, go on to line 5.

5. Add lines 3 and 4 ..... 2,700
6. Subtract line 5 from line 1 and enter the result (but not less than zero) ... 900
7. **Each following required payment:** If the payment on line 4 is due June 16, 1998, enter one-half of the amount on line 6 here and on the payment-vouchers for your payments due September 15, 1997, and January 15, 1998. If the amount on line 4 is due September 15, 1997, enter the full amount on line 6 here and on the payment-voucher for your payment due January 15, 1998 ..... \$900

If Mayra's estimated tax does not change again, her required estimated tax payment for the fourth payment period will be \$900.

**File Form 2210 to avoid penalty.** If your estimated tax payment for a previous period is less than one-fourth of your amended estimated tax, you may be charged a penalty for underpayment of estimated tax for that period when you file your tax return. To avoid the penalty, you must show that the total of your withholding and estimated tax payment for the period was at least as much as your annualized income installment. Complete Form 2210 and Schedule AI — *Annualized Income Installment Method*, and attach the form and Schedule AI to your tax return. See Form 2210, later, under *Underpayment Penalty*, for more information.

### Annualized Income Installment Method

If you do not receive your income evenly throughout the year (for example, your income from a repair shop you operate is much larger in the summer than it is during the rest of the year), your required estimated tax payment for one or more periods may be less than the amount figured using the regular installment method.

To see if you can pay less for any period, complete the *1997 Annualized Estimated Tax Worksheet (Worksheet 2.10)* in Chapter 2 of Publication 505.

**Note.** If you use the annualized income installment method to figure your estimated tax payments, you **must** attach to your tax return a completed Form 2210 and Schedule AI (Form 2210). See Form 2210 under *Underpayment Penalty*, later.

### Estimated Tax Payments Not Required

You do not have to make estimated tax payments if your withholding in each payment period is at least one-fourth of your required annual payment or at least your required annualized income installment for that period. You also do not have to make estimated tax payments if you will pay enough through withholding to keep the amount you owe with your 1997 return under \$500.

## How To Pay Estimated Tax

There are two ways to make estimated tax payments:

- 1) By crediting an overpayment on your 1996 return to your 1997 estimated tax, and
- 2) By sending in your payment with a payment-voucher from **Form 1040-ES**.

### Crediting an Overpayment

When you file your Form 1040 or Form 1040A for 1996 and you have an overpayment of tax, you can apply part or all of it to your estimated tax for 1997. On line 61 of Form 1040, or line 32 of Form 1040A, write the amount you want credited to your estimated tax rather than refunded. The amount you have credited should be taken into account when figuring your estimated tax payments.

You can use all the credited amount toward your first payment, or you can spread it out in any way you choose among any or all of your payments.

If you ask that an overpayment be credited to your estimated tax for the next year, the payment is considered to have been made on the due date of the first estimated tax installment (April 15 for calendar year taxpayers). You cannot have any of that amount refunded to you after that due date. You also cannot use that overpayment in any other way after that date.

### Using the Payment-Vouchers

Each payment of estimated tax must be accompanied by a payment-voucher from Form 1040-ES. If you made estimated tax payments last year, you should receive a copy of the 1997 Form 1040-ES in the mail. It will have payment-vouchers preprinted with your name, address, and social security number. Using the preprinted vouchers will speed processing, reduce the chance of error, and help save processing costs.

If you did not pay estimated tax last year, you will have to get a copy of Form 1040-ES from the IRS. Do so by calling 1-800-TAX-FORM (1-800-829-3676). After you make your first payment, a Form 1040-ES package with the preprinted vouchers will be mailed to you. Follow the instructions in the package to make sure you use the vouchers correctly.

Use the addressed envelopes that came with your Form 1040-ES package. If you use your own envelope, make sure you mail your payment-vouchers to the address shown in the Form 1040-ES instructions for the place where you live. **Do not** use the address shown in the Form 1040 or Form 1040A instructions.

**Change of address.** You must notify the IRS if you are making estimated tax payments and you changed your address during the year. You must send a clear and concise written statement to the IRS Service Center

where you filed your last return and provide all of the following:

- 1) Your full name (and your spouse's full name),
- 2) Your signature (and spouse's signature),
- 3) Your old address (and spouse's old address if different),
- 4) Your new address, and
- 5) Your social security number (and spouse's social security number).

You can use Form 8822, *Change of Address*, for this purpose.

You can continue to use your old preprinted payment-vouchers until the IRS sends you new ones. However, **DO NOT** correct the address on the old voucher or the address on the envelope.

## Credit for Withholding and Estimated Tax

When you file your 1996 income tax return, take credit for all the income tax and excess social security or railroad retirement tax withheld from your salary, wages, pensions, etc. Also, take credit for the estimated tax you paid for 1996. These credits are subtracted from your tax. You should file a return and claim these credits even if you do not owe tax.

If you had two or more employers and were paid wages of more than \$62,700 during 1996, too much social security or railroad retirement tax may have been withheld from your wages. See *Credit for Excess Social Security Tax or Railroad Retirement Tax Withheld* in Chapter 36.

## Withholding

If you had income tax withheld during 1996, you should receive a statement by January 31, 1997, showing your income and the tax withheld. Depending on the source of your income, you will receive:

- **Form W-2**, *Wage and Tax Statement*,
- **Form W-2G**, *Certain Gambling Winnings*, or
- A form in the 1099 series.

**Forms W-2 and W-2G.** You file Form W-2 with your income tax return. File Form W-2G with your return if it shows any federal income tax withheld from your winnings.

You should get at least two copies of each form you receive. Attach Copy B to the front of your federal income tax return. Copy C is for your records. You should also receive copies to file with your state and local returns.

## Form W-2

Your employer should give you a Form W-2 for 1996 by January 31, 1997. You should receive a separate Form W-2 from each employer you worked for.

If you stop working before the end of the year, your employer can give you your Form W-2 at any time after you leave your job. However, your employer must give it to you by January 31 of the following year (or the next day that is not a Saturday, Sunday, or holiday if January 31 is a Saturday, Sunday, or holiday). If you ask for the form, your employer must give it to you within 30 days after receiving your written request or within 30 days after your final wage payment, whichever is later.

If you have not received your Form W-2 by January 31, 1997, you should ask your employer for it. If you do not receive it by February 15, call the IRS toll-free telephone number for your area. The number is listed in the Form 1040, Form 1040A, and Form 1040EZ instructions. You will be asked to give your employer's name, address, and telephone number, and, if known, your employer's identification number. You will also be asked for your address, social security number, daytime telephone number, dates of employment, and your best estimate of your total wages and federal income tax withheld.

Form W-2 shows your total pay and other compensation and the income tax, social security tax, and Medicare tax that was withheld during the year. Take credit for the federal income tax withheld on:

- Line 52 if you file Form 1040,
- Line 29a if you file Form 1040A, or
- Line 7 if you file Form 1040EZ.

Form W-2 is also used to report any taxable sick pay you received and any income tax withheld from your sick pay.

## Form W-2G

If you had gambling winnings, the payer may have withheld 28% as income tax. If tax was withheld, the payer will give you a Form W-2G showing the amount you won and the amount of tax withheld. Report the amounts you won on line 21 of Form 1040. Take credit for the tax withheld on line 52 of Form 1040. If you had gambling winnings, you must use Form 1040; you cannot use Form 1040A or Form 1040EZ. See *Deductions Not Subject to the 2% Limit* in Chapter 30 for information on how to deduct gambling losses.

## The 1099 Series

Most forms in the 1099 series are not filed with your return. You should receive these forms by January 31, 1997. Keep these forms for your records. There are several different forms in this series, including:

- Form 1099-B, *Proceeds From Broker and Barter Exchange Transactions*,
- Form 1099-DIV, *Dividends and Distributions*,
- Form 1099-G, *Certain Government Payments*,
- Form 1099-INT, *Interest Income*,
- Form 1099-MISC, *Miscellaneous Income*,

- Form 1099-OID, *Original Issue Discount*,
- Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.*,
- Form SSA-1099, *Social Security Benefit Statement*, and
- Form RRB-1099, *Payments by the Railroad Retirement Board*.

For some types of income reported on forms in the 1099 series, you may not be able to use Form 1040A or Form 1040EZ. See the instructions to these forms for details.

**Form 1099-R.** Attach Form 1099-R to your return if box 4 shows federal income tax withholding. Include the amount withheld in the total on line 52 of Form 1040 or line 29a of Form 1040A.

**Backup withholding.** If you were subject to backup withholding on income you received during 1996, include the amount withheld, as shown on your Form 1099, in the total on line 52 of Form 1040, or line 29a of Form 1040A.

## Form Not Correct

If you receive a form with incorrect information on it, you should ask the payer for a corrected form. Call the telephone number or write to the address given for the payer on the form. The corrected Form W-2G or Form 1099 you receive will be marked "CORRECTED." A special form, Form W-2c, *Statement of Corrected Wage and Tax Amounts*, is used to correct a Form W-2.

## Form Received After Filing

If you file your return and you later receive a form for income that you did not include on your return, you should report the income and take credit for any income tax withheld by filing Form 1040X, *Amended U.S. Individual Income Tax Return*. See *Amended Returns and Claims for Refund* in Chapter 1.

## Separate Returns

If you are married but file a separate return, you can take credit only for the tax withheld from your own income. Do not include any amount withheld from your spouse's income. However, different rules may apply if you live in a community property state.

**Community property states.** Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin are community property states. If you live in a community property state and file a separate return, you and your spouse must each report half of all community income in addition to your own separate income. Each of you takes credit for half of all taxes withheld on the community income. If you were divorced during the year, each of you generally must report half the community income and can take credit for half the withholding on that

community income for the period before the divorce.

For more information on these rules, and some exceptions, see Publication 555, *Community Property*.

## Fiscal Years

If you file your tax return on the basis of a fiscal year (a 12-month period ending on the last day of any month except December), you must follow special rules, described below, to determine your credit for federal income tax withholding.

During your fiscal year, one calendar year will end and another will begin. You can claim credit on your tax return only for the tax withheld during the calendar year ending in your fiscal year. You cannot claim credit for any of the tax withheld during the calendar year beginning in your fiscal year. You will be able to claim credit for that withholding on your return for next year.

However, if income tax has been withheld from your income under the backup withholding rule, take credit for it on your tax return for the fiscal year in which you received the payment.

For a more detailed discussion of how to take credit for withholding on a fiscal year return, see *Fiscal Years* in Chapter 3 of Publication 505.

## Estimated Tax

Take credit for all your estimated tax payments for 1996 on line 53 of Form 1040 or line 29b of Form 1040A. Include any overpayment from 1995 that you had credited to your 1996 estimated tax. You must use Form 1040 or Form 1040A if you paid estimated tax. You cannot use Form 1040EZ.

**Name changed.** If you changed your name, and you made estimated tax payments using your old name, attach a brief statement to the front of your tax return indicating:

- 1) When you made the payments,
- 2) The amount of each payment,
- 3) Which IRS address you sent the payments to,
- 4) Your name when you made the payments, and
- 5) Your social security number.

The statement should cover payments you made jointly with your spouse as well as any you made separately.

## Separate Returns

If you and your spouse made separate estimated tax payments for 1996 and you file separate returns, you can take credit only for your own payments.

If you made joint estimated tax payments, you must decide how to divide the payments between your returns. One of you can claim all of the estimated tax paid and the other none, or you can divide it in any other way you agree on. If you cannot agree, you must divide the payments in proportion

to each spouse's individual tax as shown on your separate returns for 1996.

## Divorced Taxpayers

If you made joint estimated tax payments for 1996, and you were divorced during the year, either you or your former spouse can claim all of the joint payments, or you each can claim part of them. If you cannot agree on how to divide the payments, you must divide them in proportion to each spouse's individual tax as shown on your separate returns for 1996.

If you claim any of the joint payments on your tax return, enter your former spouse's social security number (SSN) in the space provided on the front of Form 1040 or Form 1040A. If you divorced and remarried in 1996, enter your present spouse's SSN in that space and write your former spouse's SSN, followed by "DIV," to the left of line 53, Form 1040, or line 29b, Form 1040A.

## Underpayment Penalty

If you did not pay enough tax either through withholding or by making estimated tax payments, you will have an underpayment of estimated tax and you may have to pay a penalty. However, you will **not** generally have to pay a penalty for 1996 if any of the following situations apply to you.

- The total of your withholding and estimated tax payments was at least as much as your 1995 tax, you are not subject to the special rule limiting use of the prior year's tax, and you paid all required estimated tax payments on time.
- The tax balance on your return (minus household employment taxes) is no more than 10% of your total 1996 tax, and you paid all required estimated tax payments on time.
- Your total 1996 tax (defined later) minus your withholding is less than \$500.
- You did not owe tax for 1995.
- All of the tax balance on your return is caused by employment taxes for household workers.

Special rules apply if you are a farmer or fisherman. See *Farmers and Fishermen* in Chapter 4 of Publication 505 for more information.

**IRS can figure the penalty for you.** If you think you owe the penalty but you do not want to figure it yourself when you file your tax return, you may not have to. Generally, the IRS will figure the penalty for you and send you a bill. However, you must complete Form 2210 and file it with your return if you check any of the boxes in Part I of the form. See *Reasons for filing* later in this section.

## General Rule

In general, you may owe a penalty for 1996 if the total of your withholding and estimated tax payments did not equal at least the **smaller** of:

- 1) 90% of your 1996 tax, or
- 2) 100% of your 1995 tax. (Your 1995 tax return must cover a 12-month period.)

### Special rules for certain individuals.

There are special rules for farmers and fishermen and for certain higher income taxpayers.

**Farmers and fishermen.** If at least two-thirds of your gross income for 1995 or 1996 is from farming or fishing, substitute 66 $\frac{2}{3}$ % for 90% in (1) above.

See *Farmers and Fishermen* in Chapter 4 of Publication 505 for more information.

**Higher income taxpayers.** If less than two-thirds of your gross income for 1995 and 1996 is from farming or fishing and your adjusted gross income (AGI) for 1995 was more than \$150,000 (\$75,000 if your filing status is married filing a separate return in 1996), substitute 110% for 100% in (2) above.

For 1995, AGI is the amount shown on Form 1040 – line 31; Form 1040A – line 16; and Form 1040EZ – line 4.

**Penalty figured for each period.** Because the penalty is figured separately for each payment period, you may owe a penalty for an earlier payment period even if you later paid enough to make up the underpayment. If you did not pay enough tax by the due date of each of the payment periods, you may owe a penalty even if you are due a refund when you file your income tax return.

**Example.** You did not make estimated tax payments during 1996 because you thought you had enough tax withheld from your wages. Early in January 1997, you made an estimate of your total 1996 tax. You then realized that your withholding was \$2,000 less than the amount needed to avoid a penalty for underpayment of estimated tax.

On January 10, you made an estimated tax payment of \$3,000, the difference between your withholding and your estimate of your total tax. Your final return shows your total tax to be \$50 less than your estimate, so you are due a refund.

You do not owe a penalty for your payment due January 15, 1997. However, you will owe a penalty through January 10 for your underpayments for the earlier payment periods.

**Minimum required each period.** You will owe a penalty for any 1996 payment period for which your estimated tax payment plus your withholding for the period and overpayments for previous periods was less than the **smaller** of:

- 1) 22.5% of your 1996 tax, or
- 2) 25% of your 1995 tax. (Your 1995 tax return must cover a 12-month period.)

**Note.** If you are subject to the rule for higher income taxpayers, discussed earlier, substitute 27.5% for 25% in (2) above.

**When penalty is charged.** If you miss a payment or you paid less than the minimum required in a period, you may be charged an underpayment penalty from the date the amount was due to the date the payment is made.

**1995 separate returns and 1996 joint return.** If you file a joint return with your spouse for 1996, but you filed separate returns for 1995, your 1995 tax is the total of the tax shown on your separate returns. You filed a separate return in 1995 if you filed as single, head of household, or married filing separately.

**1995 joint return and 1996 separate returns.** If you file a separate return for 1996, but you filed a joint return with your spouse for 1995, your 1995 tax is your share of the tax on the joint return. You filed a separate return in 1996 if you filed as single, head of household, or married filing separately. To figure your share, first figure the tax both you and your spouse would have paid had you filed separate returns for 1995, using the same filing status as in 1996. Then multiply your joint tax liability by the following fraction:

$$\frac{\text{Your separate tax liability}}{\text{Both spouses' separate tax liabilities}}$$

**Example.** Lisa and Paul filed a joint return for 1995 showing taxable income of \$48,000 and a tax of \$8,377. Of the \$48,000 taxable income, \$40,000 was Lisa's and the rest was Paul's. For 1996, they file married filing separately. Lisa figures her share of the tax on the 1995 joint return as follows:

Tax on \$40,000 based on a separate return	\$ 8,672
Tax on \$8,000 based on a separate return	<u>1,204</u>
Total .....	\$ 9,876
Lisa's portion of total (\$8,672 ÷ \$9,876)	88%
Lisa's share of 1995 joint return tax (\$8,377 × 88%) .....	<u>\$ 7,372</u>

**Form 2210.** In most cases, you do not need to file Form 2210. The IRS will figure the penalty for you and send you a bill. If you want to figure your penalty, complete Part I, Part II, and either Part III or Part IV of Form 2210. **Do not** file Form 2210 unless you must file it, as explained later under *Reasons for filing*. If you use Form 2210, you cannot file Form 1040EZ.

On Form 1040, enter the amount of your penalty on line 63. If you owe tax on line 62, add the penalty to your tax due and show your total payment on line 62. If you are due a refund, subtract the penalty from the overpayment you show on line 59.

On Form 1040A, enter the amount of your penalty on line 34. If you owe tax on line 33, add the penalty to your tax due and show your total payment on line 33. If you are due

a refund, subtract the penalty from the overpayment you show on line 30.

**Reasons for filing.** You may be able to lower or eliminate your penalty if you file Form 2210. You **must** file Form 2210 with your return if any of the following applies.

- 1) You request a waiver. (See *Waiver of Penalty*, later.)
- 2) You use the annualized income installment method.
- 3) You use your actual withholding for each payment period for estimated tax purposes.
- 4) You base any of your required installments on the tax shown on your 1995 return and you filed or are filing a joint return for either 1995 or 1996 but not for both years.

For help in completing Form 2210, including illustrated examples, see Chapter 4 of Publication 505.

**Annualized income installment method.** If you did not receive your income evenly throughout the year (for example, your income from a repair shop you operated was much larger in the summer than it was during the rest of the year), you may be able to lower or eliminate your penalty by figuring your underpayment using the **annualized income installment method**. Under this method, your required installment for one or more payment periods may be less than one-fourth of your required annual payment.

To figure your underpayment using this method, complete Schedule AI of Form 2210. Also check the box on line 1b in Part I of Form 2210. You must file the form and Schedule AI with your return. This method is explained in Chapter 4 of Publication 505.

**Actual withholding method.** Instead of using one-fourth of your withholding to figure your payments, you can choose to establish how much was actually withheld by the due dates and use those amounts. You can make this choice separately for the tax withheld from your wages and for all other withholding.

Using your actual withholding may result in a smaller penalty if most of your withholding occurred early in the year.

If you use your actual withholding, you must check the box on line 1c, Part I of the Form 2210. Complete Form 2210 and file it with your return.

**Short method for figuring the penalty.** You may be able to use the short method in Part III of Form 2210 to figure your penalty for underpayment of estimated tax. If you qualify to use this method, it will result in the same penalty amount as the regular method, but with fewer computations.

You can use the short method **only** if you meet one of the following requirements.

- 1) You made no estimated tax payments for 1996. It does not matter whether you had income tax withholding.
- 2) You paid estimated tax on all four due dates in equal installments. You must

have paid the same amount on each of the following dates:

- April 15, 1996,
- June 17, 1996,
- September 16, 1996, and
- January 15, 1997.

If you do not meet either requirement, figure your penalty using the regular method in Part IV, Form 2210.

**Note.** If you use the short method in Part III, you cannot use the annualized income installment method or the actual withholding method.

## Exceptions

Generally, you do not have to pay an underpayment penalty if either of the following conditions apply:

- Your total tax due is less than \$500, or
- You had no tax liability last year.

## Less Than \$500 Due

You do not owe a penalty if the total tax shown on your return minus the amount you paid through withholding (including excess social security and railroad retirement tax withholding) is less than \$500.

**Total tax for 1996.** For 1996, your total tax on Form 1040 is the amount on line 51 reduced by the total of the following amounts:

- 1) Any recapture of a federal mortgage subsidy from Form 8828 included on line 51,
- 2) Any social security or Medicare tax on tips not reported to your employer on line 47,
- 3) Any tax on an IRA or a qualified retirement plan from Form 5329 (other than the tax on early distributions) included on line 48,
- 4) Any household employment taxes from Schedule H included on line 50,
- 5) Any uncollected social security, Medicare, or railroad retirement tax included on line 51,
- 6) Any earned income credit on line 54, and
- 7) Any credit for federal tax on fuels from Form 4136 included on line 57.

Your total tax on Form 1040A for 1996 is the amount on line 28 minus the amount on lines 27 and 29c. Your total tax on Form 1040EZ for 1996 is the amount on line 10 minus the amount on line 8.

## No Tax Liability Last Year

You do not owe a penalty if you had no tax liability last year and you were a U.S. citizen or resident for the whole year. For this rule to apply, your tax year must have included all 12 months of the year.

You had no tax liability for 1995 if your total tax was zero or you did not need to file an income tax return.

**Example.** Ray, who is single and age 22, was unemployed for most of 1995. He earned \$2,700 in wages before he was laid off, and he received \$2,500 in unemployment compensation afterwards. He had no other income. Even though he had gross income of \$5,200, he did not have to pay income tax because his gross income was less than the filing requirement for a single person under age 65 (\$6,400 for 1995). He filed a return only to have his withheld income tax refunded to him.

In 1996, Ray began regular work as an independent contractor. Ray made no estimated tax payments in 1996. Even though he did owe tax at the end of the year, Ray does not owe the underpayment penalty for 1996 because he had no tax liability in 1995.

**Total tax for 1995.** For 1995, your total tax on Form 1040 is the amount on line 54 reduced by the total of the following amounts:

- 1) Any recapture of a federal mortgage subsidy from Form 8828 included on line 49,

- 2) Any social security or Medicare tax on tips not reported to your employer on line 50,
- 3) Any tax on an IRA or a qualified retirement plan from Form 5329 (other than the tax on early distributions) included on line 51,
- 4) Any uncollected social security, Medicare, or railroad retirement tax included on line 54,
- 5) Any earned income credit on line 57, and
- 6) Any credit for federal tax on fuels from Form 4136 included on line 60.

Your total tax on Form 1040A for 1995 is the amount on line 28 minus the amount on line 29c. Your total tax on Form 1040EZ for 1995 is the amount on line 10 minus the amount on line 8.

## Waiver of Penalty

The IRS can waive the penalty for underpayment if:

- 1) You did not make a payment because of a casualty, disaster, or other unusual

circumstance, and it would be inequitable to impose the penalty, or

- 2) You retired (after reaching age 62) or became disabled during the tax year a payment was due or during the preceding tax year, and both the following requirements are met:
  - a) You had a reasonable cause for not making the payment, and
  - b) Your underpayment was not due to willful neglect.



*Any penalty for an underpayment of either or both of the installments due April 15, 1996, and June 15, 1996, will be waived if the underpayment was caused by changes in the law made by the Small Business Job Protection Act of 1996. A list of changes that could cause an underpayment is at the beginning of this chapter under Important Changes for 1996.*

To claim a waiver, follow the procedures explained in the instructions for Form 2210.

# Part Two.

## Income

*The eight chapters in this part discuss many kinds of income. They explain which income is and is not taxed. See Part Three for information on gains and losses you report on Schedule D (Form 1040) and for information on selling your home.*

### 6.

## Wages, Salaries, and Other Earnings

### Important Changes for 1996

**Employer-provided educational assistance benefits.** The exclusion from gross income for up to \$5,250 of qualified employer-provided educational assistance benefits was extended retroactively to apply to tax years beginning after 1994 and before June 1, 1997. The exclusion does not apply to expenses for graduate level courses beginning after June 30, 1996, and it generally does not apply to any courses beginning after June 30, 1997. For more information, see Publication 508, *Educational Expenses*.

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

**Qualified state tuition programs.** Effective for tax years ending after August 20, 1996, distributions from a qualified state tuition program are taxable only to the extent they are more than the amount contributed to the program. For more information, see *State tuition programs* in Publication 525, *Taxable and Nontaxable Income*.

### Important Reminder

**Foreign source income.** If you are a U.S. citizen with income from sources outside the United States (foreign income), you must report all such income on your tax return unless it is exempt by U.S. law. This is true whether you reside inside or outside the

United States and whether or not you receive a Form W-2 or 1099 from the foreign payer. This applies to earned income (such as wages and tips) as well as unearned income (such as interest, dividends, capital gains, pensions, rents and royalties).

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

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

If you repay unearned commissions or other amounts in the same year you receive them, reduce the amount to include in your income by the repayment. However, if you repay the unearned commissions or other amounts in a later tax year, you can deduct the repayment as an itemized deduction on your Schedule A (Form 1040), or you may be able to take a credit for that year. See *Repayments* in Chapter 13.

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

**Bonuses and awards.** Amounts you receive for outstanding work, such as bonuses or awards, are included in your gross income and should be shown on your Form W-2. These include prizes such as vacation trips for meeting sales goals. If the prize or award you receive is goods or services, you must include the fair market value of the goods or services in your income. However, if your employer merely promises to pay you a bonus or award at some future time, it is not taxable until you receive it or it is made available to you. If you receive an award for length of service or safety achievement, see *Employee achievement awards* under *Income Not Taxed* in Chapter 13.

**Child-care providers.** If you provide child care, either in the child's home or in your home or other place of business, the pay you receive must be included in your income. If you provide the care in the child's home, you may be an employee. If you provide the care in your home or other place of business, you may or may not be an employee. You are an employee if you are subject to the will and control of your employer as to what you are to do and how you are to do it.

**Babysitting.** If you periodically babysit for relatives or neighborhood children, the rules for child-care providers also apply to you.

If you are an employee, you should receive a Form W-2 if your pay is subject to social security and Medicare taxes or would be subject to the withholding of income tax if

### Introduction

This chapter discusses wages, salaries, fringe benefits, and other compensation received for services as an employee. The topics include:

- Bonuses and awards
- Unemployment compensation
- Disability income
- Special rules for certain employees

The chapter also explains what income is included in the employee's gross income and what is not included.

### Useful Items

You may want to see:

#### Publication

- 463** Travel, Entertainment, Gift, and Car Expenses
- 503** Child and Dependent Care Expenses
- 505** Tax Withholding and Estimated Tax
- 525** Taxable and Nontaxable Income

#### Form

- W-2** Wage and Tax Statement

## Employee Compensation

This section explains many types of employee compensation. The subjects are arranged in alphabetical order followed by *Fringe Benefits*, *Disability Income*, and *Pension and Annuity Contributions*, which are explained in greater detail.

**Advance commissions and other earnings.** If you receive advance commissions

one exemption were claimed. Include your pay on line 7 of Form 1040 or Form 1040A, or on line 1 of Form 1040EZ, even if you do not receive a Form W-2.

If you are not an employee, you are probably self-employed and must include the payments you receive on Schedule C (Form 1040), *Profit or Loss From Business*. You may also qualify to use the simpler Schedule C-EZ (Form 1040), *Net Profit From Business*. Information on who may use it is listed in Part I of Schedule C-EZ.

**Employer-provided educational assistance.** The exclusion from gross income for up to \$5,250 of qualified employer-provided educational assistance benefits had expired after December 31, 1994. This exclusion was extended retroactively to apply to tax years beginning after 1994 and before June 1, 1997. The exclusion does not apply to graduate-level courses beginning after June 30, 1996. For more information, including how to claim the benefits for 1995 and 1996, get Publication 508, *Educational Expenses*.

**Government cost-of-living allowances.** These allowances are generally not included in your income if you are a federal civilian employee or a federal court employee who is stationed in Alaska, Hawaii, or outside the 48 contiguous states and the District of Columbia.

Allowances and differentials that increase your basic pay as an incentive for taking a less desirable post of duty are part of your compensation and must be included in your income. For example, your compensation includes Foreign Post, Foreign Service, and Overseas Tropical salary differentials. For more information, get Publication 516, *U.S. Government Civilian Employees Stationed Abroad*.

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

**Interview expenses.** If an employer asks you to appear for an interview and either pays you an allowance or reimburses you for your transportation and other travel expenses, the amount you receive is generally not taxable. You include in your income on line 21 of Form 1040 only the amount you receive that is more than your actual expenses.

**Property purchased from employer.** If your employer allows you to buy property at a price below its fair market value as compensation for your services, you must include in your income as extra wages the difference between the property's fair market value and the amount you paid for it.

**Property received for services.** Generally, if you receive property for your services, you must include its fair market value in your gross income in the year you receive the property. Property you receive for services includes shares of corporate stock you receive from your employer. However, if you receive stock or other property that is both nontransferable and subject to a substantial risk of forfeiture, you may not have to include the value of the property in your income in the year you receive it. For details, see *Restricted Property Received for Services* in Publication 525.

Dividends you receive on restricted stock are extra compensation to you. Restricted stock is stock you received from your employer and did not include in your income because it was nontransferable and subject to forfeiture. Your employer should include these payments on your Form W-2.

Dividends you receive on stock you chose to include in your income in the year transferred are treated the same as any other dividends. Report them on line 9 of Form 1040. For a discussion of dividends, see Chapter 9.

For information on how to treat dividends reported on both your Form W-2 and Form 1099-DIV, see *Dividends received on restricted stock* in Publication 525.

**Severance pay.** Amounts you receive as severance pay are taxable. A lump-sum payment for cancellation of your employment contract is income in the tax year you receive it and must be reported with your other salaries and wages.

**Accrued leave payment.** If you are a federal employee and receive a lump-sum payment for accrued annual leave when you retire or resign, this amount will be included on your Form W-2.

If you resign from one agency and are reemployed by another agency, you may have to repay part of your lump-sum annual leave payment to the second agency. You can reduce gross wages by the amount you repaid in the same tax year in which you received it. You should attach to your tax return a copy of the receipt or statement furnished by the agency to which you make repayment to explain the difference between the wages on the return and the wages on your Forms W-2.

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

**Sick pay.** Amounts you receive from your employer while you are sick or injured are part of your salary or wages. Report the amount you receive on line 7 of Form 1040 or Form 1040A, or on line 1 of Form 1040EZ. You must include in your income payments made by any of the following:

- 1) Your employer,
- 2) A welfare fund,
- 3) A state sickness or disability fund,
- 4) An association of employers or employees, or
- 5) An insurance company, if your employer paid for the plan.

However, if you paid the premiums on an accident or health insurance policy, the benefits you receive under the policy are not taxable.

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

If you received income because of a disability, see *Disability Income*, later.

**Social security and Medicare taxes paid by employer.** If you and your employer have an agreement that your employer pays your social security and Medicare taxes without deducting them from your gross wages, you must report the amount of tax paid for you as taxable wages on your tax return. You must also treat the payments as wages for figuring your social security and Medicare taxes and your social security and Medicare benefits. However, these payments are not treated as social security and Medicare wages if you are a household worker or a farm worker.

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

**Stock options.** If you receive a nonstatutory option to buy stock or other property as payment for your services, you will usually have income when you receive the option or when you exercise (use) the option. However, if your option is a statutory stock option (an incentive stock option or an option granted under an employee stock purchase plan), special rules generally delay the tax until you sell or exchange your shares of stock. For details, get Publication 525.

**Unemployment compensation.** You must include in your income all unemployment compensation you receive. You should receive a Form 1099-G showing the unemployment compensation paid to you. Generally, you enter unemployment compensation on line 19 of Form 1040, line 12 of Form 1040A, or line 3 of Form 1040EZ.

**Tax withholding and estimated tax.** Beginning in 1997, you can choose to have federal income tax withheld from your unemployment compensation. To make this

choice, complete Form W-4V, *Voluntary Withholding Request*, and give it to the paying office. Tax will be withheld at 15% of your payment.



If you do not choose to have tax withheld from your unemployment compensation, you may be liable for estimated tax. For more information on estimated tax, get Publication 505.

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

- 1) Benefits paid by a state or the District of Columbia from the Federal Unemployment Trust Fund.
- 2) Unemployment insurance benefits.
- 3) Railroad unemployment compensation benefits.
- 4) Disability payments from a government program paid as a **substitute** for unemployment compensation. (Amounts received as workers' compensation for injuries or illness are **not** unemployment compensation.)
- 5) Trade readjustment allowances under the Trade Act of 1974.
- 6) Benefits under the Airline Deregulation Act of 1978.
- 7) Unemployment assistance under the Disaster Relief Act Amendments of 1974.

**Governmental program.** If you contribute to a governmental unemployment compensation program and your contributions are not deductible, amounts you receive under the program are not included as unemployment compensation until you recover your contributions.

**Supplemental unemployment benefits.** Benefits received from a company-financed fund (to which the employees did not contribute) are not unemployment compensation. They are taxable as wages subject to income tax withholding but not subject to social security, Medicare, or federal unemployment taxes. Report these payments on line 7 of Form 1040 or Form 1040A.

You may have to repay some of your supplemental unemployment benefits to qualify for trade readjustment allowances under the Trade Act of 1974. If you repay supplemental unemployment benefits in the same year you receive them, reduce the total benefits by the amount you repay. If you repay the benefits in a later year, you must include the full amount of the benefits received in your income for the year you received them.

Deduct the repayment in the later year as an adjustment to gross income. Include the repayment on line 30 of Form 1040, and put "Sub-pay TRA" and the amount on the dotted line next to line 30. If the amount you repay in a later year is more than \$3,000, you may be able to take a credit against your tax for the later year instead of deducting the

amount repaid. For more information on this, see the discussion on *Repayments* in Chapter 13.

**Private unemployment fund.** Unemployment benefit payments from a private fund to which you voluntarily contribute are taxable only if the amounts you receive are more than your total payments into the fund. Report the taxable amount on line 21 of Form 1040.

**Payments by a union.** Benefits paid to you as an unemployed member of a union from regular union dues are included in your gross income on line 21 of Form 1040.

**Guaranteed annual wage.** Payments you receive from your employer during periods of unemployment, under a union agreement that guarantees you full pay during the year, are taxable as wages.

**State employees.** Payments can be made by a state to its employees who are not covered by the state's unemployment compensation law. If the payments are similar to benefits under that state law, they are fully taxable. Report these payments on line 21 of Form 1040.

**Fraud.** Fraudulently obtained unemployment compensation is fully taxable. You report it on line 21 of Form 1040.

**Repayment of unemployment compensation benefits.** If you repaid in 1996 unemployment compensation benefits you received in 1996, subtract the amount you repaid from the total amount you received and enter the difference on line 19 of Form 1040, line 12 of Form 1040A, or line 3 of Form 1040EZ. Also, enter "Repaid" and the amount you repaid on the dotted line next to line 19, line 12, or line 3. If, in 1996, you repaid unemployment compensation that you included in gross income in an earlier year, you may deduct the amount repaid on Schedule A (Form 1040), line 22. See *Repayments* in Chapter 13.

**Union benefits and dues.** Amounts deducted from your pay for union dues, assessments, contributions, or other payments to a union cannot be excluded from your gross income.

You may be able to deduct some of these payments as a miscellaneous deduction subject to the 2% limit if they are related to your job and if you itemize your deductions on Schedule A (Form 1040). For more information, see *Union Dues and Expenses* in Chapter 30.

**Strike and lockout benefits.** Benefits paid to you by a union from union dues as strike or lockout benefits, including both cash and the fair market value of other property, are usually included in your income as wages. You can exclude these benefits from your income only when the facts show that the union intended them as gifts to you.

**Withholding.** Amounts taken out of your pay for income tax, social security tax, Medicare tax, or savings bonds are considered received by you. They will be included on your Form W-2. The same generally is true of amounts taken out of your pay for taxable

fringe benefits, pensions, insurance, union dues, and other assessments. For more information on income tax withholding, get Publication 505.

If your employer uses your wages to pay your debts, or if your wages are attached or garnished, the full amount is considered received by you. Also included in your wages are fines or penalties taken out of your pay.

## Fringe Benefits

The value of fringe benefits you receive from your employer is taxable and must be included in your income as compensation unless the benefits are specifically excluded by law or you pay fair market value for them.

Generally, your employer determines the amount of your fringe benefits and includes this amount on your Form W-2. Two benefits you may receive are discussed here. More information on fringe benefits can be found in Chapter 4 of Publication 535, *Business Expenses*.

## Transportation

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

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

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

**Exclusion limit.** The exclusion for commuter highway vehicle transportation and transit pass fringe benefits cannot be more than a total of \$65 a month, regardless of the total value of both benefits.

The exclusion for the qualified parking fringe benefit cannot be more than \$165 a month, regardless of its value.

If the benefits have a value that is more than these limits, the excess must be included in your income.

**Commuter highway vehicle.** This is a highway vehicle that seats at least six adults (not including the driver). At least 80% of the vehicle's mileage must reasonably be expected to be for transporting employees between their homes and work place. Employees must occupy at least half of the vehicle's adult seating capacity (not including the driver).

**Transit pass.** This is any pass, token, farecard, voucher, or similar item entitling a person to ride mass transit (whether public or private) free or at a reduced rate or to ride in a commuter highway vehicle operated by

a person in the business of transporting persons for compensation.

**Qualified parking.** This is parking provided to an employee at or near the employer's place of business. It also includes parking provided on or near a location from which the employee commutes to work in a commuter highway vehicle or carpool. It does not include parking at or near the employee's home.

### Group Life Insurance Premiums

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

**Form W-2.** The amount included in your income is reported as part of your wages in box 1 of your Form W-2. It is also shown separately in box 13 with code C. See *Your payment*, later.

**Retired employees.** If you are a retired employee, you generally will have to include in your income the cost of providing you with more than \$50,000 of insurance coverage. For more information, get Publication 525.

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

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

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

- 1) Payments for coverage in a different tax year, or
- 2) Payments not taxed to you because of the exceptions discussed later.

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

**Accidental or other death benefits.** If you receive accidental or other death benefits from a policy that does not provide general death benefits (travel insurance, for example), these benefits are not included as group-term life insurance coverage.

**Exceptions.** You are not taxed on the cost of group-term life insurance if any of the following apply:

- 1) You are disabled and have ended your employment;
- 2) Your employer is the beneficiary of the policy for the entire period the insurance is in force during the tax year; or
- 3) The only beneficiary is a qualified charitable organization (defined in Chapter 26) for the entire period the insurance is in force during the tax year. You are not entitled to a deduction for a charitable contribution for naming a charitable organization as the beneficiary of your policy.

**Entire cost taxed.** You are taxed on the entire cost of group-term life insurance protection provided by your employer through a qualified employees' trust, such as a pension trust or a qualified annuity plan.

You are also taxed on the entire cost of the group-term life insurance coverage provided by your employer if you are a key employee and your employer's plan discriminates in favor of key employees.

**Life insurance agents.** Full-time life insurance agents who are considered employees for social security and Medicare tax withholding purposes are treated as employees in applying the provisions relating to group-term life insurance under a policy carried by their employer.

**More than \$50,000 from one employer.** If you have only one employer and you were insured at any time during the tax year for more than \$50,000 under a group-term life insurance policy, your taxable income from this source is included as other compensation on the Form W-2 you receive.

**More than \$50,000 from two or more employers.** If two or more employers provide you group-term life insurance coverage totaling more than \$50,000, you must figure how much to include in your income. You must include the cost of life insurance provided to you during the tax year, regardless of when your employers paid the premiums.

You figure the cost for each month of coverage by multiplying the number of thousands of dollars of insurance coverage (figured to the nearest tenth), less \$50,000 of insurance, by the cost from the following table. You must prorate the cost from the table if less than a full month of coverage is involved.

### COST PER \$1,000 OF PROTECTION FOR ONE MONTH

Age	Cost
Under 30	\$ .08
30 through 34	.09
35 through 39	.11
40 through 44	.17
45 through 49	.29
50 through 54	.48
55 through 59	.75
60 through 64	1.17
65 through 69	2.10
70 and older	3.76

**Example.** You are 51 years old and work for Employers A and B. Both employers provide group-term life insurance coverage for you for the entire year. Your coverage is \$35,000 with Employer A and \$45,000 with Employer B. You pay premiums of \$50 a year under the Employer B group plan. You figure the amount to include in your income as follows:

Employer A coverage (in thousands)	\$ 35
Employer B coverage (in thousands)	+ 45
Total coverage (in thousands)	\$ 80
Minus: Exclusion (in thousands)	- 50
Excess amount (in thousands)	\$ 30
Multiply by cost per \$1,000 per month, age 51 (from table)	× .48
Cost of excess insurance for 1 month	\$ 14.40
Multiply by number of full months coverage at this cost	× 12
Cost of excess insurance for tax year	\$172.80
Minus: Premiums you paid	- 50.00
<b>Cost to include in your income as wages</b>	<u>\$122.80</u>

For more information on employer payments for group-term life insurance, see Chapter 5 of Publication 535.

### How To Report Fringe Benefits

The amount of your taxable fringe benefits is shown on your Form W-2.

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

Your employer must determine the actual value of this fringe benefit to include in your income. Your employer determines this value by either of the following methods:

- 1) The actual value of your personal use of the car, or
- 2) The actual value of the car as if you used it entirely for personal purposes (100% income inclusion).

If your employer includes 100% of the value in your income, you can deduct the value of your business use of the car if you itemize your deductions. You figure the value of this business use on Form 2106, *Employee Business Expenses*.



*Certain employer-provided transportation can be excluded from gross income. See the discussion on Transportation, earlier.*

**Accounting period.** You must use the same accounting period your employer uses to report your taxable noncash fringe benefits. Your employer has the option to report taxable fringe benefits by using either of the following rules:

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

You must use the same accounting period to claim an employee business deduction (for use of a car, for example) that you use to report the benefit. Your employer does not have to use the same accounting period for each fringe benefit, but must use the same period for all employees who receive a particular benefit.

**Form W-2.** Your employer reports your taxable fringe benefits in box 1 (Wages, tips, other compensation) of Form W-2. The total value of your fringe benefits should also be shown in box 12. The value of your fringe benefits may be added to your other compensation on one Form W-2, or you may receive a separate Form W-2 showing just the value of your fringe benefits in box 1 with a notation in box 12.

## Disability Income

Generally, if you retire on disability you must report your pension or annuity as income. There is a tax credit for people who are permanently and totally disabled. For information on this credit and the definition of permanent and total disability, see Chapter 34.

**Disability pensions.** Generally, you must report as income any amount you receive for your disability through an accident or health insurance plan paid for by your employer. If both you and your employer pay for the plan, only the amount you receive for your disability that is due to your employer's payments is reported as income. However, certain payments may not be taxable to you. Your employer should be able to give you specific details about your pension plan and tell you the amount you paid for your disability pension. In addition to disability pensions and annuities, you may be receiving other payments for sickness and injury. See *Other Sickness and Injury Benefits* in Chapter 13.

**Cost paid by you.** If you pay the entire cost of a health or accident insurance plan, do not include any amounts you receive for your disability as income on your tax return. If your plan reimbursed you for medical expenses you deducted in an earlier year, you may have to include some, or all, of the reimbursement in your income. See *Reimbursement in a later year* in Chapter 23.

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

**Accrued leave payment.** If you retire on disability, any lump-sum payment you receive for accrued annual leave is a salary payment. The payment is not a disability payment. You must report it as wages in the tax year you receive it.

**Retirement and profit-sharing plans.** If you receive payments from a retirement or profit-sharing plan that does not provide for disability retirement, do not report them as disability income. The payments are taxable and should be reported as a pension or annuity. For more information on pensions, see Chapter 11.

**How to report.** If you retired on disability, payments you receive are taxed as wages until you reach minimum retirement age. Minimum retirement age generally is the age at which you can first receive a pension or annuity if you are not disabled. You must report your taxable disability payments as wages on line 7 of Form 1040 or Form 1040A, until you reach minimum retirement age.

Beginning on the day after you reach minimum retirement age, payments you receive are taxable as a pension. Report the payments on lines 16a and 16b of Form 1040, or on lines 11a and 11b of Form 1040A. The rules for reporting pensions are explained in *How To Report* in Chapter 11.

## Military And Certain Government Disability Pensions

Generally, you must report these disability pensions as income. But certain military and government disability pensions are not taxable.

**Members of government services.** Generally, you must include in income any disability payments you receive for personal injury or sickness resulting from active service in the:

- 1) Armed Forces of any country.
- 2) National Oceanic and Atmospheric Administration.

- 3) Public Health Service.
- 4) Foreign Service.

However, if you receive a disability pension based on a percentage of disability, do not include the disability payments in your income if any of the following apply.

- 1) You were entitled to receive a disability payment before September 25, 1975.
- 2) You were a member of a government service or its reserve component, or were under a binding written commitment to become a member, on September 24, 1975.
- 3) You receive disability payments for a "combat-related injury."
- 4) You would be entitled to receive disability compensation from the Department of Veterans Affairs (VA) if you filed an application for it.

**Combat-related injury.** A combat-related injury is a personal injury or sickness that:

- 1) Results directly from armed conflict,
- 2) Takes place while you are engaged in extra-hazardous service,
- 3) Takes place under conditions simulating war, including training exercises such as maneuvers, or
- 4) Is caused by an instrumentality of war.

**Disability based on years of service.** If you receive a disability pension based on years of service, you generally must include it in your income. But if you fall into one of the 4 categories listed under *Members of government services*, do not include in income the part of your pension that you would have received if the pension had been based on a percentage of disability. You must include the rest of your pension in your income.

**Government employee.** You do not include in your income disability payments you receive for injuries resulting directly from a violent attack that occurs while you are a U.S. government employee performing official duties outside the United States. For your disability payments to be tax exempt, the Secretary of State must determine the attack was a terrorist attack.

**VA disability benefits.** Disability benefits you receive from the Department of Veterans Affairs (VA) are not included in your gross income. If you are a military retiree and you receive disability benefits from other than the VA, do not include in your income the amount of disability benefits equal to the VA benefits to which you are entitled.

If you retire from the armed services (based on years of service) and at a later date are given a retroactive service-connected disability rating by the VA, and file a waiver for reduction of your retirement pay in an amount equal to the VA disability compensation, you do not include in your income for the retroactive period (subject to the statute of limitations) the part of your retirement

pay you would have been entitled to receive from the VA during that period.

If you receive a lump-sum disability severance payment and are later awarded VA disability benefits, you do not include the disability severance payment in your income (subject to the statute of limitations). However, you must include in your income any lump-sum readjustment or other non-disability severance payment you received on release from active duty, even though you are later given a retroactive disability rating by the VA.

## Pension and Annuity Contributions

Generally, you cannot exclude from income amounts you pay into a pension plan through payroll deductions.

**Contributions to Federal Thrift Savings Fund.** If you are a federal employee, you can choose to make contributions from your salary to the Federal Thrift Savings Fund. Your contributions are not included in income for income tax purposes. However, your salary before the contributions are taken out is used for purposes of figuring social security and Medicare taxes and benefits. Payments you later receive from the fund are taxable as a distribution from a qualified pension or annuity plan.

**Employer's contributions to qualified plan.** Generally, your employer's contributions to a qualified pension plan for you are not included in income at the time contributed. However, employer contributions that are made out of funds that would otherwise have been paid to you as salary, except that you entered into a salary reduction agreement with your employer (elective deferral), are excluded from income only up to a limit.

For 1996, you cannot set aside more than a total of \$9,500 for all elective deferrals. If you set aside more than \$9,500, the excess is included in your gross income that year.

The cost of life insurance coverage included in an employer's plan may be income if the proceeds of the policy are payable directly or indirectly to your beneficiary. See *Group Life Insurance Premiums*, earlier, under *Fringe Benefits*.

Amounts actually distributed or made available to you generally are taxable, unless they are eligible for a tax-free rollover. To qualify, they must be rolled over (normally within 60 days after receipt) to another qualified plan or to an individual retirement account or annuity (IRA). If you elect to have an eligible rollover distribution paid directly to you (even if you plan to roll over the distribution), the payer must withhold part of the distribution for income tax. You can avoid withholding if you choose a direct transfer to another qualified retirement plan. Your employer may be able to tell you how the amount you received is taxed. For more information on pension plans, see Chapter 11, and for IRAs, see Chapter 18.

**Employer's contributions to nonqualified plan.** If your employer pays into a nonqualified plan for you, you generally must include the contributions in your income as wages for the tax year in which the contributions are made. Report this income on line 7 of Form 1040 or Form 1040A, or on line 1 of Form 1040EZ. However, if your interest is not transferable and is subject to a substantial risk of forfeiture (you have a good chance of losing it) at the time of contribution, you do not have to include the value of your interest in your income when you receive it. When your interest becomes transferable or is no longer subject to a substantial risk of forfeiture, you must include the value in your income.

**Railroad retirement annuities.** If you received:

- 1) Tier 1 railroad retirement 1 benefits that are more than the "social security equivalent benefit,"
- 2) Tier 2 benefits, or
- 3) Vested dual benefits,

these payments are treated as pension or annuity income and are taxable under the rules explained in Chapter 11.

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## Special Rules for Certain Employees

This section deals with special rules for people in certain types of employment. It includes members of the clergy, people working for foreign employers, military personnel, veterans, ACTION and Peace Corps volunteers, and statutory employees.

### Clergy

If you are a member of the clergy, you must include in your income offerings and fees you receive for marriages, baptisms, funerals, masses, etc., in addition to your salary. If the offering is made to the religious institution, it is not taxable to you.

If you are a member of a religious organization and you give your outside earnings to the organization, you still must include the earnings in your income. However, you may be entitled to a charitable contribution deduction for the amount paid to the organization. See Chapter 26.

**Rental value of a home.** You do not include in your income the rental value of a home (or utility expenses) provided to you as part of your pay for your duties as an ordained, licensed, or commissioned minister. However, you must include the rental value of the home, and related allowances, as earnings from self-employment on Schedule SE (Form 1040) if you are subject to the self-employment tax.

**Housing allowance.** A housing allowance paid to you as part of your salary is not income to the extent you use it, in the year received, to provide a home or to pay utilities for a home with which you are provided. The amount of the housing allowance that you can exclude from your income cannot be more than the reasonable compensation for your services as a minister. The church or organization that employs you must officially designate the payment as a housing allowance before the payment is made. A definite amount must be designated; the amount of the housing allowance cannot be determined at a later date.

If you are employed and paid by a local congregation, a resolution by a national church agency of your denomination does not effectively designate a housing allowance for you. The local congregation must officially designate the part of your salary that is to be a housing allowance. However, a resolution of a national church agency can designate your housing allowance if you are directly employed by the agency. If no part has been officially designated, you must include your total salary in your income.

Expenses of providing a home include rent, house payments, furniture payments, costs for a garage, and utilities. They do not include the cost of food or servants.

**Homeowner.** If you own your home or are buying it, you can exclude your housing allowance from your income if you spend it for the down payment on the home, for mortgage payments, or for interest, taxes, utilities, repairs, etc. However, you cannot exclude more than the fair rental value of the home plus the cost of utilities, even if a larger amount is designated as a housing allowance. The fair rental value of a home includes the fair rental value of the furnishings in it.

**Interest and taxes on your home.** You can deduct on Schedule A (Form 1040) the qualified mortgage interest and real estate taxes you pay on your home even if you use nontaxable housing allowance funds to make the payments. See Chapters 24 and 25.

**Teachers or administrators.** If you are a minister employed as a teacher or administrator by a church school, college, or university, you are performing ministerial services for purposes of the rental exclusion. However, if you perform services as the head of a religious department, or as a teacher or administrator on the faculty of a nonchurch college, and if your specific duties involve no religious functions, you cannot exclude from your income a housing allowance or the value of a home that is provided to you.

 **TIP** *If you live in qualified campus housing as an employee of an educational institution or an academic health center, all or part of the value of that housing may be nontaxable. See Meals and Lodging in Publication 525.*

If you serve as a “minister of music” or “minister of education,” or serve in an administrative or other function of your religious organization, but are not authorized to perform all of the religious duties of an ordained minister in your church (even though you are commissioned as a “minister of the gospel”), you cannot exclude from your income a housing allowance or the value of a home provided to you.

**Theological students.** You cannot exclude a housing allowance from your income if you are a theological student serving a required internship as an assistant pastor, unless you are ordained, commissioned, or licensed as a minister.

**Traveling evangelists.** If you are an ordained minister and are providing evangelistic services, you can exclude amounts received from out-of-town churches that are designated as a housing allowance, provided you actually use them to maintain your permanent home.

**Retired members of the clergy.** The rental value of a home provided rent free by your church for your past services is not income if you are a retired minister. In addition, a housing allowance paid to you is not income to the extent you spend it for utilities, maintenance, repairs, and similar expenses that are directly related to providing a home. These amounts are also not included in net earnings from self-employment.

The general convention of a national religious denomination can designate a housing allowance for retired ministers that can be excluded from income. This applies if the local congregations authorize the general convention to establish and maintain a unified pension system for all retired clergy members of the denomination for their past services to the local churches.

A surviving spouse of a retired minister cannot exclude a housing allowance from income. If these payments were reported to you on Form 1099-R, include them on lines 16a and 16b of Form 1040, or on lines 11a and 11b of Form 1040A. Otherwise, include them on line 21 of Form 1040.

**Pension.** A pension or retirement pay for a member of the clergy is usually treated the same as any other pension or annuity. It must be reported on lines 16a and 16b of Form 1040 or on lines 11a and 11b of Form 1040A.

If you are not expected to perform any further services, payments from the congregation may be gifts. If the payments are gifts, they are not taxable if they are based solely on your financial needs and the financial capacity of the congregation. If these payments are made under a legal agreement, an established plan, or because of past practice, they do not qualify as nontaxable gifts.

**Members of religious orders.** If you are a member of a religious order who has taken a vow of poverty, the amounts you earn for services you perform which you renounce

and turn over to the order may or may not be included in your income.

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

If your order directs you to perform services for another agency of the supervising church or an associated institution, you are considered to be performing the services as an agent of the order. Any wages you earn as an agent of an order that you turn over to the order are not included in your gross income.

**Example.** You are a member of a church order and have taken a vow of poverty. You renounce any claims to your earnings and turn over to the order any salaries or wages you earn. You are a registered nurse, so your order assigns you to work in a hospital that is an associated institution of the church. However, you remain under the general direction and control of the order. You are considered to be an agent of the order and any wages you earn at the hospital that you turn over to your order are not included in your gross income.

**Services performed outside the order.** If you are directed to work outside the order, the work will not constitute the exercise of duties required by the order unless the services you perform meet both of the following requirements:

- 1) The services are the kind that are ordinarily the duties of members of the order, and
- 2) The services are part of the duties that must be exercised for, or on behalf of, the religious order as its agent.

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

**Example.** Mark Brown is a member of a religious order and has taken a vow of poverty. He renounces all claims to his earnings and turns over his earnings to the order.

Mark is a school teacher. He was instructed by the superiors of the order to get a job with a private tax-exempt school. Mark became an employee of the school, and, at his request, the school made the salary payments directly to the order.

Because Mark is an employee of the school, he is performing services for the school rather than as an agent of the order. The wages Mark earns working for the school are included in his gross income.

## Foreign Employer

Special rules apply if you work for a foreign employer.

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

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

**Non-U.S. citizen.** If you are not a U.S. citizen, or if you are a U.S. citizen but also a citizen of the Philippines, and you work for an international organization in the United States, your salary from that source is exempt from tax. If you work for a foreign government in the United States, your salary from that source is exempt from tax if your work is like the work done by an employee of the United States in that foreign country and if the foreign government gives an equal exemption for the salary of the U.S. employee.

**Alien status.** If you are an alien and you file a waiver under section 247(b) of the Immigration and Nationality Act to keep your immigrant status, you are not entitled to exempt your salary from tax. Any salary you receive after the date you file the waiver is taxable.

**Pensions.** This exemption applies only to employees' wages, salaries, and fees. Pensions received by former employees living in this country do not qualify for this exemption.

**Employment abroad.** For information on income earned abroad, get Publication 54, *Tax Guide for U.S. Citizens and Resident Aliens Abroad*.

## Military

Payments you receive as a member of a military service generally are taxed as wages except for retirement pay, which is taxed as a pension. Allowances generally are not taxed. For more information on military allowances and benefits, get Publication 3, *Armed Forces Tax Guide*.

**Military retirement pay.** If your retirement pay is based on age or length of service, it is taxable and must be included in your gross income as a pension on lines 16a and 16b of Form 1040, or on lines 11a and 11b of Form 1040A. Do not include in your income the amount of reduction in retirement or retainer pay to provide a survivor annuity for your spouse or children under the Retired Serviceman's Family Protection Plan or the Survivor Benefit Plan.

For more information on survivor annuities, see Chapter 11.

**Disability.** If you are retired on disability, see *Military and Certain Government Disability Pensions* under *Disability Income*, earlier.

## Veterans

Veterans' benefits generally are not taxable.

### Nontaxable Income

Veterans' benefits under any law, regulation, or administrative practice that was in effect on September 9, 1986, and administered by the Department of Veterans Affairs (VA), are not included in gross income. The following amounts paid to veterans or their families are not taxable:

- 1) Education, training, or subsistence allowances.
- 2) Disability compensation and pension payments for disabilities.
- 3) Grants for homes designed for wheelchair living.
- 4) Grants for motor vehicles for veterans who lost their sight or the use of their limbs.
- 5) Veterans' pensions paid either to the veterans or to their families.
- 6) Veterans' insurance proceeds and dividends paid either to veterans or their beneficiaries, including proceeds of a veteran's endowment policy paid before death.
- 7) Interest on insurance dividends you leave on deposit with the VA.

### Taxable Income

Certain amounts paid by the VA are taxable.

**Rehabilitative program payments.** VA payments to hospital patients and resident veterans for their services under the VA's therapeutic or rehabilitative programs are included as income other than wages. These payments are reported on line 21 of Form 1040.

## Volunteers

The tax treatment of amounts you receive as a volunteer worker for the Peace Corps, ACTION, or similar agency is covered in the following discussions.

## Peace Corps

If you are a Peace Corps volunteer or volunteer leader, some allowances you receive are taxable and others are exempt from tax.

**Taxable allowances.** Any taxable allowances you receive must be included in your income and reported as wages. These include:

- 1) Cash allowances received during training.
- 2) Allowances paid to your spouse and minor children while you are training in the United States.
- 3) The part of living allowances designated by the President, under the Peace Corps Act, as basic compensation.
- 4) Allowances for personal items such as domestic help, laundry and clothing maintenance, entertainment and recreation, transportation, and other miscellaneous expenses.
- 5) Leave allowances.
- 6) Readjustment allowances or "termination payments." These are considered received by you when credited to your account.

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

## ACTION

ACTION participants perform services in anti-poverty programs and Older American volunteer programs. Some amounts these participants receive are taxable and others are exempt from tax.

**VISTA.** If you are a VISTA volunteer, you must include meal and lodging allowances paid to you in your income as wages.

**University Year for Action program.** If you receive a stipend as a full-time student for service in the University Year for Action program, you must include the stipend in your income as wages.

**Older American programs.** Do not include in your income amounts you receive for supportive services or reimbursements for out-of-pocket expenses from the following programs:

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

## Other Volunteer Programs

If you receive amounts for supportive services or are reimbursed for out-of-pocket expenses under either of the following volunteer programs, you do not include these amounts in your gross income:

- Service Corps of Retired Executives (SCORE), and
- Active Corps of Executives (ACE).

**Volunteer tax counseling.** You do not include in your income any reimbursements you receive for transportation, meals, and other expenses you have in training for, or actually providing, volunteer federal income tax counseling for the elderly (TCE).

You can deduct as a charitable contribution your unreimbursed out-of-pocket expenses in taking part in the volunteer income tax assistance (VITA) program.

## Statutory Employees

Statutory employees are considered self-employed independent contractors for purposes of reporting income and expenses on their tax returns. If you received a Form W-2 and the "Statutory employee" box in box 15 was checked, get Publication 525 for more information.

# Tip Income

## Introduction

This chapter discusses the tax rules for people who receive tips, such as waiters, waitresses, other food service employees, hairdressers, cab drivers, and casino dealers. It includes:

- What records of tips you should keep,
- When and how to report tips to your employer,
- What taxes your employer must withhold from your tips,
- How to treat tips you did not report to your employer, and
- Whether tip allocation affects you and how to report your tips if your employer allocates tips.

All tips you receive are taxable income and are subject to federal income tax. You must include in gross income tips you receive directly from customers, tips from charge customers that are paid to you by your employer, and your share of any tips you receive under a tip-splitting arrangement.

**Withholding tax on tips.** Cash tips of \$20 or more that you receive in a month while working for any one employer are subject to withholding of income tax, social security or railroad retirement tax, and Medicare tax. Report the tips you receive to your employer so that the correct amount of these taxes can be determined. This is explained under *Withholding on Tips by Employer*, later in this chapter.

**Social security or railroad retirement benefits.** Your tips and other pay are used to determine the amount of social security or railroad retirement benefits you or your family may receive if you retire, become disabled, or die. Also, your tip income will be considered in determining your eligibility for Medicare benefits at age 65 or if you become disabled. You can get information about these benefits from Social Security offices or Railroad Retirement Board offices. Noncash tips are not counted as wages for social security purposes.

Your future benefits can be figured correctly only if the Social Security Administration (SSA) has your correct information. To make sure that you have received credit for all your earnings, you should request a statement of your earnings from SSA at least every other year. You can get information on how to receive a statement of your earnings

by calling 1-800-SSA-1213, or for the hearing impaired with access to TTY/TDD equipment, 1-800-325-0778. When you get the statement from SSA, you should check it to be sure it includes all of your earnings.

## Useful Items

You may want to see:

### Publication

- **531** Reporting Tip Income
- **1244** Employee's Daily Record of Tips and Report to Employer

### Form (and Instructions)

- **4137** Social Security and Medicare Tax on Unreported Tip Income

## Reporting Tips

You must report all tips as wages on Form 1040, Form 1040A, or Form 1040EZ. This includes the value of tips not paid in cash, such as passes, tickets, goods, or services. If you received tips of \$20 or more in a month and you did not report all of them to your employer, you must file Form 1040 and Form 4137. You cannot file Form 1040A or Form 1040EZ. If you are a railroad employee and you did not report tips of \$20 or more, contact your employer.

**Service charges.** A club, hotel, or restaurant may require customers who use its dining or banquet rooms to pay a service charge, which is given to the waiters or waitresses and other employees. Your share of this service charge is not a tip, but it is part of your wages paid by the employer. You should not include your share of the service charge in your report of tips to your employer. Your employer should not include your share of the service charge in tips paid to you, but should include it in your wages.

**Tip splitting.** If you split tips with fellow employees, include only your share of the tips in your report to your employer. An example of tip splitting is a waiter giving part of his tips to busboys. "Tip splitting" may be referred to also as "tip sharing" or "tip pooling."

## Daily Record of Tips

You must keep a **daily record** or **other documentation** to prove the amount of tip income you report on your return.



Daily record. Your daily record must show the following.

- 1) Your name and address,
- 2) Your employer's name, and
- 3) The establishment's name.

### Also show for each workday:

- 1) The amount of cash tips you receive directly from customers or from other employees,

- 2) Tips from credit card charge customers when paid to you by your employer,
- 3) The amount of tips you paid out to other employees through tip splitting, etc., and
- 4) The names of the other employees to whom you paid tips.

Make the entries in your daily record on or near the date you receive the tip income. Your records should also show the date each entry is made.

**Other documentation.** If you do not keep a daily record of tips, you must maintain other documentation of the tip income you receive. This other documentation must be as credible and reliable as a daily record. The records must show:

- 1) Tips added to checks by customers and paid over to you, or
- 2) Amounts paid for food or beverages on which you generally would receive a tip.

### Examples of other documentary records are copies of:

- 1) Restaurant bills,
- 2) Credit card charges, or
- 3) Charges under any other arrangement containing amounts added by customers as tips.

**Which form to use.** You can use Form 4070A, *Employee's Daily Record of Tips*, to record your tips.

**Form 4070A** can be found only in Publication 1244, *Employee's Daily Record of Tips and Report to Employer*. You can get Publication 1244 from the IRS or your employer.

**Your personal records.** You should keep your daily tip record and a copy of the written reports you give your employer with your personal records.

## When To Report Tips to Employer

You must give your employer a written report of your tips for each month by **the 10th day** of the next month. This report is required for each month that you receive tips of \$20 or more while working for that employer.

**Saturday, Sunday, holiday rule.** If the 10th day of the month falls on a Saturday, Sunday, or legal holiday, you can give your employer the report on the next day that is not a Saturday, Sunday, or legal holiday.

**Example.** You must report tips of \$20 or more you receive during April 1997 to your employer by Monday, May 12, 1997.

## How To Report Tips to Employer

The following discussions refer only to tips paid by cash, credit card, and check.

**Less than \$20 in tips in one month.** If you receive less than \$20 in tips while working for one employer during a month, you do not have to report them to that employer. But you must include the tips in gross income on your income tax return. You do not have to pay social security tax, Medicare tax, or railroad retirement tax on these tips.

**\$20 or more in tips in one month.** If you receive tips of \$20 or more in a month while working for any one employer, you must report the total amount of your tips to that employer.

**Example 1.** You work for Watson's Restaurant during the month and receive \$75 in tips. Because your tips are more than \$20 for the month, you must report the \$75 to your employer.

**Example 2.** You work for Watson's Restaurant during the month and receive \$17 in tips. In that same month you work for Parkview Restaurant and get \$14 in tips. Even though your tips total \$31, you do not have to report tips to either employer because you did not receive \$20 or more in tips from either job. However, you should keep a record of the \$31 because you must report it as income on your tax return.

**Termination of employment.** When you stop working for your employer, you should report your tips of \$20 or more to your employer at that time. If you do not report the tips when you stop working, you must give a statement to your employer either before your final payday or by the 10th day following the month you receive the tips, whichever is earlier.

**Date tips are treated as paid.** Tips are treated as paid to you when you make the written report to your employer. However, if you make no report to your employer, tips are treated as paid to you when you receive them.

**Example 1.** During December of last year, you received \$300 in tips. On January 10, of this year, you reported the tips to your employer. Your December tips will be treated as paid to you in January, the time you made the report to your employer. You must report the \$300 on this year's income tax return.

**Example 2.** If during December of last year your tips were only \$18, you would not have to make a report to your employer. In this case your tips are treated as paid in December of last year, the time you actually received them. You must report the \$18 on this year's income tax return.

**Information you must report.** To report tips to your employer, you can use **Form 4070, Employee's Report of Tips to Employer.** This form, available only in Publication 1244, tells you what information you must report. If you do not use Form 4070, your report should include the following.

- The amount of tips,
- Your employer's name and address,
- Your name, social security number, and address,
- The month (or shorter period) covered,
- Your signature, and
- The date of the report.

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## Withholding on Tips by Employer

Your employer must withhold income tax, social security or railroad retirement tax, and Medicare tax on the tips you report. Your employer usually deducts the withholding due on tips from your regular wages. However, you do not have to have income tax withheld if you can claim exemption from withholding. You can claim exemption only if you had no income tax liability last year and expect none this year. See *Exemption From Withholding* in Chapter 5 for more information.

**Employer's recordkeeping.** Your employer may withhold an amount from your wages based on an estimate of your tips. Your employer also may require your written tip reports more than once a month and deduct the taxes due on your reported tips even though they do not yet total \$20. If this is done, your employer must adjust the amount of taxes withheld from time to time, based on the actual amount of tips you report.

**Form W-2.** The Form W-2, *Wage and Tax Statement*, which you get from your employer, includes your reported tips.

- Box 1 includes your total wages, other compensation, and the tips you reported.
- Box 3 is your social security wages not including tips.
- Box 7 is your social security tips, the tips you reported to your employer.
- Box 5 is your Medicare wages and tips, which for most persons will be the sum of boxes 3 and 7. Your Medicare wages and tips total will be higher if your wages and tips are more than \$62,700.

Any tips that are allocated to you (discussed later) are shown in box 8. Allocated tips are not included in boxes 1, 5, and 7. Any errors you find in these amounts should be brought to your employer's attention as soon as possible so you can obtain a corrected form.

### Giving your employer money for taxes.

Your regular pay may not be enough for your employer to withhold all the tax due on your regular pay plus reported tips. You can give your employer money to pay this withholding tax up to the close of the calendar year.

If your wages and any money you provide are not enough to pay all of your withholding

taxes, the amounts will be applied in the following order. Your employer will first withhold from your wages all taxes due on your regular wages. This includes withholding for state and local income tax. Next, your employer will withhold from the balance of your wages taxes due on your reported tips. Social security and Medicare tax on reported tips will be withheld before any income tax will be withheld. Any taxes that remain unpaid should be collected by the employer out of your next paycheck.

You may pay estimated tax instead of giving your employer extra money. See Chapter 5 for information on estimated tax.

**Uncollected employee social security and Medicare tax on tips.** Box 13 (code A) on your Form W-2 will show the amount of social security tax on tips that your employer was unable to withhold and for which you did not give your employer extra money to pay the tax.

Box 13 (code B) will show the amount of Medicare tax on tips that your employer was unable to withhold and for which you did not give your employer extra money to pay the tax.

You must file Form 1040 to report the amount of uncollected tax on tips from box 13 (codes A and B), Form W-2, and pay it with your return, even if you do not otherwise have to file a return. Include the amount of uncollected tax in the total on line 51 of Form 1040. On the dotted line next to line 51, write "UT" and show the amount.

**Limit on social security and railroad retirement tax.** There are limits on the amount of social security and railroad retirement tax that your employer withholds from your wages and reported tips. If you worked for two or more employers in 1996, and you earned more than \$62,700 (\$46,500 for amounts subject to Tier 2 railroad retirement tax), you may have overpaid one or more of these taxes. You may be eligible for a credit for excess social security tax or railroad retirement tax, discussed in Chapter 36.

All of your wages and reported tips are subject to Medicare tax.

### No limit for withholding of income tax.

Unlike the social security and railroad retirement taxes, there is no dollar limit on the income tax withheld on wages and tips. The income tax withheld by your employer will either decrease what you owe at the end of the year or increase your refund when you file your return.

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## Tips Not Reported to Employer

If you received tips of \$20 or more in any month while working for one employer, but did not report all of them to your employer, you must figure your social security and Medicare tax on the tips not reported. You should use **Form 4137** and attach it to Form 1040. See *Social Security and Medicare Tax*

on *Unreported Tip Income (Form 4137)*, later.

**Employees subject to the Railroad Retirement Act.** If you received tips of \$20 or more in any month while working for a railroad employer and did not report them to your employer, do not use Form 4137. Instead, see *Employees subject to the Railroad Retirement Act*, in Publication 531.



Penalty for failure to report tips. *If you do not report tips to your employer as required, you may be subject to a penalty equal to 50% of the employee social security or railroad retirement tax and Medicare tax, in addition to the tax that you owe.*

**Reasonable cause.** You can avoid this penalty if you can show reasonable cause for not reporting these tips to your employer. To do so, attach a statement to your return explaining why you did not report them.

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## Tip Allocation

Large food or beverage establishments must report certain additional information about tips to the IRS.

To make sure that employees are correctly reporting tips, employers must keep records to verify amounts reported by employees. Certain employers must allocate tips if the percentage of tips reported by employees falls below a required minimum percentage of gross sales. To “allocate tips” means to assign an additional amount as tips to each employee whose reported tips are below the required percentage.

**How the rules work.** The rules apply only if the total amount of tips reported by all tipped employees to your employer is less than 8% (or some lower acceptable percentage) of the establishment’s total food or beverage sales (with some adjustments).

If reported tips total less than 8% of total sales, your employer must allocate the difference between 8% of total sales (or some

lower acceptable percentage) and the amount of reported tips among all tipped employees. However, no allocation will be made to you if you report tips at least equal to your share of 8% of the total sales.

If the customers do not tip 8% on the average, either your employer or a majority of the directly-tipped employees may petition to have the allocation percentage reduced from 8%. However, it cannot be reduced below 2%.

**Allocated tips on Form W-2.** Your employer will report the amount of tips allocated to you on your Form W-2 (in box 8), separately from your wages and reported tips. Your employer bases withholding only on wages and reported tips. Your employer **should not withhold** income, social security, railroad retirement, or Medicare taxes from the allocated amount. Any incorrectly withheld taxes should be refunded to you by your employer.

### Allocated tips you must report as income.

If you do not have adequate records for your actual tips, you must include the allocated tips shown on your Forms W-2 as additional tip income on your tax return. If you have adequate records, do not include allocated tips on your return. Include additional tip income only if those records show you actually received more tips than the amount you reported to your employer.

For more information on these requirements, see *Tip Allocation* in Publication 531.

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## Social Security and Medicare Tax on Unreported Tip Income (Form 4137)

Report on line 1 of Form 4137 **all** of the tips you received. This includes tips you reported

to your employer, unreported tips, and allocated tips that you must report as income. Report on line 2 the amount of tips you reported to your employer and on line 4 the amount of tips you did not report because the total was less than \$20 in a calendar month. These amounts are subtracted from the amount on line 1. The balances on lines 9 and 5 are the unreported tips subject to social security and Medicare tax figured on Form 4137.



*Only include cash, check, and charge tips when completing Form 4137. The value of tips not paid in cash or by check or charge card are not counted as wages for social security and Medicare tax purposes.*

Be sure to complete Schedule U on the bottom of Form 4137. Schedule U is used by the Social Security Administration to credit your social security and Medicare accounts.

Attach Form 4137 to Form 1040. Enter the tax on line 47 of Form 1040. You may not use Form 1040EZ or Form 1040A.



*Do not include on line 47, Form 1040, any amount of uncollected social security tax and Medicare tax due on tips you **did** report to your employer. This amount, if any, is shown in Box 13 on Form W-2. Instead, see Uncollected employee social security and Medicare tax on tips under Withholding on Tips by Employer for the method of paying these taxes.*

# 8.

## Interest Income

### Important Change for 1996

**Education Savings Bond Program.** The amount of modified adjusted gross income you can have and still benefit from the exclusion of interest from Series EE U.S. Savings bonds issued after 1989 increased for 1996 and increased retroactively for 1993, 1994, and 1995. If that limit reduced or eliminated your exclusion in 1993, 1994, or 1995, you may be entitled to a refund. See *Modified adjusted gross income limit* under *Education Savings Bond Program*.

### Important Reminder

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

### Introduction

This chapter discusses:

- Different types of interest income,
- What interest is taxable and what interest is nontaxable,
- When to report interest income, and
- How to report interest income on your tax return.

In general, any interest that you receive or that is credited to your account and can be withdrawn is taxable income. (It does not have to be entered in your passbook.) Exceptions to this rule are discussed later in this chapter.



As an important part of your records, you should keep a list showing sources and amounts of interest received during the year.

You may be able to deduct expenses you have in earning this income on Schedule A (Form 1040) if you itemize your deductions. See Chapter 30.

### Useful Items

You may want to see:

#### Publication

- 525** Taxable and Nontaxable Income
- 537** Installment Sales

- 550** Investment Income and Expenses
- 925** Passive Activity and At-Risk Rules
- 1212** List of Original Issue Discount Instruments

#### Form (and Instructions)

- Schedule B (Form 1040)** Interest and Dividend Income
- Schedule 1 (Form 1040A)** Interest and Dividend Income for Form 1040A Filers
- 1099** Instructions for Forms 1099, 1098, 5498, and W-2G
- 3115** Application for Change in Accounting Method
- 8815** Exclusion of Interest From Series EE U.S. Savings Bonds Issued After 1989
- 8818** Optional Form To Record Redemption of Series EE U.S. Savings Bonds Issued After 1989

### General Information

A few items of general interest are covered here.

#### Passive activity income and losses.

There are tax rules which limit the amount of losses and tax credits from passive activities that you can claim. Generally, you can use losses from passive activities only to offset income from passive activities. You generally cannot use passive activity losses to offset your other income, such as your wages or your portfolio income (that is, any gross income from interest, dividends, etc., that is not derived in the ordinary course of a trade or business). For more information about determining and reporting income and losses from passive activities, see Publication 925.

**Tax on investment income of a child under age 14.** Part of a child's investment income may be taxed at the parent's tax rate. This may happen if the child was under age 14, had more than \$1,300 of investment income (such as taxable interest and dividends) and has to file a tax return, and either parent was alive at the end of the year. If these requirements are met, **Form 8615**, *Tax for Children Under Age 14 Who Have Investment Income of More Than \$1,300*, must be completed and attached to the child's tax return. If these requirements are not met, Form 8615 is not required and the child's income is taxed at his or her own tax rate.

However, the parent can choose to include the child's interest and dividends on the parent's return if certain requirements are met. Use **Form 8814**, *Parents' Election To Report Child's Interest and Dividends*, for this purpose.

For more information about the tax on investment income of children and the parents' election, see Chapter 32.

**Beneficiary of an estate or trust.** Interest, dividends, or other investment income you receive as a beneficiary of an estate or trust is generally taxable income. You should receive a **Schedule K-1** (Form 1041), *Beneficiary's Share of Income, Deductions, Credits, etc.*, from the fiduciary. Your copy of Schedule K-1 and its instructions will tell you where to report the items on your Form 1040.

**Social security number (SSN).** You must give your name and SSN to any person required by federal tax law to make a return, statement, or other document that relates to you. This includes payers of interest.

**SSN for joint account.** If the funds in a joint account belong to one person, list that person's name first on the account and give that person's SSN to the payer. (For information on who owns the funds in a joint account, see *Joint accounts*, later.) If the joint account contains combined funds, give the SSN of the person whose name is listed first on the account.

These rules apply both to joint ownership by a married couple and to joint ownership by other individuals. For example, if you open a joint savings account with your child using funds belonging to the child, list the child's name first on the account and give the child's SSN.

**Custodian account for your child.** If your child is the actual owner of an account that is recorded in your name as custodian for the child, give the child's SSN to the payer. For example, you must give your child's SSN to the payer of dividends on stock owned by your child, even though the dividends are paid to you as custodian.

**Penalty for failure to supply SSN.** If you do not give your SSN to the payer of interest, you may have to pay a penalty. See *Failure to supply social security number* under *Penalties* in Chapter 1. Backup withholding also may apply.

**Backup withholding.** Your investment income is generally not subject to regular withholding. However, it may be subject to backup withholding to ensure that income tax is collected on this income.

Under backup withholding, when you open a new account you must certify under penalties of perjury that your social security number is correct and that you are not subject to backup withholding. Your payer will give you a **Form W-9**, *Request for Taxpayer Identification Number and Certification*, or a similar form, to make this certification. If you fail to make this certification, backup withholding may begin immediately on your new account or investment, and 31% of the interest paid on your account will be withheld. Backup withholding may also be required if

the Internal Revenue Service (IRS) has determined that you underreported your interest or dividend income. For more information, see *Backup Withholding* in Chapter 5.

**Reporting backup withholding.** If backup withholding is deducted from your interest income, the payer must give you a Form 1099-INT for the year that indicates the amount withheld. The Form 1099-INT will show any backup withholding as “Federal income tax withheld.”

**Joint accounts.** In a joint account, two or more persons hold property as joint tenants, tenants by the entirety, or tenants in common. That property can include a savings account or bond. Each person may receive a share of any interest from the property. Each person’s share is determined by local law.

**Income from property given to a child.** Property you give as a parent to your child under the Model Gifts of Securities to Minors Act, the Uniform Gifts to Minors Act, or any similar law, is a true gift for federal gift tax purposes.

Income from property transferred under these laws is taxable to the child unless it is used in any way to satisfy a legal obligation of support of that child. The income is taxable to the person having the legal obligation to support the child (the parent or guardian) to the extent that it is used for the child’s support.

**Savings account with parent as trustee.** Interest income derived from a savings account opened for a child who is a minor, but placed in the name and subject to the order of the parents as trustees, is taxable to the child, if, under the law of the state in which the child resides:

- 1) The savings account legally belongs to the child, and
- 2) The parents are not legally permitted to use any of the funds to support the child.

**Form 1099-INT.** Interest income is generally reported to you on Form 1099-INT, *Interest Income*, or a similar statement, by banks, savings and loans, and other payers of interest. This form shows you the interest you received during the year. Keep this form for your records. You do not have to attach it to your tax return.

Report on your tax return the total amount of interest income that is shown on any Form 1099-INT that you receive for the tax year. You must also report all of your interest income for which you did not receive a Form 1099-INT.

**Nominees.** Generally, if someone receives interest as a nominee for you, that person will give you a Form 1099-INT showing the interest received on your behalf.

If you receive a Form 1099-INT that includes amounts belonging to another person, see the discussion on nominee distributions, later, under *How To Report Interest Income*.

**Incorrect amount.** If you receive a Form 1099-INT that shows an incorrect amount (or other incorrect information), you should ask the issuer for a corrected form. The new Form 1099-INT you receive will be marked “CORRECTED.”

**Interest on Form 1099-OID.** Reportable interest income may also be shown on Form 1099-OID, *Original Issue Discount*. For more information about amounts shown on this form, see *Original Issue Discount (OID)*, later in this chapter.

**Individual Retirement Arrangements (IRAs).** Interest that you earn on an IRA is tax-deferred. You generally do not include it in your income until you make withdrawals from the IRA. Nor is it included in the amount to be reported as tax-exempt interest. See Chapter 18.

**Exempt-interest dividends** you receive from a regulated investment company (mutual fund) are not included in your taxable income. (However, see *Information reporting requirement*, next.) You will receive a notice from the mutual fund telling you the amount of the tax-exempt interest dividends that you received. Exempt-interest dividends are not shown on Form 1099-DIV or Form 1099-INT.

**Information reporting requirement.** Although exempt-interest dividends are not taxable, you must show them on your tax return if you are required to file. This is an information reporting requirement and does not convert the exempt-interest dividend to taxable income. See *How To Report Interest Income*, later.

**Note:** Exempt-interest dividends may be treated as tax-exempt interest on specified private activity bonds, which is a “tax preference item” that may be subject to the alternative minimum tax. See *Alternative Minimum Tax* in Chapter 31 for more information. Publication 550 contains a discussion on private activity bonds, under *State or Local Government Obligations*.

**Interest income on frozen deposits.** A frozen deposit is an account from which you are unable to withdraw funds because:

- 1) The financial institution is bankrupt or insolvent, or
- 2) The state where the financial institution is located has placed limits on withdrawals because other banks in the state are bankrupt or insolvent.

Exclude from your gross income interest credited during 1996 on frozen deposits that you could not withdraw by the end of 1996.

**Amount to exclude.** The amount of interest you must exclude from gross income in 1996 is the interest that was credited on the frozen deposits minus the sum of:

- 1) The net amount you withdrew from these deposits during 1996, and

- 2) The amount you could have withdrawn as of the end of 1996 (not reduced by any penalty for premature withdrawals of a time deposit).

If you receive a Form 1099-INT for interest income on deposits that were frozen at the end of 1996, see *Frozen deposits* under *How To Report Interest Income*, for information about reporting this interest income exclusion on your 1996 tax return.

The interest you excluded from your income in 1996 must be reported in the later tax year when you can withdraw it from your account.

**Example.** \$100 of interest was credited on your frozen deposit during the year. You withdrew \$80 but could not withdraw any more as of the end of the year. Your net amount withdrawn was \$80. You must exclude \$20. You must include \$80 in your income for the year.

**Interest on VA dividends.** Interest on insurance dividends that you leave on deposit with the Department of Veterans Affairs (VA) is not taxable. This includes interest paid on dividends on converted United States Government Life Insurance and on National Service Life Insurance policies.

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## Taxable Interest

Taxable interest includes interest you receive from bank accounts, loans you make to others, and interest from most other sources. The following are some other sources of taxable interest.

**Dividends that are actually interest.** Certain distributions commonly called dividends are actually interest. You must report as interest so-called “dividends” on deposits or on share accounts in:

- Cooperative banks,
- Credit unions,
- Domestic building and loan associations,
- Domestic savings and loan associations,
- Federal savings and loan associations, and
- Mutual savings banks.

**Money market funds.** Generally, amounts you receive from money market funds should be reported as dividends, not as interest.

**Money market certificates, savings certificates, and other deferred interest accounts.** If you open any of these accounts, and interest is paid at fixed intervals of one year or less during the term of the account, you must include this interest in your income when you actually receive it or are entitled to receive it without paying a substantial penalty. The same is true for accounts that mature in one year or less and give a single payment of interest at maturity. If interest is

deferred for more than one year, see *Original Issue Discount (OID)*, later.

**Interest subject to penalty for early withdrawal.** If you deposit money in a deferred interest account that has a term of one year or less, and you lose part of the interest because you withdrew funds before the end of the term, you must include all the interest in income at the end of the term. However, you can deduct the entire penalty on line 28 of Form 1040, even if it exceeds your interest income.

**Example.** On October 1, 1995, you invested \$10,000 in a savings certificate that was to pay you \$10,600 on April 1, 1996. Because you withdrew part of the principal or interest before April 1, the bank charged you a penalty of \$300. For 1996, you must report as income the entire \$600 accrued interest. However, you can deduct the \$300 penalty as an adjustment to gross income.

**Money borrowed to invest in money market certificate.** The interest you pay on money borrowed from a bank or savings institution to meet the minimum deposit required for a money market certificate from the institution and the interest you earn on the certificate are two separate items. You must report the total interest you earn on the certificate in your income. You may deduct the interest you pay, as investment interest subject to certain limits, only if you itemize deductions. The limits are discussed in Chapter 3 of Publication 550 under *Limit on Investment Interest*.

**Example.** You deposit \$5,000 with a bank and borrow \$5,000 from the bank to make up the \$10,000 minimum deposit required to buy a 6-month money market certificate. The certificate earns \$575 at maturity in 1996, but you receive only \$265, which represents the \$575 you earned minus \$310 interest charged on your \$5,000 loan. The bank gives you a Form 1099-INT for 1996 showing the \$575 interest you earned. The bank also gives you a statement showing that you paid \$310 interest for 1996. You must include the \$575 in your income. You can deduct up to \$310 on Schedule A (Form 1040) if you itemize your deductions, subject to the investment interest expense limit.

**Gift for opening account.** The fair market value of "gifts" or services you receive for making long-term deposits or for opening an account in a savings institution is interest. Report it in income in the year you receive it.

**Example.** In 1996, you open a savings account at your local bank. The account earns \$20, which is credited as interest. You also receive a \$10 calculator. If no other interest is credited to your account during 1996, the Form 1099-INT you receive would show \$30 interest income for 1996.

**Interest on insurance dividends.** Interest on insurance dividends that you leave on deposit with an insurance company, that is credited annually, and that can be withdrawn annually, is taxable to you when the interest is credited to your account. However, if you

can only withdraw it on the anniversary date of the policy (or other specified date), the interest is taxable in the year in which that date occurs.

**Prepaid insurance premiums.** Any increase in the value of prepaid insurance premiums, advance premiums, or premium deposit funds is interest if it is applied to the payment of premiums due on insurance policies or made available for you to withdraw. Your insurance company must give you a Form 1099-INT showing the interest you earned for the year if you had \$10 or more of interest income from that company.

**U.S. obligations.** Interest on U.S. obligations, such as U.S. Treasury bills, notes, and bonds, issued by any agency or instrumentality of the United States is taxable for federal income tax purposes, but is exempt from all state and local income taxes.

Treasury bills generally have a 13-week, 26-week, or 52-week maturity period. They are issued at a discount in denominations of \$10,000 and additional multiples of \$1,000. The difference between the discounted price you pay for the bills and the face value you receive at maturity is interest income. Report this interest income when the bill is paid at maturity.

Treasury notes have maturity periods ranging from 1 to 10 years. Maturity periods for Treasury bonds are longer than 10 years. Both notes and bonds generally pay interest every 6 months. Report this interest for the year paid. For more information, see *U.S. Treasury Bills, Notes, and Bonds* in Publication 550.

For information on Series EE and Series HH Savings Bonds, see *U.S. Savings Bonds*, later.

**Interest on tax refunds.** Interest you receive on tax refunds is taxable income.

**Interest on condemnation award.** If the condemning authority pays you interest to compensate you for a delay in paying an award, the interest is taxable.

**Installment sale payments.** Deferred payments you receive under a contract for the sale or exchange of property usually contain interest that is taxable. If little or no interest is provided for in certain contracts with payments due more than one year after the date of sale, each payment due more than 6 months after the date of sale will be treated as containing interest. These unstated interest rules apply to certain payments received on account of a seller-financed sale or exchange of property. See *Unstated Interest* in Publication 537, *Installment Sales*.

**Interest on annuity contract.** Accumulated interest on an annuity contract you sell before its maturity date is taxable.

**Usurious interest.** Usurious interest is taxable unless state law automatically changes

it to a payment on the principal. Usurious interest is interest charged at an illegal rate.

**Bonds traded flat.** If you purchase bonds when interest has been defaulted or when the interest has accrued but has not been paid, that interest is not income and is not taxable as interest if later paid. Such payments are returns of capital which reduce the remaining cost basis. Interest which accrues after the date of purchase, however, is taxable interest income for the year in which received or accrued. See *Bonds Sold Between Interest Dates*, later, for more information.

**Interest on below-market loans.** A below-market loan is a loan on which no interest is charged or on which interest is charged at a rate below the applicable federal rate. See *Below-Market Loans* in Publication 550 for more information.

## U.S. Savings Bonds

You earn interest on U.S. Savings Bonds in one of two ways. On some bonds, interest is paid at stated intervals by interest checks or coupons. Other bonds are issued at a discount and pay all interest at redemption or maturity. The interest on the latter is the difference between what you pay for the bond and its redemption or maturity value.

This section provides information on different types of U.S. Savings Bonds, how to report the interest income on these bonds, and how to treat transfers of these bonds.

**Cash-basis taxpayers.** If you use the cash method of accounting, as most individual taxpayers do, you generally report the interest on U.S. Savings Bonds when you receive it. The cash method of accounting is explained in Chapter 1 under *Accounting Methods*.

**Accrual-basis taxpayers.** If you use an accrual method of accounting, you must report interest on U.S. Savings Bonds each year as it accrues. You cannot postpone reporting interest until you receive it or the bonds mature. Accrual methods of accounting are explained in Chapter 1 under *Accounting Methods*.

**Series HH Bonds.** These bonds are issued at face value. Interest is paid twice a year by check or by direct deposit to your bank account. If you are a cash-basis taxpayer, you must report interest on these bonds as income in the year you receive it.

Series HH Bonds were first offered in 1980. Before 1980, **Series H Bonds** were issued. Series H Bonds are treated the same as Series HH Bonds. If you are a cash-basis taxpayer, you must report the interest when you receive it.

**Series EE Bonds.** These bonds are issued at a discount. You pay less than the face

value for the bonds. The face value is payable to you at maturity. The difference between the purchase price and the redemption value is taxable interest.

Series EE Bonds were first offered in 1980. Before 1980, **Series E Bonds** were issued. If you own either Series EE or Series E Bonds and use the cash method of reporting income, you can:

- 1) Postpone reporting the interest until the earlier of the year you cash the bonds or the year in which they finally mature (**method 1**), or
- 2) Choose to report the increase in redemption value as interest each year (**method 2**).

**Change from method 1.** If you want to change your method of reporting the interest from method (1) to method (2), you can do so without permission from the IRS. In the year of change you must report all interest accrued to date and not previously reported for all your bonds.

Once you choose to report the interest each year, you must continue to do so for all Series EE or Series E Bonds you own and for any you get later, unless you request permission to change, as explained next.

**Change from method 2.** To change from method (2) to method (1), complete **Form 3115, Application for Change in Accounting Method**, and attach it to your income tax return for the year of change. Type or print at the top of page 1 of the Form 3115 "Filed Under Rev. Proc. 89-46." You must file your return by the due date (including extensions). You must identify the savings bonds for which you are requesting this change in accounting method.

Permission for the change is automatically granted if you attach to Form 3115 a statement that you agree:

- 1) To report all interest on the bonds acquired during the year of change and for all later tax years when the interest is realized upon disposition, redemption, or final maturity, whichever is earlier, and
- 2) To report all interest on the bonds acquired before the year of change when the interest is realized upon disposition, redemption, or final maturity, whichever is earlier, with the exception of the part reported in prior tax years.

**TIP** If you plan to redeem Series EE bonds in the same year that you pay for higher education expenses, you should use method (1). See Education Savings Bond Program, later, for more information.

**Bonds held beyond maturity.** If you hold the bonds beyond the original maturity period, and if you have chosen to report the interest each year, you must continue to do so unless you get permission to change your method of reporting. If you have chosen to postpone reporting the interest, do not include the interest in income for the year of

original maturity. Report it in the year you redeem the bonds or the year in which the extended maturity period ends, whichever is earlier. The original maturity period has been extended on all Series E Bonds.

The extended maturity period of Series E Bonds issued between May 1941 and November 1965 ends 40 years from their issue dates. The Department of the Treasury has announced that no further extension will be given to these bonds. If you have postponed reporting interest on Series E Bonds purchased in 1956, you must report the interest on your 1996 return, unless you trade your Series E Bonds for Series HH Bonds.

The maturity period of Series E bonds issued after November 1965 is 30 years. Bonds issued in 1966 stopped accruing interest in 1996. If you have postponed reporting interest on Series E bonds purchased in 1966, you must report the interest on your 1966 return, unless you trade for Series HH bonds.

**Co-owners.** If you buy a U.S. Savings Bond issued in your name and another person's name as co-owners, such as you and your child or you and your spouse, interest on the bond is generally taxable to the co-owner who bought the bond. If you used your funds to buy the bond, you must pay the tax on the interest. This is true even if you let the other co-owner redeem the bond and keep all the proceeds. Under these circumstances, since the other co-owner will receive a Form 1099-INT at the time of redemption, the other co-owner must provide you with another Form 1099-INT showing the amount of interest from the bond that is taxable to you. The co-owner who redeemed the bond is a "nominee." See *Nominee distributions and accrued interest (Form 1040)*, later, under *How To Report Interest Income*, for more information about how a person who is a nominee reports interest income belonging to another person.

If you and the other co-owner each contribute part of the purchase price, interest on the bond is generally taxable to each of you, in proportion to the amount each of you paid.

If you and your spouse live in a community property state and hold bonds as community property, one-half of the interest is considered received by each of you. If you file separate returns, each of you must report one-half the bond interest. For more information about community property, see Publication 555, *Community Property*.

These rules are also contained in *Table 8-1*.

**Ownership transferred.** If you bought Series EE or Series E Bonds **entirely with your own funds** and had them reissued in your co-owner's name or beneficiary's name alone, you must include in your gross income for the year of reissue all interest that you earned on these bonds and have not previously reported. But, if the bonds were reissued in your name alone, you do not have to report the interest accrued at that time. This

same rule applies when bonds are transferred between spouses incident to divorce.

**Purchased jointly.** If you buy Series EE or Series E Bonds **jointly** with a co-owner and have them reissued in the co-owner's name alone, you must include in your gross income for the year of reissue your share of all the interest earned on the bonds that you have not previously reported. At the time of reissue, the former co-owner does not have to include in gross income his or her share of the interest earned that was not reported before the transfer. This interest, however, as well as all interest earned after the reissue, is income to the former co-owner.

This income reporting rule also applies when the bonds are reissued in the name of your former co-owner and a new co-owner. But the new co-owner will report only his or her share of the interest earned after the transfer.

If bonds that you and a co-owner bought **jointly** are reissued to each of you separately in the same proportion as your contribution to the purchase price, neither you nor your co-owner has to report at that time the interest earned before the bonds were reissued.

**Example 1.** You and your spouse each spent an equal amount to buy a \$1,000 Series EE Savings Bond. The bond was issued to you as co-owners. You both postpone reporting interest on the bond. You later have the bond reissued as two \$500 bonds, one in your name and one in your spouse's name. At that time neither you nor your spouse has to report the interest earned to the date of reissue.

**Example 2.** You bought a \$1,000 Series EE Savings Bond entirely with your own funds. The bond was issued to you and your spouse as co-owners. You both postpone reporting interest on the bond. You later have the bond reissued as two \$500 bonds, one in your name and one in your spouse's name. You must report half the interest earned to the date of reissue. This is the previously postponed interest earned on the \$1,000 bond that is from the \$500 bond issued to your spouse.

**Transfer to a trust.** If you own Series EE or Series E Bonds and transfer them to a trust, giving up all rights of ownership, you must include in your income for that year the interest earned to the date of transfer, if you have not already reported it. However, if you are considered the owner of the trust and if the increase in value both before and after the transfer continues to be taxable to you, you can continue to defer reporting the interest earned each year. You must include the total interest in your income when the bonds are cashed or finally mature, whichever is earlier.

The same rules apply to previously unreported interest on Series EE or Series E Bonds if the transfer to a trust consisted of Series HH or Series H Bonds you got in a trade for the Series EE or Series E Bonds. See *Savings bonds traded*, later.

**Table 8-1. Who Pays Tax on U.S. Savings Bond Interest**

How Bond Is Purchased	Who Must Pay Tax on Bond Interest
You use your funds to buy a bond in your name and the name of another person as co-owners.	You
You buy a bond in the name of another person, who is the sole owner of the bond.	The person for whom you bought the bond
You and another person buy a bond as co-owners, each contributing part of the purchase price.	Each of you, in proportion to the amount you and the other co-owner each paid
You and your spouse, who live in a community property state, buy a bond that is community property.	If you file separate returns, each of you generally pays tax on one-half.

**Decedents.** The manner of reporting interest income on Series EE or Series E Bonds, after the death of the owner, depends on the accounting and income reporting method previously used by the decedent. If the bonds transferred because of death were owned by a person who used an accrual method, or who used the cash method and had chosen to report the interest each year, the interest earned in the year of death up to the date of death must be reported on that person's final return. The person who acquires the bonds includes in income only interest earned after the date of death.

If the transferred bonds were owned by a decedent who used the cash method, who had not chosen to report the interest each year, and who bought the bonds entirely with his or her own funds, all interest earned before death must be reported in one of the following ways:

- 1) The surviving spouse or personal representative (executor, administrator, etc.) who files the final income tax return of the decedent can choose to include on that return all of the interest earned on the bonds before the decedent's death. The person who acquires the bonds then includes in income only interest earned after the date of death, or
- 2) If the choice in (1) is not made, the interest earned up to the date of death is income in respect of a decedent. It should not be included in the decedent's final return. All of the interest earned both before and after the decedent's death is income to the person who acquires the bonds. If that person uses the cash method and does not choose to report the interest each year, he or she can postpone reporting any of it until the bonds are cashed or finally mature, whichever is earlier. In the year that person reports the interest, he or she can claim a deduction for any federal estate tax paid that was for the part of the interest included in the decedent's estate.

For more information on income in respect of a decedent, see Chapter 4.

**Savings bonds traded.** If you use the cash method and did not choose to report the interest on your Series E or Series EE Bonds

as it accrued, you did not realize taxable income when you traded the bonds for Series H or Series HH Bonds, unless you received cash in the trade. Any cash you received is income to the extent of the interest earned on the bonds traded. When your Series HH or Series H Bonds mature, or if you dispose of them before maturity, you report as interest the difference between their redemption value and your cost. Your cost is the sum of the amount you paid for the traded Series EE or Series E Bonds plus any amount you had to pay at the time of the trade.

**Example.** You trade Series E Bonds with accrued interest of \$523 and a redemption value of \$2,723 for Series HH Bonds. You get \$2,500 in Series HH Bonds and \$223 in cash. You must report the \$223 as taxable income in the year of the trade to the extent that you did not previously report interest on the Series E Bonds you traded.

**\$500 minimum value.** Series EE or Series E Bonds that you want to trade must have a current redemption value of \$500 or more. To figure the current redemption value of the bonds to be traded, you must add the accrued interest to their original purchase price.

**Choice to report interest in year of trade.** You can choose to treat all of the previously unreported accrued interest on the Series EE or Series E Bonds traded for Series HH Bonds as income in the year of the trade.

**Form 1099-INT for U.S. Savings Bonds interest.** When you cash a bond, the bank or other payer that redeems it must give you a Form 1099-INT if the interest part of the payment you receive is \$10 or more. Box 3 of your Form 1099-INT should show the interest as the difference between the amount you received and the amount paid for the bond. However, your Form 1099-INT may show more interest than you have to include on your income tax return. For example, this may happen if:

- 1) You chose to report the increase in the redemption value of the bond each year. The interest shown on your Form 1099-INT will not be reduced by amounts previously included in income.
- 2) You received the bond from a decedent. The interest shown on your Form 1099-

INT will not be reduced by any interest reported by the decedent before death, or on the decedent's final return, or by the estate on the estate's income tax return.

- 3) Ownership of the bond was transferred. The interest shown on your Form 1099-INT will not be reduced by interest that accrued before the transfer.
- 4) You were named as a co-owner but did not use your funds to buy the bond. (See *Co-owners*, earlier in this chapter, for more information about the reporting requirements.)
- 5) You received the bond in a taxable distribution from a retirement or profit-sharing plan. The interest shown on your Form 1099-INT will not be reduced by the interest portion of the amount taxable as a distribution from the plan and not taxable as interest. (This amount is generally shown on Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.*, for the year of distribution.)

Interest income must be reported even if a Form 1099-INT is not received.

For information on including the correct amount of interest on your return for (1), (2), (3), and (4) above, see *How To Report Interest Income*, later. Publication 550 includes examples showing how to report these amounts.

If you received a taxable distribution of bonds from a retirement or profit-sharing plan ((5), above), see *Interest from U.S. Savings Bonds* under *How To Report Interest Income* in Publication 550 for information on how to report the interest.



**U.S. Savings Bond interest is exempt from state and local taxes.**

The Form 1099-INT you receive will indicate the amount that is for U.S. Savings Bond interest in box 3. Do not include this amount on your state or local income tax return.

**Education Savings Bond Program.** You may be able to exclude from income all or part of the interest you receive on the redemption of qualified U.S. Savings Bonds during the year if you pay qualified higher educational expenses during the same year. This exclusion is known as the *Education Savings Bond Program*.

Married taxpayers who file separate returns do not qualify for this exclusion.

**Form 8815.** Use Form 8815, *Exclusion of Interest From Series EE U.S. Savings Bonds Issued After 1989*, to figure your exclusion. Attach the form to your Form 1040 or Form 1040A.

**Qualified U.S. Savings Bonds.** A qualified U.S. Savings Bond is a Series EE U.S. Savings Bond **issued after 1989**. The bond must be issued either in your name (sole owner) or in your and your spouse's names

(co-owners). You must be at least 24 years old before the bond's issue date.

The date a bond is issued may be earlier than the date the bond is purchased because bonds are issued as of the first day of the month in which they are purchased. You can designate any individual (including a child) as a beneficiary of the bond (payable on death).

**Verification by IRS.** Only Series EE U.S. Savings Bonds issued after 1989, qualify for this exclusion. If you claim the exclusion, IRS will check it by using bond redemption information from Department of the Treasury records.

**Qualified expenses.** Qualified higher educational expenses are tuition and fees required for you, your spouse, or your dependent (for whom you can claim an exemption) to attend an eligible educational institution. Qualified expenses do not include expenses for room and board or for courses involving sports, games, or hobbies that are not part of a degree program.

**Eligible educational institutions.** These institutions include most public and nonprofit universities and colleges and certain vocational schools that are eligible for federal assistance.

**Reduction for certain benefits.** You must reduce your qualified higher educational expenses by certain benefits the student may have received. These benefits include qualified scholarships that are exempt from tax and any other nontaxable payments (other than gifts, bequests, or inheritances) received for educational expenses, such as veterans' educational assistance benefits, benefits under a qualified state tuition program, and employer-provided educational assistance benefits. See Publication 520, *Scholarships and Fellowships*, for information on qualified scholarships.

**Amount excludable.** If the total proceeds (interest and principal) from the qualified U.S. Savings Bonds you redeem during the year are not more than your qualified higher educational expenses for the year, you can exclude all of the interest. If the proceeds are more than the expenses, you will be able to exclude only part of the interest.

To determine the excludable amount, multiply the interest part of the proceeds by a fraction. The numerator (top part) of the fraction is the qualified higher educational expenses you paid during the year. The denominator (bottom part) of the fraction is the total proceeds you received during the year.

**Example.** In April 1996, Mark and Joan, a married couple, cashed a qualified Series EE U.S. Savings Bond they bought in November 1991. They received proceeds of \$6,212, representing principal of \$5,000 and interest of \$1,212. In 1996, they helped pay for their daughter's college tuition. The qualified higher educational expenses they paid during 1996 totaled \$4,000. They can exclude \$780 ( $\$1,212 \times (\$4,000 \div \$6,212)$ ) of interest in 1996.

**Modified adjusted gross income limit.** The interest exclusion is phased out if your

modified adjusted gross income (modified AGI) is:

- \$49,450 to \$64,450 for taxpayers filing single, head of household, and
- \$74,200 to \$104,200 for married taxpayers filing jointly or qualifying widow(er) with dependent child.

You do not qualify for the interest exclusion if your modified AGI is equal to or more than the upper limit for your filing status.

**Note:** The modified AGI amounts at which the exclusion phases out were retroactively increased for tax years beginning in 1993, 1994, and 1995. If that limit reduced or eliminated your exclusion in those years, you may be entitled to a refund.

For 1993, the new modified AGI amounts are:

- \$45,500 to \$60,500 for taxpayers filing single or head of household; and
- \$68,250 to \$98,250 for married taxpayers filing jointly, or qualifying widow(er) with dependent child.

For 1994, the new modified AGI amounts are:

- \$46,900 to \$61,900 for taxpayers filing single or head of household; and
- \$70,350 to \$100,350 for married taxpayers filing jointly, or qualifying widow(er) with dependent child.

For 1995, the new modified AGI amounts are:

- \$48,100 to \$63,100 for taxpayers filing single or head of household; and
- \$72,150 to \$102,150 for married taxpayers filing jointly, or qualifying widow(er) with dependent child.

If you are entitled to a refund, complete and file a separate Form 1040X, *Amended U.S. Individual Income Tax Return* for each tax year affected. (Generally, an amended return for 1993 must be filed by April 15, 1997.)

Modified AGI, for purposes of this exclusion, is adjusted gross income (line 16 of Form 1040A or line 31 of Form 1040) figured before the interest exclusion, and modified by adding back any:

- 1) Foreign earned income exclusion,
- 2) Foreign housing exclusion or deduction,
- 3) Exclusion of income for bona fide residents of American Samoa, and
- 4) Exclusion for income from Puerto Rico.

Use the worksheet in the instructions for line 9, Form 8815, to figure your modified AGI. If you have any of the exclusion or deduction items listed above, add the amount of the exclusion or deduction to the amount on line 5 of the worksheet, and enter the total on Form 8815, line 9, as your modified AGI.

If you have investment interest expense incurred to earn royalty income, see *Education Savings Bond Program* in Publication 550.



If you claim the interest exclusion, you must keep a written record of the Series EE U.S. Savings Bonds issued after 1989 that you redeem. Your written record must include the serial number, issue date, face value, and redemption proceeds of each bond. You can use **Form 8818, *Optional Form To Record Redemption of Series EE U.S. Savings Bonds Issued After 1989***, to keep this information. You should also keep bills, receipts, canceled checks, or other documentation that shows you paid qualified higher educational expenses during the year.

## Bonds Sold Between Interest Dates

If you sell bonds between interest payment dates, part of the sales price represents interest accrued to the date of sale. You must report that part of the sales price as interest income for the year of sale.

If you buy bonds between interest payment dates, interest accrued before the purchase is part of the purchase price of the bonds. When that interest is paid to you, treat it as a return of your capital investment rather than interest income.

See *Nominee distributions and accrued interest (Form 1040)*, under *How To Report Interest Income*, later in this chapter for information on reporting the payment.

## Insurance

Life insurance proceeds paid to you as beneficiary of the insured person are not usually taxable. But if you receive the proceeds in installments, you must usually report a part of each installment payment as interest income.

For more information about insurance proceeds received in installments, see Publication 525.

**Annuity.** If you buy an annuity with life insurance proceeds, the annuity payments you receive are taxed as pension and annuity income, not as interest income. See Publication 939, *Pension General Rule (Nonsimplified Method)*, for information on taxation of pension and annuity income.

## Original Issue Discount (OID)

Original issue discount (OID) is a form of interest. You report OID as it accrues, whether or not you receive any payments from the bond issuer.

A long-term debt instrument, such as a bond, note, or other evidence of indebtedness, generally has OID when the instrument is issued for a price that is less than its stated redemption price at maturity (principal

amount). The amount of OID is the difference between the principal amount and the issue price of the instrument.

All long-term debt instruments that pay no interest before maturity are presumed to be issued at a discount. Zero-coupon bonds are one example of these instruments.

The OID rules do not apply to short-term obligations (those with a fixed maturity date of one year or less from date of issue). See *Discount on Short-Term Obligations* in Publication 550.

**De minimis OID.** You can disregard the discount and treat it as zero if it is less than one-fourth of 1% (.0025) of the stated redemption price at maturity, multiplied by the number of full years from the date of original issue to maturity. This small discount is known as “de minimis OID.”

**Example 1.** You bought a 10-year bond, with a stated redemption price at maturity of \$1,000, issued at \$980 and having OID of \$20. One-fourth of 1% of \$1,000 (stated redemption price) times 10 (number of full years from the date of original issue to maturity) equals \$25. Because the \$20 discount is less than \$25, you can disregard reporting the OID.

**Example 2.** Assume the same facts as in Example 1, except that the bond was issued at \$950. The OID is \$50. Because the \$50 discount is more than the \$25 figured in Example 1, you must report the OID.

**Debt instrument bought after original issue.** If you buy a debt instrument with de minimis OID at a premium, the OID is not includible in income. If you buy a debt instrument with de minimis OID at a discount, the discount is reported under the market discount rules. See *Market Discount Bonds* in Chapter 1 of Publication 550.

**Form 1099–OID.** The issuer of the debt instrument (or your broker, if you held the instrument through a broker) should give you Form 1099–OID, *Original Issue Discount*, or a similar statement, if the total OID for the calendar year is \$10 or more. Form 1099–OID shows the amount of OID for the period in 1996 that you held the bond. It also will show the stated interest that you must include in your income. A copy of Form 1099–OID will be sent to the IRS. Do not file your copy with your return. Keep it for your records. See *Recomputation of OID shown on Form 1099–OID*, later in this discussion and also *Original issue discount (OID)*, later under *How To Report Interest Income*, for more information.

**Nominee.** If someone else is the holder of record (the registered owner) of an OID instrument that belongs to you and receives a Form 1099–OID on your behalf, that person must give you a Form 1099–OID.

**Debt instrument bought at premium.** If you bought an OID debt instrument at a premium, you do not have to report any OID as ordinary income. You buy a debt instrument

at a **premium** if its adjusted basis immediately after purchase is greater than the total of all amounts payable on the instrument after the purchase date, other than qualified stated interest. Premium is not the same as “acquisition premium,” discussed later.

When you sell or redeem an instrument bought at a premium, the difference between the sale or redemption price and your purchase price is a capital gain or loss.

**Qualified stated interest.** This is stated interest that is unconditionally payable in cash or property (other than debt instruments of the issuer) at least annually at a fixed rate.

**Exceptions to the OID rules.** The OID rules discussed in this chapter for publicly offered, long-term instruments do not apply to the following debt instruments:

- 1) Tax-exempt obligations (however, see *Stripped tax-exempt obligations under Stripped Bonds and Coupons* in Publication 550),
- 2) U.S. Savings Bonds,
- 3) Short-term debt instruments (those with a fixed maturity date of not more than one year from the date of issue),
- 4) Obligations issued by an individual before March 2, 1984, and
- 5) Loans between individuals, if:
  - a) The lender is not in the business of lending money,
  - b) The amount of the loan, plus the amount of any outstanding prior loans, is \$10,000 or less, and
  - c) Avoiding any federal tax is not one of the principal purposes of the loan.

**Debt instruments issued after 1954 and before May 28, 1969 (or before July 2, 1982, if a government instrument).** For these instruments, you pay no tax on the OID until the year you sell, exchange, or redeem the instrument. If a gain results, and if the instrument is a capital asset, the amount of the gain equal to the OID is taxed as ordinary interest income. The balance of the gain is capital gain. If there is a loss on the sale of the instrument, the entire loss is a capital loss and no reporting of OID is required.

**Debt instruments issued after May 27, 1969, (or after July 1, 1982, if a government instrument), and before 1985.** If you hold these debt instruments as capital assets, you must include a part of the discount in your gross income each year that you own the instruments. Your basis in the instrument is increased by the amount of OID that you include in your gross income.

**Debt instruments issued after 1984.** For these debt instruments, you report the total OID that applies each year regardless of whether you hold that debt instrument as a capital asset. Your basis in the instrument is

increased by the amount of OID that you include in your gross income.

**Recomputation of OID shown on Form 1099–OID.** You must recompute the OID shown in box 1 of Form 1099–OID if either of the following apply:

- 1) You bought the debt instrument after its original issue and paid a premium (as explained earlier in this section) or an acquisition premium, or
- 2) The debt instrument is a stripped bond or a stripped coupon (these include certain zero coupon instruments).

For each of these situations, see *Figuring OID on Long-Term Debt Instruments* in Publication 1212 for detailed information and examples on figuring the amount of OID to report on your income tax return. The rules for figuring OID are broken down in Publication 1212 to reflect the specific computations that apply to:

- Corporate debt instruments issued before July 2, 1982,
- All debt instruments issued after July 1, 1982, and before 1985, and
- All instruments issued after 1984.

See *Original issue discount (OID)* at the end of this chapter, for information about reporting the correct amount of OID on Schedule B (Form 1040)

**Acquisition premium.** You purchase a debt instrument at an acquisition premium if its adjusted basis immediately after purchase (including purchase at original issue) is:

- 1) Less than or equal to the total of all amounts payable on the instrument after the purchase date, other than qualified stated interest (defined under *Debt instrument bought at a premium*, earlier), and
- 2) Greater than its adjusted issue price (the issue price plus the OID previously accrued, minus any payment previously made on the instrument other than qualified stated interest).

Acquisition premium reduces the amount of OID includible in your income.

**REMIC regular interests.** If you own a regular interest in a real estate mortgage investment conduit (REMIC), you should receive a Form 1099–OID and an additional written statement by March 17, 1997 (if you are a calendar year taxpayer) that indicates the amounts you must include in your gross income. The additional written statement should also contain enough information to enable you to figure your accrual of market discount or amortizable bond premium. It should also show your share of deductible investment expenses.

Form 1099–OID shows the amount of OID and interest, if any, that accrued to you for the period you held the regular interest. You will not need to make any adjustments to the amounts reported even if you held the

regular interest for only a portion of the calendar year. However, if you bought the regular interest at a premium or acquisition premium, see *Recomputation of OID shown on Form 1099-OID* under *Original Issue Discount (OID)* earlier. See *REMICs* in Publication 550 for more information.

**If a Form 1099-OID is not received.** If you had OID for 1996 but did not receive a Form 1099-OID, see Publication 1212 which lists total OID on certain debt instruments. If your debt instrument is not listed in Publication 1212, consult the issuer for information about the OID that accrued for 1996.

**Recomputation of periodic interest shown on Form 1099-OID.** If you disposed of a corporate debt instrument or acquired it from another holder during 1996, see *Bonds Sold Between Interest Dates*, earlier, for information about the treatment of periodic interest that may be shown in box 2 of Form 1099-OID for that instrument.

**Stripped bonds and stripped coupons.** Special rules apply to the sale and purchase of stripped bonds and stripped coupons after July 1, 1982. These rules also cover the treatment of zero coupon U.S. Treasury-backed securities. See *Figuring OID on Stripped Bonds and Coupons* in Publication 1212 for more information.

**Certificates of deposit (CDs) and similar deposit arrangements.** If you purchase a CD or a similar deposit arrangement and the receipt of interest is postponed for more than one year, you must include in income each year a part of the total interest due and report it in the same way as other original issue discount (OID).

Examples of these deposit arrangements with banks, building and loan associations, etc., include:

- Certificates of deposit,
- Time deposits,
- Bonus plans,
- Savings certificates,
- Deferred income certificates,
- Bonus savings certificates, and
- Growth savings certificates.

**Bearer certificates of deposit.** These are not issued in the depositor's name and are transferable from one individual to another. They are issued by banks for a certain period, usually a number of years. Interest is usually not paid until the certificates are redeemed by the bank at the end of this period.

Banks must provide the IRS and the person redeeming the bearer certificate with a Form 1099-INT.

Certificates of deposit issued after 1982 generally must be in registered form. For more information about this requirement, see *Obligations issued in bearer form* in Chapter 15.

For more information about interest income from certificates of deposit, see *Original Issue Discount (OID)* in Publication 550.

**Market discount bonds.** A market discount bond is any bond having market discount except:

- 1) Short-term obligations (those with fixed maturity dates of up to one year from the date of issue),
- 2) Tax-exempt obligations that you bought before May 1, 1993,
- 3) U.S. Savings Bonds, and
- 4) Certain installment obligations.

Market discount arises when the value of a debt obligation decreases after its issue date, generally because of an increase in interest rates. If you buy a bond on the secondary market, it may have market discount.

If you dispose of a market discount bond, you generally must recognize the gain as taxable interest income up to the amount of the bond's **accrued market discount**, if:

- 1) The bond was issued after July 18, 1984, or
- 2) You purchased the bond after April 30, 1993.

The rest of the gain is capital gain if the bond was a capital asset. For more information about the tax treatment of market discount, see *Market Discount Bonds* in Publication 550.

**Discount on short-term obligations.** Most cash-basis individuals include any discount on short-term obligations (those with a fixed maturity date of one year or less from the date of issue) in income for the year the obligations mature or are sold or exchanged at a gain.

Holders of certain short-term obligations, however, must include the accrued interest on these obligations, as well as any other accrued interest payable on the obligations, in current income. The basis of these obligations is increased by the amount of discount included in income. See *Discount on Short-Term Obligations* in Publication 550 for more information.

**REMIC regular interests.** If you are the holder of a regular interest in a real estate mortgage investment conduit (REMIC), or an interest in a collateralized debt obligation (CDO), that interest is considered to be a debt instrument for income tax purposes, whether or not it is in the form of a debt instrument. Accordingly, the OID, market discount, and income reporting rules that apply to bonds and other debt instruments apply to such interests with certain modifications. For more information, see *REMICs and Other CDOs* in Publication 550.

## State or Local Government Obligations

Generally, interest on obligations used to finance government operations is not taxable if the obligations are issued by a state, the District of Columbia, a possession of the United States, or any of their political subdivisions. This includes interest on certain obligations issued after 1982 by an Indian tribal government treated as a state.

If you receive a Form 1099-INT for tax-exempt interest, see *Tax-exempt interest income* under *How To Report Interest Income*.

Interest on arbitrage bonds issued by state or local governments after October 9, 1969, and interest on private activity bonds generally is taxable.

For more information on whether such interest is taxable or tax exempt, see *State or Local Government Obligations* in Publication 550.

**Information reporting requirement.** If you are required to file a tax return and you received or accrued any tax-exempt interest income, you must show that interest on your return. This is an information reporting requirement and does not convert tax-exempt interest to taxable interest. See *How To Report Interest Income*, later.

## When To Report Interest Income

When you report your interest income depends on whether you use the cash method or an accrual method to report income.

**Cash method.** If you use this method, you generally report your interest income in the year in which you actually or constructively receive it. Most individual taxpayers use this method. However, there are special rules for reporting the discount on certain debt instruments. See *U.S. Savings Bonds*, and *Original Issue Discount*, earlier.

**Example.** On September 1, 1994, you loaned \$2,000 at 12% a year. The note stated that principal and interest would be due on August 31, 1996. In 1996, you received \$2,480 (\$2,000 principal and \$480 interest). If you use the cash method, you must include in income on your 1996 return the \$480 interest you received in 1996.

**Constructive receipt.** You constructively receive income when it is credited to your account or made available to you. You do not need to have physical possession of it. For example, you are considered to receive interest, dividends, or other earnings on any deposit or account in a bank, savings and loan, or similar financial institution, or interest on life insurance policy dividends left to accumulate, when they are credited to your account and subject to your withdrawal. This is true even if they are not yet entered in your passbook.

You constructively receive income on the deposit or account even if you must:

- 1) Make withdrawals in multiples of even amounts,
- 2) Give a notice to withdraw before making the withdrawal,
- 3) Withdraw all or part of the account to withdraw the earnings, or
- 4) Pay a penalty on early withdrawals, unless the interest you are to receive on an early withdrawal or redemption is substantially less than the interest payable at maturity.

You constructively receive interest when it is credited to your account under a long-term savings plan that does not let you withdraw interest until a specified date, if the plan lets you freely withdraw your deposits of principal.

**Accrual method.** If you use an accrual method, you report your interest income when you earn it, whether or not you have received it.

**Example.** If, in the previous example, you use an accrual method, you must include the interest in your income as you earn it. You would report the interest as follows: 1994, \$80; 1995, \$240; and 1996, \$160.

**Coupon bonds.** Interest on coupon bonds is taxable in the year the coupon becomes due and payable. It does not matter when you mail the coupon for payment.

## How To Report Interest Income

Generally, you report all of your taxable interest income on line 8a, Form 1040; line 8a, Form 1040A; or line 2, Form 1040EZ.

**Limits on use of Form 1040EZ.** You cannot use Form 1040EZ if any of the following are true.

- 1) Your interest income is more than \$400.
- 2) You are excluding interest under the Education Savings Bond Program.
- 3) You received interest as a nominee (that is, in your name but the interest actually belongs to someone else).
- 4) You received a Form 1099–INT for U.S. Savings Bond interest that includes amounts you reported before 1996.

Instead, you must complete the schedules for Form 1040A or Form 1040, as described later.

In addition, you cannot use Form 1040EZ if you must use Form 1040, as described next.

**Required use of Form 1040.** You must use Form 1040 instead of Form 1040A or Form 1040EZ if:

- 1) You are reporting OID in an amount more or less than the amount shown on Form 1099–OID,

- 2) You received or paid accrued interest on securities transferred between interest payment dates,
- 3) You acquired taxable bonds after 1987 and choose to reduce interest income from the bonds by any amortizable bond premium (see *Bond Premium Amortization* in Publication 550), or
- 4) You forfeited interest income because of the early withdrawal of a time deposit.

**Reporting tax-exempt interest.** If you had any tax-exempt interest income, or exempt-interest dividends from a mutual fund, you should report the total of this tax-exempt income on line 8b of Form 1040A or Form 1040. If you file Form 1040EZ, write “TEI” in the space to the right of the words “Form 1040EZ” on line 2. After “TEI,” show the amount of your tax-exempt interest, but do not add tax-exempt interest in the total on Form 1040EZ, line 2.

**Form 1099–INT.** Your taxable interest income, except for interest from U.S. Savings Bonds and Treasury obligations, is shown in box 1 of Form 1099–INT. Add this amount to any other taxable interest income you received. You must report all of your taxable interest income even if you do not receive a Form 1099–INT.

If you forfeited interest income because of the early withdrawal of a time deposit, the deductible amount will be shown on Form 1099–INT in box 2 (early withdrawal penalty). If an amount appears in box 2, file Form 1040 and report this amount on line 28 (penalty on early withdrawal of savings).

Box 3 of Form 1099–INT shows the amount of interest income you received from U.S. Savings Bonds, Treasury bills, Treasury notes, and Treasury bonds. Include the amount shown in box 3 in your total taxable interest income, unless it includes an amount previously included in interest income. If part of the amount shown in box 3 was previously included in interest income, see *Interest from U.S. Savings Bonds*, later. If you redeemed U.S. Savings Bonds you bought after 1989 and you had qualified educational expenses, see *Form 8815*, later.

Box 4 of Form 1099–INT (federal income tax withheld) will contain an amount if you were subject to backup withholding. You may have been subject to backup withholding if, for example, you did not furnish your social security number to a payer. Report the amount from box 4 on Form 1040EZ, line 7, on Form 1040A, line 29a, or on Form 1040, line 52 (federal income tax withheld).

If there are entries in boxes 5 and 6 of Form 1099–INT, you must file Form 1040. Report the amount shown in box 5 (foreign tax paid) on **Form 1116, Foreign Tax Credit**, unless you deduct this amount on Schedule A of Form 1040 as “Other taxes.” For more information on the credit and deduction, see Publication 514, *Foreign Tax Credit for Individuals*.

**Interest from U.S. Savings Bonds.** If you received a Form 1099–INT for U.S. Savings Bond interest, the form may show interest you are not required to report. See *Form 1099–INT for U.S. Savings Bonds interest*, earlier, under *U.S. Savings Bonds*.

If you have qualified education expenses (as discussed earlier under *Education Savings Bond Program*), see *Form 8815*, later, for information on your interest exclusion.

On line 1, Part I of Schedule B (Form 1040), or on line 1, Part I of Schedule 1 (Form 1040A), report all the interest shown on your Form 1099–INT.

If Form 1099–INT includes interest you previously reported, make the following adjustment. On Schedule B (Form 1040) or Schedule 1 (Form 1040A), several lines above line 2, enter a subtotal of all interest listed on line 1. Below the subtotal write “U.S. Savings Bond Interest Previously Reported,” and enter amounts previously reported or interest accrued before receiving the bond. (To figure the amount to enter for interest reported or being reported as a taxable distribution from a retirement or profit-sharing plan, see *Interest from U.S. Savings Bonds* under *How To Report Interest Income* in Publication 550.) Subtract these amounts from the subtotal and enter the result on line 2.

**Form 8815.** Use Form 8815, *Exclusion of Interest From Series EE U.S. Savings Bonds Issued After 1989*, to figure your interest exclusion when you redeem bonds and pay qualified higher educational expenses during the same year.

For more information on the exclusion and qualified higher educational expenses, see the earlier discussion under *Education Savings Bond Program*.

You must show your total interest from Series EE U.S. Savings Bonds issued after 1989 that you cashed during 1996 on line 6 of Form 8815 and on line 1 of either Schedule 1 (Form 1040A) or Schedule B (Form 1040). After completing Form 8815, enter the result from line 14 (Form 8815) on line 3 of Schedule 1 (Form 1040A) or line 3 of Schedule B (Form 1040).

**Form 1099–OID.** The taxable OID on a discounted obligation for the part of the year you owned it is shown in box 1 of Form 1099–OID. Include this amount in your total taxable interest income. You must report all taxable OID even if you do not receive a Form 1099–OID.

Box 2 of Form 1099–OID shows any taxable interest on the obligation other than OID. Add this amount to the OID shown in box 1 and include the result in your total taxable income.

If you forfeited interest or principal on the obligation because of an early withdrawal, the deductible amount will be shown in box 3. If an amount appears in box 3, file Form 1040 and report this amount on line 28.

Box 4 of Form 1099–OID will contain an amount if you were subject to backup withholding. Report the amount from box 4 on

Form 1040EZ, line 7, on Form 1040A, line 29a, or on Form 1040, line 52.

## Form 1040A

You must complete Part I of Schedule 1 (Form 1040A), if you file Form 1040A and:

- 1) Your taxable interest income totals more than \$400,
- 2) You are claiming the interest exclusion under the Education Savings Bond Program,
- 3) You received a Form 1099-INT for tax-exempt interest,
- 4) You received interest from a seller-financed mortgage and the buyer used the property as a home, or
- 5) You received, as a nominee, interest that actually belongs to someone else.

List each payer's name and the amount of interest income received from each payer. If you received a Form 1099-INT or Form 1099-OID from a brokerage firm, list the brokerage firm as the payer.

**Reporting interest on seller-financed mortgage.** If an individual buys his or her home from you in a sale that you finance, you must report the buyer's name, address, and social security number on line 1 of Schedule 1 (Form 1040A). If you do not, you may have to pay a \$50 penalty. The buyer may have to pay a \$50 penalty if he or she does not give you this information.

The buyer must report your name, address, and social security number (or employer identification number) on Schedule A (Form 1040). You must give this information to the buyer. If you do not, you may have to pay a \$50 penalty.

**Nominee distributions (Form 1040A).** If the total interest income you list on line 1, Part I of Schedule 1 (Form 1040A), includes any amount that you received as a nominee for the real owner, show that amount separately below a subtotal of all interest income listed. Identify the amount as "Nominee Distribution," and subtract it from the interest income subtotal. Report the result on line 2, Part I of Schedule 1.

For more information, see *Nominee distributions and accrued interest* later under *Form 1040*.

**Tax-exempt interest income (Form 1040A).** If you received any tax-exempt interest, such as from state or local governmental obligations, do not include this income on line 8a. Instead, enter your tax-exempt interest on line 8b. Also include on line 8b any exempt-interest dividends received from a mutual fund or other regulated investment company. Remember that OID is a form of interest. You report OID as it accrues, whether or not you receive any payments from the bond issuer.

Interest earned on an individual retirement arrangement (IRA) is tax deferred

rather than tax exempt. Do not include this amount in tax-exempt interest.

You should not have received a Form 1099-INT for tax-exempt interest. But if you did, you must fill in Schedule 1 (Form 1040A). See the *Form 1040A Instructions* for how to report this on Schedule 1. Be sure to show the tax-exempt interest on line 8b.

**Frozen deposits (Form 1040A).** Even if you receive a Form 1099-INT for interest on deposits that you could not withdraw at the end of 1996, you must exclude these amounts from your gross income, as explained earlier under *General Information*. Do not include this income on line 8a. If you are completing Part I of Schedule 1, include on line 1 the interest shown on Form 1099-INT. Several lines above line 2, put a subtotal of all interest income. Below this subtotal, write "Frozen Deposits," and show the amount of interest that you are excluding. Subtract this amount from the subtotal and write the result on line 2.

## Form 1040

You must complete Part 1 of Schedule B (Form 1040) if you file Form 1040 and any of the following apply:

- 1) Your taxable interest income is more than \$400.
- 2) You are claiming the interest exclusion under the Education Savings Bond Program.
- 3) You received interest from a seller-financed mortgage and the buyer used the property as a home.
- 4) You received a Form 1099-INT for tax-exempt interest.
- 5) You received, as a nominee, interest that actually belongs to someone else.
- 6) You received a Form 1099-INT for interest on a bond that you bought between interest payment dates.
- 7) You are reporting OID in an amount more or less than the amount shown on Form 1099-OID.
- 8) You choose to reduce your interest income from a bond by the amount of amortizable bond premium. (For information about this choice, see *Bond Premium Amortization* in Publication 550.)

On line 1, Part I of Schedule B, list each payer's name and the amount received from each.

List first any interest income from seller-financed mortgages. (For more information about reporting this income, see *Reporting interest on seller-financed mortgage*, next.)

Then, report all other taxable interest you received. Include the total amount of interest income that is shown in box 1 and box 3 of any Form 1099-INT or in box 1 and box 2 of any Form 1099-OID that you receive for the tax year, and other interest income received for which you did not receive a Form 1099. If you received a Form 1099-INT or Form

1099-OID from a brokerage firm, list the brokerage firm as the payer. If you received more than \$400 in taxable interest, you must also complete Part III of Schedule B (Form 1040). See *Foreign accounts and trusts*, discussed in Chapter 1.

If you redeemed Series EE U.S. Savings Bonds and you have qualified educational expenses, complete and attach Form 8815. Enter the result from line 14 of Form 8815 on line 3 of Schedule B. See *Education Savings Bond Program* and *Form 8815* earlier for more information.

**Reporting interest on seller-financed mortgage.** If an individual buys his or her home from you in a sale that you finance, you must report the buyer's name, address, and social security number on line 1 of Schedule B (Form 1040). If you do not, you may have to pay a \$50 penalty. The buyer may have to pay a \$50 penalty if he or she does not give you this information.

The buyer must report your name, address, and social security number (or employer identification number) on Schedule A (Form 1040). You must give this information to the buyer. If you do not, you may have to pay a \$50 penalty.

### Tax-exempt interest income (Form 1040).

If you received any tax-exempt interest income (such as interest on certain state and municipal bonds), you must report the total amount of that interest on line 8b of Form 1040. Also report on line 8b any exempt-interest dividends that you received from a mutual fund or other regulated investment company. Do not include this interest in your taxable interest income on line 8a. Remember that OID is a form of interest. You report nontaxable OID on line 8b as it accrues, whether or not you receive any payments from the bond issuer.

You should not have received a Form 1099-INT for tax-exempt interest. But if you did, you must fill in Schedule B (Form 1040). See the *Schedule B instructions* for how to report this. Be sure to also show the tax-exempt interest on Form 1040, line 8b.

Interest earned on an individual retirement arrangement (IRA) is tax deferred rather than tax exempt. Do not include such amount in tax-exempt interest.

**Frozen deposits (Form 1040).** Even if you receive a Form 1099-INT for interest on deposits that you could not withdraw at the end of 1996, you must exclude these amounts from your gross income, as explained earlier under *General Information*. Do not include this income on line 8a. If you are completing Part I of Schedule B, include the full amount of interest shown on your Form 1099-INT on line 1. Several lines above line 2, put a subtotal of all interest income. Below this subtotal, write "Frozen Deposits," and show the amount of interest that you are excluding. Subtract this amount from the subtotal and write the result on line 2.

**Nominee distributions and accrued interest (Form 1040).** If the total interest income you list on line 1, Part I of Schedule B, includes any amount that you received as a nominee for the real owner or that reflects accrued interest paid on a bond that you bought between interest payment dates, show that amount separately below a subtotal of all interest income listed. Identify the amount as "Nominee Distribution," or "Accrued Interest," as appropriate, and subtract it from the interest income subtotal. Report the result on line 2, Part I of Schedule B.

For more information, see *Bonds Sold Between Interest Dates*, earlier.

**Interest on a joint account.** If you receive a Form 1099-INT which shows your taxpayer identification number and names two or more recipients or includes amounts belonging to another person, you must file a Form 1099-INT with the IRS to show the proper distributions of the amounts shown. Complete a Form 1099-INT and **Form 1096, Annual Summary and Transmittal of U.S. Information Returns**, and file both forms with your Internal Revenue Service Center. Give the other person(s) Copy B of the Form 1099-INT which you filed as a nominee. On Form 1099-INT and Form 1096, you should be listed as the "Payer." Prepare one Form 1099-INT for each other owner and show that person as the "Recipient." You are not required, however, to file Form 1099-INT to show payments for your spouse. For more information about the reporting requirements and the penalties for failure to file (or furnish) certain information returns, see the *Instructions for Forms 1099, 1098, 5498, and W-2G*.

Similar rules apply to OID reported to you as a nominee on Form 1099-OID. You must file a Form 1099-OID with Form 1096 to show the proper distributions of the OID.

**Example.** You receive a Form 1099-INT for 1996 that shows a total of \$1,500 of interest income earned on a savings account that you hold jointly with your sister. You each have agreed to share the yearly interest income in proportion to the amount that each of you has invested, even though your identification (social security) number was given to the bank for its recordkeeping purposes. Your sister has deposited 30% of the amount invested in this account. As a result, you received as a nominee the amount of interest income belonging to your sister. For 1996, this amount is \$450, or 30% of the total interest of \$1,500.

You must provide your sister with a Form 1099-INT by January 31, 1997, showing \$450 of interest income that she earned for 1996. You must also send a copy of the nominee Form 1099-INT, along with Form 1096, to the Internal Revenue Service Center by February 28, 1997. Show your own name, address, and identification number as the "Payer" on the Form 1099-INT. Provide the same information for your sister in the blocks provided for identification of the "Recipient."

When you prepare your own 1996 federal income tax return, report the total amount of interest income, \$1,500, on line 1, Part I of Schedule B (Form 1040), and identify the name of the bank which paid this interest. Show the amount belonging to your sister, \$450, as a subtraction from the subtotal of all interest on Schedule B and identify this subtraction as a "Nominee Distribution." (Your sister will report the \$450 of interest income on her own tax return, if she has to file a return, and identify you as the payer of that amount.)

**Original issue discount (OID).** If you are reporting OID in an amount greater or less than the amount shown on Form 1099-OID, or other written statement (such as for a REMIC regular interest), include the full amount of OID shown on your Form 1099-OID or other statement on line 1, Part I of Schedule B (Form 1040). If the OID to be reported is less than the amount shown on Form 1099-OID, follow the earlier reporting rules for nominee distributions or accrued interest, as applicable, so that you will report only the OID you have to report. Below the subtotal, write "OID Adjustment," and show the OID you are not required to report. If the OID to be reported is greater than the amount shown on Form 1099-OID, show the additional OID separately below a subtotal of all interest income listed. Identify the amount as "OID Adjustment," and add it to the interest income subtotal.

**Penalty on early withdrawal of savings.** If you withdraw funds from a time savings account before maturity, you may be charged a penalty. You must report the gross amount of interest paid or credited to your account during the year, without subtracting the penalty. You deduct the penalty on line 28, Form 1040. Deduct the entire penalty even if it exceeds your interest income. The Form 1099-INT or similar statement given to you by the financial institution will show the gross amount of interest and the penalty.

**Sample returns.** The sample return in Chapter 38 has an example of reporting interest income on Form 1040A. The sample return in Chapter 39 has an example of reporting interest income on Form 1040.

# Dividends and Other Corporate Distributions

## Important Reminders

**Dividends received in January.** Any dividend declared by a regulated investment company (mutual fund) or real estate investment trust (REIT) in October, November, or December and payable to you by December 31, but actually paid during January of the following calendar year, is treated as paid to you in the earlier year.

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

## Introduction

This chapter discusses the tax treatment of:

- Dividend income,
- Capital gain distributions,
- Nontaxable distributions, and
- Other distributions you may receive from a corporation or a mutual fund.

This chapter also explains how to report dividend income on your tax return.

Dividends are distributions of money, stock, or other property paid to you by a corporation. You also may receive dividends through a partnership, an estate, a trust, or an association that is taxed as a corporation. However, some amounts you receive that are called dividends are actually interest income. See *Dividends that are actually interest* under *Taxable Interest* in Chapter 8.

Most distributions that you receive are paid in cash (or check). However, you may receive more stock, stock rights, other property, or services. These distributions are also discussed in this chapter.

## Useful Items

You may want to see:

### Publication

- 514** Foreign Tax Credit for Individuals
- 550** Investment Income and Expenses
- 564** Mutual Fund Distributions

- 925** Passive Activity and At-Risk Rules

### Form (and Instructions)

- Schedule B (Form 1040)** Interest and Dividend Income
- Schedule 1 (Form 1040A)** Interest and Dividend Income for Form 1040A Filers
- 1099** Instructions for Forms 1099, 1098, 5498, and W-2G

## General Information

This section discusses general rules on dividend income.

### Passive activity income and losses.

There are tax rules which limit the amount of losses and tax credits from passive activities that you can claim. Generally, you can use losses from passive activities only to offset income from passive activities. You generally cannot use passive activity losses to offset your other income, such as your wages or your portfolio income. **Portfolio income** is any gross income from interest, dividends, etc., that is not derived in the ordinary course of a trade or business. For more information about determining and reporting income and losses from passive activities, see Publication 925.

**Tax on investment income of a child under age 14.** Part of a child's investment income may be taxed at the parent's tax rate. This may happen if the child was under age 14, had more than \$1,300 of investment income (such as taxable interest and dividends) and has to file a tax return, and either parent was alive at the end of the year. If these requirements are met, **Form 8615, Tax for Children Under Age 14 Who Have Investment Income of More Than \$1,300**, must be completed and attached to the child's tax return. If these requirements are not met, Form 8615 is not required and the child's income is taxed at his or her own tax rate.

However, parents can choose to include their child's interest and dividends on their return if certain requirements are met. Use **Form 8814, Parents' Election To Report Child's Interest and Dividends**, for this purpose.

For more information about the tax on investment income of children and the parents' election, see Chapter 32.

**Beneficiary of an estate or trust.** Interest, dividends, or other investment income you receive as a beneficiary of an estate or trust is generally taxable income. You should receive a **Schedule K-1** (Form 1041), *Beneficiary's Share of Income, Deductions, Credits, etc.*, from the fiduciary. Your copy of Schedule K-1 and its instructions will tell you where to report the items on your Form 1040.

**Social security number (SSN).** You must give your name and SSN (or individual taxpayer identification number (ITIN)) to any person required by federal tax law to make a return, statement, or other document that relates to you. This includes payers of dividends.

For more information on SSNs and ITINs, see *Social security number (SSN)* in Chapter 8.

**Penalty for failure to supply SSN.** If you do not give your SSN or ITIN to the payer of dividends, you may have to pay a penalty. See *Failure to supply social security number* under *Penalties* in Chapter 1. Backup withholding also may apply.

**Backup withholding.** Your investment income is generally not subject to regular withholding. However, it may be subject to backup withholding to ensure that income tax is collected on this income.

Under backup withholding, when you open a new account you must certify under penalties of perjury that your SSN or ITIN is correct and that you are not subject to backup withholding. Your payer will give you a **Form W-9, Request for Taxpayer Identification Number and Certification**, or a similar form, to make this certification. If you fail to make this certification, backup withholding may begin immediately on your new account or investment, and 31% of the amount paid on your account or investment will be withheld. Backup withholding may also be required if the Internal Revenue Service (IRS) has determined that you underreported your interest or dividend income. For more information, see *Backup Withholding* in Chapter 5.

**Stock certificate in two or more names.** If two or more persons hold stock as joint tenants, tenants by the entirety, or tenants in common, each person may receive a share of any dividends from the stock. Each person's share is determined by local law.

**Form 1099-DIV.** Most corporations use Form 1099-DIV, *Dividends and Distributions*, to show you the distributions you received from them during the year. Keep this form with your records. You do not have to attach it to your tax return. Even if you do not receive Form 1099-DIV, you must report all of your taxable dividend income.

**Reporting tax withheld.** If tax is withheld from your dividend income, the payer must give you a Form 1099-DIV that indicates the amount withheld.

**Nominees.** If someone receives distributions as a nominee for you, that person will give you a Form 1099-DIV, which will show distributions received on your behalf.

If you receive a Form 1099-DIV that includes amounts belonging to another person, see *Nominees*, later under *How To Report Dividend Income*, for more information.

**Form 1099-MISC.** Certain substitute payments in lieu of dividends or tax-exempt interest that are received by a broker on your

behalf must be reported to you on Form 1099–MISC, *Miscellaneous Income*, or a similar statement. See *Reporting substitute payments* under *Short Sales* in Publication 550 for more information about reporting such substitute payments.

**Incorrect amount shown on a Form 1099.** If you receive a Form 1099 that shows an incorrect amount (or other incorrect information), you should ask the issuer for a corrected form. The new Form 1099 you receive will be marked “CORRECTED.”

**Dividends on stock sold.** If stock is sold, exchanged, or otherwise disposed of after a dividend is declared, but before it is paid, the owner of record (usually the payee shown on the dividend check) must report the dividend.

**Dividends received in January.** If a regulated investment company (mutual fund) or real estate investment trust (REIT) declares a dividend (including any exempt-interest dividend) in October, November, or December and that dividend is payable to you on a specified date by December 31, you are considered to have received the dividend on December 31 even though the company or trust actually pays the dividend during January of the following calendar year. You report the amount in the year of declaration.

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## Ordinary Dividends

Ordinary (taxable) dividends are the most common type of distribution from a corporation. They are paid out of the earnings and profits of a corporation and are ordinary income to you. This means they are not capital gains. You can assume that any dividend you receive on common or preferred stock is an ordinary dividend unless the paying corporation tells you otherwise.

**Money market funds.** Report amounts you receive from money market funds as dividend income. These amounts generally are not interest income and should not be reported as interest.

**Dividends used to buy more stock.** The corporation in which you own stock may have a **dividend reinvestment plan**. This plan lets you choose to use your dividends to buy (through an agent) more shares of stock in the corporation instead of receiving the dividends in cash. If you are a member of this type of plan and you use your dividends to buy more stock at a price equal to its fair market value, you must report the dividends as income.

If you are a member of a dividend reinvestment plan that lets you buy more stock at a price less than its fair market value, you must report as income the fair market value of the additional stock on the dividend payment date.

You also must report as income any service charge subtracted from your cash dividends before the dividends are used to buy the additional stock. But you may be able to deduct the service charge. See Chapter 30 for more information about deducting expenses of producing income.

In some dividend reinvestment plans, you can invest more cash to buy shares of stock at a price less than fair market value. If you choose to do this, you must report as income the difference between the cash you invest and the fair market value of the stock you buy. When figuring this amount, use the fair market value of the stock on the dividend payment date.

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## Capital Gain Distributions

Capital gain distributions (also called capital gain dividends) are paid to you or credited to your account by regulated investment companies, mutual funds, and real estate investment trusts. A Form 1099–DIV or the mutual fund statement will tell you the amount you are to report as a capital gain distribution. You report as long-term capital gains the capital gain distributions paid to you during the year regardless of how long you owned the stock in the regulated investment company or mutual fund. Those distributions that are not derived in the ordinary course of a trade or business are treated as portfolio income and are not considered as income from a passive activity (see *Passive activity income and losses*, earlier).

**Undistributed capital gains.** In addition to the amounts you receive, you must report as long-term capital gains any other amounts that the investment company or mutual fund credited to you as capital gain distributions, even though you did not actually receive them.

You can take credit on your return for any tax that the investment company or mutual fund has paid for you on the undistributed capital gains.

**Form 2439.** Undistributed capital gains are not reported to you on Form 1099–DIV. The company or fund will send you Form 2439, *Notice to Shareholder of Undistributed Long-Term Capital Gains*, showing the amount of the undistributed long-term capital gains and the tax that was paid. You take credit for the tax by entering the tax paid and checking box a on line 57, Form 1040. Attach Copy B of Form 2439 to your return.

You must report any undistributed gains shown on Form 2439 as capital gain distributions in addition to any other capital gain distributions reported on Form 1099–DIV.

**Basis adjustment.** Increase your basis in the stock by 65% of the undistributed capital gain. (This is the difference between the amount of undistributed long-term capital gain that you report and the amount of the tax paid for you by the fund.) Keep Copy C of

Form 2439 as part of your records to show increases in the basis of your stock.

**Real estate investment trusts (REITs).** You will receive a Form 1099–DIV or similar statement from the REIT showing the capital gain distributions you must include in your income. You report the capital gain distributions as long-term capital gain regardless of how long you owned stock in the REIT.

**Additional information.** For more information on the treatment of distributions from mutual funds and regulated investment companies, see Publication 564, *Mutual Fund Distributions*.

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## Nontaxable Distributions

You may receive a return of capital or a tax-free distribution of more shares of stock or stock rights. These distributions are not treated the same as ordinary dividends or capital gain distributions.

### Return of Capital

A return of capital is a distribution that is not paid out of the earnings and profits of a corporation. It is a return of your investment in the stock of the company. You should receive a Form 1099–DIV or other statement from the corporation showing you what part of the distribution is a return of capital. If you do not receive such a statement, you report the distribution as an ordinary dividend.

**Basis adjustment.** A return of capital reduces the basis of your stock. It is not taxed until your basis in the stock is fully recovered. If you buy stock in a corporation in different lots at different times, and you cannot definitely identify the shares subject to the return of capital, reduce the basis of your earliest purchases first.

When the basis of your stock has been reduced to zero, report any additional return of capital that you receive as a capital gain. Whether you report it as a long-term or short-term capital gain depends on how long you have held the stock. See *Holding Period* in Chapter 15.

**Example.** You bought stock in 1986 for \$100. In 1988, you received a return of capital of \$80. You did not include this amount in your income, but you reduced the basis of your stock to \$20. You received a return of capital of \$30 in 1996. The first \$20 of this amount reduced your basis to zero. You report the other \$10 as a long-term capital gain for 1996. You must report as a long-term capital gain any return of capital you receive on this stock in later years.

**Liquidating distributions.** Liquidating distributions, sometimes called liquidating dividends, are distributions you receive during a partial or complete liquidation of a corporation. These distributions are, at least in part,

one form of a return of capital. They may be paid in one or more installments. You will receive a Form 1099-DIV from the corporation showing you the amount of the liquidating distribution.

Any liquidating distribution you receive is not taxable to you until you have recovered the basis of your stock. After the basis of your stock has been reduced to zero, you must report the liquidating distribution as a capital gain (except in certain instances involving collapsible corporations). Whether you report the gain as a long-term or short-term capital gain depends on how long you have held the stock. See *Holding Period* in Chapter 15.

**Stock acquired at different times.** If you acquired stock in the same corporation in more than one transaction, you own more than one block of stock in the corporation. If you receive distributions from the corporation in complete liquidation, you must divide the distribution among the blocks of stock you own in the following proportion: the number of shares in that block over the total number of shares you own. Divide distributions in partial liquidation among that part of the stock that is redeemed in the partial liquidation. After the basis of a block of stock is reduced to zero, you must report the part of any later distribution for that block as a capital gain.

**Distributions less than basis.** If the total liquidating distributions you receive are less than the basis of your stock, you may have a capital loss. You can report a capital loss only after you have received the final distribution in liquidation that results in the redemption or cancellation of the stock. Whether you report the loss as a long-term or short-term capital loss depends on how long you held the stock. See *Holding Period* in Chapter 15.

## Distributions of Stock and Stock Rights

Distributions by a corporation of its own stock are commonly known as stock dividends. Stock rights (also known as "stock options") are distributions by a corporation of rights to subscribe to the corporation's stock. Generally, stock dividends and stock rights are not taxable to you, and you do not report them on your return.

**Taxable stock dividends and stock rights.** Distributions of stock dividends and stock rights are taxable to you if any of the following apply:

- 1) You or any other shareholder has the choice to receive cash or other property instead of stock or stock rights,
- 2) The distribution gives cash or other property to some shareholders and an increase in the percentage interest in the corporation's assets or earnings and profits to other shareholders,
- 3) The distribution is in convertible preferred stock and has the same result as in (2),

- 4) The distribution gives preferred stock to some common stock shareholders and gives common stock to other common stock shareholders, or
- 5) The distribution is on preferred stock. (The distribution, however, is not taxable if it is an increase in the conversion ratio of convertible preferred stock made solely to take into account a stock dividend, stock split, or similar event that would otherwise result in reducing the conversion right.)

The term "stock" includes rights to acquire stock, and the term "shareholder" includes a holder of rights or of convertible securities.

If you receive taxable stock dividends or stock rights, include their fair market value at the time of the distribution in your income.

**Preferred stock redeemable at a premium.** If you hold preferred stock having a redemption price higher than its issue price, the difference (the redemption premium) generally is taxable as a constructive distribution of additional stock on the preferred stock. For more information, see Publication 550.

**Basis.** Your basis in stock or stock rights received in a taxable distribution is their fair market value when distributed. If you receive stock or stock rights that are not taxable to you, see *Stocks and Bonds* under *Basis of Investment Property* in Chapter 4 of Publication 550 for information on how to figure their basis.

**Fractional shares.** You may not own enough stock in a corporation to receive a full share of stock if the corporation declares a stock dividend. However, with the approval of the shareholders, the corporation may set up a plan in which fractional shares are not issued, but instead are sold, and the cash proceeds are given to the shareholders. Any cash you receive for fractional shares under such a plan is treated as an amount realized on the sale of the fractional shares. You must determine your gain or loss and report it as a capital gain or loss on Schedule D (Form 1040). Your gain or loss is the difference between the cash you receive and the basis of the fractional shares sold.

**Example.** You own one share of common stock that you bought on January 3, 1990, for \$100. The corporation declared a common stock dividend of 5% on June 30, 1996. The fair market value of your stock at the time the stock dividend was declared was \$200. You were paid \$10 for the fractional-share stock dividend under a plan described in the above paragraph. You figure your gain or loss as follows:

Fair market value of old stock .....	\$200.00
Fair market value of stock dividend (cash received) .....	10.00
Fair market value of old stock and stock dividend .....	<u>\$210.00</u>

Basis (cost) of old stock after the stock dividend $((\$200 + \$210) \times \$100) \dots$	\$ 95.24
Basis (cost) of stock dividend $((\$10 + \$210) \times \$100) \dots\dots\dots$	4.76
Total .....	<u>\$100.00</u>
Cash received .....	\$ 10.00
Basis (cost) of stock dividend .....	4.76
<b>Gain</b> .....	<u>\$ 5.24</u>

Because you had held the share of stock more than one year at the time the stock dividend was declared, your gain on the stock dividend is a long-term capital gain.

**Scrip dividends.** A corporation that declares a stock dividend may issue you a scrip certificate that entitles you to a fractional share. The certificate is generally nontaxable when you receive it. If you choose to have the corporation sell the certificate for you and give you the proceeds, your gain or loss is the difference between the proceeds and the portion of your basis in the corporation's stock that is allocated to the certificate.

However, if you receive a scrip certificate that you can choose to redeem for cash instead of stock, the certificate is taxable when you receive it. You must include in income its fair market value on the date you receive it.

## Other Distributions

You may receive any of the following distributions during the year.

**Exempt-interest dividends.** Exempt-interest dividends you receive from a regulated investment company (mutual fund) are not included in your taxable income. (However, see *Information reporting requirement*, next.) You will receive a notice from the mutual fund telling you the amount of the exempt-interest dividends you received. Exempt-interest dividends are not shown on Form 1099-DIV or Form 1099-INT. See *Gains and Losses* in Publication 564 for information about the loss treatment of mutual fund stock on which you received exempt-interest dividends.

**Information reporting requirement.** Although these dividends are not taxable, you must show them on your tax return if you have to file. This is an information reporting requirement and does not convert exempt-interest dividends to taxable income. See *Tax-exempt interest income* under *How To Report Interest Income* in Chapter 8.

**Alternative minimum tax treatment.** Exempt-interest dividends may be treated as tax-exempt interest on specified private activity bonds, which is a "tax preference item" that may be subject to the alternative minimum tax. See *Alternative Minimum Tax* in Chapter 31 for more information.

**Dividends on insurance policies.** Insurance policy dividends that the insurer keeps and uses to pay your premiums are not taxable. If the dividends are distributed to you,

they are a partial return of the premiums you paid. Do not include them in your gross income until they are more than the total of all net premiums you paid for the contract. Report any taxable distributions on insurance policies on line 16b (Form 1040) or line 11b (Form 1040A). However, you must report as taxable interest income the interest paid or credited on dividends left with an insurance company. See Chapter 8 for treatment of interest income.

**Dividends on veterans' insurance.** Dividends you receive on veterans' insurance policies are not taxable. In addition, do not report as taxable income interest on dividends left with the Department of Veterans Affairs. See *Veterans* in Chapter 6 for more information about veterans' benefits.

**Patronage dividends.** Generally, patronage dividends you receive in money from a cooperative organization are included in your income.

Do not include in your income patronage dividends you receive on:

- 1) Property bought for your personal use, or
- 2) Capital assets or depreciable property bought for use in your business. But you must reduce the basis (cost) of the items bought. If the dividend is more than the adjusted basis of the assets, you must report the excess as income.

These rules are the same whether the cooperative paying the dividend is a taxable or tax-exempt cooperative.

**Alaska Permanent Fund dividends.** Do not report these amounts as dividends. Instead, report these amounts on line 21 of Form 1040, line 12 of Form 1040A, or line 3 of Form 1040EZ.

## How To Report Dividend Income

Generally, you can use either Form 1040 or Form 1040A to report your dividend income. However, you must use Form 1040 if you receive capital gain distributions or return of capital distributions. You cannot use Form 1040EZ if you receive any dividend income.

Report the total of your taxable dividend income on line 9 of Form 1040 or Form 1040A.

**Form 1099-DIV.** If you owned stock on which you received \$10 or more in gross dividends and other distributions, you should receive a Form 1099-DIV. Even if you do not receive Form 1099-DIV, you must report all of your taxable dividend income.

See Form 1099-DIV for more information on how to report dividend income.

**Dividends received on restricted stock.** Restricted stock is stock that you get from

your employer for services you perform and that is nontransferable and subject to a substantial risk of forfeiture. You do not have to include the value of the stock in your income when you receive it. However, if you get dividends on the restricted stock, you must include them in your income as wages, not dividends.

Your employer should include these dividends in the wages shown on your Form W-2. If you also get a Form 1099-DIV for these dividends, list them on line 5, Part II of Schedule B (Form 1040), with any other dividends you received. Enter a subtotal of all your dividend income several lines above line 6. Below the subtotal, write "Dividends on restricted stock reported as wages on line 7, Form 1040," and enter the amount of the dividends included in your wages on line 7, Form 1040. Subtract this amount from the subtotal and enter the result on line 6, Part II of Schedule B.

**Election.** You can choose to include in gross income the value of restricted stock as pay for services. If you make this choice, the dividends are treated as any other dividends.

If you receive both a Form 1099-DIV and a Form W-2 showing these dividends, do not include the dividends in your wages reported on line 7, Form 1040. List the dividends on line 5, Part II of Schedule B, along with your other dividends (if the amount of dividends received from all sources is more than \$400). Attach a statement to your Form 1040 explaining why the amount shown on line 7 of your Form 1040 is different from the amount shown on your Form W-2.

**Expenses related to dividend income.** You may deduct expenses related to dividend income only if you itemize your deductions on Schedule A (Form 1040). See Chapter 30 for general information about deducting expenses of producing income.

## Form 1040A

You must complete Part II of Schedule 1 (Form 1040A) and attach it to your Form 1040A, if:

- 1) Your gross dividend income (box 1a of Form 1099-DIV) totals more than \$400, or
- 2) You received, as a nominee, dividends that actually belong to someone else.

List on line 5 each payer's name and the amount of dividend income received from each payer. If you received a Form 1099-DIV from a brokerage firm, list the brokerage firm as the payer.

Enter on line 6 the total of the amounts listed on line 5. Also enter this total on line 9, Form 1040A.

**Nominees (Form 1040A).** If you received dividends as a nominee (that is, the dividends are in your name but actually belong to someone else), include them on line 5 of Schedule 1. Several lines above line 6, put a subtotal of all dividend income listed on line

5. Below this subtotal, write "Nominee Distributions" and show the amounts received as a nominee. Subtract the total of your nominee distributions from the subtotal. Enter the result on line 6 of Part II.

See *Nominees (Form 1040)*, later, for more information.

## Form 1040

You must fill in Part II of Schedule B and attach it to your Form 1040, if:

- 1) Your gross dividends (box 1a of Form 1099-DIV), including capital gain and nontaxable distributions, are more than \$400, or
- 2) You received, as a nominee, dividends that actually belong to someone else.

If your total dividends are more than \$400, you must also complete Part III of Schedule B.

You must report all of your dividend income (box 1a of Form 1099-DIV) on line 5, Part II of Schedule B. You must include on this line all the ordinary dividends, capital gain distributions, and return of capital distributions (other than liquidating distributions) you received. List the name of each payer and the amount of distribution you received. If your securities are held by a brokerage firm (in "street name"), list the name of the brokerage firm that is shown on Form 1099-DIV as the payer. If your stock is held by a nominee who is the owner of record, and the nominee credited or paid you dividends on the stock, show the name of the nominee and the dividends you received or for which you were credited.

Enter on line 6 the total of the amounts listed on line 5. However, if you hold stock as a nominee, see *Nominees*, later.

Enter on line 7 any amount shown on line 5 that is a capital gain distribution. Enter on line 8 any amount from line 5 that is a return of capital.

Add the amounts shown on lines 7 and 8, and enter the total on line 9. Subtract the amount on line 9 from the amount on line 6. The difference, if any, is your taxable ordinary dividends. Enter this amount on line 10, Part II of Schedule B, and on line 9, Form 1040.

**Capital gain distributions.** Report capital gain distributions (box 1c of Form 1099-DIV) on line 14, Part II of Schedule D (Form 1040). If you do not need to use Schedule D to report any other gains or losses, do not use it. Instead, show your capital gain distributions on line 13, Form 1040. Write "CGD" on the dotted line next to that line.



Use the Capital Gain Tax Worksheet in the Form 1040 instructions to figure your tax if your taxable income (Form 1040, line 37) is more than: \$96,900 if married filing jointly or qualifying widow(er); \$58,150 if single; \$83,050 if head of household; or \$48,450 if married filing separately.

**Nontaxable (return of capital) distributions.** Report return of capital distributions (box 1d of Form 1099-DIV) only after your basis in the stock has been reduced to zero. After the basis of your stock has been reduced to zero, you must show this amount on line 1, Part I of Schedule D, if you held the stock one year or less. Show it on line 9, Part II of Schedule D, if you held the stock for more than one year. Write "Dividend R.O.C. Exceeding Basis" in column (a) of Schedule D and the name of the company. Report your gain in column (g) of Schedule D. Your gain is the amount of the distribution that is more than your basis in the stock.

**Nominees (Form 1040).** Include on line 5, Part II of Schedule B (Form 1040), all dividends you received. This includes dividends you received, as a nominee, that actually belong to another person (such as your child), even if you later distributed some or all of this

income to others. Enter a subtotal of all your dividend income listed on line 5 several lines above line 6. Below the subtotal, write "Nominee Distribution," and show the amounts received as a nominee. Subtract these distributions from the subtotal, and enter the result on line 6.

If you receive a Form 1099-DIV that shows your taxpayer identification number, and names two or more recipients, or includes amounts belonging to another person, you must file a Form 1099-DIV with the IRS to show the proper distributions of the amounts shown. Complete the form and a **Form 1096, Annual Summary and Transmittal of U.S. Information Returns**, and file both forms with your Internal Revenue Service Center. Give the other person Copy B of the Form 1099-DIV that you filed as a nominee. On the forms, you should be listed as the "Payer." On Form 1099-DIV, the other owner should be listed as the "Recipient."

You are not required, however, to file a Form 1099-DIV to show payments for your spouse. For more information about the reporting requirements and the penalties for failure to file (or furnish) certain information returns, see the *Instructions for Forms 1099, 1098, 5498, and W-2G*.

**Liquidating distributions.** You will receive Form 1099-DIV from the corporation showing the amount of the liquidating distribution in boxes 5 and 6. Generally, this is treated as the sale or exchange of a capital asset and should be reported on Schedule D (Form 1040).

**Sample returns.** The sample return in Chapter 38 has an example of reporting dividend income on Form 1040A. The sample return in Chapter 39 has an example of reporting dividend income on Form 1040.

# Rental Income and Expenses

## Important Reminder

**Passive activity rules for rental activities.** There are passive loss limits and at-risk rules that may affect the amount of rental loss you can claim on your return. However, rental activities in which you materially participate are not passive activities if you meet certain requirements. Losses from these activities are not limited by the passive activity rules. See *Limits on Rental Losses*, later.

## Introduction

This chapter discusses rental income and expenses. It covers the following topics:

- Rental income
- Rental expenses
- Vacation homes and other dwelling units
- Depreciation
- Limits on rental losses
- How to report your rental income and expenses

If you sell or otherwise dispose of your rental property, see Publication 544, *Sales and Other Dispositions of Assets*.

If you have a loss from damage to, or from theft of, rental property, see Publication 547, *Disasters, Casualties, and Thefts*.

If you rent out a condominium or a cooperative apartment, some special rules apply to you even though you receive the same tax treatment as other owners of rental property. See Publication 527 for more information.

## Useful Items

You may want to see:

### Publication

- 334** Tax Guide for Small Business (for Individuals Who Use Schedule C or C-EZ)
- 527** Residential Rental Property
- 534** Depreciating Property Placed in Service Before 1987
- 535** Business Expenses
- 544** Sales and Other Dispositions of Assets
- 925** Passive Activity and At-Risk Rules
- 946** How To Depreciate Property

### Form (and Instructions)

- 4562** Depreciation and Amortization

- 8582** Passive Activity Loss Limitations
- Schedule E (Form 1040)** Supplemental Income and Loss

## Rental Income

Rental income is any payment you receive for the use or occupation of property.

You generally must include in your gross income all amounts you receive as rent.

In addition to amounts you receive as normal rent payments, there are other amounts that may be rental income.

**Advance rent.** Advance rent is any amount you receive before the period that it covers. Include advance rent in your rental income in the year you receive it regardless of the period covered or the method of accounting you use.

**Example.** You sign a 10-year lease to rent your property. In the first year, you receive \$5,000 for the first year's rent and \$5,000 as rent for the last year of the lease. You must include \$10,000 in your income in the first year.

**Security deposits.** Do not include a security deposit in your income when you receive it if you plan to return it to your tenant at the end of the lease. But, if during any year, you keep part or all of the security deposit because your tenant does not live up to the terms of the lease, include the amount you keep in your income for that year.

If an amount called a security deposit is to be used as a final payment of rent, it is advance rent. Include it in your income when you receive it.

**Payment for canceling a lease.** If your tenant pays you to cancel a lease, the amount you receive is rent. Include the payment in your income for the year you receive it regardless of your method of accounting.

**Expenses paid by tenant.** If your tenant pays any of your expenses and these payments are in place of rent, then these payments are rental income. You must include them in your income. You can deduct those expenses if they are deductible rental expenses.

**Property or services.** If you receive property or services, instead of money, as rent, include the fair market value of the property or services in your rental income.

If the services are provided at an agreed upon or specified price, that price is the fair market value when there is no evidence of a different fair market value.

**Rental of property also used as a home.** If you rent property that you also use as your home and you rent it for less than 15 days during the tax year, do not include the rent you receive in your gross income. You cannot deduct rental expenses. However, you

can deduct allowable interest, taxes, and casualty and theft losses as itemized deductions on Schedule A of Form 1040. See *Personal Use of Vacation Home or Dwelling Unit*, later.

**If you own a part interest in rental property,** you must report your part of the rental income from the property.

## Rental Expenses

This part discusses repairs and certain other expenses of renting property that you ordinarily can deduct from your gross rental income. It includes information on the expenses you can deduct if you rent part of your property, or if you change your property to rental use. Depreciation, which you can also deduct from your gross rental income, is discussed later.

**If you own a part interest in rental property,** you can deduct your part of the expenses that you paid.

**When to deduct.** You generally deduct your rental expenses in the year you pay or incur them.

**Vacant rental property.** If you hold property for rental purposes, you may be able to deduct your ordinary and necessary expenses for managing, conserving, or maintaining the property while the property is vacant. However, you cannot deduct any loss of rental income for the period the property is vacant.

**Pre-rental expenses.** You can deduct your ordinary and necessary expenses for managing, conserving, or maintaining rental property from the time you make it available for rent.

**Expenses for rental property sold.** If you sell property you held for rental purposes, you can deduct the ordinary and necessary expenses for managing, conserving, or maintaining the property until it is sold.

**Personal use of rental property.** If you sometimes use your rental property for personal purposes, you must divide your expenses between rental and personal use. Also, your rental expense deductions may be limited. See *Personal Use of Vacation Home or Dwelling Unit*, later.

## Repairs and Improvements

You can deduct the cost of repairs that you make to your rental property. You cannot deduct the cost of improvements. You recover the costs of improvements by taking depreciation (explained later).

Separate the costs of repairs and improvements, and keep accurate records. You will need to know the cost of improvements when you sell or depreciate your property.

**Repairs.** A repair keeps your property in good operating condition. It does not materially add to the value of your property or substantially prolong its life. Repainting property inside or out, fixing gutters or floors, fixing leaks, plastering, and replacing broken windows are examples of repairs.

If you make repairs as part of an extensive remodeling or restoration of your property, the whole job is an improvement.

**Improvements.** An improvement adds to the value of your property, prolongs its useful life, or adapts it to new uses. Putting a recreation room in an unfinished basement, paneling a den, adding a bathroom or bedroom, putting decorative grillwork on a balcony, putting up a fence, putting in new plumbing or wiring, putting in new cabinets, putting on a new roof, and paving a driveway are examples of improvements.

If you make an improvement to property, add the cost of the improvement to the basis of the property. Basis is explained later under *Modified Accelerated Cost Recovery System (MACRS)*.

## Other Expenses

Other expenses you can deduct from your gross rental income include advertising, janitor and maid service, utilities, fire and liability insurance, taxes, interest, commissions for the collection of rent, ordinary and necessary travel and transportation, and other expenses discussed below.

**Salaries and wages.** You can deduct reasonable salaries and wages you pay to your employees. You can also deduct bonuses you pay to your employees if, when added to their regular salaries or wages, the total is not more than reasonable pay.

You can deduct reasonable wages you pay to your dependent child if your child is your bona fide employee. However, you cannot deduct the cost of meals and lodging for the child.

**Rental payments for property.** You can deduct the rent you pay for property that you use for rental purposes. If you buy a leasehold for rental purposes, you can deduct an equal part of the cost each year over the term of the lease.

**Rental of equipment.** You can deduct the rent you pay for equipment that you use for rental purposes. However, in some cases, lease contracts are actually purchase contracts. If so, you cannot deduct these payments. You can recover the cost of purchased equipment through depreciation.

**Insurance premiums.** You can deduct insurance premiums you pay for rental purposes. If you pay the premiums for more than one year in advance, each year you can deduct the part of the premium payment that will apply to that year. You continue to deduct your premium in this manner for as long

as the insurance is in effect. You cannot deduct the total premium in the year you pay it.

**Local benefit taxes.** Generally, you cannot deduct charges for local benefits that increase the value of your property, such as for putting in streets, sidewalks, or water and sewer systems. These charges are nondepreciable capital expenditures. You must add them to the basis of your property. You can deduct local benefit taxes if they are for maintaining, repairing, or paying interest charges for the benefits.

**Charges for services.** You can deduct charges you pay for services provided for your rental property, such as water, sewer, and trash collection.

**Travel expenses.** You can deduct the ordinary and necessary costs of traveling away from home if the primary purpose of the trip was to collect rental income or to manage, conserve, or maintain your rental property. You must properly allocate between rental and nonrental activities. For information on travel expenses, see Chapter 28.

To deduct travel expenses, you must keep records that follow the rules in Chapter 28.

**Local transportation expenses.** You can deduct your ordinary and necessary local transportation expenses if you incur them to collect rental income or to manage, conserve, or maintain your rental property.

Generally, if you use your personal car, pickup truck, or light van for rental activities, you can deduct local transportation expenses using one of two methods: actual expenses or the standard mileage rate. The standard mileage rate for 1996 is **31 cents a mile** for all business miles.

To deduct car expenses under either method, you must follow certain rules. These rules are discussed in Chapter 28.

In addition, you must complete Part V of Form 4562 and attach it to your tax return.

**Tax return preparation.** You can deduct, as a rental expense, the part of tax return preparation fees you paid to prepare Part I of Schedule E. You can also deduct, as a rental expense, any expense you paid to resolve a tax underpayment related to your rental activities. On your 1996 Schedule E (Form 1040), you can deduct fees paid in 1996 to prepare Part I of your 1995 Schedule E (Form 1040).

## Renting Part of Property

If you rent part of your property, you must divide certain expenses between the part of the property used for rental purposes and the part of the property used for personal purposes as though you actually had two separate pieces of property.

You can deduct a part of some expenses, such as mortgage interest and property taxes, as a rental expense. You can deduct the other part, subject to certain limitations, only if you itemize your deductions. You can also deduct as a rental expense a part of other expenses that normally are nondeductible personal expenses, such as expenses for electricity, a second telephone line, or painting the outside of your house.

You do not have to divide the expenses that belong only to the rental part of your property. If you paint a room that you rent, or if you pay premiums for liability insurance in connection with renting a room in your home, your entire cost is a rental expense. You can deduct depreciation, discussed later, on the part of the property used for rental purposes as well as on the furniture and equipment you use for these purposes.

## How To Divide Expenses

If an expense is for both rental use and personal use, such as mortgage interest or heat for the entire house, you must divide the expense between the rental use and the personal use. You can use any reasonable method for dividing the expense. The two most common methods are one based on the number of rooms in your home and one based on the square footage of your home.

**Allocating costs.** Dividing certain expenses by the number of people involved may be the proper method to use. For example, if you provide meals to tenants, the most accurate method of dividing food costs between rental and personal expenses may be one based on the total number of people eating the food. Or, if you rent an apartment and your tenants have unrestricted use of your second telephone line, dividing the monthly charge for that line by the number of people using it may be the best method to use.

## Limits on Deductions for Rental Expenses

If you rent out part of your property and you also use that or another part of the same property for personal purposes during the year, your deductions for rental expenses for the property may be limited. See *Personal Use of Vacation Home or Dwelling Unit*, later, for more information.

## Property Changed to Rental Use

If you change your home, apartment, or other property, or a part of it, to rental use at any time other than at the beginning of your tax year, you must divide yearly expenses, such as depreciation, taxes, and insurance, between rental use and personal use.

You can deduct as rental expenses only the part of the expense that is for the part of the year the property was used or held for rental purposes.

You cannot deduct depreciation or insurance for any property or part of property held for personal use. However, you can deduct the allowable part of the interest and tax expenses for personal use as an itemized deduction on Schedule A (Form 1040).

**Example.** Your tax year is a calendar year. You moved from your home in May and started renting it out on June 1. You can deduct as rental expenses seven-twelfths of your yearly expenses, such as taxes and insurance.

You can deduct as rental expenses, starting with June, the amounts you pay for items generally billed monthly, such as utilities.

**Information on depreciation.** See *Personal home changed to rental use*, later, under *Modified Accelerated Cost Recovery System (MACRS)* for information about how to figure your deduction for depreciation.

**Other limits.** If you change property to rental use and later use part or all of it for personal purposes, there are other rules that apply to how much of your rental expenses you can deduct. These rules are explained later under *Personal Use of Vacation Home or Dwelling Unit*.

## Not Rented For Profit

If your rental of a property is an activity that you do not carry on to make a profit, you can deduct your rental expenses only up to the amount of your rental income. You cannot carry forward any of your rental expenses that are more than your rental income. For more information about the rules for an activity not engaged in for profit, see Chapter 1 of Publication 535.

**Where to report.** Report your rental income on line 21, Form 1040. Deduct your mortgage interest, real estate taxes, and casualty losses on the appropriate lines of Schedule A (Form 1040).

You claim your other expenses, subject to the rules explained in Chapter 1 of Publication 535, as miscellaneous itemized deductions on line 22 of Schedule A. You can deduct these expenses only if they, together with certain other miscellaneous itemized deductions, total more than 2% of your adjusted gross income. For more information about miscellaneous deductions, see Chapter 30.

## Personal Use of Vacation Home or Dwelling Unit

If you have any personal use of a vacation home or other dwelling unit that you rent out, you must divide your expenses between the rental use and the personal use. See *Figuring Days of Personal Use and How To Divide Expenses*, later.

If you use the dwelling unit as a home and you rent it for fewer than 15 days during the year, do not include any of the rent in your income and do not deduct any of the rental expenses. If you rent out the dwelling unit for 15 or more days, you must include the rent in your income and, if you have a net loss, you may not be able to deduct all of the rental expenses. See *How To Figure Income and Deductions*, later.

**Dwelling unit.** The rules in this section apply to vacation homes and other dwelling units. A dwelling unit includes a house, apartment, condominium, mobile home, boat, or similar property. A dwelling unit has basic living accommodations, such as sleeping space, a toilet, and cooking facilities. A dwelling unit does not include property used solely as a hotel, motel, inn, or similar establishment.

Property is used solely as a hotel, motel, inn, or similar establishment if it is regularly available for occupancy by paying customers and is not used by an owner as a home during the year.

**Example.** You rent out a room in your home that is always available for short-term occupancy by paying customers. You do not use the room yourself, and you only allow paying customers to use the room. The room is used solely as a hotel, motel, inn, or similar establishment and is not a dwelling unit.

## Dwelling Unit Used as Home

You use a dwelling unit as a home during the tax year if you use it for personal purposes more than the greater of 14 days, or 10% of the total days it is rented to others at a fair rental price. See *Figuring Days of Personal Use*, later.

If a dwelling unit is used for personal purposes on a day it is rented at a fair rental price, do not count that day as a day of rental in applying (2) above. Instead, count it as a day of personal use in applying both (1) and (2) above.

**Example.** You own a cottage at the shore. You rent it out at a fair rental price from June 1 through August 31, a total of 92 days. The tenant who rented the cottage for the month of July was unable to use it from July 4 through July 8. The tenant allowed you to use the cottage for those 5 days. The tenant did not ask for a refund of or a reduction in the rent. Your family used the cottage for 3 of those days.

To determine the number of days the cottage was rented at a fair rental price, do not count those 3 days you used it for personal purposes. The cottage was rented at a fair rental price for 89 days (92 – 3).

**Fair rental price.** A fair rental price for your property generally is an amount that a person who is not related to you would be willing to pay. The rent you charge is not a fair rental price if it is substantially less than the rents charged for other properties that are similar to your property.

**Examples.** The following examples show how to determine whether you used your rental property as a home.

**Example 1.** You converted the basement of your home into an apartment with a bedroom, a bathroom, and a small kitchen. You rent the apartment at a fair rental price to college students during the regular school year. You rent to them on a 9-month (273 days) lease.

During the summer, your brothers stay with you for a month (30 days) and live in the apartment rent free.

Your basement apartment is used as a home because you use it for personal purposes for 30 days. That is more than the greater of 14 days or 10% of the total days it is rented.

**Example 2.** You rent out the guest bedroom in your home at a fair rental price during the local college's homecoming, commencement, and football weekends (a total of 27 days). Your sister-in-law stays in the room, rent free, for the last three weeks (21 days) in July.

The room is used as a home because you use it for personal use for 21 days. That is more than the greater of 14 days or 10% of the total days it is rented.

## Figuring Days of Personal Use

A day of personal use of a dwelling unit is any day that it is used by:

- 1) You or any other person who has an interest in it, unless you rent it to another owner as his or her main home under a shared equity financing agreement (defined later),
- 2) A member of your family or a member of the family of any other person who has an interest in it, unless the family member uses the dwelling unit as his or her main home and pays a fair rental price. Family includes only brothers and sisters, half-brothers and half-sisters, spouses, ancestors (parents, grandparents, etc.) and lineal descendants (children, grandchildren, etc.),
- 3) Anyone under an arrangement that lets you use some other dwelling unit, or
- 4) Anyone at less than a fair rental price.

**Main home.** If the other owner or member of the family in (1) or (2) above has more than one home, his or her main home is the one lived in most of the time.

**Shared equity financing agreement.** This is an agreement under which two or more persons acquire undivided interests for more than 50 years in an entire dwelling unit, including the land, and one or more of the co-owners is entitled to occupy the unit as his or her main home upon payment of rent to the other co-owner or owners.

**Donation of use of property.** You use a dwelling unit for personal purposes if:

You donate the use of the unit to a charitable organization,

The organization sells the use of the unit at a fund-raising event, and

The purchaser uses the unit.

## Examples

The following examples show how to determine days of personal use.

**Example 1.** You and your neighbor are co-owners of a condominium at the beach. You rent the unit out to vacationers whenever possible. The unit is not used as a main home by anyone. Your neighbor uses the unit for two weeks every year.

Because your neighbor has an interest in the unit, both of you are considered to have used the unit for personal purposes during those two weeks.

**Example 2.** You and your neighbors are co-owners of a house under a shared equity financing agreement. Your neighbors live in the house and pay you a fair rental price.

Even though your neighbors have an interest in the house, the days your neighbors live there are not counted as days of personal use by you. This is because your neighbors rent the house as their main home under a shared equity financing agreement.

**Example 3.** You own a rental property that you rent to your son. Your son has no interest in this dwelling unit. He uses it as his main home. He pays you a fair rental price for the property.

Your son's use of the property is not personal use by you because your son is using it as his main home, he has no interest in the property, and he is paying you a fair rental price.

**Example 4.** You rent your beach house to Marcia. Marcia rents her house in the mountains to you. You each pay a fair rental price.

You are using your house for personal purposes on the days that Marcia uses it because your house is used by Marcia under an arrangement that allows you to use her house.

## Days Not Counted as Personal Use

Some days you spend at the dwelling unit are not counted as days of personal use.

**Repairs and maintenance.** Any day that you spend working substantially full time repairing and maintaining your property is not counted as a day of personal use. Do not count such a day as a day of personal use even if family members use the property for recreational purposes on the same day.

**Use as home before or after renting.** When determining if you used your property as a home, the following special rule applies. Do not count as days of personal use the days on which you used the property as your main home either before or after renting it or

offering it for rent in the following circumstances:

- 1) You rented or tried to rent the property for 12 or more consecutive months, or
- 2) You rented or tried to rent the property for a period of less than 12 consecutive months and the period ended because you sold or exchanged the property.

This special rule does not apply when dividing expenses between rental and personal use.

## How To Divide Expenses

If you use a dwelling unit for both rental and personal purposes, you must divide your expenses between the rental use and the personal use. For purposes of dividing your expenses:

- 1) Any day that the unit is rented at a fair rental price is a day of rental use even if you have personally used the unit for that day, and
- 2) A unit is not considered used for rental during the time that it is held out for rent but not actually rented.

**Example.** You offer your beach cottage for rent from June 1 through August 31 (92 days). Your family uses the cottage during the last 2 weeks in May (14 days). You were unable to find a renter for the first week in August (7 days). The person who rented the cottage for July allowed you to use it over a weekend (2 days) without any reduction in or refund of rent. The cottage was not used at all before May 17 or after August 31.

The cottage was used for rental a total of 85 days (92 – 7). The days it was held out for rent but not rented (7 days) are not days of rental use. For purposes of dividing expenses, the July weekend on which you used it (2 days) is rental use because you received a fair rental price for the weekend.

You used the cottage for personal purposes for 14 days (the last 2 weeks in May).

The total use of the cottage was 99 days (14 days personal use + 85 days rental use). You can deduct 85/99 (86%) of the cottage expenses as rental expenses.

## How To Figure Your Income and Deductions

How you figure your rental income and deductions depends on how much personal use you made of the property and how many days the property was rented.

### General Rule

If you do not use a dwelling unit as a home, you divide your expenses between personal use and rental use based on the number of days it was used for each purpose.

Your deductible rental expenses can be more than your gross rental income. However, see *Limits on Rental Losses*, later.

**Where to report.** Report the rental income and all of the rental expenses on Schedule E

(Form 1040), *Supplemental Income and Loss*.

You can deduct allowable interest, taxes, and casualty losses for the personal use of the property on Schedule A (Form 1040) if you itemize deductions.

## Income and Deductions for Property Used as a Home

If you use a dwelling unit as a home during the year (see *Dwelling Unit Used as Home* earlier), how you figure your rental income and deductions depends on how many days the unit was rented.

**Rented fewer than 15 days.** If you use a dwelling unit as a home and you rent it for fewer than 15 days during the year, you do not include in income any of the rental income. Also, you cannot deduct any expenses as rental expenses.

However, you can deduct your allowable interest, taxes, and casualty and theft losses on Schedule A (Form 1040) if you itemize deductions.

**Rented 15 days or more.** If you use a dwelling unit as a home and rent it for 15 days or more during the year, you include all your rental income in your gross income. You must divide your expenses between the personal use and the rental use based on the number of days used for each purpose. If you had a net profit from the rental property for the year (that is, if your rental income is more than the total of your rental expenses, including depreciation), deduct all of your rental expenses. However, if you had a net loss, you may not be able to deduct all of your rental expenses.

Use *Table 10–1* to figure your deductible expenses.

## Depreciation

When you use your property to produce income, such as rents, the law generally allows you to recover (get back) some or all of what you paid for the property through tax deductions. You do this by “depreciating” the property; that is, by deducting some of your cost on your tax return each year.

Several factors determine how much depreciation you can deduct. The main factors are: (1) your basis in the property, and (2) the recovery period for the property.

You can deduct depreciation only on the part of your property used for rental purposes. Depreciation reduces your basis for figuring gain or loss on a later sale or exchange. You may have to use **Form 4562, Depreciation and Amortization**, to figure and report your depreciation. See *How To Report Rental Income and Expenses*, later.

You should claim the correct amount of depreciation each tax year. If, in an earlier year, you did not claim depreciation that you were entitled to deduct, you must still reduce your basis in the property by the amount of depreciation that you should have deducted.

**Table 10-1. Worksheet for Figuring the Limit on Rental Deductions for a Dwelling Unit Used as a Home**

Use this worksheet only if you answer "yes" to all of the following questions.

- Did you use the dwelling unit as a home this year? (See *Dwelling Unit Used as Home*.)
- Did you rent the dwelling unit 15 days or more this year?
- Are the total of your rental expenses and depreciation more than your rental income?

1. Enter rents received .....	_____	_____
2. a. Enter the rental portion of deductible home mortgage interest (see instructions) .....	_____	_____
b. Enter the rental portion of real estate taxes .....	_____	_____
c. Enter the rental portion of deductible casualty and theft losses (see instructions) .....	_____	_____
d. Enter direct rental expenses (see instructions) .....	_____	_____
e. <b>Fully deductible rental expenses.</b> Add lines 2a–2d .....	_____	_____
3. Subtract line 2e from line 1. If zero or less, enter zero.....	_____	_____
4. a. Enter the rental portion of expenses directly related to operating or maintaining the dwelling unit (such as repairs, insurance, and utilities) .....	_____	_____
b. Enter the rental portion of excess mortgage interest (see instructions) .....	_____	_____
c. Add lines 4a and 4b .....	_____	_____
d. <b>Allowable operating expenses.</b> Enter the smaller of line 3 or line 4c.....	_____	_____
5. Subtract line 4d from line 3. If zero or less, enter zero.....	_____	_____
6. a. Enter the rental portion of excess casualty and theft losses (see instructions) .....	_____	_____
b. Enter the rental portion of depreciation of the dwelling unit .....	_____	_____
c. Add lines 6a and 6b .....	_____	_____
d. <b>Allowable excess casualty and theft losses and depreciation.</b> Enter the smaller of line 5 or line 6c.....	_____	_____
7. a. <b>Operating expenses to be carried over to next year.</b> Subtract line 4d from line 4c .....	_____	_____
b. <b>Excess casualty and theft losses and depreciation to be carried over to next year.</b> Subtract line 6d from line 6c .....	_____	_____

Enter the amounts on **lines 2e, 4d, and 6d** on the appropriate lines of Schedule E (Form 1040), Part I.

**Worksheet Instructions**

Follow these instructions for the worksheet above. If you were unable to deduct all your expenses last year, including operating expenses, casualty and theft losses, and depreciation, because of the rental income limit, add these unused amounts to your expenses for this year.

**Line 2a.** Figure the mortgage interest on the dwelling unit that you could deduct on Schedule A (Form 1040) if you had not rented the unit. **Do not** include interest on a loan that did not benefit the dwelling unit. For example, **do not** include interest on a home equity loan used to pay off credit cards or other personal loans, buy a car, or pay college tuition. Include interest on a loan used to buy, build, or improve the dwelling unit, or to refinance such a loan. Enter the rental portion of this interest on line 2a of the worksheet.

**Line 2c.** Figure the casualty and theft losses related to the dwelling unit that you could deduct on Schedule A (Form 1040) if you had not rented the dwelling unit. To do this, complete Section A of Form 4684, treating the losses as personal losses. On line 17 of Form 4684, enter 10% of your adjusted gross income figured **without** your rental income and expenses from the dwelling unit. Enter the rental portion of the result from line 18 of Form 4684 on line 2c of this worksheet. **Note:** Do **not** file this Form 4684 or use it to figure your personal losses on Schedule A. Instead, figure the personal portion on a separate Form 4684.

**Line 2d.** Enter the total of your rental expenses that are directly related only to the rental activity. These include interest on loans used for rental activities other than to buy, build, or improve the dwelling unit. Also include rental agency fees, advertising, office supplies, and depreciation on office equipment used in your rental activity.

**Line 4b.** On line 2a, you entered the mortgage interest you could deduct on Schedule A if you had not rented out the dwelling unit. Enter on line 4b of this worksheet the mortgage interest you could not deduct on Schedule A because it is **more than** the limit on home mortgage interest. **Do not** include interest on a loan that did not benefit the dwelling unit (as explained in the line 2a instructions).

**Line 6a.** To find the rental portion of excess casualty and theft losses you can deduct, follow these steps. Use the Form 4684 you prepared for line 2c of this worksheet.

**A.** Enter the amount from line 10 of Form 4684 .....

**B.** Enter the rental portion of (A) .....

**C.** Enter the amount from line 2c of the worksheet .....

**D.** Subtract (C) from (B). Enter the result here and on line 6a of the worksheet .....

**Allocating the limited deduction.** If you cannot deduct all of the amount on line 4c or 6c this year, you can allocate the allowable deduction in any way you wish among the expenses included on line 4c or 6c. Enter the amount you allocate to each expense on the appropriate line of Schedule E, Part I.

You cannot deduct the unclaimed depreciation in the current or any later tax year. However, you may be able to claim the depreciation on an amended return (Form 1040X) for the earlier year. See *Amended Returns and Claims for Refund* in Chapter 1 for more information.

**Land.** You can never depreciate land. This generally includes the cost of clearing, grading, planting, and landscaping because

these expenses are all part of the cost of land.

### Depreciation Systems

There are three ways to figure depreciation. The depreciation system you use depends on the type of asset and when the asset was placed in service. For **tangible property** you use:

- 1) MACRS if placed in service after 1986,
- 2) ACRS if placed in service after 1980 but before 1987, or
- 3) Straight line or an accelerated method of depreciation, such as the declining balance method, if placed in service before 1981.

Tangible property is any property that you can see and touch. This includes automobiles, buildings, and equipment.

If you placed property in service before 1996, continue to use the same method of figuring depreciation that you used in the past. If you are depreciating property placed in service before 1987, see Publication 534.

**Section 179 election.** You cannot claim the section 179 deduction for property merely held for the production of income, including certain rental property. See Publication 946.

**Cannot be more than basis.** The total of all your yearly depreciation deductions cannot be more than your cost or other basis of the property. For this purpose, the total depreciation must include any depreciation that you were allowed to claim, even if you did not claim it.

**Cooperative apartments.** If you are a tenant-stockholder in a cooperative housing corporation and you rent your cooperative apartment to others, you may deduct your share of the corporation's depreciation. See *Cooperative apartments* in Publication 527 for information on how to figure your depreciation deduction.

## Modified Accelerated Cost Recovery System (MACRS)

The modified accelerated cost recovery system (MACRS) applies to all tangible property placed in service during 1996.

MACRS consists of two systems that determine how you depreciate your property. The main system is called the **General Depreciation System (GDS)**. The second system is called the **Alternative Depreciation System (ADS)**. GDS is used to figure your depreciation deduction for property used in most rental activities, unless you elect ADS.

To figure your MACRS deduction, you need to know the following information about your property:

- 1) Its recovery period,
- 2) Its placed-in-service date, and
- 3) Its depreciable basis.

**Excluded property.** You cannot use MACRS for certain personal property placed in service before 1987 (before August 1, 1986, if election made) that is transferred after 1986 (after July 31, 1986, if election made). Generally, if you acquired the property from a related party, or if you or a related party used the property before 1987, you cannot use MACRS. Property that does not come under MACRS must be depreciated under ACRS or one of the other methods of depreciation, such as straight line or declining balance. In addition, you may elect to exclude certain property from the application of MACRS. See Publication 534 for more information.

**Personal home changed to rental use.** You must use MACRS to figure the depreciation on property you used as your home and changed to rental property in 1996.

## Recovery Periods Under GDS

Each item of property that can be depreciated is assigned to a property class. The recovery period of a piece of property depends on the class the property is in. The property classes are:

- 3-year property,
- 5-year property,
- 7-year property,
- 10-year property,
- 15-year property,
- 20-year property,
- Nonresidential real property, and
- Residential rental property.

The class to which property is assigned is determined by its class life. Class life is discussed in Publication 946.

Under GDS, tangible property that you placed in service during 1996 in your rental activities generally falls into one of the following classes. Also see *Table 10-2* in this chapter. The other recovery classes are discussed in Publication 946.

- 1) **5-year property.** This class includes computers and peripheral equipment, office machinery (typewriters, calculators, copiers, etc.), automobiles, and light trucks.  
Depreciation on automobiles, certain computers, and cellular telephones is limited. See Chapter 4 of Publication 946.
- 2) **7-year property.** This class includes office furniture and equipment (desks, files, etc.), and appliances, carpets, furniture, etc. used in residential rental property. This class also includes any property that does not have a class life and that has not been designated by law as being in any other class.
- 3) **15-year property.** This class includes roads and shrubbery (if depreciable).
- 4) **Residential rental property.** This class includes any real property that is a rental building or structure (including a mobile home) for which 80% or more of the gross rental income for the tax year is from dwelling units. A dwelling unit is a house or an apartment used to provide living accommodations in a building or structure, but does not include a unit in a hotel, motel, inn, or other establishment where more than half of the units are used on a transient basis. If you live in any part of the building or structure, the gross rental income includes the fair rental value of the part you live in. This property is depreciated over **27.5 years**.

**Additions or improvements to property.** Treat additions or improvements you make to any property as separate property items for depreciation purposes. The recovery period for an addition or improvement begins on the later of:

- 1) The date the addition or improvement is placed in service, or
- 2) The date the property to which the addition or improvement was made is placed in service.

The class and recovery period of the addition or improvement is the one that would apply to the underlying property if it were placed in service at the same time as the addition or improvement.

**Example.** You own a residential rental house that you have been renting out since 1980 and are depreciating under ACRS. If you put an addition onto the house, and you place the improvement in service after 1986, you use MACRS for the addition. Under MACRS, the addition would be depreciated as residential rental property.

**When to begin depreciation.** You can begin to depreciate property when you place it in service in your trade or business or for the production of income. Property is considered placed in service in a rental activity when it is ready and available for a specific use in that activity.

## Basis

To deduct the proper amount of depreciation each year, you must first determine your basis in the property you intend to depreciate. The basis used for figuring depreciation is your original basis in the property increased by any improvements made to the property. Your original basis is usually your cost. However, if you acquire the property in some other way, such as by inheriting it, getting it as a gift, or building it yourself, you may have to figure your original basis in another way. Other adjustments could also affect your basis. See Chapter 14.

## Conventions

In the year that you place property in service or in the year that you dispose of property, you are allowed to claim depreciation for only part of the year. The part of the year (or convention) depends on the class of the property.

A half-year convention is used to figure the deduction for property used in rental activities other than residential rental property. However, under a special rule, a mid-quarter convention may have to be used. For residential rental property, use a mid-month convention in all situations.

**Half-year convention.** The half-year convention treats all property placed in service, or disposed of, during a tax year as placed in service, or disposed of, in the middle of that tax year.

A half year of depreciation is allowable for the first year property is placed in service, regardless of when the property is placed in service during the tax year. For each of the remaining years of the recovery period, you will take a full year of depreciation. If you hold the property for the entire recovery period, a half year of depreciation is allowable

**Table 10-2. MACRS Recovery Periods for Property Used in Rental Activities**

Type of property	MACRS Recovery Period to use	
	General Depreciation System	Alternative Depreciation System
Computers and their peripheral equipment .....	5 years	5 years
Office machinery, such as: typewriters calculators copiers .....	5 years	6 years
Automobiles .....	5 years	5 years
Light trucks .....	5 years	5 years
Office furniture and equipment, such as: desks files .....	7 years	10 years
Appliances, such as: stoves refrigerators .....	7 years	12 years
Carpets .....	7 years	12 years
Furniture used in rental property .....	7 years	12 years
Any property that does not have a class life and that has not been designated by law as being in any other class .....	7 years	12 years
Fences .....	15 years	20 years
Roads .....	15 years	20 years
Shrubbery .....	15 years	20 years
Residential rental property (buildings or structures) and structural components such as furnaces, water pipes, venting, etc. ....	27.5 years	40 years
Improvements and additions, such as a new roof .....	The recovery period of the property to which the addition or improvement is made, determined as if the property were placed in service at the same time as the improvement or addition.	

for the year following the end of the recovery period. If you dispose of the property before the end of the recovery period, a half year of depreciation is allowable for the year of disposition.

**Mid-quarter convention.** Under a mid-quarter convention, all property placed in service, or disposed of, during any quarter of a tax year is treated as placed in service, or disposed of, in the middle of the quarter.

A mid-quarter convention must be used in certain circumstances for property used in rental activities, other than residential rental property. This convention applies if the total basis of such property that is placed in service in the last 3 months of a tax year is more than 40% of the total basis of all such property you place in service during the year.

Do not include in the total basis any property placed in service and disposed of during the same tax year.

**Example.** During the tax year, John Joyce purchased the following items to use in his rental property:

A dishwasher for \$400, which he placed in service in January;

Used furniture for \$100, which he placed in service in September; and

A refrigerator for \$500, which he placed in service in October.

John uses the calendar year as his tax year. The total basis of all property placed in service in that year is \$1,000. The \$500 basis of the refrigerator placed in service during the last 3 months of his tax year exceeds \$400 ( $40\% \times \$1,000$ ). John must use the mid-quarter convention for all three items. The dishwasher, refrigerator, and used furniture are 7-year property under GDS.

**Mid-month convention.** Under a mid-month convention, residential rental property placed in service, or disposed of, during any month is treated as placed in service, or disposed of, in the middle of that month.

## MACRS Depreciation Under GDS

You can figure your MACRS depreciation deduction under GDS in one of two ways. The deduction is the same both ways. You can either:

- 1) Use the percentage from the optional MACRS tables, or
- 2) Actually compute the deduction using the depreciation method and convention that apply over the recovery period of the property.

If you actually compute the deduction, the depreciation method you use depends on the class of the property.

### Using the Optional Tables

You can use *Table 10-3* to compute annual depreciation under MACRS. The percentages in Tables A, B, and C make the change from declining balance to straight line in the year that straight line will yield a larger deduction. See *Declining Balance Method*, earlier.

If you elect to use the straight line method for 5-, 7-, or 15-year property, or the 150% declining balance method for 5- or 7-year property, use the tables in *Appendix A* of Publication 946.

**How to use the tables.** The following section explains how to use the optional tables. Figure the depreciation deduction by multiplying your unadjusted basis in the property by the percentage shown in the appropriate table. Your *unadjusted basis* is your depreciable basis without reduction for depreciation previously claimed. The tables show the percentages for the first 6 years.

**Tables A, B, and C.** These tables take the half-year and mid-quarter conventions into consideration in figuring percentages. Use Table A for 5-year property, Table B for 7-year property, and Table C for 15-year property. Use the percentage in the second column (half-year convention) unless you must use the mid-quarter convention (explained earlier). If you must use the mid-quarter convention, use the column that corresponds to the calendar year quarter in which you placed the property in service.

**Example 1.** You purchased a stove and refrigerator and placed them in service in February. Your basis in the stove is \$300, and your basis in the refrigerator is \$500. Both are 7-year property. Using the half-year convention column in Table B, you find the depreciation percentage for year 1 is 14.29%. For that year, your depreciation deduction on the stove is \$43 ( $\$300 \times .1429$ ), and on the refrigerator is \$71 ( $\$500 \times .1429$ ).

Using the half-year convention for year 2, you find your depreciation percentage is 24.49%. Your 1996 depreciation deduction will be \$73 ( $\$300 \times .2449$ ) for the stove and \$122 ( $\$500 \times .2449$ ) for the refrigerator.

**Example 2.** Assume the same facts in Example 1, except you buy the refrigerator in October instead of February. You must use the mid-quarter convention to figure depreciation on the stove and refrigerator. The basis of the refrigerator (\$500), placed in service in the last 3 months of the tax year, is more than 40% of the total basis of all property (\$800) placed in service during the year.

Because you placed the stove in service in February, you use the first quarter column of Table B and find that the depreciation percentage for year 1 is 25%. For that year, your depreciation deduction on the stove is \$75 ( $\$300 \times .25$ ).

Because you placed the refrigerator in service in October, you use the fourth quarter column of Table B and find that the depreciation percentage for year 1 is 3.57%. Your depreciation deduction on the refrigerator is \$18 ( $\$500 \times .0357$ ).

**Table D.** Use this table for residential rental property. Find the row for the month that you placed the property in service. Use the percentages listed for that month for your depreciation deduction. The mid-month convention is considered in the percentages used in the tables.

**Example.** You purchased a single family rental house and placed it in service in February. Your basis in the house is \$80,000. Using Table D, you find that the percentage for property placed in service in February of year 1 is 3.182%. That year's depreciation deduction is \$2,546 ( $\$80,000 \times .03182$ ).

## Figuring Depreciation Without Using the Tables

**5-, 7-, or 15-year property.** For property in the 5- or 7-year class, you use the double (200%) declining balance method over 5 or 7 years and a half-year convention. Or use the mid-quarter convention if it applies. For property in the 15-year class, you use the 150% declining balance method over 15 years and a half-year convention.

You can also choose to use the 150% declining balance method for property in the 5-, 7-, or 15-year class over its ADS recovery period. See *MACRS Depreciation Under ADS*, later, for the ADS recovery periods. You make this election on Form 4562. In Part II, column (f), enter "150 DB."

Change from either declining balance method to the straight line method in the first tax year that the straight line method gives you a larger deduction.

You can also choose to use the straight line method with a half-year or mid-quarter convention for 5-, 7-, and 15-year property. The choice to use the straight line method for one item in a class of property applies to all property in that class that is placed in service during the tax year of the election. You elect the straight line method on Form 4562. In Part II, column (f), enter "S/L." Once you make this election, you cannot change to another method.

## Table 10-3. Optional MACRS TABLES

Table 10-3-A. MACRS 5-Year Property

Year	Half-year convention	Mid-quarter convention			
		First quarter	Second quarter	Third quarter	Fourth quarter
1	20.00%	35.00%	25.00%	15.00%	5.00%
2	32.00	26.00	30.00	34.00	38.00
3	19.20	15.60	18.00	20.40	22.80
4	11.52	11.01	11.37	12.24	13.68
5	11.52	11.01	11.37	11.30	10.94
6	5.76	1.38	4.26	7.06	9.58

Table 10-3-B. MACRS 7-Year Property

Year	Half-year convention	Mid-quarter convention			
		First quarter	Second quarter	Third quarter	Fourth quarter
1	14.29%	25.00%	17.85%	10.71%	3.57%
2	24.49	21.43	23.47	25.51	27.55
3	17.49	15.31	16.76	18.22	19.68
4	12.49	10.93	11.97	13.02	14.06
5	8.93	8.75	8.87	9.30	10.04
6	8.92	8.74	8.87	8.85	8.73

Table 10-3-C. MACRS 15-Year Property

Year	Half-year convention	Mid-quarter convention			
		First quarter	Second quarter	Third quarter	Fourth quarter
1	5.00%	8.75%	6.25%	3.75%	1.25%
2	9.50	9.13	9.38	9.63	9.88
3	8.55	8.21	8.44	8.66	8.89
4	7.70	7.39	7.59	7.80	8.00
5	6.93	6.65	6.83	7.02	7.20
6	6.23	5.99	6.15	6.31	6.48

Table 10-3-D. Residential Rental Property (27.5-year)

	Use the row for the month of the taxable year placed in service.					
	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Jan.	3.485%	3.636%	3.636%	3.636%	3.636%	3.636%
Feb.	3.182	3.636	3.636	3.636	3.636	3.636
March	2.879	3.636	3.636	3.636	3.636	3.636
Apr.	2.576	3.636	3.636	3.636	3.636	3.636
May	2.273	3.636	3.636	3.636	3.636	3.636
June	1.970	3.636	3.636	3.636	3.636	3.636
July	1.667	3.636	3.636	3.636	3.636	3.636
Aug.	1.364	3.636	3.636	3.636	3.636	3.636
Sept.	1.061	3.636	3.636	3.636	3.636	3.636
Oct.	0.758	3.636	3.636	3.636	3.636	3.636
Nov.	0.455	3.636	3.636	3.636	3.636	3.636
Dec.	0.152	3.636	3.636	3.636	3.636	3.636

**Residential rental property.** You must use the straight line method and a mid-month convention for residential rental property.

### Declining Balance Method

To figure your MACRS deduction, first determine your declining balance rate from the table later. However, if you elect to use the 150% declining balance method for 5- or 7-year property, figure the declining balance rate by dividing 1.5 (150%) by the ADS recovery period for the property.

Multiply the adjusted basis of the property by the declining balance rate, and apply

the convention that applies to figure your depreciation for the first year. In later years, use the following steps to figure your depreciation.

- 1) Adjust your basis by subtracting the amount of depreciation allowable for the earlier years.
- 2) Multiply your adjusted basis in (1) by the same rate used in the first year.

Follow these steps each year that you use the declining balance method. See *Conventions*, for information on depreciation in the year you dispose of property.

**Declining balance rates.** The following table shows the declining balance rate that applies for each class of property and the first year for which the straight line method will give an equal or greater deduction. (The rates for 5- and 7-year property are based on the 200% declining balance method.)

Class	Declining Balance Rate	Year
5	40.00%	4th
7	28.57%	5th
15	10.00%	7th

## Straight Line Method

To figure your MACRS deduction under the straight line method, you must figure a new depreciation rate for each tax year in the recovery period. For any tax year, figure the straight line rate by dividing the number 1 by the years remaining in the recovery period at the beginning of the tax year. Multiply the unrecovered basis of the property by the straight line rate. You must figure the depreciation for the first year using the convention that applies. (See *Conventions*, earlier.) If the remaining recovery period at the beginning of the tax year is less than 1 year, the straight line rate for that tax year is 100%.

**Example.** Using the straight line method for property with a 5-year recovery period, the straight line rate is 20% ( $1 \div 5$ ) for the first tax year. After applying the half-year convention, the first year rate is 10% ( $20\% \div 2$ ).

At the beginning of the second year, the remaining recovery period is  $4\frac{1}{2}$  years because of the half-year convention. The straight line rate for the second year is 22.22% ( $1 \div 4.5$ ).

To figure your depreciation deduction for the second year:

- 1) Subtract the depreciation taken in the first year from the basis of the property, and
- 2) Multiply the remaining basis in (1) by 22.22%.

**Residential rental property.** In the first year you claim depreciation for residential rental property, you can only claim depreciation for the number of months the property is in use, and you must use the mid-month convention. Also, for the first year of depreciation under ADS, you must use the mid-month convention to figure your depreciation deduction.

## MACRS Depreciation Under ADS

If you choose, you can use the ADS method for most property. Under ADS, you use the straight line method of depreciation.

Table 10-2 shows the recovery periods for property used in rental activities that you depreciate under ADS. See *Appendix B* in Publication 946 for other property. If your property is not listed, it is considered to have no class life.

Use the mid-month convention for residential rental property. For all other property, use the half-year or mid-quarter convention.

**Election.** You choose to use ADS by entering the depreciation on line 16, Part II of Form 4562.

The election of ADS for one item in a class of property generally applies to all property in that class that is placed in service during the tax year of the election. However, the election applies on a property-by-property basis for residential rental property.

Once you choose to use ADS, you cannot change your election.

## Other Rules About Depreciable Property

In addition to the rules about what methods you can use, there are other rules you should be aware of with respect to depreciable property.

**If you dispose of depreciable property at a profit,** you may have to report, as ordinary income, all or part of the profit. See Publication 544, *Sales and Other Dispositions of Assets*.

**Additional tax on preference items.** If you use accelerated depreciation, you may have to file **Form 6251**, *Alternative Minimum Tax—Individuals*. Accelerated depreciation includes MACRS and ACRS and any other method that allows you to deduct more depreciation than you could deduct using a straight line method.

## Limits on Rental Losses

Rental real estate activities are generally considered passive activities and the amount of loss you can deduct is limited. Generally, you cannot deduct losses from rental real estate activities unless you have income from other passive activities. See *Passive Activity Limits*, later.

Losses from passive activities are first subject to the **at-risk rules**. At-risk rules limit the amount of deductible losses from holding most real property placed in service after December 31, 1986.

**Exception.** If your rental losses are less than \$25,000 (\$12,500 if married filing separately), the passive activity limits probably do not apply to you. See *Losses From Rental Real Estate Activities*, later.

**Property used as a home.** If you used the rental property as a home during the year, the passive activity rules do not apply to that home. Instead, you must follow the rules explained earlier under *Personal Use of Vacation Home or Dwelling Unit*.

## At-Risk Rules

The at-risk rules place a limit on the amount you can deduct as losses from activities often described as tax shelters. Holding real property (other than mineral property) placed in service before 1987 is not subject to the at-risk rules.

Generally, any loss from an activity subject to the at-risk rules is allowed only to the extent of the total amount you have at risk in the activity at the end of the tax year. You are considered at risk in an activity to the extent of cash and the adjusted basis of other property you contributed to the activity and certain amounts borrowed for use in the activity. See Publication 925 for more information.

## Passive Activity Limits

All rental activities (except those meeting the exception for real estate professionals, below) are passive activities. Losses from such activities are limited.

**Passive activity rules.** You generally cannot offset income, other than passive income, with losses from passive activities. Nor can you offset taxes on income, other than passive income, with credits resulting from passive activities.

In general, any rental activity not meeting the exception below is a passive activity. For this purpose, a rental activity is an activity from which you receive income mainly for the use of tangible property, rather than for services.

Use **Form 8582**, *Passive Activity Loss Limitations* to figure the amount of any passive activity loss for the current year for all activities and the amount of the passive activity loss allowed on your tax return.

**Exception for real estate professionals.** Rental activities in which you *materially participate* during the year are not passive activities if for that year you were a real estate professional because you met both of the requirements listed next. Losses from these activities are not limited by the passive activity rules.

**Requirements.** During the year, the time you spend performing services in real property trades or businesses in which you materially participate must be:

- 1) More than half of the time spent performing all personal services during the year, and
- 2) More than 750 hours.

A real property trade or business is one that develops, redevelops, constructs, reconstructs, acquires, converts, rents, operates, manages, leases, or sells real property.

Services you performed as an employee are not treated as performed in a real property trade or business, unless you own more than 5% of the stock (or more than 5% of the capital or profits interest) in the employer.

Once you meet the requirements, you can determine whether you materially participate in your rental activities on a property-by-property basis or you can treat all interests in rental real estate as one activity. For more information about making this choice, see Publication 527.

**Married persons.** In the case of a joint return, you meet the requirements for time spent performing services only if either you or your spouse separately satisfies the requirements. Do not count services performed by the other spouse.

## Losses From Rental Real Estate Activities

You can deduct up to \$25,000 (\$12,500 if married filing separately and living apart from your spouse the entire year; \$0 if married filing separately and not living apart from your spouse the entire year) of losses from rental real estate activities in which you **actively participated** during the tax year. This allows you to deduct up to \$25,000 of otherwise unallowable losses from rental real estate activities against other income (nonpassive income). The \$25,000 (\$12,500) figure is reduced if your adjusted gross income is more than \$100,000 (\$50,000 if married filing separately and living apart from your spouse the entire year).

If you lived with your spouse at any time during the year and are filing a separate return, you cannot use this special offset to reduce your nonpassive income or tax on nonpassive income.

**Active participation.** You actively participate in a rental real estate activity if you own at least 10% of the rental property and you make management decisions in a significant and bona fide sense. Management decisions include approving new tenants, deciding on rental terms, approving expenditures, and similar decisions. For these purposes, you are considered to own any portion of the property owned by your spouse.

See Publication 925 for more information on the passive loss limits, including information on the treatment of unused disallowed passive losses and credits and the treatment of gains and losses realized on the disposition of a passive activity.

## How To Report Rental Income and Expenses

Report rental income on your return for the year you actually or constructively receive it (if you are a cash-basis taxpayer). You are considered to constructively receive income when it is made available to you, for example, by being credited to your bank account.

For more information about when you constructively receive income, see *Accounting Methods* in Chapter 1.

**Expenses carried over.** If you could not deduct all of your 1995 rental expenses because you used your property as a home, treat the part you could not deduct in 1995 as a 1996 rental expense. Deduct the expenses carried over to 1996 only up to the amount of your 1996 gross rental income, even if you did not use the property as your home in 1996.

**Where to report.** Where you report rental income and expenses, including depreciation, depends on whether you provide certain services to your tenant.

If you rent out buildings, rooms, or apartments, and provide only heat and light, trash collection, etc., you normally report your rental income and expenses in Part I of Schedule E (Form 1040), *Supplemental Income and Loss*. However, do not use that schedule to report a not-for-profit activity; see *Not Rented For Profit*, under *Rental Expenses*, earlier.

If you provide significant services that are primarily for your tenant's convenience, such as regular cleaning, changing linen, or maid service, you report your rental income and expenses on Schedule C (Form 1040), *Profit or Loss From Business* or Schedule C-EZ, *Net Profit From Business*. Significant services do not include the furnishing of heat and light, cleaning of public areas, trash collection, etc. For information, see Publication 334. You also may have to pay self-employment tax on your rental income. See Publication 533.

**Form 1098.** If you paid \$600 or more of mortgage interest on your rental property, you should receive a Form 1098, *Mortgage Interest Statement*, or a similar statement showing the interest you paid for the year. If you and at least one other person (other than your spouse if you file a joint return) were liable for, and paid interest on the mortgage, and the other person received the Form 1098, report your share of the interest on line 13 of Schedule E. Attach a statement to your return showing the name and address of the other person. In the left margin of Schedule E, next to line 13, write "See attached."

## Schedule E

Use Part I of Schedule E (Form 1040) to report your rental income and expenses. List your total income, expenses, and depreciation for each rental property. Be sure to answer the question on line 2. On line 20 of Schedule E (Form 1040), show the depreciation you are claiming.

You must complete and attach Form 4562 for rental activities only if you are claiming:

- Depreciation on rental property placed in service during 1996, or
- Depreciation on any rental property that is listed property (such as a car), regardless of when it was placed in service, or

- Any automobile expenses (actual or the standard mileage rate).

Otherwise, figure your depreciation on your own worksheet. You do not have to attach these computations to your return.

If you have more than three rental or royalty properties, complete and attach as many Schedules E as are needed to list the properties. Complete lines 1 and 2 for each property. However, fill in the "Totals" column on only one Schedule E. The figures in the "Totals" column on that Schedule E should be the combined totals of all Schedules E. If you need to use page 2 of Schedule E, use page 2 of the same Schedule E you used to enter the combined totals in Part I.

**Example.** During the year, Eileen Green bought a townhouse that she rents out. She receives \$1,100 a month rental income. Her rental expenses for the year are as follows:

Fire insurance (1-year policy) .....	\$ 200
Mortgage interest .....	5,000
Fee paid to real estate company for collecting monthly rent .....	572
General repairs .....	175
Real estate taxes imposed and paid .....	800

Eileen bought the property and placed it in service on January 1. Her basis for depreciation of the townhouse is \$65,000. She is using MACRS with a 27.5-year recovery period. On April 1, Eileen bought a new dishwasher for the rental property at a cost of \$425. She uses the MACRS method with a 7-year recovery period.

Eileen uses the percentage for "Jan." in *Table 10-3-D* to figure her deduction for the townhouse. She uses the percentage under "Half-year convention" in *Table 10-3-B* to figure her deduction for the dishwasher. She must report the depreciation on Form 4562.

Eileen figures her net rental income or loss for the townhouse as follows:

Total rental income received	
(\$1,100 × 12) .....	\$13,200
Minus Expenses:	
Fire insurance (1-year policy) .....	\$ 200
Mortgage interest .....	5,000
Real estate fee .....	572
General repairs .....	175
Real estate taxes .....	800
Total expenses .....	6,747
Balance .....	\$ 6,453
Minus Depreciation:	
On townhouse	
(\$65,000 × 3.485%) .....	\$2,265
On dishwasher	
(\$425 × 14.29%) .....	61
Total depreciation .....	2,326
<b>Net rental income for townhouse</b> .....	<b>\$ 4,127</b>

# Retirement Plans, Pensions, and Annuities

## Important Changes for 1996

**Annuity payments from qualified plans.** If your annuity starting date is **after November 18, 1996**, you generally must use the Simplified General Rule to figure your taxable pension. New law changed the recovery factors (anticipated monthly payments) used to figure the tax-free portion of your annuity from a qualified plan. The revised factors are:

- 360 (from 300), if annuitant is age 55 or under
- 310 (from 260), if annuitant is over age 55 but not more than 60
- 260 (from 240), if annuitant is over age 60 but not more than 65
- 210 (from 170), if annuitant is over age 65 but not more than 70
- 160 (from 120), if annuitant is over age 70

In most instances, the General Rule can no longer be used for qualified plans. If you are age 75 or over on the annuity starting date, see the discussion under *Simplified General Rule*.

**Repeal of \$5,000 death benefit exclusion.** The new law repeals the \$5,000 exclusion for employer-provided death benefits. If an employee dies **after August 20, 1996**, his or her beneficiary can no longer exclude from income up to \$5,000 in benefits paid by or on behalf of an employer because of the employee's death.

## Important Changes for 1997

**Minimum required distribution rule modified.** Beginning in 1997, new law modifies the definition of the required beginning date that is used to figure the minimum required distribution from qualified retirement plans. Under the new law, the required beginning date of a participant who is still employed after age 70½ is April 1 of the calendar year that follows the calendar year in which he or she retires. The new law does not extend this provision to IRAs. As discussed in this chapter under *Tax for Failure to Make Minimum Distribution*, for years prior to 1997, all participants in qualified plans and IRAs must

start distributions by April 1 of the year following the calendar year in which they reach age 70½. For more information on this new provision, get Publication 575.

**Suspension of the 15% tax on excessive distributions.** New law suspends the 15% excise tax on excessive distributions for distributions received **after December 31, 1996**, and before January 1, 2000. As discussed in this chapter under *Tax on Excess Distributions*, retirement distributions in excess of \$155,000 are subject to a 15% excise tax on the amount over \$155,000. The dollar limit that currently applies for lump-sum distributions is \$775,000.

**Repeal of SARSEPs and creation of new SIMPLE plan.** After December 31, 1996, an employer will no longer be permitted to establish a Salary Reduction Simplified Employee Pension (SARSEP) plan. SARSEPs established before 1997 may continue receiving participant contributions. New employees of the employer hired after 1996 will be allowed to participate in the SARSEP.

**Beginning in 1997**, new law creates a SIMPLE Retirement plan for small employers. For more information, get Publication 560, *Retirement Plans for the Self-Employed*.

**Additional pension provisions.** New law also modified several other pension provisions. Get Publication 553, *Highlights of 1996 Tax Changes*, for additional important changes that may affect your **1996 and 1997 income tax returns**.

## Introduction

This chapter discusses the tax treatment of amounts you receive from:

- Employee pensions and annuities,
- Disability retirement, and
- Purchased annuities.

If you are retired from the Federal Government (either regular or disability retirement), get Publication 721, *Tax Guide to U.S. Civil Service Retirement Benefits*. Also, you should get Publication 721 if you are the survivor or beneficiary of a federal employee or retiree who died.

Information on amounts you receive from an individual retirement arrangement (IRA), as well as general information on IRAs, is in Chapter 18.

## Useful Items

You may want to see:

### Publications

- 559** Survivors, Executors, and Administrators
- 575** Pension and Annuity Income (Including Simplified General Rule)

- 721** Tax Guide to U.S. Civil Service Retirement Benefits
- 939** Pension General Rule (Nonsimplified Method)

### Forms and Instructions

- W-4P** Withholding Certificate for Pension or Annuity Payments
- 4972** Tax on Lump-Sum Distributions
- 5329** Additional Taxes Attributable to Qualified Retirement Plans (Including IRAs), Annuities, and Modified Endowment Contracts

## Employee Pensions and Annuities

Generally, if you did not pay any part of the cost of your employee pension or annuity and your employer did not withhold part of the cost of the contract from your pay while you worked, the amounts you receive each year are fully taxable. You must report them on your income tax return.

If you paid part of the cost of your annuity, you are not taxed on the part of the annuity you receive that represents a return of your cost. The rest of the amount you receive is taxable. You use either the **General Rule** or the **Simplified General Rule** to figure the taxable and tax-free parts of your pension or annuity.



*If your annuity starting date is after November 18, 1996, see Simplified General Rule, later.*

If your annuity starting date was **before July 2, 1986**, and you recovered your cost under the **Three-Year Rule**, you cannot use the General Rule or the Simplified General Rule because your payments are fully taxable.

**Changing the method.** If your annuity starting date is after July 1, 1986 (but before November 19, 1996), you can change the way you figure your pension cost recovery exclusion. You can change from the General Rule to the Simplified General Rule, or the other way around. Make the change by filing amended returns for all your tax years beginning with the year in which your annuity starting date occurred. You must use the same method for all years. Generally, you can make the change only within 3 years from the due date of your return for the year in which you received your first annuity payment. You can make the change later if the date of the change is within 2 years after you paid the tax for that year.

If your annuity starting date was before July 2, 1986, you cannot choose the Simplified General Rule at any time.



*If your annuity starting date is after November 18, 1996, you generally cannot use the General Rule for annuity payments from a qualified plan.*

**More than one program.** If you receive benefits from more than one program, such as a pension plan and a profit-sharing plan, you must figure the taxable part of each separately. Make separate computations even if the benefits from both are included in the same check. For example, benefits from one of your programs could be fully taxable, while the benefits from your other program could be taxable under the General Rule or the Simplified General Rule. Your former employer or the plan administrator should be able to tell you if you have more than one program.

**Railroad retirement benefits.** Part of the railroad retirement benefits you receive is treated like social security benefits, and part is treated like an employee pension. For information about railroad retirement benefits treated as an employee pension, see *Railroad Retirement* in Publication 575, *Pension and Annuity Income (Including Simplified General Rule)*.

**Credit for the elderly or the disabled.** If you receive a pension or annuity, you may be able to take the credit for the elderly or the disabled. See Chapter 34.

**Withholding and estimated tax.** The payer of your pension, profit-sharing, stock bonus, annuity, or deferred compensation plan will withhold income tax on the taxable parts of amounts paid to you. You can choose not to have tax withheld except for amounts paid to you that are eligible rollover distributions. See *Eligible rollover distributions* under *Rollovers*, later. You make this choice by filing Form W-4P, *Withholding Certificate for Pension or Annuity Payments*.

For payments other than eligible rollover distributions, you can tell the payer how to withhold by filing Form W-4P. If an eligible rollover distribution is paid directly to you, 20% will generally be withheld. There is no withholding on a direct rollover of an eligible rollover distribution. See *Direct rollover option* under *Rollovers*, later. If you choose not to have tax withheld or you do not have enough tax withheld, you may have to pay estimated tax.

For more information, see *Pensions and Annuities* under *Withholding* in Chapter 5.

**Loans.** If you borrow money from an employer's qualified pension or annuity plan, a tax-sheltered annuity program, a government plan, or from a contract purchased under any of these plans, you may have to treat the loan as a distribution. This means that you may have to include in income all or part of the amount borrowed. Even if you do not have to treat the loan as a distribution, you might not be able to deduct the interest on the loan in some situations. For details, see *Loans Treated as Distributions* in Publication 575. For information on the deductibility of interest, see Chapter 25.

**Elective deferrals.** Some retirement plans allow you to choose (elect) to have part of

your pay contributed by your employer to a retirement fund, rather than have it paid to you. You do not pay tax on this money until you receive it in a distribution from the fund.

Elective deferrals generally include elective contributions to cash or deferred arrangements (known as **section 401(k) plans**), section 501(c)(18) plans, salary reduction simplified employee pension (SARSEP) plans, and tax-sheltered annuities provided for employees of tax-exempt organizations and public schools.

For information on the tax treatment of elective deferrals, including their limits, see *Elective deferrals* under *Excess Contributions, Deferrals, and Annual Additions* in Publication 575. For information about tax-sheltered annuities, see Publication 571, *Tax-Sheltered Annuity Programs for Employees of Public Schools and Certain Tax-Exempt Organizations*.

**H.R. 10 (Keogh) plans.** Keogh plans are retirement plans that can only be set up by a sole proprietor or a partnership (but not a partner). They can cover self-employed persons, such as the sole proprietor or partners, as well as regular (common-law) employees.

Distributions from these plans are usually fully taxable. If you have an investment (cost) in the plan, however, your pension or annuity payments are taxed under the General Rule or the Simplified General Rule.

**Deferred compensation plans of state and local governments and tax-exempt organizations.** If you participate in one of these plans (known as **section 457 plans**), you will not be taxed currently on your pay that is deferred under the plan. You or your beneficiary will be taxed on this deferred pay only when it is distributed or otherwise made available to either of you.

Distributions of deferred pay are not eligible for the 5- or 10-year tax option, rollover treatment, or the death benefit exclusion, all discussed later. Distributions are, however, subject to the tax for failure to make minimum distributions, discussed later.

For information on these deferred compensation plans and their limits, see *Section 457 plans—deferred compensation plans of state and local governments and tax-exempt organizations* under *Excess Contributions, Deferrals, and Annual Additions* in Publication 575.

## Cost

Before you can figure how much, if any, of your pension or annuity benefits is taxable, you must determine your cost in the plan (your investment). Your total cost in the plan includes everything that you paid. It also includes amounts your employer paid that were taxable at the time paid. Cost does not include any amounts you deducted or excluded from income.

From this total cost paid or considered paid by you, subtract any refunds of premiums, rebates, dividends, unrepaid loans, or

other tax-free amounts you received by the later of the annuity starting date or the date on which you received your first payment.

If you use the General Rule (see *Caution* below) to figure the tax treatment of your payments, you must also subtract from your cost the value of any refund feature in your contract.

The **annuity starting date** is the later of the first day of the first period for which you receive a payment from the plan or the date on which the plan's obligation becomes fixed.



*If your annuity starting date is after November 18, 1996, you generally cannot use the General Rule for annuity payments from a qualified plan.*

Your employer or the organization that pays you the benefits (plan administrator) should show your cost in Box 5 of your Form 1099-R.

**Foreign employment.** If you worked in a foreign country before 1963 and your employer paid into your retirement plan, a part of those payments may be considered part of your cost. For details, see *Foreign employment* under *Investment in the Contract (Cost)* in Publication 575.

## Simplified General Rule

If you can use the Simplified General Rule to figure the taxability of your annuity, it will probably be simpler and more beneficial than the General Rule, discussed later.



*If your annuity starting date is after November 18, 1996, you generally cannot use the General Rule for annuity payments from a qualified plan.*

**Who can use it.** You may be able to use the Simplified General Rule if you are a retired employee or if you are receiving a survivor annuity as the survivor of a deceased employee. You can use it to figure the taxability of your annuity **only** if:

- Your annuity starting date is after July 1, 1986,
- The annuity payments are for either (a) your life, or (b) your life and that of your beneficiary,
- The annuity payments are from a qualified employee plan, a qualified employee annuity, or a tax-sheltered annuity, **and**
- At the time the payments began, either you were under age 75 **or** the payments were **guaranteed** for fewer than 5 years.



*If you are 75 or over, and your annuity starting date is after November 18, 1996, you must use the General Rule if the payments are guaranteed for at least 5 years. You must use the Simplified General Rule if the payments are guaranteed for fewer than 5 years.*

If you are not sure whether your retirement plan is a qualified plan (that meets certain Internal Revenue Code requirements), ask your employer or plan administrator.

Your annuity contract provides **guaranteed payments** if a minimum number of payments or a minimum amount (for example, the amount of your investment) is payable even if you and any survivor annuitant do not live to receive the minimum. If the minimum amount is less than the total amount of the payments you are to receive, barring death, during the first 5 years after payments begin (figured by ignoring any payment increases), you are entitled to fewer than 5 years of guaranteed payments.

If you are the survivor of a deceased retiree, you can use the Simplified General Rule if the retiree used it.

**Amount of exclusion.** If your annuity starting date is after 1986, the total you can exclude from your taxable income over the years is limited to your cost.

If your annuity starting date was after July 1, 1986, and before January 1, 1987, you can continue to take your monthly exclusion for as long as you receive your annuity.

In both cases, any unrecovered cost at your, or the last annuitant's, death is allowed as a miscellaneous itemized deduction on the final return of the decedent. This deduction is not subject to the 2%-of-adjusted-gross-income limit.

**How to use it.** If your annuity starting date is before November 19, 1996 and you meet the conditions to choose the Simplified General Rule, you must use **Worksheet A** to figure your taxable annuity. In completing the worksheet, use your age at the birthday preceding your annuity starting date. Be sure to keep a copy of the completed worksheet; it will help you figure your taxable pension in later years.

 **Be sure to use the correct worksheet.** If your annuity starting date is after November 18, 1996, you must use Worksheet B.

**Worksheet A—Simplified General Rule**

1. Total pension received this year.  
Also add this amount to the total for Form 1040, line 16a, or Form 1040A, line 11a ..... \$ \_\_\_\_\_
2. Your cost in the plan (contract) at annuity starting date (**before November 19, 1996**), plus any death benefit exclusion ..... \_\_\_\_\_  
Age at annuity starting
3. date: \_\_\_\_\_ Enter: \_\_\_\_\_  
55 and under 300  
56 – 60 260  
61 – 65 240  
66 – 70 170  
71 and over 120 \_\_\_\_\_
4. Divide line 2 by line 3..... \_\_\_\_\_

5. Multiply line 4 by the number of months for which this year's payments were made ..... \_\_\_\_\_  
NOTE: If your annuity starting date is **before 1987**, enter the amount from line 5 on line 8 below. Skip lines 6, 7, 10, and 11.
6. Any amounts previously recovered tax free in years after 1986 ..... \_\_\_\_\_
7. Subtract line 6 from line 2 ..... \_\_\_\_\_
8. Enter the smaller of line 5 or line 7 ..... \_\_\_\_\_
9. **Taxable pension for year.**  
Subtract line 8 from line 1. Enter the result, but not less than zero. Also add this amount to the total for Form 1040, line 16b, or Form 1040A, line 11b ..... \$ \_\_\_\_\_  
NOTE: If your Form 1099–R shows a larger taxable amount, use the amount on line 9 instead.
10. Add lines 6 and 8..... \_\_\_\_\_
11. Balance of cost to be recovered.  
Subtract line 10 from line 2 ..... \$ \_\_\_\_\_



**If you are the beneficiary of an employee who died after August 20, 1996**, you are not eligible for the \$5,000 death benefit exclusion. See Death Benefit Exclusion, later.

**Be sure to use Worksheet B if your annuity starting date is after November 18, 1996.** Keep a copy of the completed worksheet; it will help you figure your taxable pension in later years.

**Worksheet B—Simplified General Rule**

1. Total pension received this year.  
Also add this amount to the total for Form 1040, line 16a, or Form 1040A, line 11a ..... \$ \_\_\_\_\_
2. Your cost in the plan (contract) at annuity starting date (**after November 18, 1996**) ..... \_\_\_\_\_  
Age at annuity starting
3. date: \_\_\_\_\_ Enter: \_\_\_\_\_  
55 and under 360  
56 – 60 310  
61 – 65 260  
66 – 70 210  
71 and over 160 \_\_\_\_\_
4. Divide line 2 by line 3..... \_\_\_\_\_
5. Multiply line 4 by the number of months for which this year's payments were made ..... \_\_\_\_\_  
NOTE: If your annuity starting date is **before 1987**, enter the amount from line 5 on line 8 below. Skip lines 6, 7, 10, and 11.
6. Any amounts previously recovered tax free in years after 1986 ..... \_\_\_\_\_
7. Subtract line 6 from line 2 ..... \_\_\_\_\_
8. Enter the smaller of line 5 or line 7 ..... \_\_\_\_\_

9. **Taxable pension for year.**  
Subtract line 8 from line 1. Enter the result, but not less than zero. Also add this amount to the total for Form 1040, line 16b, or Form 1040A, line 11b ..... \$ \_\_\_\_\_  
NOTE: If your Form 1099–R shows a larger taxable amount, use the amount on line 9 instead.
10. Add lines 6 and 8..... \_\_\_\_\_
11. Balance of cost to be recovered.  
Subtract line 10 from line 2 ..... \$ \_\_\_\_\_

**Death benefit exclusion.** If you are a beneficiary of a deceased employee (or former employee), who died before August 21, 1996, you may qualify for a death benefit exclusion of up to \$5,000. This exclusion is discussed later in this chapter.

If you choose the Simplified General Rule and you qualify for the death benefit exclusion, increase your cost in the pension or annuity plan by the allowable death benefit exclusion. Your cost is on line 2 of the worksheet.

The payer of the annuity does not add the death benefit exclusion to the cost for figuring the nontaxable and taxable part of payments reported on Form 1099–R. Therefore, the Form 1099–R taxable amount will be larger than the amount you will figure for yourself. Report on your return the smaller amount that you figure. Keep a copy of the completed worksheet for your records until you fully recover the cost in the pension or annuity plan.

**Example.** Diane Greene, age 48, began receiving a \$1,500 monthly annuity in March 1996 upon the death of her husband. She received 10 payments in 1996. Her husband had contributed \$25,000 to his qualified employee plan. Diane is entitled to a \$5,000 death benefit exclusion because her husband died before August 21, 1996. She adds that amount to her husband's contributions to the plan, increasing her total cost in the plan to \$30,000.

Diane chooses to use the Simplified General Rule. She fills out the worksheet as follows:

**Worksheet A—Simplified General Rule**

1. Total pension received this year.  
Also add this amount to the total for Form 1040, line 16a, or Form 1040A, line 11a ..... \$15,000
2. Your cost in the plan (contract) at annuity starting date, (**before November 19, 1996**), plus any death benefit exclusion ..... 30,000  
Age at annuity starting
3. date: \_\_\_\_\_ Enter: \_\_\_\_\_  
55 and under 300  
56 – 60 260  
61 – 65 240  
66 – 70 170  
71 and over 120 \_\_\_\_\_
4. Divide line 2 by line 3..... 100

5. Multiply line 4 by the number of months for which this year's payments were made .....	1,000
NOTE: If your annuity starting date is <b>before 1987</b> , enter the amount from line 5 on line 8 below. Skip lines 6, 7, 10, and 11.	
6. Any amounts previously recovered tax free in years after 1986 .....	0
7. Subtract line 6 from line 2 .....	30,000
8. Enter the smaller of line 5 or line 7 .....	1,000
<b>9. Taxable pension for year.</b>	
Subtract line 8 from line 1. Enter the result, but not less than zero. Also add this amount to the total for Form 1040, line 16b, or Form 1040A, line 11b .....	
	<u>\$14,000</u>
NOTE: If your Form 1099-R shows a larger taxable amount, use the amount on line 9 instead.	
10. Add lines 6 and 8 .....	1,000
<b>11. Balance of cost to be recovered.</b>	
Subtract line 10 from line 2 .....	<u>\$29,000</u>

In completing Form 1099-R, the payer of the annuity chooses to report the taxable part of the annuity payments using the Simplified General Rule. However, since the payer does not adjust the investment in the contract by the death benefit exclusion, the payer figures the tax-free part of each monthly payment to be \$83.33, based on a total investment of \$25,000.

However, Diane figures a \$100 monthly tax-free amount (see line 4 of the worksheet). Because of this difference in the computations, the Form 1099-R given by the payer shows a greater taxable amount than what she figures for herself. She reports on line 16b of Form 1040 only the smaller taxable amount based on her own computation. She keeps a copy of the worksheet for her records.

## General Rule

You must use the General Rule to figure the taxability of your pension or annuity if your annuity starting date is after July 1, 1986 (but before November 19, 1996), and you do not qualify for, or you do not choose, the Simplified General Rule (explained earlier).

 **If your annuity starting date is after November 18, 1996, you generally cannot use the General Rule for annuity payments from a qualified plan. Non-qualified plans and certain annuitants age 75 or over must use the General Rule.**

You must also use the General Rule if your annuity starting date was before July 2, 1986, and you did not qualify to use the Three-Year Rule. (The Three-Year Rule was repealed.)

Under the General Rule, you exclude a part of each payment from your income because it is considered a return of your cost. The remainder of each payment (including the full amount of any later cost-of-living increases) is taxable. Finding the tax-free part

is very complex and requires you to use actuarial tables. For a full explanation and the tables you need, get Publication 939, *Pension General Rule (Nonsimplified Method)*.

The tax-free amount remains the same even if the total payment increases. If your annuity starting date was before 1987, you can continue to exclude the same part of each annuity payment from your income, for as long as you receive your annuity. If your annuity starting date is after 1986, your total exclusion over the years cannot be more than your cost of the contract reduced by the value of any refund feature.

If the annuity starting date of the annuitant is after July 1, 1986, and the annuitant (or a survivor annuitant) dies before the total cost is recovered, a miscellaneous itemized deduction is allowed for the unrecovered cost on the final income tax return of the decedent (or his or her survivor). The deduction is not subject to the 2%-of-adjusted-gross-income limit.

## Survivors

If you receive a survivor annuity because of the death of a retiree who had reported the annuity under the **Three-Year Rule**, include the total received in income. (The retiree's cost has already been recovered tax free.)

If the retiree was reporting the annuity payments under the **General Rule**, apply the same exclusion percentage the retiree used to your initial payment called for in the contract. The resulting tax-free amount will then remain fixed. Any increases in the survivor annuity are fully taxable.

If the retiree was able to use the **Simplified General Rule**, the monthly tax-free amount remains fixed. Continue to use the same monthly tax-free amount for your survivor payments. See *Simplified General Rule*, earlier.

In both cases, if the annuity starting date is after 1986, the total exclusion over the years cannot be more than the cost.

If you are the survivor of an employee, or former employee, who died before becoming entitled to any annuity payments, you must figure the taxable and tax-free parts of your annuity payments. You may qualify to add up to \$5,000 to the decedent's cost to be recovered tax free.

 **If you are the beneficiary of an employee who died after August 20, 1996, you are not eligible for the \$5,000 death benefit exclusion.**

This **death benefit exclusion** is treated as an addition to the cost of the annuity. See *Death benefit exclusion*, earlier, under *Simplified General Rule*.

**Estate tax.** If your annuity was a joint and survivor annuity that was included in the decedent's estate, an estate tax may have been paid on it. You can deduct, as a miscellaneous itemized deduction, the part of the total estate tax that was based on the annuity. This deduction is not subject to the 2%-of-adjusted-gross-income limit. The deceased annuitant must have died after the

annuity starting date. This amount cannot be deducted in one year. It must be deducted in equal amounts over your remaining life expectancy.

## How To Report

If you file Form 1040, report your total annuity on line 16a and the taxable part on line 16b. If your pension or annuity is fully taxable, enter it on line 16b; do not make an entry on line 16a.

If you file Form 1040A, report your total annuity on line 11a and the taxable part on line 11b. If your pension or annuity is fully taxable, enter it on line 11b; do not make an entry on line 11a.

**More than one annuity.** If you receive more than one annuity and at least one of them is not fully taxable, enter the total amount received from **all** annuities on line 16a, Form 1040, or line 11a, Form 1040A, and enter the taxable part on line 16b, Form 1040, or line 11b, Form 1040A. If all the annuities you receive are fully taxable, enter the total of all of them on line 16b, Form 1040, or line 11b, Form 1040A.

**Joint return.** If you file a joint return and you and your spouse each receive one or more pensions or annuities, report the total of the pensions and annuities on line 16a, Form 1040, or line 11a, Form 1040A, and report the taxable part on line 16b, Form 1040, or line 11b, Form 1040A.

## Death Benefit Exclusion

If you are the beneficiary of a deceased employee (or former employee), who died before August 21, 1996, the pension or annuity you get because of that person's death may qualify for a death benefit exclusion. This exclusion cannot be more than \$5,000.

 **If you are the beneficiary of an employee who died after August 20, 1996, you are not eligible for the \$5,000 death benefit exclusion.**

If you are eligible for the exclusion, add it to the cost or unrecovered cost of the annuity when you figure your cost at the annuity starting date.

If you are the survivor under a joint and survivor annuity, the exclusion applies only if:

- 1) The decedent died before receiving, or becoming entitled to receive, retirement pension or annuity payments, or
- 2) The decedent received disability income payments that were not treated as pension or annuity income (the decedent had not reached minimum retirement age).

For more information, see *Payments to beneficiaries of deceased employees (death benefit exclusion)* under *Life Insurance Proceeds* in Chapter 13, and *Death benefit exclusion* under *Investment in the Contract (Cost)* in Publication 575.

## Lump-Sum Distributions

You may be able to elect optional methods of figuring the tax on lump-sum distributions you receive from a qualified retirement plan (an employer's qualified pension, stock bonus, or profit-sharing plan). A qualified plan is a plan that meets certain requirements of the Internal Revenue Code. For information on a distribution you receive that includes employer securities, see *Distributions of employer securities* under *Lump-Sum Distributions* in Publication 575.

**Distributions that qualify.** A lump-sum distribution is paid within a single tax year. It is the distribution or payment of a plan participant's **entire balance** from all of the employer's qualified plans (i.e., pension, profit-sharing, or stock bonus plans). The participant's entire balance does not include deductible voluntary employee contributions or certain forfeited amounts.

The distribution is paid:

- 1) Because of the plan participant's death,
- 2) After the participant reaches age 59½,
- 3) Because the participant, if an employee, separates from service, or
- 4) After the participant, if a self-employed individual, becomes totally and permanently disabled.

**Tax treatment.** You can recover your **cost** in the lump sum tax free. Also, you may be entitled to special tax treatment for the remaining part of the distribution.

In general, your **cost** consists of:

- 1) The plan participant's total nondeductible contributions to the plan,
- 2) The total of the plan participant's taxable costs of any life insurance contract distributed,
- 3) Any employer contributions that were taxable to the plan participant, and
- 4) Repayments of loans that were taxable to the plan participant.

You must reduce this cost by amounts previously distributed tax free.

**Capital gain treatment.** Only a plan participant, who was born before 1936 can elect to treat a portion of the taxable part of a lump-sum distribution as a capital gain that is taxable at a 20% (.20) rate. This treatment applies to the portion you receive for the participation in the plan before 1974. You can elect this treatment only once for any plan participant. Use Form 4972, *Tax on Lump-Sum Distributions*, to make this choice.

**5- or 10-year tax option.** If the plan participant was born before 1936, you can elect to use the 5- or 10-year option to compute the tax on the ordinary income portion of the distribution. (This also includes the capital gain portion of the distribution if you do not elect the capital gain treatment for it.) To qualify, you must elect to use the 5- or 10-year tax option for all lump-sum distributions received in the tax year.



*You may be able to figure the tax on a lump-sum distribution under the 5-year tax option even if the plan participant was born after 1935. You can do this only if the distribution is made on or after the date the participant reached age 59½ and the distribution otherwise qualifies.*

To qualify for the 5- or 10-year option for a distribution you receive for your own participation in the retirement plan, you must have been a participant in the plan for at least 5 full tax years. You can only make one lifetime election to use this option for any plan participant.

If you choose the 5-year tax option, you figure your tax, using Form 4972, as though the distribution were received over 5 years.

However, if you choose the 10-year tax option, you can instead treat the distribution as though it were received over 10 years using special tax rates. Form 4972 shows how to make this computation. The Form 4972 Instructions contain a special tax rate schedule that you must use in making the 10-year tax option computation. Publication 575 illustrates how to complete Form 4972 to figure the separate tax.

**Form 1099-R.** If you receive a total distribution from a plan, you should receive a Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.* If the distribution qualifies as a lump-sum distribution, box 3 shows the capital gain, and box 2a minus box 3 is the ordinary income. If you do not get a Form 1099-R, or if you have questions about it, contact your plan administrator.

## Rollovers

Generally, a rollover is a tax-free distribution to you of cash or other assets from a qualified retirement plan that you transfer to an **eligible retirement plan**. However, see *Direct rollover option*, later.

An eligible retirement plan is an IRA, a qualified employee retirement plan, or a qualified annuity plan. See Chapter 18 for information on rollovers from IRAs.

In general, the most you can roll over is the part that would be taxable if you did not roll it over. You cannot roll over your contributions, other than your deductible employee contributions. You do not pay tax on the amount that you roll over. This amount, however, is generally taxable later when it is paid to you or your survivor.

You must complete the rollover by the 60th day following the day on which you receive the distribution. (This 60-day period is extended for the period during which the distribution is in a frozen deposit in a financial institution.) For all rollovers to an individual retirement arrangement (IRA), you must irrevocably elect rollover treatment by written notice to the trustee or issuer of the IRA.

**Eligible rollover distributions.** Generally, you can roll over any part of the taxable portion of most nonperiodic distributions from a

qualified retirement plan, unless it is a required minimum distribution.

**Direct rollover option.** You can choose to have the administrator of your old plan transfer the distribution directly from your old plan to the new plan (if permitted) or IRA. If you decide on a rollover, it is generally to your advantage to choose this direct rollover option. Under this option, the plan administrator would not withhold tax from your distribution.

**Withholding tax.** If you choose to have the distribution paid to you, it is taxable in the year distributed unless you roll it over to a new plan or IRA within 60 days. The plan administrator must withhold income tax of 20% from the taxable distribution paid to you. (See *Pensions and Annuities* under *Withholding* in Chapter 5.) This means that, if you decide to roll over an amount equal to the distribution before withholding, your contribution to the new plan or IRA must include other money (for example, from savings or amounts borrowed) to replace the amount withheld. The administrator should give you a written explanation of your distribution options within a reasonable period of time before making an eligible rollover distribution.

**Deductible voluntary employee contributions.** If you receive an eligible rollover distribution from your employer's qualified plan of part of the balance of your accumulated deductible voluntary employee contributions, you can roll over tax free any part of this distribution. The rollover can be either to an IRA or to certain other qualified plans.

**Rollover by surviving spouse or other beneficiary.** You may be entitled to roll over into an IRA part or all of a retirement plan distribution you receive as the surviving spouse of a deceased employee. The rollover rules apply to you as if you were the employee. However, you cannot roll it over to another qualified retirement plan.

A beneficiary other than the employee's surviving spouse cannot roll over a distribution.

**Alternate payee under qualified domestic relations order.** You may be able to roll over all or any part of a distribution from a qualified employer plan that you receive under a qualified domestic relations order (QDRO). If you receive the distribution as an employee's spouse or former spouse under a QDRO, the rollover rules apply to you (the alternate payee) as if you were the employee. You can rollover the distribution from the plan into an IRA or to another eligible retirement plan. See Publication 575 for more information on benefits received under a QDRO.

**Bond purchase plans.** The Department of the Treasury stopped issuing U.S. Retirement Plan Bonds after April 30, 1982. They

are a special series of interest-bearing bonds that retirement plans could buy.

If you redeem a retirement bond, you can defer the tax on the amount received by rolling it over to an IRA as discussed under *Roll-overs* in Chapter 18.

**For more information** on the rules for rolling over distributions, see Publication 575.

## Tax on Early Distributions

Distributions you receive from your **qualified retirement plan or deferred annuity contract** before you reach age 59½ (and amounts you receive when you cash in retirement bonds before you reach age 59½) are usually subject to an additional tax of 10%. The tax applies to the taxable part of the distribution.

For this purpose, a **qualified retirement plan** means:

- 1) A qualified employee retirement plan,
- 2) A qualified annuity plan,
- 3) A tax-sheltered annuity plan for employees of public schools or tax-exempt organizations, or
- 4) An individual retirement arrangement (IRA).

**Exceptions to tax.** The 10% tax does not apply to distributions that are:

- 1) Made to a beneficiary or to the estate of the plan participant or annuity holder on or after his or her death,
- 2) Made because you are totally and permanently disabled,
- 3) Made as part of a series of substantially equal periodic (at least annual) payments over your life expectancy or the joint life expectancy of you and your beneficiary (if from a qualified employee plan, payments must begin after separation from service),
- 4) Made to you after you separated from service if the separation occurred during or after the calendar year in which you reached age 55,
- 5) Not more than your deductible medical expense (the medical expense that exceeds 7.5% of your adjusted gross income) whether or not you itemize deductions for the tax year,
- 6) Paid to alternate payees under qualified domestic relations orders,
- 7) Made to you if, as of March 1, 1986, you separated from service and began receiving benefits from the qualified plan under a written election designating a specific schedule of benefit payments,
- 8) Made to you to correct excess deferrals, excess contributions, or excess aggregate contributions,
- 9) Allocable to investment in a deferred annuity contract before August 14, 1982,
- 10) From an annuity contract under a qualified personal injury settlement,

- 11) Made under an immediate annuity contract, or
- 12) Made from a deferred annuity contract purchased by your employer upon the termination of a qualified employee retirement plan or qualified annuity that is held by your employer until you separate from the service of the employer.

Only exceptions (1) through (3) apply to distributions from IRAs. Exceptions (4) through (8) apply only to distributions from qualified employee plans. Exceptions (9) through (12) apply only to distributions from deferred annuity contracts not purchased by qualified employer plans.

**Reporting tax or exception.** If distribution code 1 is shown in box 7 of Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.*, multiply the taxable part of the early distribution by 10% and enter the result on line 48 of Form 1040 and write "No" on the dotted line. You do not have to file Form 5329, *Additional Taxes Attributable to Qualified Retirement Plans (Including IRAs), Annuities, and Modified Endowment Contracts*.

However, if you owe this tax and also owe any other additional tax on a distribution, you must file Form 5329 to report the taxes.

You do not have to file Form 5329 if you qualify for an exception to the 10% tax and distribution code 2, 3, or 4 is shown in box 7 of Form 1099-R. However, you must file Form 5329 if the code is not shown or the code shown is incorrect (e.g., code 1 is shown although you meet an exception).

## Tax on Excess Distributions

If you received **retirement distributions** in excess of \$155,000 during the calendar year, you are subject to an additional 15% excise tax on the amount over \$155,000. The 15% tax is offset by any 10% early distribution tax that applies to the excess distribution. (See the preceding discussion.)

**Retirement distributions** means distributions from qualified employee retirement plans, qualified annuity plans, tax-sheltered annuities, and individual retirement arrangements (IRAs).

**TIP** You will not be subject to this additional 15% tax if you receive the **retirement distributions** after December 31, 1996 (and before the year 2000).

**Exceptions to tax.** The 15% tax on excess distributions does not apply to the following distributions:

- 1) Distributions after death,
- 2) Distributions paid to your spouse or former spouse under a qualified domestic relations order (QDRO) that are taxable to the payee (the distributions are included in determining your spouse's or former spouse's excess distributions),

- 3) Distributions based on the employee's investment in the contract,
- 4) Distributions to the extent rolled over,
- 5) Retirement distributions of annuity contracts, the value of which is not taxable at the time of the distribution (other than distributions under, or proceeds from the sale or exchange of, such contracts),
- 6) Retirement distributions of excess deferrals (and income allocable to them), and
- 7) Retirement distributions of excess contributions (and income allocable to them) under section 401(k) plans or IRAs, or excess aggregate contributions (and income on them) under qualified plans. (The aggregate contributions relate to highly compensated employees and the plan will figure the excess.)

**Combining distributions.** If distributions for you are made to you and others, you must combine the distributions in figuring the amount of excess distributions for the year.

**Lump-sum distributions.** A different limit applies to a lump-sum distribution for which you elect to use the 5- or 10-year tax option or capital gain treatment. The threshold amount of \$155,000 increases five times to \$775,000 for lump-sum distributions. You must figure a separate tax on the lump-sum distribution over \$775,000.

**Special grandfather election.** If you made a special "grandfather election" on your 1987 or 1988 return, you can exclude from the amount subject to the tax a pro-rated part of a distribution that is related to your accrued benefits on August 1, 1986. To have made this special choice, your accrued benefit as of August 1, 1986, must have exceeded \$562,500. For more information, see the instructions for Part IV of Form 5329.

**Form 5329.** You must file a Form 5329 if you receive excess distributions from a qualified retirement plan, whether or not you owe the 15% tax.

## Tax for Failure to Make Minimum Distribution

For years beginning before 1997, your qualified retirement plan must distribute to you your entire interest in the plan, or begin to make minimum distributions to you, by April 1 of the year following the calendar year in which you reach age 70½. It does not matter whether you have retired.

**TIP** Beginning in 1997, this rule will take into account whether you have retired. New law modifies the definition of the required beginning date that is used to figure the minimum required distribution from qualified retirement plans. Under the new law, the required beginning date of a participant who is still employed after age 70½ is April 1 of the calendar year that follows the calendar year in which he or she retires. The new law does not apply to IRAs.

This rule applies to qualified employee retirement plans, qualified annuity plans, deferred compensation plans under section 457, tax-sheltered annuity programs (for benefits accruing after 1986), and IRAs.

You reach age 70½ on the date that is 6 calendar months after the date of your 70th birthday. For example, if your 70th birthday was on July 1, 1995, you were age 70½ on January 1, 1996. Your required beginning date is April 1, 1997. If your 70th birthday was on June 30, 1995, you were age 70½ on December 30, 1995, and your required beginning date was April 1, 1996.

**Exceptions.** The above rule does not apply to governmental plans or church plans. Nor does it apply to any individual (unless a 5% owner) who reached age 70½ before 1988.

In these cases, distributions must begin no later than April 1 of the calendar year following the later of:

- 1) The calendar year in which you reach age 70½, or
- 2) The calendar year in which you retire.

**5% owners.** If you are a 5% (or more) owner of the company maintaining the plan, distributions to you must begin by April 1 of the calendar year after the year in which you reach 70½, regardless of when you retire.

**Minimum distributions.** These are regular periodic distributions that are large enough to use up the entire interest over your life expectancy or over the joint life expectancies of you and a designated surviving beneficiary (or over a shorter period).

**Additional information.** For more information on this rule and how to figure the required amount to be distributed, see *Tax on Excess Accumulation* in Publication 575.

**Tax on failure to distribute.** If you do not receive these required minimum distributions, you, as the payee, are subject to an additional excise tax. The tax equals 50% of the difference between the amount that must be distributed and the amount that was distributed during the tax year. You can get this excise tax excused if you establish that the shortfall in distributions was due to reasonable error and that you are taking reasonable steps to remedy the shortfall.

**State insurer delinquency proceedings.** You might not receive the minimum distribution because of state insurer delinquency proceedings for an insurance company. If your payments are reduced below the minimum due to these proceedings, you should contact your plan administrator. Under certain conditions, you will not have to pay the excise tax.

**Form 5329.** You must file a Form 5329 if you owe a tax because you did not receive a minimum required distribution from your qualified retirement plan.

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## Disability Income

Generally, if you retire on disability, you must report your pension or annuity as income.

If you were 65 or older at the end of the tax year, or if you were under 65, retired on permanent and total disability, and you received taxable disability income, you may be able to claim the credit for the elderly or the disabled. See Chapter 34 for more information about the credit.

**How to report.** You must report all your taxable disability income on line 7, Form 1040, or line 7, Form 1040A, until you reach minimum retirement age.

If you made contributions to your pension or annuity plan, your payments are taxable under the rules discussed earlier, beginning with the day after you reach **minimum retirement age**.

Generally, minimum retirement age is the age at which you would have first received a pension or annuity were you not disabled.

For more information on how to report disability pensions, including military and certain government disability pensions, see Chapter 6.

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## Purchased Annuities

If you privately purchased an annuity contract from a commercial organization, such as an insurance company, you must use the General Rule to figure the tax-free part of each annuity payment. For more information, get Publication 939, *Pension General Rule (Nonsimplified Method)*.

**Sale of annuity.** Gain on the sale of an annuity contract before its maturity date is ordinary income to the extent that the gain is due to interest accumulated on the contract. You do not recognize gain or loss on an exchange of an annuity contract solely for another annuity contract.

See *Transfers of Annuity Contracts* in Publication 575 for more information about exchanges of annuity contracts.

# Social Security and Equivalent Railroad Retirement Benefits

## Introduction

This chapter discusses the taxability of any social security or equivalent tier 1 railroad retirement benefits you may have received. It also explains:

- How to figure whether your benefits are taxable,
- How to use the social security benefits worksheet,
- How to report your taxable benefits on Form 1040 and Form 1040A (with examples), and
- How to treat repayments that are more than the benefits you received during the year.

When the term “benefits” is used in this chapter, it applies to both social security benefits and equivalent tier 1 railroad retirement benefits. Social security benefits include survivor and disability benefits. They do not include supplemental security income (SSI) payments, which are not taxable. Equivalent tier 1 railroad retirement benefits are the part of tier 1 benefits equal to the social security benefits that a railroad employee or beneficiary would have been entitled to receive if the employee’s service had been covered under the social security system rather than the railroad retirement system.

If you received these benefits during 1996, you should have received a Form SSA-1099 or Form RRB-1099 (Form SSA-1042S for Form RRB-1042S if you are a nonresident alien) showing the amount.

**What is not discussed.** This chapter does not discuss the tax rules for railroad retirement benefits other than the social security equivalent benefit portion of tier 1 benefits (including special guaranty benefits). The tax rules for the non-social security equivalent benefit portion of tier 1 benefits, tier 2 benefits, vested dual benefits, and supplemental annuity benefits, are discussed in Publication 575, *Pension and Annuity Income (Including Simplified General Rule)*.

The tax rules for foreign social security benefits also are not discussed in this chapter. These benefits are taxable as an annuity unless exempt from U.S. tax under a treaty.

## Useful Items

You may want to see:

### Publication

- 575** Pension and Annuity Income (Including Simplified General Rule)
- 590** Individual Retirement Arrangements (IRAs)
- 915** Social Security and Equivalent Railroad Retirement Benefits

## Are Any of Your Benefits Taxable?

To find out whether any of your benefits are taxable, compare the **base amount** for your filing status with the total of:

- 1) One-half of your benefits, plus
- 2) All your other income, including tax-exempt interest. (Do not reduce your income by any exclusions for interest from Series EE U.S. savings bonds, for foreign earned income or foreign housing, or for income earned in American Samoa or Puerto Rico by bona fide residents.)

Use the worksheet later in this discussion to figure this total income. If the total income is more than your base amount, part of your benefits is taxable.



*If the only income you received during 1996 was your social security or equivalent tier 1 railroad retirement benefits, your benefits generally are not taxable and you probably do not have to file a return. If you have income in addition to your benefits, you may have to file a return even if none of your benefits are taxable.*

If you are married and file a joint return for 1996, you and your spouse must combine your incomes and your benefits when figuring if any of your combined benefits are taxable. Even if your spouse did not receive any benefits, you must add your spouse’s income to yours when figuring if any of your benefits are taxable.

**Base amount.** Your base amount is:

- \$25,000 if you are single, head of household, or qualifying widow(er),
- \$25,000 if you are married filing separately and **lived apart** from your spouse for **all** of 1996,
- \$32,000 if you are married filing jointly, or
- \$-0- if you are married filing separately and **lived with** your spouse at any time during 1996.

**Who is taxed.** The person who has the legal right to receive the benefits must determine if the benefits are taxable. For example, if you and your child receive benefits, but the check for your child is made out in your

name, you must use only your portion of the benefits in figuring if any part is taxable to you. The portion of the benefits that belongs to your child must be added to your child’s other income to see if any of those benefits are taxable.

**Repayments.** Any repayment of benefits you made during 1996 is automatically subtracted from the gross benefits you received in 1996. It does not matter if the repayment was for a benefit you received in an earlier year. If you repaid more than the gross benefits you received in 1996, see *Repayments More Than Gross Benefits*, later. Your gross benefits are shown in box 3 of Form SSA-1099 or RRB-1099 and your repayments are shown in box 4. The amount in box 5 shows your net benefits for 1996 (box 3 minus box 4). Use the amount in box 5 to figure if any of your benefits are taxable.

**Reporting your benefits.** If part of your benefits is taxable, you must use Form 1040 or 1040A. You cannot use Form 1040EZ.

On Form 1040, report your net benefits (the amount in box 5 of your Form SSA-1099 or RRB-1099) on line 20a. Report the taxable part on line 20b. On Form 1040A, report your net benefits on line 13a and the taxable part on line 13b.

Also, if you are married filing separately and you lived apart from your spouse for all of 1996, make the following entries. On Form 1040, enter “D” to the left of line 20a. On Form 1040A, enter “D” to the left of line 13a.

**If none of your benefits are taxable,** do not report any of them on your tax return. But if you are married filing separately and you lived apart from your spouse for all of 1996, make the following entries. On Form 1040 enter “D” to the left of line 20a and “-0-” on line 20b. On Form 1040A, enter “D” to the left of line 13a and “-0-” on line 13b.

**Worksheet.** You can use the following worksheet to figure whether your income plus half your benefits is more than your base amount.

- A. Write in the amount from **box 5** of all your Forms SSA-1099 and RRB-1099. Include the full amount of any lump-sum benefit payments received in 1996, for 1996 and earlier years, if you choose to report the full amount for the 1996 tax year. (If you received more than one form, combine the amounts from box 5 and write in the total.) ..... A. \_\_\_\_\_

**Note:** If the amount on line A is zero or less, stop here; none of your benefits are taxable this year.

- B. Enter one-half of the amount on line A ..... B. \_\_\_\_\_

- C. Add your taxable pensions, wages, interest, dividends, and other taxable income and write in the total ..... C. \_\_\_\_\_
- D. Write in any tax-exempt interest income (such as interest on municipal bonds) plus exclusions from income (such as Series EE U.S. Savings Bond interest exclusion) ..... D. \_\_\_\_\_
- E. Add lines B, C, and D and write in the total ..... E. \_\_\_\_\_

**Note.** Compare the amount on line E to your **base amount** for your filing status. If the amount on line E is less than the base amount for your filing status, none of your benefits are taxable this year. If the amount on line E is more than your **base amount**, some of your benefits are taxable.

**Example.** You and your spouse are filing a joint return for 1996, and you both received social security benefits during the year. In January 1997, you received a Form SSA-1099 showing net benefits of \$6,600 in box 5. Your spouse received a Form SSA-1099 showing net benefits of \$2,400 in box 5. You also received a taxable pension of \$10,000 and interest income of \$500. You did not have any tax-exempt interest income. Your benefits are not taxable for 1996 because your income, as figured in the following worksheet, is not more than your base amount (\$32,000).

- A. Write in the amount from **box 5** of all your Forms SSA-1099 and RRB-1099. Include the full amount of any lump-sum benefit payments received in 1996, for 1996 and earlier years, if you choose to report the full amount for the 1996 tax year. (If you received more than one form, combine the amounts from box 5 and write in the total.) ..... A. \$ 9,000

**Note:** If the amount on line A is zero or less, stop here; none of your benefits are taxable this year.

- B. Enter one-half of the amount on line A ..... B. 4,500
- C. Add your taxable pensions, wages, interest, dividends, and other taxable income and write in the total ..... C. 10,500
- D. Write in any tax-exempt interest income (such as interest on municipal bonds) plus any exclusions from income (such as Series EE U.S. Savings Bond interest exclusion) ..... D. -0-

- E. Add lines B, C, and D and write in the total ..... E. \$15,000

**Note.** Compare the amount on line E to your **base amount** for your filing status. If the amount on line E is less than the base amount for your filing status, none of your benefits are taxable this year. If the amount on line E is more than your **base amount**, some of your benefits are taxable.

## How Much Is Taxable?

If part of your benefits is taxable, how much is taxable depends on the total amount of your benefits and other income. Generally, the higher that total amount, the greater the taxable part of your benefits.

**Maximum taxable part.** The taxable part of your benefits usually cannot be more than 50%. However, up to 85% of your benefits may be taxable, but only if one of the following situations applies to you.

- 1) The total of one-half of your benefits and all your other income is more than \$34,000 (\$44,000 if you are married filing jointly), or
- 2) You are married filing separately and **lived with your spouse** at any time during 1996.

**Which worksheet to use.** A worksheet to figure your taxable benefits is in the instructions for your tax form. You can use either that worksheet or Worksheet 1 in this chapter (or Publication 915), unless one of the following situations applies to you.

- 1) You contributed to an individual retirement arrangement (IRA) and your IRA deduction is limited because you or your spouse is covered by a retirement plan at work—In this situation, you **must** use the special worksheets in Appendix B of Publication 590 to figure both your IRA deduction and your taxable benefits.
- 2) You exclude interest from Series EE U.S. savings bonds ( Form 8815) or take an exclusion for foreign earned income or housing (Form 2555 or Form 2555-EZ) or for income earned in American Samoa ( Form 4563) or Puerto Rico by bona fide residents—In this situation, you **must** use Worksheet 1 in this chapter (or Publication 915) to figure your taxable benefits.
- 3) You receive a lump-sum payment for an earlier year—In this situation, also complete Worksheet 2 or 3 and Worksheet 4 in Publication 915. See *Lump-Sum Election*.

**Lump-Sum Election.** You must include the taxable part of a lump-sum (retroactive) payment of benefits received in 1996 in your 1996 income, even if the payment includes benefits for an earlier year. Generally, you use your 1996 income to figure the taxable

part of the entire amount of benefits received in 1996.

However, if your taxable benefits would be less, you can choose to figure the taxable part of benefits received in 1996 for an earlier year as if they had been received in the earlier year. This method uses the earlier year's income to figure the taxable amount. You add the taxable part of those benefits to your taxable benefits for 1996 and include the total in your 1996 income.

**Making the election.** If you received a lump-sum benefit payment in 1996 that includes benefits for one or more earlier years, follow the instruction in Publication 915 under *Lump-Sum Election* to see whether making the election will lower your taxable benefits. That discussion also explains how to make the election.

## Examples

Following are a few examples you can use as a guide to figure the taxable part of your benefits.

**Example 1.** George White is single and files Form 1040 for 1996. He received the following income in 1996:

Fully taxable pension .....	\$18,600
Wages from part-time job .....	9,400
Interest income .....	990
Total .....	<u>\$28,990</u>

George also received social security benefits during 1996. The Form SSA-1099 he received in January 1997 shows \$5,980 in box 5. To figure his taxable benefits, George completes the worksheet shown here.

### Worksheet 1. Social Security and Equivalent Railroad Retirement Benefits

1. Enter the total amount from **box 5** of **ALL** your Forms SSA-1099 and RRB-1099 ..... 5,980

**Note.** If line 1 is zero or less, stop here; none of your benefits are taxable. Otherwise, go to line 2.

2. Enter one-half of line 1 ..... 2,990
3. Enter the total of the amounts from:  
 Form 1040: Lines 7, 8a, 8b, 9-14, 15b, 16b, 17-19, and 21.  
 Form 1040A: lines 7, 8a, 8b, 9, 10b, 11b, and 12 ..... 28,990
4. Form 1040A filers: Enter any exclusion for Series EE U.S. savings bond interest (Form 8815, line 14).

Form 1040 filers: Enter the total of any exclusions/adjustments for:

- Series EE U.S. savings bond interest (Form 8815, line 14),
- Foreign earned income or housing (Form 2555, lines 43 and 48, or Form 2555-EZ, line 18),
- Certain income of bona fide residents of American Samoa (Form 4563, line 15) or Puerto Rico

5. Add lines 2, 3, and 4	31,980
6. Enter the amount from Form 1040, line 30 or from Form 1040A, line 15c	-0-
7. Subtract line 6 from line 5	31,980
8. Enter \$25,000 (\$32,000 if married filing jointly; \$0 if married filing separately and you lived with your spouse at any time during 1996)	25,000
9. Subtract line 8 from line 7. If zero or less, enter -0-	6,980

**Note.** If line 9 is zero or less, stop here; none of your benefits are taxable. (Do not enter any amounts on Form 1040, line 20a or 20b or on Form 1040A, line 13a or 13b. But if you are married filing separately and you lived apart from your spouse for all of 1996, enter "D" to the left of line 20a, Form 1040, or line 13a, Form 1040A. Also enter -0- on Form 1040, line 20b or on Form 1040A, line 13b.) Otherwise, go on to line 10.

10. Enter \$9,000 (\$12,000 if married filing jointly; \$0 if married filing separately and you lived with your spouse at any time in 1996)	9,000
11. Subtract line 10 from line 9. If zero or less, enter -0-	-0-
12. Enter the smaller of line 9 or line 10	6,980
13. Enter one-half of line 12	3,490
14. Enter the smaller of line 2 or line 13	2,990
15. Multiply line 11 by 85% (.85). If line 11 is zero, enter -0-	-0-
16. Add lines 14 and 15	2,990
17. Multiply line 1 by 85% (.85)	5,083
18. Taxable benefits. Enter the smaller of line 16 or line 17	2,990

- Enter the amount from line 1 above on Form 1040, line 20a or on Form 1040A, line 13a.
- Enter the amount from line 18 above on Form 1040, line 20b or on Form 1040A, line 13b

The amount on line 18 of George's worksheet shows that \$2,990 of his social security benefits is taxable. On line 20a of his Form 1040, George enters his net benefits of \$5,980. On line 20b, he enters his taxable part of \$2,990.

**Example 2.** Ray and Alice Hopkins file a joint return on Form 1040A for 1996. Ray is retired and receives a fully taxable pension of \$15,500. Ray also receives social security benefits and his Form SSA-1099 for 1996 shows net benefits of \$5,600 in box 5. Alice

worked during the year and had wages of \$14,000. She made a deductible payment to her IRA account of \$1,000. Ray and Alice have two savings accounts. The Forms 1099-INT they received showed they had a total of \$250 in interest income. They complete Worksheet 1 and find that none of Ray's social security benefits are taxable. They leave lines 13a and 13b of their Form 1040A blank.

**Worksheet 1. Social Security and Equivalent Railroad Retirement Benefits**

1. Enter the total amount from box 5 of ALL your Forms SSA-1099 and RRB-1099	5,600
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**Note.** If line 1 is zero or less, stop here; none of your benefits are taxable. Otherwise, go to line 2.

2. Enter one-half of line 1	2,800
3. Enter the total of the amounts from: Form 1040: Lines 7, 8a, 8b, 9-14, 15b, 16b, 17-19, and 21. Form 1040A: lines 7, 8a, 8b, 9, 10b, 11b, and 12	29,750
4. Form 1040A filers: Enter any exclusion for Series EE U.S. savings bond interest (Form 8815, line 14). Form 1040 filers: Enter the total of any exclusions/adjustments for: • Series EE U.S. savings bond interest (Form 8815, line 14), • Foreign earned income or housing (Form 2555, lines 43 and 48, or Form 2555-EZ, line 18), and • Certain income of bona fide residents of American Samoa (Form 4563, line 15) or Puerto Rico	-0-
5. Add lines 2, 3, and 4	32,550
6. Enter the amount from Form 1040, line 30 or from Form 1040A, line 15c	1,000
7. Subtract line 6 from line 5	31,550
8. Enter \$25,000 (\$32,000 if married filing jointly; \$0 if married filing separately and you lived with your spouse at any time during 1996)	32,000
9. Subtract line 8 from line 7. If zero or less, enter -0-	-0-

**Note.** If line 9 is zero or less, stop here; none of your benefits are taxable. (Do not enter any amounts on Form 1040, line 20a or 20b or on Form 1040A, line 13a or 13b. But if you are married filing separately and you lived apart from your spouse for all of 1996, enter "D" to the left of line 20a, Form 1040, or line 13a, Form 1040A. Also enter -0- on Form 1040, line 20b or on Form 1040A, line 13b.) Otherwise, go on to line 10.

10. Enter \$9,000 (\$12,000 if married filing jointly; \$0 if married filing separately and you lived with your spouse at any time in 1996)	9,000
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11. Subtract line 10 from line 9. If zero or less, enter -0-	-0-
12. Enter the smaller of line 9 or line 10	6,980
13. Enter one-half of line 12	3,490
14. Enter the smaller of line 2 or line 13	2,990
15. Multiply line 11 by 85% (.85). If line 11 is zero, enter -0-	-0-
16. Add lines 14 and 15	2,990
17. Multiply line 1 by 85% (.85)	5,083
18. Taxable benefits. Enter the smaller of line 16 or line 17	2,990

- Enter the amount from line 1 above on Form 1040, line 20a or on Form 1040A, line 13a.
- Enter the amount from line 18 above on Form 1040, line 20b or on Form 1040A, line 13b

**Example 3.** Joe and Betty Johnson file a joint return on Form 1040 for 1996. Joe is a retired railroad worker and in 1996 received the social security equivalent portion of tier 1 benefits. Joe's Form RRB-1099 shows \$10,000 in box 5. Betty is a retired government worker and receives a fully taxable pension of \$38,000. They also had \$2,300 in interest income and interest of \$200 on a Series EE U.S. savings bond. Joe and Betty paid qualified higher educational expenses for their dependent daughter and the savings bond interest qualified for exclusion. They figure their taxable benefits by completing Worksheet 1.

**Worksheet 1. Social Security and Equivalent Railroad Retirement Benefits**

1. Enter the total amount from box 5 of ALL your Forms SSA-1099 and RRB-1099	10,000
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**Note.** If line 1 is zero or less, stop here; none of your benefits are taxable. Otherwise, go to line 2.

2. Enter one-half of line 1	5,000
3. Enter the total of the amounts from: Form 1040: Lines 7, 8a, 8b, 9-14, 15b, 16b, 17-19, and 21. Form 1040A: lines 7, 8a, 8b, 9, 10b, 11b, and 12	40,300
4. Form 1040A filers: Enter any exclusion for Series EE U.S. savings bond interest (Form 8815, line 14). Form 1040 filers: Enter the total of any exclusions/adjustments for: • Series EE U.S. savings bond interest (Form 8815, line 14), • Foreign earned income or housing (Form 2555, lines 43 and 48, or Form 2555-EZ, line 18), and • Certain income of bona fide residents of American Samoa (Form 4563, line 15) or Puerto Rico	200
5. Add lines 2, 3, and 4	45,500

6. Enter the amount from Form 1040, line 30 or from Form 1040A, line 15c	-0-
7. Subtract line 6 from line 5	45,500
8. Enter \$25,000 (\$32,000 if married filing jointly; \$0 if married filing separately and you lived with your spouse at any time during 1996)	32,000
9. Subtract line 8 from line 7. If zero or less, enter -0-	13,500
<b>Note.</b> If line 9 is zero or less, stop here; none of your benefits are taxable. (Do not enter any amounts on Form 1040, line 20a or 20b or on Form 1040A, line 13a or 13b. But if you are married filing separately and you lived apart from your spouse for all of 1996, enter "D" to the left of line 20a, Form 1040, or line 13a, Form 1040A. Also enter -0- on Form 1040, line 20b or on Form 1040A, line 13b.) Otherwise, go on to line 10.	
10. Enter \$9,000 (\$12,000 if married filing jointly; \$0 if married filing separately and you lived with your spouse at any time in 1996)	12,000
11. Subtract line 10 from line 9. If zero or less, enter -0-	1,500
12. Enter the smaller of line 9 or line 10	12,000
13. Enter one-half of line 12	6,000
14. Enter the smaller of line 2 or line 13	5,000
15. Multiply line 11 by 85% (.85). If line 11 is zero, enter -0-	1,275
16. Add lines 14 and 15	6,275
17. Multiply line 1 by 85% (.85)	8,500
18. <b>Taxable benefits.</b> Enter the smaller of line 16 or line 17	6,275
<ul style="list-style-type: none"> <li>• Enter the amount from line 1 above on Form 1040, line 20a or on Form 1040A, line 13a.</li> <li>• Enter the amount from line 18 above on Form 1040, line 20b or on Form 1040A, line 13b.</li> </ul>	

## Repayments More Than Gross Benefits

In some situations, your Form SSA-1099 or Form RRB-1099 will show that the total benefits you repaid (box 4) is more than the gross benefits (box 3) you received. If this occurred, your net benefits in box 5 will be a negative figure and none of your benefits will be taxable. If you receive more than one form, a negative figure in box 5 of one form is used to offset a positive figure in box 5 of another form. If you have any questions about this negative figure, contact your local Social Security Administration office or your local U.S. Railroad Retirement Board field office.

**Joint return.** If you and your spouse file a joint return, and your Forms SSA-1099 or RRB-1099 show that your repayments are more than your gross benefits, but your spouse's are not, subtract the amount in box 5 of your form from the amount in box 5 of your spouse's form. You do this to get your net benefits when figuring if your combined benefits are taxable.

**Example.** John and Mary file a joint return for 1996. John received Form SSA-1099 showing \$3,000 in box 5. Mary also received Form SSA-1099 and the amount in box 5 was (\$500). John and Mary will use \$2,500 (\$3,000 minus \$500) as the amount of their net benefits when figuring if any of their combined benefits are taxable.

**Repayment of benefits received in an earlier year.** If the sum of the amount shown in box 5 of all of your Forms SSA-1099 and RRB-1099 is a negative figure, you can take an itemized deduction for the part of this negative figure that represents

benefits you included in gross income in an earlier year.

This deduction, **if \$3,000 or less**, is subject to the 2%-of-adjusted-gross-income limit that applies to certain miscellaneous itemized deductions. Claim it on line 22, Schedule A (Form 1040).

**If this deduction is more than \$3,000**, you should figure your tax two ways:

- 1) Figure your tax for 1996 with the itemized deduction. This more-than-\$3,000 deduction is **not** subject to the 2%-of-adjusted-gross-income limit that applies to certain miscellaneous itemized deductions.
- 2) Figure your tax for 1996 without the itemized deduction. If a portion of the negative figure represents a repayment of 1984 benefits, you must first recompute your 1984 tax, reducing your 1984 social security benefits by that portion. Recompute your 1985, 1986, etc., tax in the same manner, using any portion of the negative figure that represents a repayment of benefits for those years. Reduce your 1996 tax, figured without the deduction, by the total decrease in your 1984, 1985, 1986, etc., tax as recomputed.

Compare the tax figured in methods (1) and (2). Your tax for 1996 is the smaller of the two amounts. If method (1) results in less tax, take the itemized deduction on line 27, Schedule A (Form 1040). If method (2) results in less tax, claim a credit for the applicable amount on line 57 of Form 1040 and write "I.R.C. 1341" in the margin to the left of line 57. If both methods produce the same tax, deduct the repayment in full on line 27, Schedule A (Form 1040).

**Table 12-1. Social Security and Equivalent Railroad Retirement Benefits**

If you are married filing separately and you **lived apart** from your spouse for all of 1996, make the following entries on your return.

- On Form 1040, enter "D" to the left of line 20a.
- On Form 1040A, enter "D" to the left of line 13a.

1. Enter the total amount from box 5 of ALL your Forms SSA-1099 and RRB-1099 .....	1. _____
<b>Note:</b> If line 1 is zero or less, stop here; none of your benefits are taxable. Otherwise, go on to line 2.	
2. Enter one-half of line 1 .....	2. _____
3. Enter the total of the amounts from:	
<b>Form 1040:</b> Lines 7, 8a, 8b, 9-14, 15b, 16b, 17-19, and 21.	
<b>Form 1040A:</b> Lines 7, 8a, 8b, 9, 10b, 11b, and 12. ....	3. _____
4. <b>Form 1040A filers:</b> Enter any exclusion for Series EE U.S. savings bond interest (Form 8815, line 14.)	
<b>Form 1040 filers:</b> Enter the total of any exclusions/adjustments for:	
• Series EE U.S. savings bond interest (Form 8815, line 14),	
• Foreign earned income or housing (Form 2555, lines 43 and 48, or Form 2555-EZ, line 18) and	
• Certain income of bona fide residents of American Samoa (Form 4563, line 15) or Puerto Rico .....	4. _____
5. Add lines 2, 3, and 4 .....	5. _____
6. Enter the amount from Form 1040, line 30 or from Form 1040A, line 15c .....	6. _____
7. Subtract line 6 from line 5 .....	7. _____
8. Enter \$25,000 (\$32,000 if married filing jointly; \$0 if married filing separately and you lived with your spouse at any time during 1996) .....	8. _____
9. Subtract line 8 from line 7. If zero or less, enter -0- .....	9. _____
<b>Note.</b> If line 9 is zero or less, stop here; none of your benefits are taxable. (Do not enter any amounts on Form 1040, line 20a or 20b or on Form 1040A, line 13a or line 13b. But if you are married filing separately and you lived apart from your spouse for all of 1996, enter -0- on Form 1040, line 20b or on Form 1040A, line 13b.) Otherwise, go on to line 10.	
10. Enter \$9,000 (\$12,000 if married filing jointly; \$0 if married filing separately and you lived with your spouse at any time during 1996) .....	10. _____
11. Subtract line 10 from line 9. If zero or less, enter -0- .....	11. _____
12. Enter the <b>smaller</b> of line 9 or line 10 .....	12. _____
13. Enter one-half of line 12 .....	13. _____
14. Enter the <b>smaller</b> of line 2 or line 13 .....	14. _____
15. Multiply line 11 by 85% (.85). If line 11 is zero, enter -0- .....	15. _____
16. Add lines 14 and 15 .....	16. _____
17. Multiply line 1 by 85% (.85) .....	17. _____
18. <b>Taxable benefits.</b> Enter the <b>smaller</b> of line 16 or line 17 .....	18. _____

- Enter the amount from line 1 above on Form 1040, line 20a or on Form 1040A, line 13a.
- Enter the amount from line 18 above on Form 1040, line 20b or on Form 1040A, line 13b.

**Note:** If you received a lump-sum payment in this year that was for an earlier year, also complete Worksheet 2 or 3 and Worksheet 4 in Publication 915, to see whether you can report a lower taxable benefit.

## Other Income

### Important Changes for 1996

**Death benefit exclusion repealed.** The exclusion from gross income for the first \$5,000 of employer-provided death benefits is repealed for payments received for decedents dying after August 20, 1996. See *Payments to beneficiaries of deceased employees (death benefit exclusion)* under *Life Insurance Proceeds*.

**Individual taxpayer identification number (ITIN) for aliens.** The IRS will issue an ITIN to a nonresident or resident alien who does not have — and is not eligible to get — a social security number (SSN). To apply for an ITIN, Form W-7 must be filed with the IRS. It usually takes about 30 days to get an ITIN. The ITIN is entered wherever an SSN is requested on a tax return. If you are required to include another person's SSN on your return and that person does not have — and cannot get — an SSN, enter that person's ITIN.

An ITIN is for tax use only. It does not entitle the holder to social security benefits or change the holder's employment or immigration status under U.S. law.

**Damages received for nonphysical injuries or sickness or punitive damages are taxable.** Generally, amounts received after August 20, 1996, as damages for nonphysical injuries or sickness or as punitive damages are taxable. See *Damages received after August 20, 1996*.

### Introduction

This chapter discusses many kinds of income and explains whether they are taxable or nontaxable.

- Income that is taxable must be reported on your tax return and is subject to tax.
- Income that is nontaxable may have to be shown on your tax return but is not subject to tax.

You must include on your return all income you receive in the form of money, property, and services unless the tax law states that you do not include them. Some items, however, are only partly excluded from income. They are listed and discussed briefly in this chapter.

### Useful Items

You may want to see:

#### Publication

- 501** Exemptions, Standard Deduction, and Filing Information
- 520** Scholarships and Fellowships
- 525** Taxable and Nontaxable Income
- 544** Sales and Other Dispositions of Assets
- 550** Investment Income and Expenses

### Miscellaneous Taxable Income

This section begins with brief discussions of numerous income items arranged in alphabetical order. These discussions are followed by discussions of other taxable income items which are discussed in greater detail as follows:

- Bartering
- Canceled debts
- Recoveries (including state income tax refunds)
- Rental of personal property
- Repayments
- Royalties



*When you report miscellaneous taxable income on line 21 of Form 1040, write a brief description of the income on the dotted line next to line 21.*

**Activity not for profit.** You must include on your return income from an activity from which you do not expect to make a profit. An example of this type of activity would be a hobby or a farm you operate mostly for recreation and pleasure. Enter this income on line 21 of Form 1040. Deductions for expenses related to the activity are limited. They cannot total more than the income you report, and can be taken only if you itemize deductions on Schedule A (Form 1040). See *Not-for-Profit Activities* in Chapter 1 of Publication 535, *Business Expenses*, for information on whether an activity is considered carried on for a profit.

**Alaska Permanent Fund dividend income.** If you received a payment from Alaska's mineral income fund (Alaska Permanent Fund dividends), you should report this amount on line 21 of Form 1040. The state of Alaska sends each recipient a document with the check that shows this amount. The amount is also reported to IRS.



*If you otherwise qualify to use Form 1040A or 1040EZ, you can report the Alaska Permanent Fund dividend on line 12 of Form 1040A or line 3 of Form 1040EZ. See your form instructions.*

**Alimony.** Include in your income on line 11 of Form 1040 any alimony payments you receive. Amounts you receive for child support are not income to you. Alimony and child support payments are discussed in Chapter 20.

**Allowances and reimbursements.** If you receive travel, transportation, or other business expense allowances or reimbursements from your employer, see Chapter 28. If you are reimbursed for moving expenses, see Chapter 19.

**Court awards and damages.** To determine if settlement amounts you receive by compromise or judgment must be included in your income, you must consider the item that the settlement replaces. Include the following as ordinary income:

- 1) Interest on any award.
- 2) Compensation for lost wages or lost profits in most cases.
- 3) Punitive damages. Also see *Damages received after August 20, 1996*.
- 4) Amounts received in settlement of pension rights (if you did not contribute to the plan).
- 5) Damages for:
  - a) Patent or copyright infringement,
  - b) Breach of contract, or
  - c) Interference with business operations.
- 6) Any recovery under the Age Discrimination in Employment Act.

Do not include in your income compensatory damages for the following:

- 1) Personal physical injury or physical sickness (whether received in a lump sum or installments). Also see *Damages received after August 20, 1996*.
- 2) Damage to your character.
- 3) Alienation of affection.
- 4) Surrender of custody of a minor child.

**Credit card insurance.** If you receive benefits under a credit card disability or unemployment insurance plan, the benefits are taxable to you. These plans make the minimum monthly payment on your credit card account if you cannot make the payment due to injury, illness, disability, or unemployment. Report on line 21 of Form 1040 the amount of benefits you receive during the year that is more than the amount of the premiums you paid during the year.

**Damages received after August 20, 1996.** Generally, amounts received after August 20, 1996, as damages for nonphysical injuries or sickness or as punitive damages are taxable.

**Damages received for nonphysical injuries or sickness.** Damages for nonphysical injuries or sickness, such as employment

discrimination, defamation, or emotional distress, are generally taxable. However, damages for emotional distress due to nonphysical injuries or sickness are excludable up to the amount paid for medical care for the emotional distress.

Only damages received for physical injuries or physical sickness can be excluded from income. If emotional distress is due to physical injuries or physical sickness, the damages you receive for that emotional distress are not taxable.

**Emotional distress defined.** Emotional distress includes physical symptoms that result from emotional distress, such as headaches, insomnia, and stomach disorders.

**Punitive damages.** Punitive damages generally are taxable. It does not matter if they relate to a physical injury or physical sickness. This rule does not create any inference about punitive damages under prior law.

**Pre-existing agreement.** If you receive damages under a written binding agreement, court decree, or mediation award that was in effect (or issued on or before) September 13, 1995, these rules do not apply to you.

For more information on whether or not other kinds of income are taxable, get Publication 525, *Taxable and Nontaxable Income*.

**Estate and trust income.** An estate or trust, unlike a partnership, may have to pay federal income tax. If you are a beneficiary of an estate or trust, you are taxed on your share of its income. However, there is never a double tax. Estates and trusts file their returns on Form 1041, *U.S. Income Tax Return for Estates and Trusts*, and you report your share of the income on Schedule K-1 of Form 1041.

**Current income required to be distributed.** If you are the beneficiary of a trust that must distribute all of its current income, you must report your share of the distributable net income whether or not you have actually received it.

**Current income not required to be distributed.** If you are the beneficiary of an estate or trust and the fiduciary has the choice of whether to distribute all or part of the current income, you must report:

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

to the extent of your share of distributable net income.

**How to report estate and trust income.** Each item of income is treated the same for you as for the estate or trust. For example, if dividend income is distributed to you from a trust, you report the distribution as dividend income on your return. The same rule applies to distributions of tax-exempt interest and capital gains.

The fiduciary of the estate or trust must tell you the type of items making up your

share of the estate or trust income and any credits you are allowed on your individual income tax return.

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

**Grantor trust.** Income earned by a grantor trust is taxable to the grantor, not the beneficiary, if the grantor keeps certain control over the trust. This rule applies if the property (or income from the property) put into the trust will or may revert (be returned) to the grantor or the grantor's spouse. The grantor is the one who transferred property to the trust.

Generally, for transfers after March 1, 1986, a trust is a grantor trust if the grantor has a reversionary interest valued (at the date of transfer) at more than 5% of the value of the transferred property. For transfers in trust made before March 2, 1986, a trust was a grantor trust if it was expected that the property would revert to the grantor within 10 years.

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

- 1) A corporate director,
- 2) An executor or administrator of an estate,
- 3) A notary public, or
- 4) An election precinct official.

**Corporate director.** If you received (or should have received) a Form W-2 showing corporate director fees, report these fees on line 7 of Form 1040 or Form 1040A, or on line 1 of Form 1040EZ.

Otherwise, report these payments on Schedule C (Form 1040) or Schedule C-EZ (Form 1040) as self-employment income.

**Executor or administrator of an estate.** If these payments total \$600 or more for the year, you may receive a Form 1099-MISC. Report these payments on Schedule C (Form 1040) or Schedule C-EZ (Form 1040) as self-employment income. **Exception:** If you are not in the trade or business of being an executor (for instance, you are the executor of a friend's or relative's estate), do not include these amounts on Schedule C or Schedule C-EZ. Report them on line 21 of Form 1040.

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

**Election precinct official.** You should receive a Form W-2 showing payments for services performed as an election official or election worker. Report these payments on line 7 of Form 1040 or Form 1040A, or on line 1 of Form 1040EZ.

**Free tour.** If you received a free tour from a travel agency for organizing a group of tourists, you must include its value in your income. Report the fair market value of the

tour on line 21 of Form 1040, or on Schedule C or Schedule C-EZ (Form 1040). You cannot deduct your expenses in serving as the voluntary leader of the group at the group's request.

**Gambling winnings.** You must include your gambling winnings in income on line 21 of Form 1040. If you itemize your deductions on Schedule A (Form 1040), you can deduct gambling losses you had during the year, but only up to the amount of your winnings. See Publication 529, *Miscellaneous Deductions*, for information on recordkeeping.

**Lotteries and raffles.** Winnings from lotteries and raffles are gambling winnings. In addition to cash winnings, you must include in your income the fair market value of bonds, cars, houses, and other noncash prizes at their fair market value.

**TIP** If you win a state lottery prize payable in installments, you must include in your gross income the annual payments and any amount you receive designated as "interest" on the unpaid installments.

**Form W-2G.** You may have received a Form W-2G showing the amount of your gambling winnings and any tax taken out of them. Include the amount from box 1 on line 21 of Form 1040. Be sure to include any amount from box 2 on line 52 of Form 1040.

**Hobby losses.** Losses from a hobby are not deductible from other income. A hobby is an activity from which you do not expect to make a profit. See *Activity not for profit*, earlier.

**CAUTION** If you collect stamps, coins, or other items as a hobby for recreation and pleasure, and you sell any of the items, your gain is taxable as a capital gain. (See Chapter 17.) However, if you sell items from your collection at a loss, you cannot deduct a net loss.

**Illegal income.** Illegal income, such as stolen or embezzled funds, must be included in your gross income on line 21 of Form 1040, or on Schedule C or Schedule C-EZ (Form 1040) if from your self-employment activity.

**Indian fishing rights.** If you are a member of a qualified Indian tribe that has fishing rights secured by treaty, executive order, or an Act of Congress as of March 17, 1988, do not include in your income amounts you receive from activities related to those fishing rights. The income is not subject to income tax, self-employment tax, or employment taxes.

**Jury duty.** Jury duty pay you receive must be included in your income on line 21 of Form 1040. If you must give the pay to your

employer because your employer continues to pay your salary while you serve on the jury, you can deduct the amount turned over to your employer as an adjustment to your income. Include the amount you repay your employer on line 30 of Form 1040. Write "Jury pay" and the amount on the dotted line next to line 30.

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

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

**Note received for services.** If your employer gives you a note as payment for your services, you must include the fair market value (usually the discount value) of the note in your income as wages for the year you receive it. When you later receive payments on the note, part of each payment is a recovery of the fair market value that you previously included in your income. Do not include that part in your income again. Include the rest of the payment in your income in the year of payment.

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

**Employee cash awards or bonuses.** Cash awards or bonuses given to you by your employer for good work or suggestions generally must be included in your income as wages. However, certain employee awards can be excluded from your income. See *Employee achievement awards* under *Income Not Taxed*, later.

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

**Pulitzer, Nobel, and other prizes.** If you were awarded a Pulitzer, Nobel, or other prize in recognition of past accomplishments (in religious, charitable, scientific, artistic, educational, literary, or civic fields), you do not include this prize in your income if you meet **all** of the following requirements.

- 1) You were selected without any action on your part to enter the contest or proceeding.
- 2) You are not required to perform substantial future services as a condition to receiving the prize or award.
- 3) The prize or award is transferred directly to a governmental unit or tax-exempt charitable organization as designated by you.

See Publication 525 for more information about the conditions that apply to the transfer.

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

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

## Bartering

Bartering is an exchange of property or services. You must include in your income, at the time received, the fair market value of property or services you receive in bartering. If you exchange services with another person and you both have agreed ahead of time as to the value of the services, that value will be accepted as fair market value unless the value can be shown to be otherwise.

Report this income on Schedule C or Schedule C-EZ (Form 1040).

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

**Example 2.** You are self-employed and a member of a barter club. The club uses "credit units" as a means of exchange. It adds credit units to your account for goods or services you provide to members, which you can use to purchase goods and services offered by other members of the barter club. The club subtracts credit units from your account when you receive goods or services from other members. You must include in income the value of credit units that are added to your account, even though you may not actually receive goods or services from other members until a later tax year.

**Example 3.** You own a small apartment building and an artist gives you a work of art that the artist created in return for 6 months' rent-free use of an apartment. You must report as rental income on Schedule E (Form 1040) the fair market value of the art work, and the artist must report as income on Schedule C or Schedule C-EZ (Form 1040) the fair rental value of the apartment.

**Barter exchange.** If you exchanged property or services through a barter exchange, you should receive Form 1099-B or a similar statement from the barter exchange. You should receive the statement by January 31, 1997, and it should show the value of cash, property, services, credits, or scrip you received from exchanges during the year. The IRS will also receive a copy of Form 1099-B.

## Canceled Debts

Generally, if a debt you owe is canceled or forgiven, other than as a gift or bequest, you must include the canceled amount in your gross income. You have no income from the canceled debt if it is intended as a gift to you. A debt includes any indebtedness for which you are liable or which attaches to property you hold.

If you are not self-employed, you report the amount on line 21 of Form 1040. If you are self-employed, you report the amount on Schedule C or C-EZ (Form 1040) if you are a sole proprietor or on Schedule F (Form 1040) if you are a farmer.

**Form 1099-C.** If a federal government agency, financial institution, or credit union cancels or forgives a debt you owe of \$600 or more, you will receive a Form 1099-C, *Cancellation of Debt*. The amount of the canceled debt is shown in box 2.

**Interest included in canceled debt.** If any interest is forgiven and included in the amount of canceled debt in box 2, the amount of interest will also be shown in box 3. Whether or not you must include the interest portion of the canceled debt in your gross income depends on whether the interest would be deductible if you paid it.

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

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

**Stockholder debt.** If you are a stockholder in a corporation and the corporation cancels or forgives your debt to it, the canceled debt is dividend income to you.

If you are a stockholder in a corporation and you cancel a debt owed to you by the corporation, you generally do not realize income. This is because the canceled debt is considered as a contribution to the capital of the corporation equal to the amount of debt principal that you canceled.

## Exceptions and Exclusions

There are several exceptions and exclusions to the inclusion of canceled debt in income. Some of the more common ones are explained next.

**Student loans.** Certain student loans contain a provision that all or part of the debt incurred to attend the qualified educational institution will be canceled if you work for a certain period of time in certain professions for any of a broad class of employers. You do not have income if your student loan is canceled after you agreed to this provision

and then performed the services required. To qualify, the loan must have been made by:

- 1) The government—federal, state, or local, or an instrumentality, agency, or subdivision thereof,
- 2) A tax-exempt public benefit corporation that has assumed control of a state, county, or municipal hospital, and whose employees are considered public employees under state law, or
- 3) An educational institution under an agreement with an entity described in (1) or (2) that provided the funds to the institution to make the loan.

**Deductible debt.** If a debt that qualified for a tax deduction is canceled, you do not realize income from the canceled debt. However, whether or not you must include the canceled debt in your gross income depends on whether you use the cash or an accrual method of accounting. If you use the cash method, you do not include it in income. If you use an accrual method, you do include it in income. For more information, see Chapter 5 of Publication 334, *Tax Guide for Small Business*.

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

**Bankruptcy exclusion.** If your debt is canceled in a bankruptcy case under title 11 of the United States Code, do not include the canceled debt in your gross income. However, you must reduce your tax attributes (but not below zero) by the canceled amount that is not included in your income. See Publication 908, *Bankruptcy Tax Guide*, for more information.

**Insolvency exclusion.** If your debt is canceled when you are insolvent, you do not include the canceled debt (up to a certain limit) in your gross income. However, you must reduce your tax attributes (but not below zero) by the canceled amount that is not included in your income. This exclusion applies only to the amount by which you are insolvent. See Publication 908 for more information.



*If the canceled debt occurs because of a title 11 bankruptcy case, the bankruptcy exclusion takes precedence over the insolvency exclusion.*

## Partnership Income

A partnership is not a taxable entity. The income, gains, losses, credits, and deductions of a partnership are “passed through” to the partners based on each partner’s distributive share of these items.

The partnership must file a return on Form 1065, *U.S. Partnership Return of Income*, and send Schedule K-1 to each partner. In addition, the partnership will send each partner a copy of the *Partner’s Instructions for Schedule K-1 (Form 1065)* to help each partner report his or her share of the partnership’s income, credits, deductions, and tax preference items.



*Do not attach Schedule K-1 (Form 1065) to your Form 1040. Keep it for your records.*

For an example of how to report partnership items, see Chapter 39.

For more information on partnerships, get Publication 541, *Partnerships*.

## S Corporation Income

In general, an S corporation does not pay tax on its income. Instead, the income and expenses of the corporation are “passed through” to the shareholders.

An S corporation must file a return on Form 1120S, *U.S. Income Tax Return for an S Corporation*, and send Schedule K-1 (Form 1120S) to each shareholder. In addition, the S corporation will send each shareholder a copy of the *Shareholder’s Instructions for Schedule K-1 (Form 1120S)* to help each shareholder report his or her share of the S corporation’s income, credits, and deductions.



*Do not attach Schedule K-1 (Form 1120S) to your Form 1040. Keep it for your records.*

For more information on S corporations and their shareholders, see the instructions for Form 1120S.

## Recoveries

A recovery is a return of an amount you deducted or took a credit for in an earlier year. Generally, you must include all or part of the recovered amounts in your income in the year the recovery is received. The most common recoveries are refunds, reimbursements, and rebates of deductions itemized on Schedule A (Form 1040). Non-itemized deduction recoveries include such items as payments you receive on previously deducted bad debts and recoveries of items for which you previously claimed a tax credit.

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

**Form 1099-G.** If you received a state or local income tax refund in 1996, you may receive a statement, Form 1099-G, *Certain Government Payments*, from the payer of the refund (or credit or offset) by January 31, 1997. The IRS will also receive a copy of the Form 1099-G.

Report any interest you received on state or local income tax refunds on line 8a of Form 1040.

**Interest.** Interest on any of the amounts you recover must be reported as interest income in the year received.

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

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

This allocation is necessary to determine the amount of recovery from any earlier years and to determine the amount, if any, of your allowable deduction for this item for the current year. For information on how to compute the allocation, see *Recoveries* in Publication 525.

**Tax benefit rule.** If you recover an amount that you deducted or took a credit for in an earlier year, include the recovery in your income only to the extent the deduction or credit reduced your tax in the earlier year. This could happen if you were subject to the alternative minimum tax or had credits that reduced your tax liability to zero. For more information, get Publication 525.

## Itemized Deduction Recoveries

If you recover any amount that you deducted in an earlier year on Schedule A (Form 1040), you must determine how much, if any, of the recovery to include in your income.



*Due to changes in the tax law, different computations are needed for the recovery of items deducted after 1986 and for those deducted before 1987. The discussions in this section apply to the recovery of items deducted after 1986. If you recovered an item deducted before 1987, contact your local IRS office for assistance, or see a tax practitioner.*

**Total recoveries generally included in income.** The total amount recovered in 1996 is included in your income if certain requirements are met.

Recoveries of amounts deducted **after 1986** will generally be included in your income if:

- 1) The recoveries are not more than the amount deducted,
- 2) Your total deductions on the earlier year return did not exceed your total income, and
- 3) The recoveries are equal to or less than the amount by which your itemized deductions exceeded the standard deduction for your filing status in the earlier year.

**Where to report.** Enter your state and local income tax refund on line 10 of Form

1040, and the total of all other recoveries as other income on line 21 of Form 1040. You cannot use Form 1040A or Form 1040EZ.

**Example.** For 1995, you filed a joint return. Your taxable income was \$20,000. The standard deduction for your filing status was \$6,550, and you had itemized deductions of \$7,650. In 1996, you received the following recoveries for amounts deducted on your 1995 return:

Medical expenses .....	\$200
State and local income tax refund .....	400
Real estate tax rebate .....	<u>325</u>
<b>Total recoveries .....</b>	<b><u>\$925</u></b>

None of the recoveries were more than the deductions taken for 1995.

Because your total recoveries are less than the amount by which your itemized deductions exceeded the standard deduction (\$7,650 – 6,550 = \$1,100), you must include your total recoveries in your income for 1996. Report the state and local income tax refund of \$400 on line 10 of Form 1040 and the balance of your recoveries, \$525, on line 21 of Form 1040.

**Standard deduction for 1995.** To determine if amounts deducted on your 1995 return and recovered in 1996 must be included in your income, you must know the standard deduction for your filing status for 1995. Standard deduction amounts for 1995 are in Publication 525.

**Total recoveries not included in income.** The total recovery that must be included in your income is limited to the itemized deduction amount that reduced your tax for the earlier year. (See *Tax Benefit Rule*, earlier.)

You are generally allowed to claim the standard deduction if you do not itemize your deductions. Only your itemized deductions that are more than your standard deduction are subject to the recovery rule (unless you are required to itemize your deductions). If your total deductions on the earlier year return were not more than your income for that year, include in your income this year the smaller of:

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

**Example.** You filed a joint return for 1995 with taxable income of \$25,000. Your itemized deductions were \$8,350. The standard deduction that you could have claimed was \$6,550. In 1996 you recover \$2,400 of your 1995 itemized deductions. None of the recoveries were more than the actual deductions for 1995. Include \$1,800 of the recoveries in your 1996 income. This is the smaller of your recoveries (\$2,400) or the amount by which your itemized deductions were more than the standard deduction (\$8,350 – 6,550 = \$1,800).

**Recovery limited to deduction.** You do not include in your income any amount of your recovery that is more than the amount you deducted in the earlier year. The amount you include in your income is limited to the smaller of:

- 1) The amount deducted on Schedule A (Form 1040), or
- 2) The amount recovered.

**Example.** During 1995 you paid \$1,700 for medical expenses. From this amount you subtracted \$1,500, which was 7.5% of your adjusted gross income. Your taxable income for 1995 was \$13,500. Your actual medical expense deduction was \$200. In 1996, you received a \$500 reimbursement from your medical insurance for your 1995 expenses. The only amount of the \$500 reimbursement that must be included in your income in 1996 is \$200—the amount actually deducted.

**Other recoveries.** See *Recoveries* in Publication 525 if:

- 1) Your total deductions exceeded your income in the prior year.
- 2) You have recoveries of items other than itemized deductions.
- 3) Your standard deduction was zero in the prior year for which you received the recovery.
- 4) You received a recovery for an item for which you claimed a tax credit (other than investment credit or foreign tax credit) in a prior year.
- 5) You were subject to the alternative minimum tax, or you had credits that reduced your tax liability to zero, in the year the deduction was claimed.
- 6) Your last payment of 1995 estimated state income tax was made in 1996.
- 7) Your itemized deductions for 1995 were limited as discussed in Chapter 22.

## Rental of Personal Property

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

- 1) Whether or not the rental activity is a business, and
- 2) Whether or not the rental activity is conducted for profit.

Generally, if your primary purpose is income or profit and you are involved in the rental activity with continuity and regularity, your rental activity is a business. See Publication 535 for details on deducting expenses for both business and not-for-profit activities.

**Reporting business income and expenses.** If you are in the business of renting personal property, report your income and expenses on Schedule C or C-EZ. The form

instructions have information on how to complete them.

**Reporting nonbusiness income.** If you are not in the business of renting personal property, report your rental income on line 21 of Form 1040. List the type and amount of the income on the dotted line to the left of the amount you report on line 21.

**Reporting nonbusiness expenses.** If you rent personal property for a profit, report your rental expenses on line 30 of Form 1040. Enter the amount and “PPR” on the dotted line to the left and include the amount of your deductible expenses in the total amount you enter on line 30.

If you do not rent personal property for a profit, your deductions are limited and you cannot report a loss to offset other income. You report these rental expenses on Schedule A (Form 1040). Chapter 1 of Publication 535 has details on how to claim these expenses.

## Repayments

If you had to repay an amount that you had included in your income in an earlier year because at that time you thought you had an unrestricted right to it, you can deduct the amount repaid from your income in the year in which you repay it.

**Type of deduction.** The type of deduction you are allowed in the year of repayment depends on the type of income you included in the earlier year. For instance, if you repay an amount that you previously reported as a capital gain, deduct the repayment as a capital loss.

**Repayment \$3,000 or less.** If the amount you repaid was \$3,000 or less, deduct it from your income in the year you repaid it. If you reported it as wages, unemployment compensation, or other ordinary income, enter it on line 22 of Schedule A (Form 1040). If you reported it as a capital gain, deduct it on Schedule D (Form 1040).

**Repayment over \$3,000.** If the amount you repaid was more than \$3,000, you can take a deduction for the amount repaid or you can take a credit against your tax. Follow the steps below and compare the results. Use the method (credit or deduction) that results in less tax.

- 1) Figure your tax for 1996 claiming a deduction for the repaid amount.
- 2) Figure your tax for 1996 **without** deducting the amount you repaid. Then,
  - a) Refigure your tax from the earlier year without including in income the amount you repaid in 1996.
  - b) Subtract the tax in (a) from the tax shown on your return for the earlier year.
  - c) Then subtract the answer in (b) from the tax for 1996 figured without the deduction.

How you treat the repayment on your 1996 return depends on which answer above results in less tax.

- If the answer in Step (1) is less tax, deduct the amount repaid on the same form or schedule on which you previously reported it. For example, if you reported it as self-employment income, deduct it on Schedule C or Schedule C–EZ (Form 1040), or if you reported it as wages, deduct it on line 27 of Schedule A (Form 1040).
- If the answer in Step (2) is less tax, claim a credit on line 57 of Form 1040, and write “I.R.C. 1341” next to line 57.

An example of this computation can be found in Publication 525.

**Repaid social security benefits.** If you repaid social security benefits, see *Repayments* in Chapter 12.

## Royalties

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

You generally report royalties on Part I of Schedule E (Form 1040). However, if you hold an operating oil, gas, or mineral interest or are in business as a self-employed writer, inventor, artist, etc., report your gross income and expenses on Schedule C or Schedule C–EZ (Form 1040).

**Copyrights and patents.** Royalties from copyrights on literary, musical, or artistic works, and similar property, or from patents on inventions, are amounts paid to you for the right to use your work over a specified period of time. Royalties are generally based on the number of units sold, such as the number of books, tickets to a performance, or machines sold.

**Oil, gas, and minerals.** Royalty income from oil, gas, and mineral properties is the amount you receive when natural resources are extracted from your property. The royalties are based on units, such as barrels, tons, etc., and are paid to you by a person or company who leases the property from you.

**Depletion.** If you are the owner of an economic interest in mineral deposits or oil and gas wells, you can recover your investment through the depletion allowance. For information on this subject, see Chapter 13 of Publication 535.

**Coal and iron ore.** Under certain circumstances, you can treat amounts you receive from the disposal of coal and iron ore as payments from the sale of a capital asset, rather than as royalty income. For information about gain or loss from the sale of coal and iron ore, get Publication 544.

**Interest in the property sold.** If you sell your complete interest in the oil, gas, or mineral rights, the amount you receive is considered payment for the sale of your property, not royalty income. Under certain circumstances, the sale is subject to capital gain or

loss treatment on Schedule D (Form 1040). For information on capital gain or loss, see Chapter 15.



*You can report the sale as an installment sale if you are to receive at least one payment after the tax year in which the sale took place. For more information, get Publication 537, Installment Sales.*

**Part of future production sold.** If you own mineral property but sell part of the future production, you generally treat the money you receive from the buyer at the time of the sale as a loan from the buyer. Do not include it in your income or take depletion based on it.

When production begins, you include all the proceeds in your income, deduct all the production expenses, and deduct depletion from that amount to arrive at your taxable income from the property.

**Retained interest.** If you retain a royalty, an overriding royalty, or a net profit interest in a mineral property for the life of the property, you have made a lease or a sublease, and any cash you receive for the assignment is ordinary income subject to a depletion allowance.

## Income Not Taxed

You generally should not report the following items on your return. However, some of the items are only partly excluded from your income. A discussion of other totally and partly excluded items follows this list.

### Accident and health insurance proceeds

### “Black lung” benefits

### Casualty insurance and other reimbursements (Chapter 27)

### Child support payments (Chapter 20)

### Damages awarded for physical injury or sickness

### Employment agency fees (Chapter 30)

### Federal Employees’ Compensation Act payments

### Government cost-of-living allowances for civilian employees stationed outside the continental U.S. (or in Alaska) (Chapter 6)

### Housing allowance for members of the clergy (Chapter 6)

### Interest on state or local government obligations (Chapter 8)

### Meals and lodging

### Military allowances

### Moving expense reimbursements (Chapter 19)

### Scholarship and fellowship grants

### Social security and equivalent railroad retirement benefits (Chapter 12)

### Supplemental security income (SSI)

## Veterans’ benefits (Chapter 6)

## Welfare benefits

## Workers’ compensation

**Campaign contributions.** These contributions are not income to a candidate unless they are diverted to his or her personal use. To be exempt from tax, the contributions must be spent for campaign purposes or kept in a fund for use in future campaigns. However, interest earned on bank deposits, dividends received on contributed securities, and net gains on sales of contributed securities are taxable and must be reported on Form 1120–POL, *U.S. Income Tax Return for Certain Political Organizations*. Excess campaign funds transferred to an office account must be included in the officeholder’s income on line 21 of Form 1040, in the year transferred.

**Cash rebates.** A cash rebate you receive from a dealer or manufacturer of an item you buy is not income.

**Example.** You buy a new car for \$9,000 cash and receive a \$400 rebate check from the manufacturer. The \$400 is not income to you. Your cost is \$8,600. This is your basis on which you figure gain or loss if you sell the car, and depreciation if you use it for business.

**Employee achievement awards.** Exclude from your income employee achievement awards you receive only if your employer can deduct them. To be deducted by your employer and excluded by you, the awards must meet all the following requirements:

- 1) Be given for length of service or safety achievement.
- 2) Be tangible personal property other than cash, gift certificates, or equivalent items.
- 3) Be given under conditions and circumstances that do not create a significant likelihood of the payment of disguised compensation.
- 4) Be given as part of a meaningful presentation.
- 5) Be no more than the specified dollar limits.

**Dollar limits.** There are limits to the total awards you can exclude in one year. Awards from nonqualified plans are limited to \$400, and total awards from both qualified and nonqualified plans are limited to \$1,600. The cost to your employer is the determining factor for these limits. Amounts over the limits cannot be deducted by your employer and must be included in your income.

**Qualified plan award.** A qualified plan award is one you are awarded as part of an established written plan by your employer that does not discriminate in favor of highly compensated employees. An award will not be considered a qualified plan award if the average cost of all employee achievement awards given by your employer during the

tax year is more than \$400. In determining average cost, awards of nominal value are not taken into account.

**Example.** Ben Green received three employee achievement awards during the year: a nonqualified plan award of a watch valued at \$250, and two qualified plan awards of a stereo valued at \$1,000 and a set of golf clubs valued at \$500. Assuming that the requirements for qualified plan awards are otherwise satisfied, each award by itself would be excluded from his income. However, since the \$1,750 total value of the awards is more than \$1,600, Ben must include \$150 (\$1,750 – \$1,600) in his income.

**Energy conservation subsidies.** You can exclude from gross income any subsidy provided, either directly or indirectly, by public utilities for the purchase or installation of an energy conservation measure for a dwelling unit. You can only exclude 50% of the subsidy if you purchased or installed the energy conservation measure for nonresidential property.

**Energy conservation measure.** This includes installations or modifications that are primarily designed to reduce consumption of electricity or natural gas, or improve the management of energy demand.

**Dwelling unit.** This includes a house, apartment, condominium, mobile home, boat, or similar property. If a building or structure contains both dwelling and other units, any subsidy must be properly allocated.

**Foster-care providers.** Payments you receive from a state, political subdivision, or tax-exempt child-placement agency for providing foster care to qualified individuals in your home are not included in your income. You cannot deduct the related expenses. However, you must include in your income payments received for the care of more than 5 individuals age 19 or older.

A qualified foster individual is a person who:

- 1) Is living in a foster family home, and
- 2) Was placed there by:
  - a) An agency of a state or one of its political subdivisions, or
  - b) A tax-exempt child placement agency licensed by a state, if the individual is under age 19.

**Difficulty-of-care payments.** These payments are not included in your income. These are additional payments made to foster-care providers for physically, mentally, or emotionally handicapped individuals by a state, political subdivision, or tax-exempt child placement agency that are designated as difficulty-of-care payments. A state must determine that the additional compensation is needed. You must include in your income difficulty-of-care payments received for more than:

- 1) 10 children under age 19, and
- 2) 5 individuals age 19 or older.

**Maintaining space in home.** If you are paid by a placement agency to maintain space in your home for foster-care individuals, or if you receive payments that you must include in your income, you are in business as a foster-care provider and you are self-employed. You must include these payments in your income. You can deduct expenses related to these payments. Report the income and expenses on Schedule C or Schedule C–EZ (Form 1040) and net business income on Schedule SE (Form 1040).

To help you determine the amount you can deduct for the use of your home, see *Home Office* in Chapter 30. For more information on foster care, get Publication 501.

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

Items given to you as an incentive to enter into a business transaction are not gifts. For example, items such as small appliances or dinnerware given to you by a bank as an incentive to make a deposit are interest income to you and must be reported at their fair market value.

**Inherited pension or IRA.** If you inherited a pension or an individual retirement arrangement (IRA), special rules apply. See Chapter 11 if you inherited a pension. See Chapter 18 if you inherited an IRA.

**Interest on frozen deposits.** Generally, you can exclude from your income the amount of interest earned on a frozen deposit. See *Interest income on frozen deposits* in Chapter 8.

**Interest on qualified savings bonds.** You may be able to exclude from your income all or part of the interest from qualified U.S. savings bonds you redeem if you pay qualified higher educational expenses in the same year. For more information on this exclusion, see *Education Savings Bond Program* under *U.S. Savings Bonds* in Chapter 8.

**Living expenses paid by insurance.** Do not include in your income amounts you receive under an insurance policy for additional living expenses you and your family had because you lost the use of your home due to a fire, storm, or other casualty. The amount you exclude from income is limited to your extra living expenses that are more than the normal expenses you would have had. Extra living expenses, for this purpose, include only those to keep you and your family at the same standard of living you had before the loss.

**Sale of home.** If you are 55 or older and sell your main home, you may be able to exclude

from income all or part of any gain from the sale. See Chapter 16.

**Transporting schoolchildren.** Do not include in your income a school board mileage allowance for taking children to and from school if you are not in the business of taking children to school. You cannot deduct expenses for providing this transportation.

**Utility rebates.** If you are a customer of an electric utility company and you participate in the utility's energy conservation program, you may receive on your monthly electric bill either:

- 1) A reduction in the purchase price of electricity furnished to you (rate reduction), or
- 2) A nonrefundable credit against the purchase price of the electricity.

The amount of the rate reduction or nonrefundable credit is not included in your income.

## Life Insurance Proceeds

Life insurance proceeds paid to you because of the death of the insured person are not taxable unless the policy was turned over to you for a price. This is true even if the proceeds were paid under an accident or health insurance policy or an endowment contract.

**Proceeds not received in installments.** If death benefits are paid to you in a lump sum or other than at regular intervals, include in your gross income only the benefits that are more than the amount payable to you at the time of the insured person's death. If the benefit payable at death is not specified, you include in your income the benefit payments that are more than the present value of the payments at the time of death.

**Proceeds received in installments.** If you receive life insurance proceeds in installments, you can exclude part of each installment from your income.

To determine the excluded part, divide the amount held by the insurance company (generally the total lump sum payable at the death of the insured person) by the number of installments to be paid. Include anything over this excluded part in your income as interest.

**Surviving spouse.** If your spouse died before October 23, 1986, and insurance proceeds are payable to you because of the death of your spouse, and you receive them in installments, you can exclude up to \$1,000 a year of the interest included in the installments.

**More information.** For more information, see *Life Insurance Proceeds* in Publication 525.

**Surrender of policy for cash.** If you surrender a life insurance policy for cash, you must include in income any proceeds that are more than the amount of premiums that you paid.

**Reporting.** You should receive a Form 1099-R. Report these amounts on lines 16a and 16b of Form 1040, or lines 11a and 11b of Form 1040A.

**Endowment proceeds.** Endowment proceeds paid in a lump sum to you at maturity are taxable only if the proceeds are more than the cost of the policy. Add any amounts that you previously received under the contract and excluded from your income to the lump-sum payment to find how much of the total is a return of your cost and how much is more than your cost. Include any amount over your cost in your income.

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

**Payments to beneficiaries of deceased employees (death benefit exclusion).**

The first \$5,000 of payments made by or for an employer because of an employee's death can be excluded from the income of the beneficiaries. The payments need not be made as the result of a contract. The amount excluded for any deceased employee cannot be more than \$5,000 regardless of the number of employers or the number of beneficiaries.



*This \$5,000 exclusion is repealed for payments received for decedents dying after August 20, 1996.*

This exclusion also covers payments of the balance to the credit of a deceased employee under a stock bonus, pension, or profit-sharing plan, as long as they are received during one tax year of the beneficiary.

**Example.** William Smith was an officer of a corporation at the time of his death in July 1996. The board of directors voted to pay Mr. Smith's salary to his widow for the rest of the year for his past services. During the year the corporation made payments of \$18,000 to the widow. She can exclude from her income the first \$5,000 she received, but must include the remaining \$13,000 on line 21 of her Form 1040.

**Self-employed individuals.** The death benefit exclusion also applies to lump-sum distributions paid on behalf of self-employed individuals, if paid under a qualified pension, profit-sharing, or stock bonus plan.

**Payments not qualifying.** Any amount the deceased employee (or self-employed individual) had a guaranteed right to receive, had death not occurred, cannot be excluded as a tax-free death benefit. If the deceased employee was receiving a retirement annuity and the beneficiary continues to receive payments under a joint and survivor annuity option, these payments do not qualify for the

death benefit exclusion. However, if the deceased employee had retired on disability and at the time of death had not reached minimum retirement age, payments to the beneficiary may qualify for the death benefit exclusion. Minimum retirement age generally is the age at which an individual can receive a pension or annuity if that individual is not disabled.

**Paid in installments.** Death benefits paid in installments over a period of years are annuity payments. If you are the beneficiary of an employee who died while still employed, the pension or annuity you receive may qualify for the death benefit exclusion. This exclusion is limited to \$5,000 and generally applies to the amount by which the present value of the annuity, figured as of the date of the employee's death, is more than the larger of:

- 1) The employee's contributions to the plan, or
- 2) The amount the employee had a guaranteed right to receive.

If you are eligible for the exclusion, add it to the cost or unrecovered cost of the annuity in figuring, at the annuity starting date, the investment in the contract.

Treatment of annuity payments to beneficiaries of employees and the death benefit exclusion are discussed in Chapter 11.

**Deceased public safety officers.** If you are a surviving dependent of a public safety officer (law enforcement officer or firefighter) who died in the line of duty, do not include in your income the death benefit payable to you by the Bureau of Justice Assistance.

## Welfare and Other Public Assistance Benefits

Do not include in your income the benefit payments from a public welfare fund, such as payments due to blindness. Payments from a state fund for the victims of crime should not be included in the victims' incomes if they are in the nature of welfare payments. Do not deduct medical expenses that are reimbursed by such a fund. You must include in your income any welfare benefits obtained fraudulently.

**Payments for age and residency.** Payments the state of Alaska makes to its citizens who meet certain age and residency tests that are not based on need are not welfare benefits. Include them in gross income on line 21 of Form 1040.

**Persons with disabilities.** If you have a disability, you must include in income compensation you receive for services you perform unless the compensation is otherwise excluded. However, you do not include in income the value of goods, services, and cash that you receive, not in return for your services, but for your training and rehabilitation. Excludable amounts include payments for transportation and attendant care, such as

interpreter services for the deaf, reader services for the blind, and services to help mentally retarded persons do their work.

**Disaster relief grants.** Grants made under the Disaster Relief Act of 1974 to help victims of natural disasters are not included in income. Do not deduct casualty losses or medical expenses that are specifically reimbursed by these disaster relief grants. Disaster unemployment assistance payments under the Act are unemployment benefits that are taxable. See *Unemployment compensation* in Chapter 6.

**Mortgage assistance payments.** Payments made under section 235 of the National Housing Act for mortgage assistance are not included in the homeowner's gross income.

Interest paid for the homeowner under the mortgage assistance program cannot be deducted.

**Payments to reduce cost of winter energy.** Payments made by a state to qualified people to reduce their cost of winter energy use are not taxable.

## Other Sickness and Injury Benefits

In addition to welfare or insurance benefits, you may receive other payments for sickness or injury. *Table 13-1* gives a general overview of some of these payments.

**Workers' compensation.** Amounts you receive as workers' compensation for an occupational sickness or injury are fully exempt from tax if they are paid under a workers' compensation act or a statute in the nature of a workers' compensation act. The exemption also applies to your survivor(s). The exemption from tax, however, does not apply to retirement benefits you receive based on your age, length of service, or prior contributions to the plan, even though you retired because of occupational sickness or injury.

**Note.** If part of your workers' compensation reduces your social security or equivalent railroad retirement benefits received, that part is considered social security (or equivalent railroad retirement) benefits and may be taxable. For more information, see Publication 915, *Social Security and Equivalent Railroad Retirement Benefits*.

**Return to work.** If you return to work after qualifying for workers' compensation, payments you continue to receive while assigned to light duties are taxable. Report these payments as wages on line 7 of Form 1040 or Form 1040A, or on line 1 of Form 1040EZ.

**Federal Employees' Compensation Act (FECA).** Payments made under this Act for personal injury or sickness, including payments to beneficiaries in case of death, are not taxable. However, you are taxed on

☞ **Table 13-1. Are Your Sickness and Injury Benefits Taxable?**

Type of Benefit	General Rule
Workers' Compensation	<u>Not taxable</u> if paid under a workers' compensation act or a statute in the nature of a workers' compensation act <u>and</u> paid due to a work related sickness or injury. However, payments received after returning to work are <u>taxable</u> .
Federal Employees' Compensation Act (FECA)	<u>Not taxable</u> if paid because of personal injury or sickness. However, payments received as "continuation of pay" for up to 45 days while a claim is being decided and pay received for sick leave while a claim is being processed are <u>taxable</u> .
Compensatory Damages	<u>Not taxable</u> if received for injury or sickness.
Accident or Health Insurance Benefits	<u>Not taxable</u> if you paid the insurance premiums.
Disability Benefits	<u>Not taxable</u> if received for loss of income or earning capacity due to an injury covered by a "no-fault" automobile policy.
Compensation for Permanent Loss or Loss of Use of a Part or Function of Your Body, or for Permanent Disfigurement	<u>Not taxable</u> if paid due to the injury. The payments must be figured without regard to any period of absence from work.
Reimbursements for Medical Care	<u>Not taxable</u> —but the reimbursement may reduce your medical expense deduction.

amounts you receive under this Act as "continuation of pay" for up to 45 days while a claim is being decided. Report this income on line 7 of Form 1040 or Form 1040A, or on line 1 of Form 1040EZ. Also, pay for sick leave while a claim is being processed is taxable and must be included in your income as wages.

You can deduct the amount you spend to "buy back" sick leave for an earlier year to be eligible for nontaxable FECA benefits for that period. It is a miscellaneous deduction subject to the 2% limit on Schedule A (Form 1040). If you buy back sick leave in the same year you use it, the amount reduces your taxable sick leave pay. Do not deduct it separately.

**Other compensation.** Many other amounts you receive as compensation for injury or illness are not taxable. These include:

- **Compensatory damages** you receive for physical injury or physical illness, whether

paid in a lump sum or in periodic payments,

- **Benefits you receive under an accident or health insurance policy** on which either you paid the premiums or your employer paid the premiums but you had to include them in your gross income,
- **Disability benefits** you receive for loss of income or earning capacity as a result of injuries under a "no-fault" car insurance policy, and
- **Compensation you receive for permanent loss or loss of use** of a part or function of your body, or for your permanent disfigurement. This compensation must be based only on the injury and not on the period of your absence from work. These benefits are exempt from tax even though your employer pays for the accident and health plan that provides these benefits.

**Reimbursement for medical care.** A reimbursement for medical care is generally not taxable. However, this reimbursement may reduce your medical expense deduction. For more information, see Chapter 23.

## Scholarship and Fellowship Grants

If you receive a scholarship or fellowship grant, you may be able to exclude from income all or part of the amounts you receive.

**Qualified scholarships.** Only a candidate for a degree can exclude amounts received as a qualified scholarship. A qualified scholarship is any amount you receive that is for:

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

Amounts used for room and board **do not** qualify.

**Payments for services.** All payments you receive for services must be included in income, even if the services are a condition of receiving the grant and are required of all candidates for the degree. This includes amounts received for teaching and research. Include these payments on line 7 of Form 1040 or Form 1040A, or on line 1 of Form 1040EZ. For more information on scholarships and fellowship grants, get Publication 520.

**VA payments.** Allowances paid by the Department of Veterans Affairs are not included in your gross income. These allowances are not considered scholarship or fellowship grants.

**Prizes.** Scholarship prizes won in a contest are not scholarships or fellowships if you do not have to use the prizes for educational purposes. You must include these amounts in your gross income on line 21 of Form 1040, whether or not you use the amounts for educational purposes.

**Qualified tuition reductions.** These reductions are excluded from your income. A qualified tuition reduction is the amount of reduction in tuition for education (below the graduate level) furnished to an employee of an educational institution (or certain other persons) provided certain requirements are met. However, graduate students who engage in teaching or research activities for the educational institution may qualify for this exclusion. For more information, get Publication 520.

# Part Three.

## Gains and Losses

The four chapters in this part discuss investment gains and losses, including how to figure your basis in property. A gain from selling or trading stocks, bonds, or other investment property may be taxed or it may be tax free, at least in part. A loss may or may not be deductible. These chapters also discuss gains from selling property you personally use — including the special rules for selling your home. Nonbusiness casualty and theft losses are discussed in Chapter 27 in Part Five.

### 14.

## Basis of Property

### Introduction

This chapter discusses how to figure your basis in property and covers the following topics:

- Cost basis of property you buy.
- Adjustments to basis after you get property.
- Property you get because of a casualty or condemnation.
- Property you get in exchange for your services.
- Business or investment property you get in an exchange or trade-in.
- Property you get as a gift.
- Property transferred to you because of a divorce.
- Property you inherit.
- Stocks, bonds, and mutual funds in which you invest.

Basis is a way of measuring your investment in property for tax purposes. Use the basis of property to figure the deductions for depreciation, amortization, depletion, and casualty losses. Also use it to figure gain or loss on the sale or other disposition of property. You must keep accurate records of all items that affect the basis of property so you can make these computations.

### Useful Items

You may want to see:

#### Publication

- 463** Travel, Entertainment, Gift, and Car Expenses
- 525** Taxable and Nontaxable Income
- 537** Installment Sales
- 550** Investment Income and Expenses

- 551** Basis of Assets
- 564** Mutual Fund Distributions

### Cost Basis

The basis of property you buy is usually its cost. The cost is the amount you pay in cash, debt obligations or in other property. Your cost also includes, for example, amounts you pay for:

- 1) Sales tax charged on the purchase,
- 2) Freight charges to obtain the property,
- 3) Installation and testing charges,
- 4) Excise taxes,
- 5) Legal and accounting fees (when they must be capitalized),
- 6) Revenue stamps,
- 7) Recording fees,
- 8) Real estate taxes (if assumed for the seller) and,
- 9) Commissions.

In addition, the cost basis of real estate and business assets will include other items.

**Loans with low or no interest** If you buy property on any time-payment plan that charges little or no interest, the basis of your property is your stated purchase price minus the amount considered to be unstated interest. You generally have **unstated interest** if your interest rate is less than the federal rate that applies.

For more information, see *Unstated Interest* in Publication 537.

### Real Property

If you buy real property, certain fees and other expenses you pay are part of your basis in the property. Real property is land and generally anything built on, growing on, or attached to land. For example, a building is considered real property.

**Assumption of a mortgage.** If you buy property and assume an existing mortgage on the property, your basis includes the amount you pay for the property plus the unpaid mortgage you assume.

**Settlement costs.** You can include in the basis of property you buy the settlement fees and closing costs that are for buying it. You

cannot include the fees and costs that are for getting a loan on the property. (A fee is for buying property if you would have had to pay it even if you bought the property for cash.)

Some of the settlement fees or closing costs that you can include in the basis of your property are:

- 1) Abstract fees (sometimes called abstract of title fees),
- 2) Charges for installing utility services,
- 3) Legal fees (including title search and preparing the sales contract and deed),
- 4) Recording fees,
- 5) Surveys,
- 6) Transfer taxes,
- 7) Owner's title insurance, and
- 8) Any amounts the seller owes that you agree to pay, such as back taxes or interest, recording or mortgage fees, charges for improvements or repairs, and sales commissions.

You must reasonably allocate these fees or costs between land and improvements, such as buildings, to figure the basis for depreciation of the improvements. Allocate the fees according to the fair market values of the land and improvements at the time of purchase.

Settlement costs **do not include** amounts placed in escrow for the future payment of items such as taxes and insurance.

Some settlement fees and closing costs you **cannot** include in the basis of the property are:

- 1) Fire insurance premiums.
- 2) Rent for occupancy of the property before closing.
- 3) Charges for utilities or other services relating to occupancy of the property before closing.
- 4) Charges connected with getting a loan, such as:
  - a) Points (discount points, loan origination fees),
  - b) Mortgage insurance premiums,
  - c) Loan assumption fees,
  - d) Cost of a credit report, and

- e) Fees for an appraisal required by a lender.
- 5) Fees for refinancing a mortgage.

**Real estate taxes.** If you buy real property and agree to pay taxes the seller owed on it, treat the taxes you pay as part of your basis. You cannot deduct them as taxes paid.

If you reimburse the seller for taxes the seller paid for you, you can usually deduct that amount. Do not include that amount in the basis of the property.

**Points.** If you pay points to get a loan (including a mortgage, second mortgage, line of credit, or a home equity loan), you generally must capitalize them. You can amortize them ratably over the term of the loan. Do not add the cost to the basis of the related property.

**Points on home mortgage.** Special rules may apply to amounts you and the seller pay as points when you get a mortgage to buy your main home. If these amounts meet certain requirements, you can deduct them in full as points for the year in which they are paid. If you deduct seller-paid points, reduce your basis by that amount. For more information, see *Points* in Publication 936, *Home Mortgage Interest Deduction*.

## Adjusted Basis

Before figuring any gain or loss on a sale, exchange, or other disposition of property, or figuring allowable depreciation, depletion, or amortization, you must usually make certain adjustments (increases and decreases) to the basis of the property. The result of these adjustments to the basis is the adjusted basis.

## Increases to Basis

Increase the basis of any property by all items properly added to a capital account. This includes the cost of any improvements having a useful life of more than 1 year and amounts spent after a casualty to restore the damaged property. Other items added to the basis of property include the cost of extending utility service lines to the property and legal fees, such as the cost of defending and perfecting title.

**Improvements.** Add the cost of improvements that increase the value of property, lengthen its life, or adapt it to a different use to your basis in the property. For example, improvements include putting a recreation room in your unfinished basement, adding another bathroom or bedroom, putting up a fence, putting in new plumbing or wiring, installing a new roof, or paving your driveway.

**Assessments for local improvements.** Add assessments for improvements such as streets and sidewalks, which increase the value of the property assessed, to the basis of the property. Do not deduct them as

taxes. However, you can deduct as taxes assessments you pay for maintenance or repair or meeting interest charges on the improvements.

**Example.** Your city changes the street in front of your store into an enclosed pedestrian mall and assesses you and other affected landowners for the cost of the conversion. The city adds the assessment to your property's basis. In this example, the assessment is a depreciable asset.

## Decreases to Basis

Some items that reduce the basis of your property are:

- 1) The section 179 deduction,
- 2) The deduction for clean-fuel vehicles and clean-fuel vehicle refueling property,
- 3) Nontaxable corporate distributions,
- 4) Deductions previously allowed or allowable for amortization, depreciation, and depletion,
- 5) Exclusion from income of subsidies for energy conservation measures (see *Energy conservation subsidies*, in Chapter 13),
- 6) Credit for qualified electric vehicles,
- 7) Gain from the sale of your old home on which tax was postponed,
- 8) Casualty and theft losses,
- 9) Certain canceled debt excluded from income,
- 10) Rebates received from the manufacturer or seller,
- 11) Easements,
- 12) Residential energy credit,
- 13) Gas-guzzler tax, and
- 14) Tax credit or refund for buying a diesel-powered highway vehicle.

Some of these decreases to basis are discussed next.

**Casualties and thefts.** If you have a casualty or theft loss, decrease the basis of your property by any insurance proceeds or other amount you get. Also decrease it by any deductible loss not covered by insurance. However, increase your basis for your costs after a casualty to restore the damaged property. For more information, see Chapter 27.

**Easements.** The amount you get for granting an easement usually is considered to be from the sale of an interest in your real property. It reduces the basis of the affected part of the property. If the amount received is more than the basis of the part of the property affected by the easement, reduce your basis to zero and treat the excess as a recognized gain.

If the recognized gain is on a capital asset, see Chapter 17 for more information about how to report it. If the recognized gain is on property used in a trade or business, get Publication 544, *Sales and Other Dispositions of Assets*, for more information about how to report this gain.

**Residential energy credit.** The residential energy credit is no longer available. However, if in the past you were allowed the credit, decrease the basis of your home by the credit if you added the cost of the energy items to the basis of your home.

**Section 179 deduction.** If you take the section 179 deduction for all or part of the cost of business property, decrease the basis of the property by the deduction.

For more information, get Publication 946, *How To Depreciate Property*.

**Depreciation.** Decrease the basis of your property by the depreciation you could have deducted on your tax returns under the method of depreciation you selected. If you deducted less depreciation than you could have under the method you selected, decrease the basis by the amount you could have taken under that method.

Table 14-1. Examples of Adjustments to Basis

<u>Increases to Basis</u>	<u>Decreases to Basis</u>
Capital improvements: Putting an addition on your home Replacing an entire roof Paving your driveway Installing central air conditioning Rewiring your home	Exclusion from income of subsidies for energy conservation measures
Assessments for local improvements: Water connections Sidewalks Roads	Casualty or theft loss deductions and insurance reimbursements
Casualty Losses: Restoring damaged property	Credit for qualified electric vehicles
Legal fees: Cost of defending and perfecting a title	Gain from the sale of your old home on which tax was postponed
Zone costs	Section 179 deduction
	Deduction for clean-fuel vehicles and clean-fuel vehicle refueling property
	Depreciation
	Nontaxable corporate distributions

If you deducted more depreciation than you should have, decrease your basis as follows. Decrease it by the depreciation you should have deducted plus the part of the excess depreciation you deducted that actually reduced your tax liability for any year.

For more information about depreciation, get Publication 946.

**Credit for qualified electric vehicles.** If you claim the credit for qualified electric vehicles, you must reduce the basis of the property on which you claimed the credit. For more information about this credit, see Chapter 15 in Publication 535, *Business Expenses*.

**Deduction for clean-fuel vehicle and clean-fuel vehicle refueling property.** If you take the deduction for either clean-fuel vehicles or clean-fuel vehicle refueling property, or both, decrease the basis of the property by the deduction. For more information about these deductions, see Chapter 15 in Publication 535.

**Tax-free subsidies for energy conservation measures.** A subsidy from a public utility company for the purchase or installation of any energy conservation measure is tax free. Reduce the basis of the property on which you got the subsidy by the tax-free amount. For more information about this subsidy, see chapter 13.

## Adjusted Basis Example

You owned a duplex used as rental property that cost you \$40,000. The \$40,000 cost was allocated \$35,000 for the building and \$5,000 for the land. You added an improvement to the duplex that cost \$10,000. In February last year the duplex was damaged by fire. Up to that time you had been allowed depreciation of \$23,000. You sold the salvage for \$1,300 and collected \$19,700 from your insurance company. You deducted a casualty loss of \$1,000 on your income tax return for last year. You spent \$19,000 of the insurance proceeds for restoration of the duplex, which was completed this year. Figure the adjusted basis of the duplex after the restoration as follows:

Original cost of duplex .....	\$35,000	
Addition to duplex .....	10,000	
Total cost of duplex .....	\$45,000	
Minus: Depreciation .....	23,000	
Adjusted basis before casualty .....	\$22,000	
Minus: Casualty loss .....	\$ 1,000	
Insurance proceeds .....	19,700	
Salvage proceeds .....	1,300	22,000
Adjusted basis after casualty .....	\$ -0-	
Add: Cost of restoring duplex .....	19,000	
<b>Adjusted basis after restoration</b> .....		<b>\$19,000</b>

Your basis in the land is its original cost of \$5,000.

## Other Basis

There are many times when you cannot use cost as a basis. In these cases, the fair market value or the adjusted basis of certain property may be used. Fair market value is discussed next. Adjusted basis is discussed earlier.

**Fair market value (FMV).** FMV is the price at which the property would change hands between a buyer and a seller, neither having to buy or sell, and both having reasonable knowledge of all necessary facts. Sales of similar property on or about the same date may be helpful in figuring the FMV of the property.

**Property received for services.** If you get property for your services, the property's FMV is taxable. The taxable amount becomes your basis. If the services were performed for a price agreed on beforehand, the price will be accepted as the FMV of the property if there is no evidence to the contrary.

**Restricted property.** If you get property for your services and the property is subject to certain restrictions, your basis in the property is its FMV when it becomes substantially vested, unless you make an election. Property becomes substantially vested when you can transfer it or when it is not subject to a substantial risk of forfeiture. For more information, see *Restricted Property Received for Services* in Publication 525.

**Bargain purchases.** A bargain purchase is a purchase of an item for less than its FMV. If your employer lets you buy goods or other property at less than FMV, include the difference between the purchase price and the property's FMV in your income. Your basis in the property is its FMV, that is, your purchase price plus the amount you include in your income.

If the difference between your purchase price and the FMV is a qualified employee discount, do not include the difference in income. However, your basis in the property is still its FMV. See *Qualified Employee Discount* in Chapter 4 of Publication 535.

**Taxable exchanges.** A taxable exchange is one in which the gain is taxable or the loss is deductible. If you get property in exchange for other property in a taxable exchange, the basis of the property you get is usually its FMV at the time of the exchange.

## Involuntary Exchanges

If you get property as a result of an involuntary exchange, such as a casualty, theft, or condemnation, you may figure the basis of the replacement property you get using the basis of the property exchanged.

**Similar or related property.** If you get property that is similar or related in service or use to the property exchanged, the new property's basis is the same as the old

property's basis on the date of the exchange. However, make the following adjustments:

Decrease the basis by—

- Any loss recognized on the exchange, and
- Any money received that was not spent on similar property.

Increase the basis by—

- Any gain recognized on the exchange, and
- Any cost of getting replacement property.

**Not similar or related property.** If you get money or other property that is not similar or related in service or use to the old property and you buy new property that is similar or related in service or use to the old property, the basis of the new property is the cost of the new property decreased by the gain not recognized on the exchange.

**Example.** The state condemned your property. The adjusted basis of the property was \$26,000, and the state paid you \$31,000 for it. You realized a gain of \$5,000 (\$31,000 – \$26,000). You bought new property that is similar in use to the old property for \$29,000. You recognize a gain of \$2,000 (\$31,000 – \$29,000), the unspent part of the payment from the state. Your gain not recognized is \$3,000, the difference between the \$5,000 realized gain and the \$2,000 recognized gain. You figure the basis of the new property as follows:

Cost of new property .....	\$29,000
Minus: Gain not recognized .....	3,000
<b>Basis of new property</b> .....	<b>\$26,000</b>

**Allocating the basis.** If you buy more than one piece of replacement property, allocate your basis among the properties based on their respective costs.

**Example.** If, in the previous example, the state had condemned unimproved real property and the new property you bought was improved real property with both land and buildings, you would make an allocation. Take the new property's \$26,000 basis and allocate it between land and buildings based on their costs.

## Nontaxable Exchanges

A nontaxable exchange is an exchange in which you are not taxed on any gain and you cannot deduct any loss. If you get property in a nontaxable exchange, its basis is usually the same as the basis of the property you exchanged. See *Nontaxable Trades* in Chapter 15.

**Example.** You trade in an old truck, which has an adjusted basis of \$1,700, for a new one costing \$6,800. The dealer allows you \$2,000 on the old truck, and you pay \$4,800. This is a nontaxable exchange, and the basis of the new truck is \$6,500, that is,

the adjusted basis of the old one, \$1,700, increased by the additional cost, \$4,800. If you instead sell your old truck to a third party for \$2,000 and then buy the new one from the dealer, you have a taxable gain on the sale. The basis of the new truck is the price you pay the dealer for it.

**Partially nontaxable exchange.** A partially nontaxable exchange is an exchange in which you get unlike property or money and like property.

The basis of property you get is usually the same as the basis of the property exchanged **decreased** by any money you get and any loss recognized on the exchange; and then **increased** by any additional costs incurred and any gain recognized on the exchange.

Allocate the basis among the properties, other than money, you got in the exchange. In making this allocation, the basis of the unlike property is its fair market value on the date of exchange. The rest is the basis of the like property.

**Trade-in or sale and purchase.** If a sale and purchase are a single transaction, you cannot increase the basis of property for depreciation by selling your old property outright to a dealer and then buying new property from the same dealer. If the sale of your old property to the dealer and the purchase of new property from that dealer are dependent on each other, you are considered to have traded in your old property. Treat the transaction as an exchange no matter how you carry it out. You cannot avoid this trade-in rule by using a subsidiary in the transaction.

**Example.** You are a salesperson and use one of your cars 100% for business. You have used this car in your sales activities for 2 years and have depreciated it. Your adjusted basis in the car is \$22,600, and its FMV is \$23,100.

You are interested in a new car with a listed retail price of \$28,695, which usually sells for \$28,000. If you trade your old car and \$4,900 for the new one, your basis for depreciation for the new car would be \$27,500 (\$4,900 plus \$22,600 basis of your old car). However, you want a higher basis for depreciating the new car, so you agree to pay the dealer \$28,000 for the new car if he will pay you \$23,100 for your old car.

Since the sale and purchase are dependent on each other, you are treated as if you had exchanged your old car for the new one. Your basis for depreciating the new car is \$27,500, which is the same as it would be if you had traded the old car.

For information about the trade of a car used partly for business, see Publication 463.

## Property Received as a Gift

To figure the basis of property you get as a gift, you must know its adjusted basis to the donor just before it was given to you. You

also must know its FMV at the time it was given to you and any gift tax paid on it.

**FMV less than donor's adjusted basis.** If the FMV of the property was less than the donor's adjusted basis, your basis for gain on its sale or other disposition is the donor's adjusted basis plus or minus any required adjustment to basis while you held the property (see *Adjusted Basis*, earlier). Your basis for loss on its sale or other disposition is its FMV when you got the gift plus or minus any required adjustment to basis while you held the property. See *Adjusted Basis*, earlier.

**Example.** You got an acre of land as a gift. At the time of the gift, the land had an FMV of \$8,000. The donor's adjusted basis was \$10,000. After you got the property, no events occur that would increase or decrease your basis in it. If you later sell the property for \$12,000, you will have a \$2,000 gain. You must use the donor's adjusted basis (\$10,000) at the time of the gift as your basis to report a gain. If you sell the property for \$7,000, you have a \$1,000 loss because you must use the FMV (\$8,000) at the time of the gift to report a loss.

If the sales price is between \$8,000 and \$10,000, you have neither a gain nor a loss. For instance, if the sales price was \$9,000 and you tried to figure a gain using the donor's adjusted basis (\$10,000), you would get a loss of \$1,000. If you then tried to figure a loss using the FMV (\$8,000), you would get a gain of \$1,000.

**Business property.** If you hold the gift as business property, your basis for figuring any depreciation, depletion, or amortization deduction is the same as the donor's adjusted basis plus or minus any required adjustments to basis while you hold the property.

**FMV equal to or greater than donor's adjusted basis.** If the FMV of the property was equal to or greater than the donor's adjusted basis, your basis is the same as the donor's adjusted basis at the time you got the gift. Increase your basis by all or part of the gift tax paid, depending on the date of the gift.

Also, for figuring gain or loss from a sale or other disposition of the property or figuring depreciation, depletion, or amortization deductions on business property, you must increase or decrease your basis (the donor's adjusted basis) for any required adjustments to basis while you held the property. See *Adjusted Basis*, earlier.

**Gift received before 1977.** If you got a gift before 1977, increase your basis in the gift by the gift tax paid on it. (Your basis in the gift is the donor's adjusted basis.) However, do not increase your basis above the FMV of the gift when it was given to you.

**Example 1.** You were given a house in 1976 with an FMV of \$21,000. The donor's adjusted basis was \$20,000. The donor paid a gift tax of \$500. Your basis is \$20,500, the donor's adjusted basis plus the gift tax paid.

**Example 2.** If, in Example 1, the gift tax paid had been \$1,500, your basis would be

\$21,000. This is the donor's adjusted basis plus the gift tax paid, limited to the FMV of the house at the time you got the gift.

**Gift received after 1976.** If you got a gift after 1976, increase your basis in the gift by the part of the gift tax paid that is due to the net increase in value of the gift. (Your basis in the gift is the donor's adjusted basis.) Figure the increase by multiplying the gift tax paid on the gift by a fraction. The numerator (top part) of the fraction is the net increase in value of the gift and the denominator (bottom part) is the value of the gift. The net increase in value of the gift is the FMV of the gift minus the donor's adjusted basis.

**Example.** Last year you got a gift of property from your mother that had an FMV of \$50,000. Her adjusted basis was \$20,000. She paid a gift tax of \$9,000 on the property. For figuring depreciation, depletion, amortization, and gain or loss, your basis is \$25,400, figured as follows:

Fair market value .....	\$50,000
Minus: Adjusted basis .....	<u>20,000</u>
Net increase in value .....	<u>\$30,000</u>
Gift tax paid .....	\$ 9,000
Multiplied by (\$30,000 ÷ \$50,000) .....	<u>.60</u>
Gift tax due to net increase in value .....	\$ 5,400
Adjusted basis of property to your mother .....	<u>20,000</u>
<b>Your basis in the property</b> .....	<u><u>\$25,400</u></u>

## Property Transferred From a Spouse

The basis of property transferred to you or transferred in trust for your benefit by your spouse is the same as the transferor's adjusted basis. The same rule applies to a transfer by your former spouse if the transfer is incident to divorce. However, adjust your basis for any gain recognized by the transferor on a property transferred in trust. This rule applies only to a property transfer in trust in which the liabilities assumed plus the liabilities to which the property is subject are more than the adjusted basis of the property transferred.

If the property transferred is a Series E or EE United States savings bond, the transferor must include in income the interest accrued to the date of transfer. The transferee's basis in the bond immediately after the transfer is equal to the transferor's adjusted basis plus the interest income includible in the transferor's income.

The transferor must give you records needed to determine the adjusted basis and holding period of the property as of the date of the transfer. For more information about the transfer of property between spouses, see Chapter 15.

## Inherited Property

Your basis in property you inherit is usually its FMV at the date of the decedent's death. If a federal estate tax return has to be filed, your basis in property you inherit can be its

FMV at the alternate valuation date if the estate qualifies and elects to use alternate valuation. If a federal estate tax return does not have to be filed, your basis in the property is its appraised value at the date of death for state inheritance or transmission taxes.

Your basis in inherited property may also be figured under the special farm or closely held business real property valuation method, if chosen for estate tax purposes.

For more information about the basis of inherited property, such as property held by a surviving tenant and qualified joint interest in property held by a husband and wife, see *Inherited Property* in Publication 551.

## Property Changed to Business or Rental Use

When you hold property for personal use and change it to business use or use it to produce rent, you must figure the basis for depreciation. An example of this would be renting out your former main home.

**Basis for depreciation.** The basis for depreciation equals the lesser of:

- 1) The FMV (defined earlier under *Other Basis*) of the property on the date of the change, or
- 2) Your adjusted basis (defined earlier under *Adjusted Basis*) on the date of the change.

**Example.** Several years ago you paid \$160,000 to have your house built on a lot that cost you \$20,000. Before changing the property to rental use last year, you paid \$20,000 for permanent improvements to the house and claimed a \$2,000 casualty loss deduction to the house. Because land is not depreciable, you can include only the cost of the house when figuring the basis for depreciation.

Your adjusted basis in the house when you change its use is \$178,000 (\$160,000 + \$20,000 - \$2,000). On the date of the change in use, your property has an FMV of \$180,000, of which \$15,000 is for the land and \$165,000 is for the house. The basis for depreciation on the house is the FMV on the date of the change (\$165,000) because it is less than your adjusted basis (\$178,000).

**Sale of property.** If you later sell or dispose of the property, the basis of the property to be used will depend on whether you are figuring gain or loss.

**Gain.** The basis for gain is your adjusted basis when you sell the property.

**Example.** Assume the same facts as in the previous example except that, after being allowed depreciation deductions of \$37,500, you sell the property at a gain. Your adjusted basis in this case would be \$160,500 (\$178,000 + \$20,000 (land) - \$37,500).

**Loss.** Figure the basis for loss using the smaller of your adjusted basis or the FMV of the property at the time of the change.

**Example.** Assume the same facts as in the previous example except that, after being allowed depreciation deductions of \$37,500, you sell the property at a loss. Your adjusted basis in this case would be the FMV (\$180,000) because it is less than the adjusted basis (\$198,000) on the date of the exchange. That amount (\$180,000) is reduced by the depreciation deduction to arrive at a basis of \$142,500 (\$180,000 - \$37,500).

## Stocks and Bonds

The basis of stocks or bonds you own generally is the purchase price plus the costs of purchase, such as commissions and recording or transfer fees. If you got stocks or bonds other than by purchase, your basis is usually determined by FMV or the donor's adjusted basis, as discussed earlier.

You must adjust the basis of stocks for certain events that occur after purchase. For example, if you get additional stock from nontaxable stock dividends or stock splits, reduce the basis of your original stock. Also reduce your basis when you get nontaxable distributions because these are a return of capital.

**Example.** In 1994 you bought 100 shares of XYZ stock for \$1,000 or \$10 a share. In 1995 you bought 100 shares of XYZ stock for \$1,600 or \$16 a share. In 1996 XYZ declared a 2-for-1 stock split. You now have 200 shares of stock with a basis of \$5 a share and 200 shares with a basis of \$8 a share.

**Other basis.** There are other ways to figure the basis of stocks or bonds depending on how you acquired them. Some ways in which you can acquire stock are by automatic investment services, dividend reinvestment plans, and stock rights. For detailed information, get Publication 550.

**Identifying shares.** If you buy and sell securities at different times in varying quantities and you cannot definitely identify the securities you sell, the figure the basis of those sold under the first-in first-out method—that is, the first securities you acquired are the first sold.

**Identification.** You will make an adequate identification if you show that certificates representing shares of stock from a lot that you bought on a certain date or for a certain price were delivered to your broker or other agent.

If you left the security certificates with your broker or other agent, an adequate identification is made if you:

- 1) Tell your broker the particular security to be sold or transferred at the time of the sale or transfer, and

- 2) Get a written confirmation of this from your broker or other agent within a reasonable time.

If you bought securities in different lots at different times and you hold a single certificate for these securities, you make an adequate identification if you:

- 1) Tell your broker the particular security to sell or transfer when you deliver the certificate to your broker, and
- 2) Get a written confirmation of this from your broker or other agent within a reasonable time.

Stock identified this way is the stock sold or transferred even though stock certificates from a different lot are delivered to the broker or other agent. If you sell part of the stock represented by a single certificate directly to the buyer instead of through a broker, you will make an adequate identification if you keep a written record of the particular stock that you intend to sell. This method of identification also applies to bonds sold or transferred.

**Mutual fund shares.** You can choose to use the average basis of shares you own in a regulated investment company (mutual fund) if you acquired the shares at various times and prices and if you left the shares on deposit in an account kept by a custodian or agent for acquiring or redeeming the shares. You figure average basis by using either the double-category method or the single-category method. These methods and other information about the basis of mutual fund shares are explained in Publication 564.

**Premiums on bonds.** If you buy a taxable bond at a premium and choose to amortize the premium paid, reduce the basis of the bond by the amount of the amortized premium deducted each year. See *Bond Premium Amortization* in Chapter 3 of Publication 550 for more information. Although you cannot take a deduction for the premium on tax-exempt bonds, each year you must amortize the premium and reduce your basis in the bonds by the amortized amount.

**Original issue discount (OID) on debt instruments.** You must increase your basis in an OID debt instrument by the amount of OID that you included in income for that instrument. See *Original Issue Discount* in Chapter 8.

**Tax-exempt bonds.** OID on tax-exempt bonds is not taxable. However, there are special rules for figuring basis on tax-exempt OID bonds issued after September 3, 1982, and acquired after March 1, 1984. See Chapter 4 of Publication 550.

# Sale of Property

## Important Reminder

**Foreign-source income.** If you are a U.S. citizen with investment income from sources outside the United States (foreign income), you must report all such income on your tax return unless it is exempt by U.S. law. This is true whether you reside inside or outside the United States and whether or not you receive a Form 1099 from the foreign payor.

## Introduction

This chapter discusses the tax consequences of selling or trading investment property. It explains:

- What is a sale or trade,
- When you have a nontaxable trade,
- What to do with a related party transaction,
- Whether the property you sell is a capital asset or a noncapital asset,
- Whether you have a capital or ordinary gain or loss from the sale of property,
- How to determine your holding period, and
- When you can make a tax-free rollover of a gain from selling certain securities.

**Sales not discussed in this publication.** Certain sales or trades of property are discussed in other IRS publications. They include, for example, installment sales, covered in Publication 537, *Installment Sales*, and transfers of property at death, covered in Publication 559, *Survivors, Executors, and Administrators*.

Publication 544, *Sales and Other Dispositions of Assets*, provides information about various types of transactions involving business property, including dispositions of assets used in a trade or business or for the production of income.

Publication 550, *Investment Income and Expenses (Including Capital Gains and Losses)*, provides more detailed discussion about sales and trades of investment property. Publication 550 includes information about the rules covering nonbusiness bad debts, straddles, section 1256 contracts, puts and calls, commodity futures, short sales, and wash sales. It also discusses investment-related expenses.

Publication 925, *Passive Activity and At-Risk Rules*, discusses the rules that limit losses and credits from passive activities as well as the rules that apply to the disposition of an interest in a passive activity.

If you sell your home, different tax rules apply. These rules are discussed in Chapter 16.

**Note:** Beginning in 1998, you may have to pay tax on only one-half of your gain from the sale or exchange of **qualified small business stock**. This exclusion applies only to stock issued after August 10, 1993, and held by you for more than 5 years. You must have acquired the stock at its original issue, directly or through an underwriter, in one of the following ways:

- 1) In exchange for money or other property (not including stock), or
- 2) As pay for services provided to the corporation (other than services performed as an underwriter of the stock).

For more information, see *Exclusion for Gain From Small Business Stock* in Chapter 4 of Publication 550.

## Useful Items

You may want to see:

### Publication

- 504** Divorced or Separated Individuals
- 550** Investment Income and Expenses
- 564** Mutual Fund Distributions

### Form (and Instructions)

- Schedule D (Form 1040)** Capital Gains and Losses
- 8824** Like-Kind Exchanges

## Sales and Trades

Sales and trades (or exchanges) of assets generally result in taxable gains or deductible losses, although some trades of property are nontaxable.

**Form 1099-B.** If you sold property such as stocks, bonds, or certain commodities through a broker during 1996, you should receive, for each sale, a Form 1099-B, *Proceeds From Broker and Barter Exchange Transactions*, or an equivalent statement from the broker. You should receive the statement by January 31, 1997. It will show the gross proceeds from the sale. The Internal Revenue Service (IRS) will also get a copy of Form 1099-B from the broker.

If you receive a Form 1099-B or equivalent statement, you must complete Schedule D of Form 1040.

## What is a Sale or Trade?

A sale is generally a transfer of property for money only or for a promise to pay money, such as a mortgage or note. A trade is a transfer of property in return for other property or services and may be taxed in the same way as a sale.

**Sale and purchase.** Ordinarily, a transaction is not a trade when you voluntarily sell property for cash and immediately buy similar property to replace it. Such a sale and purchase are two separate transactions.

**Redemption of stock.** A redemption of stock is treated as a sale or trade and is subject to the capital gain or loss provisions unless the redemption is a dividend or other distribution on stock.

**Dividend vs. sale or trade.** Whether a redemption is treated as a sale, trade, dividend, or other distribution depends on the circumstances in each case. Both direct and indirect ownership of stock will be considered. The redemption is treated as a sale or trade of stock if:

- 1) The redemption is not essentially equivalent to a dividend (see Chapter 9),
- 2) There is a substantially disproportionate redemption of stock,
- 3) There is a complete redemption of all the stock of the corporation owned by the shareholder, or
- 4) The redemption is a distribution in partial liquidation of a corporation.

**Redemption or retirement of bonds.** A redemption or retirement of bonds or notes at their maturity is a sale or trade that you must report on Schedule D (Form 1040) whether or not you realize gain or loss on the transaction.

However, if the issuer has merely extended the maturity date of its notes, during which period some of the noteholders have agreed not to redeem their notes until all the other notes are retired or their retirement is provided for, neither a trade nor a closed or completed transaction has occurred. Under these circumstances, you do not figure gain or loss.

**Surrender of stock.** A surrender of stock by a dominant shareholder who retains control of the corporation is treated as a contribution to capital rather than as an immediate loss deductible from taxable income. The surrendering shareholder must reallocate his or her basis in the surrendered shares to the shares he or she retains.

## How To Figure a Gain or Loss

You figure gain or loss on a sale or trade of property by comparing the amount you realize with the adjusted basis of the property.

**Gain.** If the amount you realize from a sale or trade is more than the adjusted basis of the property you transfer, the difference is a gain.

**Loss.** If the adjusted basis of the property you transfer is more than the amount you realize, the difference is a loss.

**Adjusted basis.** The adjusted basis of property is your original cost or other original basis properly adjusted (increased or decreased) for certain items. See Chapter 14 for more information about determining the adjusted basis of property.

**Amount realized.** The amount you realize from a sale or trade of property is everything you receive for the property. This includes the money you receive plus the fair market value of any property or services you receive.

If you finance the buyer's purchase of your property and the debt instrument does not provide for adequate stated interest, the unstated interest will reduce the amount realized. For more information, see Publication 537.

**Fair market value.** Fair market value is the price at which the property would change hands between a buyer and a seller, neither being forced to buy or sell and both having reasonable knowledge of all the relevant facts.

The fair market value of notes or other evidence of indebtedness you receive as a part of the sale price is usually the best amount you can get from selling them to, or discounting them with, a bank or other buyer of debt instruments.

**Debt paid off.** An indebtedness against the property, or against you, that is paid off as a part of the transaction, or that is assumed by the buyer, must be included in the amount realized. This is true even if neither you nor the buyer is personally liable for the debt. For example, if you sell or trade property that is subject to a nonrecourse loan, the amount you realize includes the full amount of the note assumed by the buyer even if the amount of the note exceeds the fair market value of the property.

**Payment of cash.** If you trade property for other property and in addition pay cash, the amount you realize is the fair market value of the property you receive. Determine your gain or loss by subtracting your adjusted basis (the cash you pay plus the adjusted basis of the property you traded in) from the amount you realize. If the result is a positive number, it is a gain. If the result is a negative number, it is a loss.

**Example 1.** You sell stock that you had pledged as security for a bank loan of \$8,000. Your basis in the stock is \$6,000. The buyer pays off your bank loan and pays you \$20,000 in cash. The amount realized is \$28,000 (\$20,000 + \$8,000). Your gain is \$22,000 (\$28,000 – \$6,000).

**Example 2.** You trade A Company stock with an adjusted basis of \$7,000 for B Company stock with a fair market value of \$10,000, which is your amount realized. Your gain is \$3,000 (\$10,000 – \$7,000). If you also receive a note for \$6,000 that has a discount value of \$4,000, your gain is \$7,000 (\$10,000 + \$4,000 – \$7,000).

**No gain or loss.** You may have to use a basis for figuring gain that is different from the

basis used for figuring loss. In this case, you may have neither a gain nor a loss. See *Other Basis* in Chapter 14. In these situations, if you use the basis for figuring a gain and the result is a loss, and then use the basis for figuring a loss and the result is a gain, you will have neither a gain nor a loss.

**Example.** You receive a gift of investment property having an adjusted basis of \$10,000 at the time of the gift. The fair market value at the time of the gift is \$9,000. You later sell the property for \$9,500. You have neither gain nor loss. Your basis for figuring gain is \$10,000, and \$10,000 minus \$9,500 results in a \$500 loss. Your basis for figuring loss is \$9,000, and \$9,500 minus \$9,000 results in a \$500 gain.

## Nontaxable Trades

Certain trades or exchanges are nontaxable. This means that any gain from the exchange is not taxed, and any loss cannot be deducted. In other words, even though you may realize a gain or loss on the exchange, it will not be recognized for tax purposes. The property you get generally has the same basis as the adjusted basis of the property you gave up.

For additional information on nontaxable trades, see Chapter 1 of Publication 544.

**Like-kind exchanges.** If you trade business or investment property for other business or investment property of a like kind, you must postpone tax on the gain or postpone deducting the loss until you sell or dispose of the property you receive. To be nontaxable, a trade must meet all six of the following conditions:

- 1) The property must be business or investment property. You must hold both the property you trade and the property you receive for business or investment purposes. Neither property may be property used for personal purposes, such as your home or family car.
- 2) The property must not be property held primarily for sale. The property you trade and the property you receive must not be property you sell to customers, such as merchandise. It must be property held for productive use in your trade or business or property held for investment.
- 3) There must be an exchange of like-kind property. The exchange of real estate for real estate and the exchange of personal property for similar personal property are exchanges of like-kind property. (However, real property located in the United States and real property located outside the United States are not like-kind property.) The trade of an apartment house for a store building, or a panel truck for a pickup truck, are like-kind exchanges. The exchange of a piece of machinery for a store building is not a like-kind exchange.

- 4) The property must not be stocks, bonds, notes, choses in action, certificates of trust or beneficial interests, or other securities or evidences of indebtedness or interest, including partnership interests. However, you can have a nontaxable exchange of corporate stocks under a different rule, as discussed later under *Corporate stocks*.
- 5) The property must meet the identification requirement. The property to be received must be identified by the day that is 45 days after the date of transfer of the property given up in the exchange.
- 6) The exchange must meet the completed transaction requirement. The property must be received by the earlier of:
  - a) The 180th day after the date on which you transfer the property given up in the trade, or
  - b) The due date, including extensions, for your tax return for the year in which the transfer of the property given up occurs.

If you trade property with a related party in a like-kind exchange, a special rule may apply. See *Related Party Transactions*, later in this chapter. Also, see Chapter 1 of Publication 544 for more information on exchanges of business property and special rules for exchanges using qualified intermediaries or involving multiple properties.

**Partially nontaxable exchange.** If you receive cash or nonlike-kind property in addition to like-kind property, and the above conditions are met, you have a partially nontaxable trade. You are taxed on any gain you realize, but only to the extent of the cash and the fair market value of the nonlike-kind property you receive. You cannot deduct a loss.

**Like-kind property and nonlike-kind property transferred.** If you give up nonlike-kind property in addition to the like-kind property, you must recognize gain or loss only on the nonlike-kind property you give up. The gain or loss is the difference between the adjusted basis of the nonlike-kind property and its fair market value. See Chapter 1 of Publication 544 for more information about partially nontaxable exchanges.

**Like-kind property and money transferred.** If conditions (1) – (6) are met, you have a nontaxable trade even if you pay money in addition to transferring property in exchange for like-kind property.

**Basis.** To figure the basis of the property received, see *Nontaxable Exchanges*, in Chapter 14.

**How to report.** You must report the exchange of like-kind property on **Form 8824, Like-Kind Exchanges**. If you figure a recognized gain or loss on Form 8824, report it on Schedule D of Form 1040 or on Form 4797, *Sales of Business Property*, whichever applies.

For information on using Form 4797, see Chapter 5 of Publication 544.

**Corporate stocks.** The following trades of corporate stocks generally do not result in a taxable gain or a deductible loss.

**Stock for stock of the same corporation.** You can exchange common stock for common stock or preferred stock for preferred stock in the same corporation without having a recognized gain or loss. This is true for a trade between two stockholders as well as a trade between a stockholder and the corporation.

**Corporate reorganizations.** In some instances, you can trade common stock for preferred stock, preferred stock for common stock, or stock in one corporation for stock in another corporation without having a recognized gain or loss. These trades must be part of mergers, recapitalizations, transfers to controlled corporations, bankruptcies, corporate divisions, corporate acquisitions, or other corporate reorganizations.

**Convertible stocks and bonds.** You generally will not have a recognized gain or loss if you convert bonds into stock or preferred stock into common stock of the same corporation according to a conversion privilege in the terms of the bond or the preferred stock certificate.

**Property for stock of a controlled corporation.** If you transfer property to a corporation solely in exchange for stock in that corporation, and immediately after the trade you are in control of the corporation, you ordinarily will not recognize a gain or loss. This rule applies both to individuals and to groups who transfer property to a corporation. It does not apply if the corporation is an investment company.

However, if you had a gain from the disposition of depreciable property from this transaction, you may be taxed on part of the gain. See Publication 544 for more information.

For this purpose, to be in control of a corporation, you or your group of transferors must own, immediately after the exchange, at least 80% of the total combined voting power of all classes of stock entitled to vote, and at least 80% of the outstanding shares of each class of nonvoting stock of the corporation.

If this provision applies to you, you must attach to your return a complete statement of all facts pertinent to the exchange.

**Additional information.** For more information on trades of stock, see *Nontaxable Trades* in Publication 550.

**Insurance policies and annuities.** You will not have a recognized gain or loss if you trade:

- 1) A life insurance contract for another life insurance contract or for an endowment or an annuity contract,
- 2) An endowment contract for an annuity contract, or for another endowment contract that provides for regular payments beginning at a date not later than

the beginning date under the old contract, or

- 3) An annuity contract for another annuity contract.

The insured or annuitant must stay the same as under the original contract. Exchanges of contracts not included in this list, such as an annuity contract for an endowment contract, or an annuity or endowment contract for a life insurance contract, are taxable.

**U.S. Treasury notes or bonds.** You can trade certain issues of U.S. Treasury obligations for other issues, designated by the Secretary of the Treasury, with no gain or loss recognized on the trade. See *U.S. Treasury Notes or Bonds* under *Nontaxable Trades* in Publication 550 for information about the tax treatment of income from these investments.



For other information on Treasury notes or bonds, write to:

Bureau of the Public Debt  
U.S. Department of the Treasury  
Capitol Area Servicing Center  
1300 C Street, S.W.  
Washington, D.C. 20239-1500



Or visit on the Internet:  
<http://www.ustreas.gov/treasury/bureaus/pubdebt/>

**Transfers of property between spouses or incident to divorce.** Generally, no gain or loss is recognized on a transfer of property from an individual to (or in trust for the benefit of) a spouse, or if incident to a divorce, a former spouse. This nonrecognition rule does not apply if the recipient spouse or former spouse is a nonresident alien. The rule also does not apply to a transfer in trust to the extent the adjusted basis of the property is less than the amount of the liabilities assumed plus any liabilities on the property.

Any transfer of property to a spouse or former spouse on which gain or loss is not recognized is treated by the recipient as a gift and is not considered a sale or exchange. The recipient's basis in the property will be the same as the adjusted basis of the giver immediately before the transfer. This carryover basis rule applies whether the adjusted basis of the transferred property is less than, equal to, or greater than either its fair market value at the time of transfer or any consideration paid by the recipient. This rule applies for purposes of determining loss as well as gain. Any gain recognized on a transfer in trust increases the basis.

A transfer of property is incident to a divorce if the transfer occurs within one year after the date on which the marriage ends, or if the transfer is related to the ending of the marriage.

For more information, see Publication 504.

## Related Party Transactions

Special rules apply to the sale or trade of property between related parties.

**Gain on sale or trade of depreciable property.** The capital gain provisions do not apply and your gain is ordinary income, if:

- 1) You have a recognized gain on the sale or trade of property, including a leasehold or a patent application, that is depreciable property in the hands of the party who receives it, and
- 2) The transaction is between you and a controlled entity, or you and a trust in which you or your spouse is a beneficiary.

See Chapter 2 in Publication 544 for more information.

**Like-kind exchanges.** Generally, if you trade business or investment property for other business or investment property of a like kind, no gain or loss is recognized. See *Like-kind exchanges* earlier under *Nontaxable Trades*.

This rule also applies to exchanges of property between related parties, defined next under *Loss on sale or trade of property*. However, if either related party disposes of the like-kind property within 2 years after the exchange, the gain or loss on the exchange must be recognized. Each related person must report any gain or loss not recognized on the original exchange on the tax return filed for the year in which the later disposition occurred.

These rules generally do not apply to:

- Dispositions due to the death of either related person,
- Involuntary conversions (see Chapter 1 of Publication 544 for condemnations and Publication 547 for casualties and thefts), or
- Exchanges or dispositions whose main purpose is not the avoidance of federal income tax.

The 2-year period does not include the period during which the holder's risk of loss is substantially diminished by:

- The holding of a put on the property,
- The holding by another person of a right to acquire the property, or
- A short sale or any other transaction.

**Loss on sale or trade of property.** You cannot deduct a loss on the sale or trade of property, other than a distribution in complete liquidation of a corporation, if the transaction is directly or indirectly between you and the following related parties:

- 1) Members of your family — this includes only your brothers and sisters, half-brothers and half-sisters, spouse, ancestors (parents, grandparents, etc.),

and lineal descendants (children, grandchildren, etc.),

- 2) A corporation in which you directly or indirectly own more than 50% in value of the outstanding stock (see *Constructive ownership of stock*, later), or
- 3) A tax-exempt charitable or educational organization that is directly or indirectly controlled, in any manner or by any method, by you or by a member of your family, whether or not this control is legally enforceable.

In addition, a loss on the sale or trade of property is not deductible if the transaction is directly or indirectly between the following related parties:

- 1) A grantor and fiduciary, or the fiduciary and beneficiary, of any trust,
- 2) Fiduciaries of two different trusts, or the fiduciary and beneficiary of two different trusts, if the same person is the grantor of both trusts,
- 3) A trust fiduciary and a corporation of which more than 50% in value of the outstanding stock is directly or indirectly owned by or for the trust, or by or for the grantor of the trust,
- 4) A corporation and a partnership if the same persons own more than 50% in value of the outstanding stock of the corporation and more than 50% of the capital interest, or the profits interest, in the partnership,
- 5) Two S corporations if the same persons own more than 50% in value of the outstanding stock of each corporation,
- 6) Two corporations, one of which is an S corporation, if the same persons own more than 50% in value of the outstanding stock of each corporation,
- 7) Two corporations that are members of the same controlled group (under certain conditions, however, these losses are not disallowed but must be deferred),
- 8) Two partnerships if the same persons own, directly or indirectly, more than 50% of the capital interests or the profits interests, or
- 9) A partnership and a person who owns, directly or indirectly, more than 50% of the capital interest, or the profits interest, in the partnership.

If you sell or trade to a related party a number of blocks of stock or pieces of property in a lump sum, you must figure the gain or loss separately for each block of stock or piece of property. The gain on each item may be taxable. However, you cannot deduct the loss on any item. Also, you cannot reduce gains from the sales of any of these items by losses on the sales of any of the other items.

**Indirect transactions.** These include sales through a stock exchange. You cannot deduct your loss on the sale of stock through

your broker if, for example, under a prearranged plan a related party or entity buys the same stock that you had owned.

**Constructive ownership of stock.** In determining whether a person directly or indirectly owns any of the outstanding stock of a corporation, the following rules apply.

**Rule 1.** Stock directly or indirectly owned by or for a corporation, partnership, estate, or trust is considered owned proportionately by or for its shareholders, partners, or beneficiaries.

**Rule 2.** An individual is considered to own the stock that is directly or indirectly owned by or for his or her family. Family includes only brothers and sisters, half-brothers and half-sisters, spouse, ancestors, and lineal descendants.

**Rule 3.** An individual owning, other than by applying rule 2, any stock in a corporation is considered to own the stock that is directly or indirectly owned by or for his or her partner.

**Rule 4.** When applying rule 1, 2, or 3, stock constructively owned by a person under rule 1 is treated as actually owned by that person. But stock constructively owned by an individual under rule 2 or 3 is not treated as owned by that individual for again applying either rule 2 or 3 to make another person the constructive owner of the stock.

**Property received from a related party.** If you sell or trade at a gain property that you acquired from a related party, you recognize the gain only to the extent it is more than the loss previously disallowed to the related party. This rule applies only if you are the original transferee and you acquired the property by purchase or exchange. This rule does not apply if the related party's loss was disallowed because of the wash sale rules, described in Publication 550 under *Wash Sales*.

**Example 1.** Your brother sells you stock with a cost basis of \$10,000 for \$7,600. Your brother cannot deduct the loss of \$2,400. Later, you sell the same stock to an unrelated party for \$10,500, realizing a gain of \$2,900. Your reportable gain is \$500 — the \$2,900 gain minus the \$2,400 loss not allowed to your brother.

**Example 2.** If, in *Example 1*, you sold the stock for \$6,900 instead of \$10,500, your recognized loss is only \$700 (\$7,600 basis minus \$6,900). You cannot deduct the loss that was not allowed to your brother.

## Capital or Ordinary Gain or Loss

This section discusses the tax treatment of different types of investment transactions. For information about the tax treatment of gains and losses on the sale or exchange of property used in a trade or business, see Publication 544.

If you have a taxable gain or a deductible loss from a transaction, it may be either a capital gain or loss or an ordinary gain or

loss, depending on the circumstances. Generally, a sale or trade of a capital asset (defined later) results in a capital gain or loss. A sale or trade of a noncapital asset generally results in ordinary gain or loss. Depending on the circumstances, a gain or loss on a sale or trade of property used in a trade or business may be treated as either capital or ordinary, as explained in Publication 544. In some situations, part of your gain or loss may be a capital gain or loss and part may be an ordinary gain or loss.

**Character of gain or loss.** It is important for you to properly distinguish or classify your gains and losses as either ordinary or capital gains or losses. You also need to classify your capital gains and losses as either short-term or long-term. The correct classification helps you figure the limit on capital losses and your proper tax if you can use the *Capital Gain Tax Computation* explained in Chapter 17.

For information about determining whether your capital gain or loss was short-term or long-term, see the discussion under *Holding Period*, later in this chapter.

## Capital Assets and Noncapital Assets

For the most part, everything you own and use for personal purposes, pleasure, or investment is a **capital asset**. Some examples are:

- Stocks or bonds held in your personal account
- A house owned and used by you and your family
- Household furnishings
- A car used for pleasure or commuting
- Coin or stamp collections
- Gems and jewelry
- Gold, silver, or any other metal.

The following items are **noncapital assets**:

- 1) **Property held mainly for sale to customers** or property that will physically become a part of the merchandise that is for sale to customers;
- 2) **Depreciable property** used in your trade or business, even if fully depreciated;
- 3) **Real property** used in your trade or business;
- 4) **A copyright, a literary, musical, or artistic composition, a letter or memorandum**, or similar property:
  - a) That you created by your personal efforts,
  - b) That was prepared or produced for you as a letter, memorandum, or similar property, or
  - c) That you acquired under circumstances (for example, by gift) entitling

you to the basis of a person who created the property or for whom it was prepared or produced;

- 5) **Accounts or notes receivable** acquired in the ordinary course of a trade or business, or for services rendered as an employee, or from the sale of any of the properties described in (1); and
- 6) **U.S. Government publications** that you received from the government free or for less than the normal sales price, or that you acquired under circumstances entitling you to the basis of someone who received the publications free or for less than the normal sales price.

## Property Held for Personal Use

Property held for personal use is a capital asset. Gain from a sale or exchange of that property is a capital gain. Loss from the sale or exchange of that property is not deductible. You can deduct a loss relating to personal use property only if it results from a casualty loss, such as a loss caused by a fire or hurricane as discussed in Chapter 27.

## Investment Property

Investment property is a capital asset. Any gain or loss from its sale or exchange is generally a capital gain or loss.

**Gold, silver, stamps, coins, gems, etc.** These are capital assets except when they are held for sale by a dealer. Any gain or loss you have from their sale or trade generally is a capital gain or loss.

**Stocks, stock rights, and bonds.** All of these (including stock received as a dividend) are capital assets except when held for sale by a securities dealer. However, if you own small business stock, see *Losses on Small Business Stock and Exclusion for Gain From Small Business Stock* in Publication 550.

**Worthless securities.** Stocks, stock rights, and corporate or government bonds with interest coupons or in registered form, which became worthless during the tax year, are treated as though they were capital assets sold on the last day of the tax year if they were capital assets in your hands. To determine whether they are long-term or short-term capital assets, you are considered to have held the stocks or securities until the last day of the year in which they became worthless. See *Holding Period*, later.

If you are a cash-basis taxpayer and make payments on a negotiable promissory note that you issued for stock that became worthless, you can deduct these payments as losses in the years you actually make the payments. Do not deduct them in the year the stock became worthless.

**How to report loss.** Report worthless securities on line 1 or line 9 of Schedule D (Form 1040), whichever applies. In columns (c) and (d), write "Worthless."

**Filing a claim for refund.** If you do not claim a loss for a worthless security on your original return for the year it becomes worthless, you can file a claim for a credit or refund due to the loss. Use Form 1040X, *Amended U.S. Individual Income Tax Return*, to amend your return for the year the security became worthless. You must file it within 7 years from the date your original return for that year had to be filed, or 2 years from the date you paid the tax, whichever is later. For more information about filing a claim, see *Amended Returns and Claims for Refund* in Chapter 1.

**Discounted debt instruments.** Treat your gain or loss on the sale, redemption, or retirement of a bond or other evidence of indebtedness originally issued at a discount or bought at a discount as follows.

**Short-term government obligations.** Treat gains on short-term federal, state, or local government obligations (other than tax-exempt obligations) as ordinary income up to the ratable share of the acquisition discount. This treatment applies to obligations that have a fixed maturity date not more than one year from the date of issue. Any gain that is more than the ratable share of the acquisition discount is capital gain. Any loss is capital loss. **Acquisition discount** is the stated redemption price at maturity minus your basis in the obligation.

However, do not treat these gains as income to the extent you previously included the discount in income. This amount increases your basis in the obligation. See *Discount on Short-Term Obligations* in Chapter 1 of Publication 550 for more information.

**Short-term nongovernment obligations.** Treat gains on short-term nongovernment obligations as ordinary income up to the ratable share of original issue discount (OID). This treatment applies to obligations that have a fixed maturity date of not more than one year from the date of issue.

However, to the extent you previously included the discount in income, you do not have to include it in income again. This amount increases your basis. See *Discount on Short-Term Obligations* in Publication 550 for more information.

**Tax-exempt state and local government bonds.** If these bonds were originally issued at a discount before September 4, 1982, and you acquired them before March 2, 1984, treat your part of the OID as tax-exempt interest. To figure your gain or loss on the sale or exchange of these bonds, reduce the amount realized by your part of the OID.

If the bonds were issued after September 3, 1982, and acquired after March 1, 1984, increase the adjusted basis by your part of the OID to figure gain or loss. For more information on the basis of these bonds, see *Discounted tax-exempt obligations* under *Stocks and Bonds*, in Publication 550.

If you redeem tax-exempt bonds issued before June 9, 1980, before maturity, treat the entire OID on the bonds as tax-exempt interest. If the bonds were issued after June 8, 1980, treat only your part of the OID as tax-exempt interest.

Any gain from market discount is usually taxable on disposition or redemption of tax-exempt bonds. If you bought the bonds before May 1, 1993, the gain from market discount is capital gain. If you bought the bonds after April 30, 1993, the gain from market discount is ordinary income.

You figure the market discount by subtracting the price you paid for the bond from the sum of the original issue price of the bond and the amount of accumulated OID from the date of issue that represented interest to any earlier holders. For more information, see *Market Discount Bonds* under *Original Issue Discount* in Chapter 8.

A loss on the sale or other disposition of a tax-exempt state or local government bond is deductible as a capital loss.

**Long-term debt instruments issued after 1954, and before May 28, 1969 (or before July 2, 1982, if a government issue).** If you sell, exchange, or redeem for a gain one of these debt instruments, the part of your gain that is not more than your ratable share of the original issue discount (OID) at the time of the sale or redemption is ordinary income. The balance of the gain is capital gain. If, however, there was an intention to call the debt instrument before maturity, all of your gain that is not more than the entire OID is treated as ordinary income at the time of the sale. This treatment of taxable gain also applies to corporate instruments issued after May 27, 1969, under a written commitment that was binding on that date and thereafter.

See *Original Issue Discount (OID)* in Chapter 8 for information on OID.

**Long-term corporate debt instruments issued after May 27, 1969, and government instruments issued after July 1, 1982.** If you hold one of these debt instruments, you must include a part of the OID in your gross income each year that you own the instrument. Your basis in the instrument is increased by the amount of OID that you have included in your gross income. See *Original Issue Discount (OID)* in Chapter 8 for information about the OID that you must report on your tax return.

If you sell or exchange the debt instrument before maturity, your gain on the sale is a capital gain, provided the debt instrument was a capital asset. However, if at the time the instrument was originally issued there was an intention to call it before its maturity, your gain on the sale of the instrument generally is ordinary income to the extent of the entire OID reduced by any amounts of OID previously includible in your income. In this case, any balance of the gain is a capital gain.

If the debt instrument has market discount you generally must report gain as ordinary income up to the instrument's accrued market discount. This rule applies to debt instruments issued after July 18, 1984, or purchased after April 30, 1993. See *Market Discount Bonds* under *Original Issue Discount* in Chapter 8.

Any amount that you receive on the retirement of a debt instrument is treated in the

same way as if you had sold or exchanged that instrument.

See *Capital or Ordinary Gain or Loss* in Publication 550 for more information about the tax treatment on the sale or redemption of discounted debt instruments.

**Notes of individuals.** If you hold an obligation of an individual that was issued with OID after March 1, 1984, you generally must include the OID in your income currently, and your gain or loss on its sale or retirement is generally capital gain or loss. An exception to this treatment applies if the obligation is a loan between individuals and all of the following requirements are met:

- 1) The lender is not in the business of lending money,
- 2) The amount of the loan, plus the amount of any outstanding prior loans, is \$10,000 or less, and
- 3) Avoiding federal tax is not one of the principal purposes of the loan.

If the exception applies, or the obligation was issued before March 2, 1984, you do not include the OID in your income currently. When you sell or redeem the obligation, the part of your gain that is not more than your ratable share of the OID at that time is ordinary income. The balance of the gain, if any, is capital gain. Any loss on the sale or redemption is capital loss.

**Example.** You bought a \$10,000 note of an individual for \$6,000 on which no payments had been made. You receive principal payments totaling \$4,000. Then you sell the note for \$3,800. Only 60% (\$6,000/\$10,000) of the \$4,000 is a return of your investment. The balance is discount income. You reduce your cost by \$2,400 (\$4,000 × 60%) to figure your adjusted basis. Your capital gain is \$200, figured as follows:

Selling price of note .....	\$3,800	
Minus adjusted basis of note:		
Cost of note .....	\$6,000	
Minus return on investment .....	2,400	3,600
<b>Capital gain</b>		<u>\$ 200</u>

The OID rules discussed in Chapter 8, under *Original Issue Discount (OID)*, apply to obligations issued by individuals after March 1, 1984. The OID rules will not apply to loans between individuals in amounts of \$10,000 or less (including the outstanding amounts of prior loans) if the lender is not in the business of lending money, except if a principal purpose of the loan is to avoid federal tax.

**Obligations issued in bearer form.** Generally, any loss on a registration-required obligation held in bearer form is not deductible unless the issuer was subject to a tax when the obligation was issued. Any gain on the sale or other disposition of the obligation is ordinary income.

A registration-required obligation is any obligation except an obligation:

- 1) That is issued by a natural person,
- 2) That is not of a type offered to the public,
- 3) That has a maturity at the date of issue of not more than 1 year, or
- 4) That was issued before 1983.

**Loss on deposits in an insolvent or bankrupt financial institution.** If you can reasonably estimate your loss on a deposit because of the bankruptcy or insolvency of a qualified financial institution, you can choose to treat the amount as either a casualty loss or an ordinary loss in the current year. Either way, you claim the loss as an itemized deduction. Otherwise, you can wait until the year of final determination of the actual loss and treat the amount as a nonbusiness bad debt (discussed later under *Nonbusiness Bad Debts*) in that year.

If you claim a casualty loss, attach **Form 4684, *Casualties and Thefts***, to your return. Each loss must be reduced by \$100. Your total casualty losses for the year are reduced by 10% of your adjusted gross income.

If you claim an ordinary loss, report it as a miscellaneous itemized deduction on line 22 of Schedule A (Form 1040). The maximum amount you can claim is \$20,000 (\$10,000 if you are married filing separately) reduced by any expected state insurance proceeds. Your loss is subject to the 2% of adjusted gross income limit. You cannot choose to claim an ordinary loss if any of the deposit is federally insured.

You cannot choose either of these methods if:

- 1) You own at least 1% of the financial institution,
- 2) You are an officer of the institution, or
- 3) You are related to such an owner or officer.

If the actual loss that is finally determined is more than the amount deducted as an estimated loss, you can claim the excess loss as a bad debt. If the actual loss is less than the amount deducted as an estimated loss, you must include in income (in the final determination year) the excess loss claimed.

**Sale of annuity.** The part of any gain on the sale of an annuity contract before its maturity date that is based on interest accumulated on the contract is ordinary income.

### Nonbusiness Bad Debts

If someone owes you money that you cannot collect, you have a bad debt. You may be able to deduct the amount owed to you when you figure your tax for the year the debt becomes worthless. A debt must be genuine for you to deduct a loss. A debt is genuine if it arises from a debtor-creditor relationship based on a valid and enforceable obligation to repay a fixed or determinable sum of money.

Bad debts that you did not get in the course of operating your trade or business

are nonbusiness bad debts. To be deductible, nonbusiness bad debts must be totally worthless. You cannot deduct a partially worthless nonbusiness bad debt.

**Basis in bad debt required.** To deduct a bad debt, you must have a basis in it — that is, you must have already included the amount in your income or loaned out your cash. For example, you cannot claim a bad debt deduction for court-ordered child support not paid to you by your former spouse. If you are a cash-basis taxpayer (most individuals are), you cannot take a bad debt deduction for expected income such as unpaid salaries, wages, rents, fees, interest, and dividends unless you have previously included the amount in your income.

**How to report bad debts.** Deduct nonbusiness bad debts as short-term capital losses on Schedule D (Form 1040). There are limits on how much of your capital losses may be deducted. For a discussion of these limits, see Chapter 17.

In Part I, line 1 of Schedule D, enter the name of the debtor and “statement attached,” in column (a), and the amount of the bad debt in column (f). Use a separate line for each bad debt.

For each bad debt, attach a statement to your return that contains:

- 1) A description of the debt, including the amount, and the date it became due,
- 2) The name of the debtor, and any business or family relationship between you and the debtor,
- 3) The efforts you made to collect the debt, and
- 4) Why you decided the debt was worthless. For example, you could show that the borrower has declared bankruptcy, or that legal action to collect would probably not result in payment of any part of the debt.

**Filing a claim for refund.** If you do not deduct a bad debt on your original return for the year it becomes worthless, you can file a claim for a credit or refund due to the bad debt. Use Form 1040X, *Amended U.S. Individual Income Tax Return*. You must file it within 7 years from the date your original return for that year had to be filed, or 2 years from the date you paid the tax, whichever is later. For more information about filing a claim, see *Amended Returns and Claims for Refund* in Chapter 1.

**Additional information.** For more information, see *Nonbusiness Bad Debts* in Publication 550.

For information on business bad debts, see Chapter 14 of Publication 535.

### Losses on Small Business Stock

You can deduct as an ordinary loss, rather than as a capital loss, your loss on the sale, trade, or worthlessness of certain stock you

own in a small business corporation or certain stock in a small business investment company. Gain on this stock is capital gain and is reported on Schedule D (Form 1040) if the stock is a capital asset in your hands. See *Losses on Small Business Stock* and *Losses on Small Business Investment Company Stock* in Publication 550.

## Holding Period

If you sold or traded investment property, you must determine whether any capital gain or loss is a short-term or long-term capital gain or loss by determining your holding period.

**Long term or short term.** If you hold investment property *more than one year*, any capital gain or loss is a **long-term** capital gain or loss. If you hold the property **one year or less**, any capital gain or loss is a **short-term** capital gain or loss.

To determine how long you held the investment property, begin counting on the date after the day you acquired the property. The same date of each following month is the beginning of a new month regardless of the number of days in the preceding month. The day you disposed of the property is part of your holding period.

**Example.** If you buy investment property on February 5, 1996, you start counting on February 6. The 6th of each following month is the beginning of a new month. If you sell the property on February 5, 1997, your holding period is not more than one year and you will have a short-term capital gain or loss. If you sell it on February 6, 1997, your holding period is more than one year and you will have a long-term capital gain or loss.

**Securities traded on established market.** For securities traded on an established securities market, your holding period begins the day after the trading date you bought the securities, and ends on the trading date you sold them. Ignore the settlement date(s) for tax purposes.

**Example.** You are a cash-basis, calendar-year taxpayer. You sold stock at a gain on December 27, 1996. According to the rules of the stock exchange, the sale was closed by delivery of the stock 3 trading days after the sale, on January 2, 1997. You received payment of the sales price on that same day. Report your gain on your 1996 return, even though you received the payment in 1997. The gain is long term or short term depending on whether you held the stock more than one year. Your holding period ended on December 27. If you had sold the stock at a loss, you would also report it on your 1996 return.

**Nontaxable trades.** If you acquire investment property in a trade for other investment property and your basis for the new property is determined, in whole or in part, by your basis in the old property, your holding period for the new property begins on the day following

the date you acquired the old property. Chapter 14 discusses basis.

**Property received as a gift.** If you receive a gift of property and your basis is determined by the donor's basis, your holding period is considered to have started on the same day the donor's holding period started. See *Property Received as a Gift* in Chapter 14.

If your basis is determined by the fair market value of the property, your holding period starts on the day after the date of the gift.

**Inherited property.** If you inherit investment property and your basis for it is:

- 1) Determined with reference to its fair market value at the date of the decedent's death,
- 2) Determined with reference to its fair market value at the alternate valuation date, or
- 3) The decedent's adjusted basis (for appreciated property),

your capital gain or loss on any later disposition of that property is treated as a long-term capital gain or loss. You are considered to have held the property for more than one year even if you dispose of it within one year after the decedent's death. See *Inherited Property* in Publication 551, *Basis of Assets*.

**Real property bought.** To figure how long you have held real property bought under an unconditional contract, begin counting on the earlier of the day after you received title to it or the day after you took possession of it and assumed the burdens and privileges of ownership. However, taking delivery or possession of real property under an option agreement is not enough to start the holding period. The holding period cannot start until there is an actual contract of sale. The holding period of the seller cannot end before that time.

**Mutual fund stock.** If you received exempt-interest dividends on mutual fund stock that you held 6 months or less and sold at a loss, you cannot claim the part of the loss that is equal to or less than the exempt-interest dividends. You must report the rest of the loss as a short-term capital loss.

See Publication 564, *Mutual Fund Distributions*, for more information on mutual fund distributions.

**Real estate investment trust (REIT).** If you received a capital gain distribution on REIT stock that you held 6 months or less and sold at a loss, you report as a long-term capital loss the part of the loss that is equal to, or less than, the capital gain distribution. This rule does not apply to dispositions of stock under a periodic liquidation plan. See *Capital Gain Distributions* in Chapter 9 for information on capital gain distributions.

**Automatic investment service and dividend reinvestment plans.** If you take part in a plan to buy stock through a bank or other agent, the date the bank or other agent buys the stock is your purchase date for figuring the holding period of that stock. In determining your holding period for shares bought by the bank or agent, full shares are considered bought first and any partial shares are considered bought last. If a full share or a partial share was bought over a period of more than one purchase date, your holding period for that share is a split holding period. A part of the share is considered to have been bought on each date that stock was bought by the bank or other agent with the proceeds of available funds.

**Nontaxable stock dividend.** The holding period for new stock you received as a nontaxable stock dividend begins on the same day as the holding period of the old stock. This rule also applies to stock acquired in a "spin-off," which is a distribution of stock or securities in a controlled corporation.

**Nontaxable stock rights.** Your holding period for nontaxable stock rights begins on the same day as the holding period of the underlying stock. The holding period for stock acquired through the exercise of stock rights begins on the date the right was exercised.

## Rollover of Gain

This section discusses the tax-free rollover of certain gains from the sale of publicly traded securities. If you buy certain replacement property and make the choice described in this section, you postpone part or all of your gain. You postpone the gain by adjusting the basis of the replacement property as described in *Basis of replacement property*, later. This postpones your gain until the year you dispose of the replacement property.

You qualify to make this choice if you meet the following tests:

- 1) You sell publicly traded securities at a gain. Publicly traded securities are securities traded on an established securities market.
- 2) Your gain from the sale is a capital gain.
- 3) During the 60-day period beginning on the date of the sale, you buy replacement property. This replacement property must be either common stock or a partnership interest in a specialized small business investment company (SSBIC). This is any partnership or corporation licensed by the Small Business Administration under section 301(d) of the Small Business Investment Act of 1958, as in effect on May 13, 1993.

**Amount of gain postponed.** If you make the choice described in this section, you must recognize gain only up to the following amount:

- 1) The amount realized on the sale, minus
- 2) The cost of any common stock or partnership interest in an SSBIC that you bought during the 60-day period beginning on the date of sale (and did not previously take into account on an earlier sale of publicly traded securities).

If this amount is less than the amount of your gain, you can postpone the rest of your gain, subject to the limit described next. If this amount is more than the amount of your gain, you must recognize the full amount of your gain.

**Limit on gain postponed.** The amount of gain you can postpone each year is limited to the smaller of:

- 1) \$50,000 (\$25,000 if you are married and file a separate return), or

- 2) \$500,000 (\$250,000 if you are married and file a separate return), minus the amount of gain you postponed for all earlier years.

**Basis of replacement property.** You must subtract the amount of postponed gain from the basis of your replacement property.

**How to report gain.** If you choose to postpone gain, report the entire gain realized from the sale on line 1 or line 9 of Schedule D (Form 1040), whichever is appropriate. Directly below the line on which you report the gain, enter "SSBIC Rollover" in column (a) and enter the amount of gain postponed in column (f).

Also attach a schedule showing:

- 1) How you figured the postponed gain,
- 2) The name of the SSBIC in which you purchased common stock or a partnership interest,
- 3) The date of that purchase, and
- 4) Your new basis in that SSBIC stock or partnership interest.

You must make the choice to postpone gain by the due date (including extensions) of the tax return on which you must report the gain. Your choice is revocable with the consent of the Commissioner of the IRS.

## Selling Your Home

### Important Change for 1996

**Service in hazardous duty area.** The replacement period for postponing tax on any gain from the sale of your home is suspended if you served in a qualified hazardous duty area (Bosnia and Herzegovina, Croatia, and Macedonia). See *Replacement Period* under *Postponing Gain*, later, for more information.

### Important Reminders

**Change of address.** If you change your mailing address, be sure to notify the IRS using Form 8822, *Change of Address*. Mail it to the Internal Revenue Service Center for your old address (addresses for the Service Centers are on the back of the form).

**Combat zone service.** The replacement period for postponing tax on any gain from the sale of your home is suspended if you served in the Persian Gulf Area combat zone. See *Replacement Period* under *Postponing Gain*, later, for more information.

**Form 1099-S.** Normally, the person responsible for closing the sale of a home (generally, the settlement agent) must report the sale to the IRS on Form 1099-S, *Proceeds From Real Estate Transactions*. That person must give you a copy of the information reported on Form 1099-S. He or she is not allowed to charge you separately for filing Form 1099-S but may take into account the cost of filing the form in deciding what to charge you for services.

**Qualified mortgage bonds and mortgage credit certificates.** If you sell your main home that was purchased or improved with federally subsidized financing, you may have to recapture part of the subsidy. See *Recapture of Federal Subsidy*, later.

**Home sold with undeducted points.** If you have not deducted all the points you paid to secure a mortgage on your old home, you may be able to deduct the remaining points in the year of the sale. See *Mortgage ending early* under *Points* in Chapter 25 of this publication.

## Introduction

This chapter explains how to treat any gain or loss from selling your main home (generally, the one in which you live). You must include any gain in your income unless you postpone or exclude all or part of it. See *Table 16-1* for an overview of postponing or excluding gain.

You must report the sale of your main home using Form 2119. This is true whether you sell the home at a gain or a loss and whether or not you buy another main home.

### Useful Items

You may want to see:

#### Publication

- 523** Selling Your Home
- 530** Tax Information for First-Time Homeowners

#### Form (and Instructions)

- Schedule D (Form 1040)** Capital Gains and Losses
- 1040X** Amended U.S. Individual Income Tax Return
- 2119** Sale of Your Home
- 8822** Change of Address
- 8828** Recapture of Federal Mortgage Subsidy

## Gain or Loss On the Sale

If you sell your main home, you may have to pay tax on all or part of the gain from the sale. But if you replace the home and meet the conditions described later under *Gain on Sale*, you postpone paying the tax.

If you have a loss on the sale, you cannot deduct it.

**More than one owner.** If you and your spouse sell your jointly owned home and file a joint return, you figure and report your gain or loss as one taxpayer. If you file separate returns, each of you must figure and report your own gain or loss according to your ownership interest in the home. Your ownership interest is determined by state law.

If you and a joint owner other than your spouse sell your jointly owned home, each of you must figure and report your own gain or loss according to your ownership interest in the home. Each of you applies the rules discussed in this chapter on an individual basis.

## How To Figure Gain or Loss

Gain or loss on the sale of your old home is figured in Part I of Form 2119. To figure the gain or loss, you must know the selling price, the amount realized, and the adjusted basis.

**Selling price.** The selling price (line 4 of Form 2119) is the total amount you receive

for your home. It includes money, all notes, mortgages, or other debts assumed by the buyer as part of the sale, and the fair market value of any other property or any services you receive.

If you received a Form 1099-S, *Proceeds From Real Estate Transactions*, the total amount you received for your home (except for the fair market value of any property other than cash or notes or any services you received or will receive) should be shown in box 2. If you received or will receive any property other than cash or notes or any services as part of the sale, the value of these items is not shown on Form 1099-S. However, box 4 of that form should be checked.

**Payment by employer.** You may have to sell your home because of a job transfer. If your employer pays you for a loss on the sale or for your selling expenses, do **not** include the payment as part of the selling price. Include it in your gross income as wages on line 7 of Form 1040. For more information, see *How To Report* in Chapter 19.

**Option to buy.** If you grant an option to buy your home and the option is exercised, add the amount you receive for the option to the selling price of your home. If the option is not exercised, you must report the amount as ordinary income in the year the option expires. Report this amount on line 21 of Form 1040.

**Selling expenses.** Selling expenses (line 5 of Form 2119) include commissions, advertising, and legal fees. Loan charges paid by the seller, such as loan placement fees or "points," are usually a selling expense.

**Amount realized.** The amount realized (line 6 of Form 2119) is the selling price minus selling expenses.

**Amount of gain or loss.** If the amount realized is more than the home's adjusted basis (line 7 of Form 2119), the difference is your gain (line 8 of Form 2119). If the amount realized is less than the adjusted basis, the difference is your loss. See *Loss on Sale*, later.

To figure the adjusted basis of your property, see *Basis*, later.

## Gain on Sale

You will generally be subject to tax on all of the gain if you do not buy and live in another main home. However, if you are age 55 or older, you may qualify to exclude all or part of the gain as explained later under *Exclusion of Gain*.

You **postpone** the tax on all or part of the gain if you buy and live in another main home and meet the conditions described in the following paragraphs.

**Purchase price at least as much as sales price.** Your entire gain on the sale of your home is not taxed at the time of the sale if, within **2 years before or 2 years after** the sale, you buy and live in another main home that costs at least as much as the adjusted sales price (described later) of the old home.

Table 16-1. **Two Ways To Avoid 1996 Tax on Gain from Sale of Your Main Home**

What To Do	How To Qualify	How You Benefit	How To Find Out More
<b>1. Postpone Gain</b>	You must buy (or build) and live in a new home within the replacement period.	You may not have to pay tax on all (or part) of your gain in 1996. (But you have to reduce the basis of your new home by the amount of the postponed gain. This will increase any gain on the later sale of that home.)	See <i>Postponing Gain</i> in this chapter.
<b>2. Exclude Gain</b>	You must be age 55 or older on the date of sale. You must also meet ownership and use tests and must choose to take the exclusion.	You exclude up to \$125,000 (\$62,500 if married filing separately) of your gain. (But you can exclude gain only once in your lifetime after July 26, 1978.)	See <i>Exclusion of Gain</i> in this chapter.
Any part of your gain that you do not postpone or exclude is taxable. You must include that part in your income.			

If you are on active duty in the Armed Forces, if you served in a combat zone, or if your tax home is outside the U.S., the 2-year period after the sale may be suspended. See *People Outside the U.S. and Members of the Armed Forces under Replacement Period*, later.

**Purchase price less than sales price.** If the purchase price of your new main home is less than the adjusted sales price of your old home and you buy and live in the new home within 2 years before or 2 years after the sale, the gain taxed in the year of the sale is the lesser of:

- 1) The gain on the sale of the old home (reduced by any gain you exclude as explained later under *Exclusion of Gain*), or
- 2) The amount by which the adjusted sales price of the old home is more than the purchase price of the new home.

**Source of funds to buy home.** You need not use the same funds received from the sale of your old home to buy or build your new home. For example, you can use less cash than you received by increasing the amount of your mortgage loan and still postpone the tax on your gain.

## Loss on Sale

You **cannot** deduct a loss on the sale of your home. It is a personal loss. However, you must report the sale on Form 2119. The loss has no effect on the basis of any new home.

## Special Situations

The paragraphs that follow explain how to determine your gain or loss if you trade one home for another one or if your home is foreclosed on, repossessed, or abandoned. Transfers of a home to your spouse are also covered here.

**Trading homes.** If you trade your old home for another home, treat the trade as a sale and a purchase. The cost of the new home, for purposes of postponing gain, is its fair market value.

**Example.** You owned and lived in a home that had an adjusted basis of \$41,000. A real estate dealer accepted your old home as a trade-in and allowed you \$50,000 toward a new house priced at \$80,000 (its fair market value). You also paid \$30,000 cash for the new home. You are considered to have sold your old home for \$50,000 and to have had a gain of \$9,000 (\$50,000 – \$41,000). Because you replaced it with a new home costing more than the sales price of the old one, you must postpone the tax on the gain. The basis of your new home is \$71,000 (\$80,000 cost – \$9,000 gain that is not currently taxed).

If the dealer had allowed you \$27,000 and assumed your unpaid mortgage of \$23,000 on your old home, \$50,000 would still be considered the sales price of the old home (the trade-in allowed plus the mortgage assumed).

**Foreclosure or repossession.** If your home was foreclosed on or repossessed, you have a sale that you must report on Form 2119, *Sale of Your Home*. If the sale resulted in a taxable gain, also report it on Schedule D (Form 1040).

**Form 1099-A and Form 1099-C.** Generally, you will receive Form 1099-A, *Acquisition or Abandonment of Secured Property*, from your lender. This form will have the information you need to determine the amount of your gain or loss and whether you have any ordinary income from cancellation of debt. If your debt is canceled, you may receive Form 1099-C, *Cancellation of Debt*, instead of Form 1099-A.

For more information, get Publication 523.

**Abandonment.** If you abandon your home and it secures a debt that is canceled, you may have ordinary income. If the home is foreclosed on or repossessed, you may also have a gain or loss. See *Foreclosure or repossession*, earlier. Get Publication 523 for more information.

**Transfer to spouse.** If you transfer your home to your spouse, or to your former spouse incident to your divorce, you generally have no gain or loss. This is true even if

you receive cash or other consideration for the home. Therefore, the rules in this chapter do not apply. You do not have to file Form 2119.

**Exception.** If your spouse or former spouse is a nonresident alien, the rules in this chapter apply and you must file Form 2119.

**More information.** If you need more information, see *Transfer to spouse* in Publication 523 and *Property Settlements* in Publication 504, *Divorced or Separated Individuals*.

## Basis

You will need to know your basis in your home as a starting point for determining any gain or loss when you sell it.

Your basis in your home is determined by how you got the home. Your basis is its cost if you bought it or built it. If you got it in some other way, its basis is either its fair market value when you received it or the adjusted basis of the person you received it from.

While you owned your home, you may have made adjustments (increases or decreases) to the basis. This adjusted basis is used to figure gain or loss on the sale of your home.

You can find more information on basis and adjusted basis in Chapter 14 of this publication and in Publication 523.

**Settlement fees or closing costs.** If you buy your home, you may have to pay settlement fees or closing costs in addition to the contract price of the property. You can include in your basis the settlement fees and closing costs that are for buying the home. You cannot include in your basis the fees and costs that are for getting a mortgage loan. A fee is for buying the home if you would have had to pay it even if you paid cash for the home.

Chapter 14 lists some of the settlement fees and closing costs that you can include in the basis of property, including your home. It also lists some settlement costs that cannot be included in basis.

In addition to the items listed in Chapter 14, you **cannot** include in basis:

- 1) Any item that you deducted as a moving expense (settlement fees and closing costs incurred after 1993 cannot be deducted as moving expenses), and
- 2) VA funding fees.

See *Settlement fees or closing costs under New Home*, later, for information about the fees and costs (real estate taxes and mortgage interest, including points) that you may be able to deduct.

## Adjusted Basis

Adjusted basis is your basis **increased** or **decreased** by certain amounts.

**Increases to basis.** These include any:

- 1) Improvements.
- 2) Additions.
- 3) Special assessments for local improvements.
- 4) Amounts spent after a casualty to restore damaged property.

**Decreases to basis.** These include any:

- 1) Gain from the sale of your old home on which tax was postponed.
- 2) Insurance payments for casualty losses.
- 3) Deductible casualty losses not covered by insurance.
- 4) Payments received for granting an easement or right-of-way.
- 5) Depreciation allowed or allowable if you used your home for business or rental purposes.
- 6) Residential energy credit (generally allowed from 1977 through 1987) claimed for the cost of energy improvements that you added to the basis of your home.
- 7) Energy conservation subsidy excluded from your gross income because you received it (directly or indirectly) from a public utility after December 31, 1992, to buy or install any energy conservation measure.

**Energy conservation measure.** This includes an installation or modification that is primarily designed either to reduce consumption of electricity or natural gas or to improve the management of energy demand for a home.

**Improvements.** These add to the value of your home, prolong its useful life, or adapt it to new uses. You add the cost of improvements to the basis of your property.

**Examples.** Putting a recreation room in your unfinished basement, adding another bathroom or bedroom, putting up a fence, putting in new plumbing or wiring, putting on a new roof, or paving your driveway are improvements.

**Repairs.** These maintain your home in good condition. They do not add to its value or prolong its life, and you do not add their cost to the basis of your property.

**Examples.** Repainting your house inside or outside, fixing your gutters or floors, repairing leaks or plastering, and replacing broken window panes are examples of repairs.



You should keep records of your home's purchase price and purchase expenses. You should also save receipts and other records for all improvements, additions, and other items that affect the basis of your home. This includes any Form 2119 that you filed to report postponement of gain from the sale of a previous home.

Ordinarily, you must keep records for 3 years after the due date for filing your return for the tax year in which you sold, or otherwise disposed of, your home. But if you use the basis of your old home in figuring the basis of your new one, such as when you sell your old home and postpone tax on any gain, you should keep those records longer. Keep those records as long as they are needed for tax purposes.

## Postponing Gain

Generally, you **must** postpone tax on the gain on the sale of your main home if you buy and live in a new main home within the replacement period and it costs at least as much as the adjusted sales price of the old home. However, if you are age 55 or older and meet certain qualifications, no tax applies to the extent you choose to exclude the gain. See *Exclusion of Gain*, later.

This section explains the time allowed for replacement and how to determine the taxable gain, if any.

The tax on the gain is **postponed, not forgiven**. You subtract any gain that is not taxed in the year you sell your old home from the cost of your new home. This gives you a lower basis in the new home. If you sell the new home in a later year and again replace it, you may have to continue to postpone tax on your gain.

**Example.** You sold your home for \$90,000 and had a \$5,000 gain. Within the time allowed for replacement, you bought another home for \$103,000 and moved into it. The \$5,000 gain will not be taxed in the year of sale, but you must subtract it from the \$103,000. This makes the basis of your new home \$98,000. If you later sell the new home for \$110,000, and you do not buy and live in a new home within the allowed time, you will be subject to tax on the \$12,000 gain (\$110,000 – \$98,000) in the year of that sale.

## Main Home

Usually, the home you live in most of the time is your main home. The home you sell and the one you buy to replace it must both qualify as your main home.

Your main home can be a houseboat, a mobile home, a cooperative apartment, or a condominium.

Fixtures (permanent parts of the property) generally are part of your main home. Furniture, appliances, and similar items that are not fixtures generally are not part of your main home.

If you change your home to a rental property, it no longer qualifies as your main home. If you then sell it, you cannot postpone tax on any gain from the sale. See *Home changed to rental property*, later under *Old Home*. *Property used partly as your home and partly for business or rental* is also discussed later under *Old Home*.

**Land.** You may sell the land on which your main home is located, but not the house itself. In this case, you cannot postpone tax on any gain you have from the sale of the land.

**Example.** You sell the land on which your main home is located. Within the replacement period, you buy another piece of land and move your house to it. This sale is not considered a sale of your main home, and you cannot postpone tax on any gain on the sale.

**More than one home.** If you have more than one home, only the sale of your main home qualifies for postponing the tax. If you have two homes and live in both of them, your main home is the one you live in most of the time.

**Example 1.** You own and live in a house in town. You also own beach property, which you use in the summer months. The town property is your main home; the beach property is not.

**Example 2.** You own a house, but you live in another house that you rent. The rented home is your main home.

## Replacement Period

Your replacement period is the time period during which you must replace your old home to postpone any of the gain from its sale. It starts **2 years before** and ends **2 years after** the date of sale.

**Example.** On April 27, 1996, before you sell your old home, you buy and move into a new home that you use as your main home. You have until April 27, 1998, a period of 2 years, to sell your old home and postpone tax on any gain.

**Occupancy test.** You must physically live in the new home as your main home within the required period. If you move furniture or other personal belongings into the new home but do not actually live in it, you have not met the occupancy test.

**No added time beyond the specified period is allowed.** To postpone gain on the sale of your home, you must replace the old home and occupy the new home within the specified period. You are not allowed any additional time, even if conditions beyond your control keep you from doing it. For example, destruction of the new home while it was being built would not extend the replacement period. However, the replacement period may be suspended, as discussed later, for people outside the U.S. or members of the Armed Forces.

If you do not replace the home in time and you had postponed gain in the year of sale, you must file an amended return for the year of sale. You must include in your income the entire gain on the sale of your old home.

Also, if you began building your new home within the specified period, but for any reason were unable to live in it within 2 years, no more time for occupancy is allowed. You must report your entire gain on an amended return for the year of the sale. See *Amended Return*, later.

### People Outside the U.S.

The replacement period after the sale of your old home is suspended while you have your tax home (the place where you live and work) outside the U.S. This suspension applies only if your stay abroad begins before the end of the 2-year replacement period. The replacement period, plus the period of suspension, is limited to **4 years** after the date of sale of your old home.

For more information, see *People Outside the U.S.* in Publication 523. For a discussion of tax home, see Chapter 28.

**Combat zone service.** The running of the replacement period (including the suspension if you live and work outside the U.S.) is suspended for any period you served in a combat zone (defined later under *Members of the Armed Forces*) in support of the Armed Forces, plus 180 days. This suspension applies even though you were not a member of the Armed Forces. It applies to Red Cross personnel, accredited correspondents, and civilians under the direction of the Armed Forces in support of those forces.

The rules for suspending the running of the replacement period and for applying that suspension to your spouse are the same as the suspension rules explained later under *Members of the Armed Forces* and its discussion, *Combat zone service*.

### Members of the Armed Forces

The replacement period after the sale of your old home is suspended while you serve on extended active duty in the Armed Forces. You are on extended active duty if you are serving under a call or order for more than 90 days or for an indefinite period. The suspension applies only if your service begins before the end of the 2-year replacement period. The replacement period, plus any period of suspension, is limited to **4**

**years** after the date you sold your old home. For more information, see *Members of the Armed Forces* in Publication 523.

**Overseas assignment.** The suspension of the replacement period after the sale of your old home is extended for up to an additional 4 years while you are stationed outside the U.S. This also applies while you are required to live in on-base quarters following your return from a tour of duty outside the U.S. In this case, you must be stationed at a remote site where the Secretary of Defense has determined that adequate off-base housing is not available.

The suspension can continue for up to 1 year after the last day you are stationed outside the U.S. or the last day you are required to reside in government quarters on base. However, the replacement period, plus any period of suspension, is limited to **8 years** after the date of sale of your old home.

If you qualify for the time suspension for members of the Armed Forces and have already filed an income tax return reporting gain from the sale of a home that can be further postponed, you can file Form 1040X to claim a refund. See *Amended Return*, later.

**Combat zone service.** The running of the replacement period (including any suspension) is suspended for any period you served in a combat zone.

**Combat zone.** The term "combat zone" means:

- 1) The Persian Gulf Area combat zone (effective August 2, 1990), and

- 2) The qualified hazardous duty area of Bosnia and Herzegovina, Croatia, and Macedonia, which is treated as a combat zone effective November 21, 1995.

**Service outside combat zone.** If you performed military service in an area outside the combat zone that was in direct support of military operations in the combat zone **and** you received special pay for duty subject to hostile fire or imminent danger, you are treated as if you served in the combat zone.

Also, you are treated as if you served in a combat zone if you performed services as part of Operation Joint Endeavor, were outside the United States, and were deployed away from your permanent duty station.

**When suspension ends.** This suspension ends 180 days after the later of:

- 1) The last day you were in the combat zone (or, if earlier, the last day the area qualified as a combat zone), or
- 2) The last day of any continuous hospitalization (limited to 5 years if hospitalized in the U.S.) for an injury sustained while serving in the combat zone.

**More information.** For more information on suspension of the replacement period, see *Combat zone service* in Publication 523. For more information on other tax benefits available to those who served in a combat zone, get Publication 3, *Armed Forces Tax Guide*.

**Figure 16-A. An Illustration of the Time Allowed for Replacement**

This illustrates the time period during which you can replace your main home and postpone tax on the gain from sale. It does not apply if you served in a combat zone (defined under *Members of the Armed Forces*).  
**Caution:** The dates in this chart are for illustration purposes only. Your dates may be different.

	If you sold your former home on June 30, 1996:	
	Your time for replacement begins on:	Your time for replacement ends on or before:
Most taxpayers	June 30, 1994 (2 years before sale)	June 30, 1998 (2 years after sale)
Certain people outside the U.S. and members of the Armed Forces <sup>1</sup>	June 30, 1994 (2 years before sale)	June 30, 2000 (4 years after sale)
Certain members of the Armed Forces stationed overseas <sup>2</sup>	June 30, 1994 (2 years before sale)	June 30, 2004 (8 years after sale)

<sup>1</sup> Your 2-year replacement period after the sale can be suspended while you live and work outside the U.S. or are on extended active duty in the Armed Forces. However, your replacement period, plus any period of suspension, cannot exceed 4 years after the date of sale of your old home. See *People Outside the U.S.* or *Members of the Armed Forces*.

<sup>2</sup> Your 2-year replacement period after the sale can be suspended while you are stationed outside the U.S. or required to live in on-base quarters after returning from a tour of duty outside the U.S. However, your replacement period, plus any period of suspension, cannot exceed 8 years after the date of sale of your old home. See *Overseas assignment* under *Members of the Armed Forces*.

## Amended Return

If you sell your old home and do not plan to replace it, you must include the gain in income for the year of sale. If you later change your mind, buy or build and live in another home within the replacement period, and meet the requirements to postpone gain, you will have to file an amended return (Form 1040X) for the year of sale to claim a refund. For information on the time allowed for filing an amended return, see Chapter 1.

**Extended replacement period.** If you have an extended replacement period because you have your tax home outside the U.S. or are a member of the Armed Forces, the replacement period may go beyond the last date you can file an amended return claiming a refund for the year of sale. If there is a possibility you may change your mind and buy (or build) and live in another home during the extended replacement period, get Publication 523 to find out how to file a "protective claim" for refund of the tax you paid on the gain.

## Old Home

Gain or loss on the sale of your old home is figured in Part I of Form 2119.

You use Part III of Form 2119 to figure the adjusted sales price, the taxable gain, and the postponed gain.

If the amount realized from the sale of your old home does not exceed the cost of your new home, you postpone your entire gain. In this case, you do not need to figure fixing-up expenses, discussed next.

**Fixing-up expenses.** Any fixing-up expenses you have are used in figuring the adjusted sales price. Fixing-up expenses (line 16 of Form 2119) are decorating and repair costs that you paid to sell the old home. For example, the costs of painting the home, planting flowers, and replacing broken windows are fixing-up expenses. Fixing-up expenses must meet all the following conditions. The expenses must:

- 1) Be for work done during the 90-day period ending on the day you sign the contract of sale with the buyer.
- 2) Be paid no later than 30 days after the date of sale.
- 3) Not be deductible in arriving at your taxable income.
- 4) Not be used in figuring the amount realized.
- 5) Not be capital expenditures or improvements.

**Note.** You deduct fixing-up expenses from the amount realized **only** in figuring the part of the gain that you postpone. You **cannot** deduct them in figuring the actual gain on the sale of the old home.

**Adjusted sales price.** Use the adjusted sales price of your old home (line 18 of Form

2119) to figure the part of your gain that you can postpone. The adjusted sales price is the amount realized minus any exclusion you claim (line 14 of Form 2119) and minus any fixing-up expenses you might have. Compare the adjusted sales price with the cost of your new home to find the amount of gain that you can postpone.

**Example.** Your old home had a basis of \$55,000. You signed a contract to sell it on December 17. On the following January 7, you sold it for \$71,400. Selling expenses were \$5,000. During the 90-day period ending December 17, the date you signed the sales contract, you had the following work done. You paid for the work within 30 days after the date of sale.

Fixing-up expenses:	
Inside and outside painting .....	\$800
Improvements:	
New venetian blinds and new water heater .....	\$900

Within the required time, you bought and lived in a new home that cost \$64,600. The amount of gain on which tax is postponed, the amount of gain on which tax is not postponed, and the basis of your new home, are figured as follows:

<u>Gain On Sale</u>	
a) Selling price of old home	\$71,400
b) Minus: Selling expenses	5,000
c) Amount realized on sale	\$66,400
d) Basis of old home .....	\$55,000
e) Add: Improvements (blinds and heater) .....	900
f) Adjusted basis of old home .....	55,900
g) Gain on sale [(c) minus (f)] .....	<u>\$10,500</u>

<u>Gain Taxed in Year of Sale</u>	
h) Amount realized on sale	\$66,400
i) Minus: Fixing-up expenses (painting) .....	800
j) Adjusted sales price .....	\$65,600
k) Minus: Cost of new home	64,600
l) Excess of adjusted sales price over cost of new home .....	<u>\$ 1,000</u>
m) Gain taxed in year of sale [lesser of (g) or (l)] .....	<u>\$ 1,000</u>

<u>Gain Postponed</u>	
n) Gain on sale [line (g)] .....	\$10,500
o) Minus: Gain taxed [line (m)] .....	1,000
p) Gain postponed .....	<u>\$ 9,500</u>

<u>Adjusted Basis of New Home</u>	
q) Cost of new home [line (k)] .....	\$64,600
r) Minus: Gain postponed [line (p)] .....	9,500
s) Adjusted basis of new home .....	<u>\$55,100</u>

**Property used partly as your home and partly for business or rental.** You may use part of your property as your home and part of it for business or to produce income. Examples are a working farm on which your house is located, an apartment building in which you live in one unit and rent out the others, or a store building with an upstairs apartment in which you live. If you sell the whole property, you postpone only the tax on the part used as your home. This includes the land and outbuildings, such as a garage for the home, but not those used for the business or the production of income. For more information, see *Property used partly as your home and partly for business or rental* in Publication 523.

**Business use of your home.** If, in the year of sale, you are entitled to deduct expenses for the business use of your home, you cannot postpone the gain on the part of the home used for business. For information on how to figure the business part, see *Business Part of Home Expenses* in Publication 587, *Business Use of Your Home*.

If, in the year of sale, you are **not** entitled to deduct expenses for the business use of your home, you may be able to postpone all your gain, even if you were entitled to deduct expenses for the business use of your home in earlier years.

**Home changed to rental property.** You cannot postpone tax on the gain on rental property, even if you once used it as your home. The rules explained in this chapter generally will not apply to its sale. Gains are taxable and losses are deductible as explained in Publication 544, *Sales and Other Dispositions of Assets*. The basis of the property is determined as explained under *Property Changed to Business or Rental Use* in Chapter 14.

**Temporary rental of home before sale.** You have not changed your home to rental property if you temporarily rented out your old home before selling it, or your new home before living in it, as a matter of convenience or for another nonbusiness purpose. You can postpone the tax on the gain from the sale if you meet the requirements explained earlier. For information on how to treat the rental income you receive, see Chapter 10.

**Failed attempt to rent home.** If you place your home with a real estate agent for rent or sale and it is **not** rented, it is not considered business property or property held for the production of income. The rules explained in this chapter apply to the sale of the home.

**Condemned property.** If your home is condemned for public use and you have a gain, you can postpone the tax on the gain in one of two ways. You can postpone the tax under the rules explained in this chapter or under those discussed under *Involuntary Conversions* in Chapter 1 of Publication 544, *Sales and Other Dispositions of Assets*.

**Gain on casualty.** The tax on a gain from a fire, storm, or other casualty cannot be postponed under the rules explained in this chapter, but may be postponed under the rules explained in Publication 547, *Casualties, Disasters, and Thefts (Business and Nonbusiness)*.

## New Home

For purposes of postponing gain, this section explains:

- 1) What qualifies as a new home,
- 2) How to determine the cost of your new home, and
- 3) The rules that apply if and when you later sell your new home.

### What Qualifies as a New Home

Your new home must be your main home. See *Main Home*, earlier.

You must include in income any gain from the sale of your old home if you replace that home with property that is not your main home.

**New home outside the U.S.** A new home outside the U.S. qualifies as a new home for purposes of postponing gain. You must buy or build and live in the new home as your main home within the time allowed for replacement.

**Retirement home.** You have not purchased a new home if you sell your home and invest the proceeds in a retirement home project that gives you living quarters and personal care, but does not give you any legal interest in the property. Therefore, you must include in income any gain on the sale of your home. However, if you are 55 or older, see *Exclusion of Gain*, later in this chapter.

**Title to new home not held by you or spouse.** You have not purchased a new home if you reinvest the proceeds from the sale of your old home in a home in which neither you nor your spouse holds any legal interest. For example, if someone else (such as your child) holds the title to the new home, you cannot postpone the gain from the sale of your old home.

**More than one new home bought in 2-year period.** If you buy (or build) and live in more than one main home during the replacement period, only the last one can be treated as your new main home to determine whether you must postpone the gain from the sale of the old home.

However, there is an exception to this rule if you sell a new home (other than the last one you used as your main home during the replacement period) because of a work-related move. If the exception applies, then the home you sold because of the work-related move is treated as your new home for purposes of whether you must postpone gain on the sale of the old home. For details,

see *New home sold in 2-year period*, later under *New Home Later Sold At Gain*.

### How To Determine Cost of New Home

You need to know the cost of your new home to figure the gain taxed and the gain on which tax is postponed on the sale of your old home. The cost of your new home includes costs incurred within the replacement period (beginning 2 years before and ending 2 years after the date of sale) for the following items:

- 1) Buying or building the home.
- 2) Rebuilding the home.
- 3) Capital improvements or additions.

You cannot consider any costs incurred before or after the replacement period. However, if you are a person outside the U.S. or a member of the Armed Forces, you can include any costs incurred during the suspension period (discussed under *Replacement Period*, earlier).

**Debts on new home.** The cost of a new home includes the debts it is subject to when you buy it (purchase-money mortgage or deed of trust) and the face amount of notes or other liabilities you give for it.

**Temporary housing.** If a builder gives you temporary housing while your new home is being finished, you must reduce the contract price to arrive at the cost of the new home. To figure the amount of the reduction, multiply the contract price by a fraction. The numerator is the value of the temporary housing and the denominator is the sum of the value of the temporary housing plus the value of the home.

**Seller-paid points.** If you bought your new home after April 3, 1994, you must subtract any seller-paid points from its cost in figuring how much of the gain from selling your old home is taxed. If you bought your new home after 1990 but before April 4, 1994, you must reduce its cost by the seller-paid points only if you chose to deduct them as home mortgage interest in the year paid.

**Settlement fees or closing costs.** The cost of your new home includes the settlement fees and closing costs that you can include in your basis. See *Settlement fees or closing costs* under *Basis*, earlier.

**Deductible costs.** If you itemize your deductions in the year you buy the house, you can deduct some of the costs you paid at closing, such as real estate taxes, mortgage interest, and "points" that are deductible as interest. You may also be able to deduct points paid by the seller at closing. For more information, see Chapters 24 and 25.

**Real estate taxes.** If you agree to pay taxes the seller owed on your new home (that is, taxes up to the date of sale), the taxes you pay are treated as part of the cost. You cannot deduct them as taxes paid. If the

seller paid taxes for you (that is, taxes beginning with the date of sale), you can still deduct the taxes. If you do not reimburse the seller for your part of the taxes, you must reduce your basis in your new home by the amount of those taxes. For more information, see *Settlement or closing costs* under *Basis* in Publication 530.

**Inheritance or gift.** If you receive any part of your new home as a gift or an inheritance, you cannot include the value of that part in the cost of the new home when figuring the gain taxed in the year of sale and the gain on which tax is postponed. However, you include the basis of that part in your adjusted basis to determine any gain when you sell the new home.

**Example.** Your father died in March 1995 and you inherited his home. Its basis to you is \$62,000. You spent \$14,000 to modernize the home, resulting in an adjusted basis to you of \$76,000. You moved into the home in July 1995.

When your father died, you owned a home that you bought in 1991 for \$60,000. You sell that home in 1996 for \$65,000, at a gain of \$5,000. You have fixing-up expenses of \$200 on your old home.

To find the gain taxed in the year of the sale, you compare the adjusted sales price of the old home, \$64,800 (\$65,000 – \$200), with the \$14,000 you invested in your new home. The \$5,000 gain is fully taxed because the adjusted sales price of the old home is more than the amount you paid to remodel your new home, and the difference between the two amounts is more than \$5,000. For this purpose, you do not include the value of the inherited part of your property (\$62,000) in the cost of your new home.

### New Home Later Sold At Gain

If you bought your present home and postponed tax on gain from a prior sale under the postponement-of-gain rules discussed earlier, you continue to postpone the tax if you replace your present home under those rules.

**Example.** In 1985 you sold your home, which you had owned since 1980, and bought and occupied a new one. The tax on the gain was postponed and the basis of the home you bought in 1985 was reduced by the gain you postponed. This year you sold the home you bought in 1985 and bought and moved into a more expensive one. You must postpone tax on the gain from selling the home you bought in 1985.

**New home sold in 2-year period.** If you postponed the gain on the sale of your old home, then sell your new home within 2 years after the sale of your old home, you generally cannot postpone the gain on the sale of the new home. Any gain on the sale of that new home is taxable; any loss is not deductible. Report the gain or loss on Schedule D (Form 1040), not Form 2119. If you sold the home at a loss, write "Personal

Loss" across columns (f) and (g) of line 1 or 9 of Schedule D, whichever is appropriate.

The following examples illustrate this rule.

**Example 1.** You sold your first home in March 1995 for \$120,000, and you had a \$10,000 gain on the sale. You postponed the \$10,000 gain because you bought and moved into a second home in April 1995 for \$135,000. Your basis in the second home, as reported on the Form 2119 filed with your 1995 return, was \$125,000 (\$135,000 cost – the \$10,000 postponed gain).

In June 1996 you sold the second home for \$142,000 and you moved into an apartment. You purchased and moved into a third home in January 1997 for \$146,000.

Your replacement home for the first home you sold (in March 1995) is the last main home you bought in the following 2-year period. This is the third home you bought (in January 1997). Since its \$146,000 cost is more than the \$120,000 sales price of your first home, your \$10,000 gain is still postponed. Your basis in your third home is \$136,000 (\$146,000 cost – the \$10,000 postponed gain). You must file a new Form 2119 for 1995 to show your replacement home is the home you bought in January 1997.

You cannot postpone the gain on the June 1996 sale of your second home. This is because it was within 2 years after the March 1995 sale of your first home on which you postponed the gain. Since you no longer treat your second home as the replacement for your first home, the basis of your second home is its \$135,000 cost. You must include the gain on its sale in your 1996 income. The gain is \$7,000 (\$142,000 sales price – the \$135,000 basis). Report it on Schedule D (Form 1040), not Form 2119.

**Example 2.** The facts are the same as in Example 1 except you purchased your third home in September 1997 rather than in January. Your second home is the replacement home for your first home (sold in March 1995). This is because it was the only home bought in the following 2-year period.

Although you bought another new main home within 2 years after selling your second home, you cannot postpone the gain on the June 1996 sale of your second home. This is because its sale was within 2 years of the March 1995 sale of your first home. You must report the \$17,000 gain on the June 1996 sale of your second home (\$142,000 sales price – \$125,000 basis) on your 1996 tax return. Your basis in your third home (that you bought in September 1997) is its cost, \$146,000.

**Exception.** The rules that normally apply when you buy more than one new home, or sell a new home, during the 2-year replacement period do not apply if you had to do that because of a **work-related move**. A "work-related move" is one for which you are allowed a deduction for moving expenses. To qualify for the deduction, the move must be closely related to the start of

work, and you must meet the time and distance requirements explained in Chapter 19.

If the exception applies, you postpone gain by treating each sale as though the 2-year rule did not apply.

**Example.** You buy two new homes and sell a new home within 2 years as shown below:

January 1996	You sell your house in <b>Chicago</b> at a gain.
February 1996	You buy and move into a more expensive house in <b>Memphis</b> .
March 1997	You sell your house in <b>Memphis</b> due to a transfer required by your employer.
March 1997	You buy and move into a more expensive house in <b>New York City</b> . The move meets the requirements for a moving expense deduction.

When you complete the 1996 Form 2119 for the sale of your house in Chicago, compare the cost of the home bought in Memphis with the adjusted sales price of the house in Chicago. This determines the gain you postpone, even though you bought and lived in another new main home (New York City in March 1997) within 2 years of the sale of your Chicago home.

Your 1997 Form 2119 will compare the adjusted sales price of the house in Memphis (sold March 1997) with the cost of the house in New York City. This determines the gain you postpone, even though you sold the new home in Memphis within 2 years of the sale of your Chicago home (sold January 1996).

**Holding period.** If you postponed tax on any part of the gain from the sale of your old home, you will be considered to have owned your new home for the combined period you owned both the old and the new homes. This may affect whether any taxable gain when you sell the new home is reported on Schedule D (Form 1040) as a short-term or long-term capital gain. See Chapter 15 for more information on holding periods.

## Certain Sales by Married Persons

Special rules apply if any of the following situations apply to you.

- 1) You or your spouse owned the old home separately, but the two of you own the new home jointly.
- 2) You and your spouse owned the old home jointly, but either you or your spouse owns the new home separately.
- 3) Your spouse dies after you sell your old home and before you buy and live in a new home.
- 4) You and your spouse had two separate gains from the sales of homes that had been your separate main homes before your marriage, and you jointly buy one new home.

- 5) You and your spouse have agreed to live apart, and you each buy and live in separate new homes.

For more information about any of these situations, see the discussion *Certain Sales by Married Persons* in Publication 523.

## How and When To Report

If you sold your home during the year, report the details of the sale as explained in this section. Report the sale even if you have a loss, you postponed the tax on the entire gain, or you have not purchased or moved into a new home.

**Form 2119.** Use Form 2119, *Sale of Your Home*, to report the sale of your old home and any purchase of a new one within the replacement period. File Form 2119 with your tax return for the year you sold your old home. If you file your return before buying a new home, you may also have to file a second Form 2119 when you do buy your new home. See Chapter 39 for an example of a filled-in Form 2119.

Keep a copy of Form 2119 with your tax records for the year. Form 2119 is also a supporting document that shows how your new home's basis is decreased by the amount of any postponed gain on the sale of your old home. Therefore, you should also keep a copy of Form 2119 with your records for the basis of your new home.

**Reporting a loss.** You must report the sale of your main home even if you have a loss on the sale. Complete Part I of Form 2119 for the year in which the sale occurred. You cannot deduct the loss from your income.

If you report a loss on the sale, you do not have to file a second Form 2119 if you later purchase a new home. The loss on the sale has no effect on the basis of your new home.

**Reporting exclusion of gain.** If you qualify for the one-time exclusion of gain from selling your home, use Form 2119 to claim the exclusion. See *Exclusion of Gain*, later.

**Schedule D (Form 1040).** If you report taxable gain on the sale of your main home, you will also have to file a Schedule D (Form 1040), *Capital Gains and Losses*, with your return.

**Maximum tax rate on capital gains.** Your net capital gain is taxed at a maximum tax rate of 28%, even if you have ordinary income that is taxed at a higher rate. If you have a net capital gain and part of your taxable income is taxed at a rate higher than 28%, figure your tax using the *Capital Gain Tax Worksheet* in the Form 1040 instructions.

**New home purchased before return filed.** If you buy and live in a new home before you file a return for the year of sale of your old

home, complete Form 2119 and attach it to your return.

**Reporting a gain.** If your new home costs as much as or more than the adjusted sales price of your old home, you postpone the tax on the entire gain. You do not need to report the sale on Schedule D (Form 1040).

If the new home costs less than the adjusted sales price of the old home, the gain is taxed up to the amount of the difference. Report the taxable gain on Schedule D (Form 1040) for the year of the sale.

**New home not yet purchased.** If you plan to replace your home but have not done so by the time your return for the year of sale is due, you must still report the sale. Complete Form 2119, Part I only, and attach it to your return for the year of sale.

If you do not plan to replace your home within the replacement period, you must complete Form 2119 and attach it to your return for the year of sale. If you have a gain on the sale, you will also need to complete Schedule D (Form 1040) and attach it to your return.

**New home purchased after return filed.** If you postponed gain from the sale of your old home and you buy and live in a new home after you file your return but within the replacement period, you should notify the IRS. File a second Form 2119 giving the date you first lived in the new home and its cost.

If you paid tax on the gain from the sale of your old home, but replaced it within the replacement period, see *New home purchased after tax paid on gain*, later.

**New home costs at least as much as adjusted sales price.** If you postponed gain from the sale of your old home, and your new home costs at least as much as the adjusted sales price of your old home, file a second Form 2119 by itself. Your address, signature, and the date are required on this Form 2119. If you filed a joint return for the year of sale, both you and your spouse must sign the Form 2119. File it with the Internal Revenue Service Center where you would file your next tax return.

**New home costs less.** If you postponed gain from the sale of your old home, and your new home costs less than the adjusted sales price of the old home, you must file an amended return (Form 1040X) for the year of the sale. Attach a second completed Form 2119 and Schedule D (Form 1040) showing the gain you must report. You will have to pay interest on any additional tax due on the amended return. The interest is generally figured from the due date of the return for the year of sale.

**New home purchased after tax paid on gain.** If you paid tax on the gain from the sale of your old home, and you buy or build and live in a new home within the replacement period, you must file an amended return (Form 1040X) for the year of sale of your old home. Complete a new Form 2119, and include it with your amended return. Report on Schedule D (Form 1040) any gain on

which you cannot postpone the tax, and claim a refund of the rest of the tax.

**No new home or no new home within replacement period.** If you do not plan to replace your old home, you must complete Form 2119 and Schedule D (Form 1040) to report any gain. Attach them to your tax return for the year of the sale. The entire gain is taxable unless you are eligible to exclude all or part of the gain. See *Exclusion of Gain*, later.

You may have postponed gain on the sale of your old home because you planned to replace it. If you do not replace it within the replacement period, you must file a second Form 2119. Attach it to an amended return (Form 1040X) for the year of the sale. Include a Schedule D (Form 1040) to report your gain and any other appropriate schedule. For example, you would have to include Form 6252 to report an installment sale. You will have to pay interest on the additional tax due on your amended return. The interest is generally figured from the due date of the return for the year of sale.

**Divorce after sale.** If you are divorced after filing a joint return on which you postponed tax on the gain on the sale of your home, but you do not use your share of the proceeds to buy or build a new home (and your former spouse does), you must file an amended joint return to report the tax on your share of the gain. If your former spouse refuses to sign the amended joint return, attach a letter explaining why your former spouse's signature is missing.

**Installment sale.** Some sales are made under arrangements that provide for part or all of the selling price to be paid in a later year. These sales are called "installment sales." If you finance the buyer's purchase of your home yourself, instead of having the buyer get a loan or mortgage from a bank, you may have an installment sale. If the sale qualifies, you can report the part of the gain you cannot postpone on the installment basis.

**Seller-financed mortgage.** If you sell your home and hold a note, mortgage, or other financial agreement, the payments you receive generally consist of both interest and principal. You must report the interest you receive as part of each payment separately as interest income. If the buyer of your home uses the property as a main or second home, you must also report the name, address, and social security number of the buyer on line 1 of either Schedule B (Form 1040) or Schedule 1 (Form 1040A). The buyer must give you his or her social security number and you must give the buyer your social security number. Failure to meet these requirements may result in a \$50 penalty for each failure.

**More information.** For more information, see Publication 537, *Installment Sales*.

**Statute of limitations.** The 3-year limit for assessing tax on the gain from the sale of

your home begins when you give the IRS information that shows that:

- 1) You replaced your old home, and how much the new home cost,
- 2) You do not plan to buy and occupy a new home within the replacement period, **or**
- 3) You did not buy and occupy a new home within the replacement period.

This information may be on the Form 2119 attached to your tax return for the year of the sale, or on a second Form 2119 filed later. File the second Form 2119 with the Service Center where you will file your next tax return. If needed, send an amended return for the year of the sale to include in income the gain that you cannot postpone.

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## Exclusion of Gain

This section discusses excluding from gross income all or part of the gain from the sale of your main home if you meet certain age, ownership, and use tests at the time of the sale. This is a one-time exclusion of gain for sales after July 26, 1978.

The decision of when to take the exclusion depends on many factors. You will want to consider your personal tax and financial situation before deciding when to take the one-time exclusion. If you meet the requirements discussed in this section and you make the choice to exclude gain on the sale of your main home, the excluded gain is not taxed.

If you change your mind after you file the return for the year of sale, you may be able to make or revoke the choice later. You would have to file an amended return for the year of sale within certain time limits. See *How To Make and Revoke a Choice To Exclude Gain* in Publication 523.

## Age, Ownership, and Use

You can choose to exclude from income \$125,000 of gain on the sale of your main home (\$62,500 if you are married on the date of sale and file a separate return) if you meet **all** the following tests.

- 1) You were **55 or older** on the date of the sale.
- 2) During the **5-year period** ending on the date of the sale, you:
  - **Owned** your main home for at least **3 years**, and
  - **Lived in** your main home for at least **3 years**.
- 3) Neither you nor your spouse have ever excluded gain on the sale of a home after July 26, 1978.

For more information and examples, see *Exclusion of Gain* in Publication 523.

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## Recapture of Federal Subsidy

If you financed your home under a federally subsidized program (loans from tax-exempt qualified mortgage bonds or loans with mortgage credit certificates), you may have to recapture all or part of the benefit you received from that program when you sell or otherwise dispose of your home. You recapture the benefit by increasing your federal income tax for the year of the sale. The postponement and exclusion of gain provisions discussed earlier in this chapter do not apply to this recapture tax.

The recapture tax is figured on **Form 8828**. If your mortgage loan is subject to the recapture rules, you must file Form 8828 even if you do not owe a recapture tax.

**Loans subject to recapture rules.** The recapture of the subsidy applies to loans provided after 1990 that:

- 1) Came from the proceeds of qualified mortgage bonds issued after August 15, 1986, or
- 2) Were based on mortgage credit certificates.

The recapture also applies to assumptions of these loans.

If your mortgage loan is subject to this recapture rule, you should have received a notice containing information that you need to figure the recapture tax.

**When the recapture applies.** The recapture of the federal mortgage subsidy applies only if you meet *all* of the following conditions.

- 1) You sell or otherwise dispose of your home at a gain,
- 2) You dispose of your home during the first 9 years after the date you closed your mortgage loan, and
- 3) Your income for the year of disposition exceeds that year's adjusted qualifying income for your family size for that year (related to the income requirements a person must meet to qualify for the federally subsidized program).

**When recapture does not apply.** The recapture does *not* apply if any of the following situations apply to you:

- The mortgage was secured solely as a qualified home improvement loan of not more than \$15,000,
- The home is disposed of as a result of your death,
- You dispose of the home more than 9 years after the date you closed your mortgage loan,
- You transfer the home to your spouse, or to your former spouse incident to a divorce, where no gain is included in your income,
- You dispose of the home at a loss,
- Your home is destroyed by a casualty, and you repair it or replace it on its original site within 2 years after the destruction, or
- You refinance your mortgage loan (unless you later meet all of the conditions listed previously under *When the recapture applies*).

# Reporting Gains and Losses

## Introduction

This chapter discusses how to report capital gains and losses from sales, exchanges, and other dispositions of investment property on Schedule D of Form 1040. The discussion includes:

- How to report short-term gains and losses,
- How to report long-term gains and losses,
- How to figure capital loss carryovers,
- How to figure your tax using the 28% maximum tax rate on net capital gains, if it applies, and
- An illustrated example of how to complete Schedule D.

If you sell or otherwise dispose of property used in a trade or business or for the production of income, see Publication 544, *Sales and Other Dispositions of Assets*, before completing Schedule D.

## Useful Items

You may want to see:

### Publication

- 537** Installment Sales
- 544** Sales and Other Dispositions of Assets
- 550** Investment Income and Expenses

### Form (and Instructions)

- Schedule D (Form 1040)** Capital Gains and Losses
- 4797** Sales of Business Property
- 6252** Installment Sale Income
- 8582** Passive Activity Loss Limitations

## Schedule D

Report capital gains and losses on Schedule D (Form 1040). You can use the *Capital Loss Carryover Worksheet* in the Schedule D instructions to figure your capital loss carryover. To figure your tax using the maximum capital gains rate you can use the *Capital Gain Tax Worksheet* in the Form 1040 instructions.

**Reporting gain on an installment sale.** If you will receive any of the proceeds from the sale of your property after the year of sale, you may have an installment sale. Generally, you report gain from an installment sale using the installment method. Under this

method, you report part of the gain each year that you receive a payment. For information, see Form 6252, and Publication 537, *Installment Sales*.

If you use the cash method of accounting, you cannot use the installment method to report gain from the sale of stock or securities traded on an established securities market. You must report the entire gain for the year of sale (the year in which the trade date occurs).

**Passive activity gains and losses.** If you have gains or losses from a passive activity, you may also have to report them on **Form 8582**. In some cases, the loss may be limited under the passive activity rules. Refer to Form 8582 and its separate instructions for more information about reporting capital gains and losses from a passive activity.

**Form 1099-B transactions.** If you sold property, such as stocks, bonds, or certain commodities, through a broker, you should receive Form 1099-B, *Proceeds From Broker and Barter Exchange Transactions*, or an equivalent statement from the broker. Use the Form 1099-B or equivalent statement to complete Schedule D.

Report the gross proceeds shown in box 2 of Form 1099-B as the **gross sales price** in column (d) of either line 1 or line 9 of Schedule D, whichever applies. However, if the broker advises you, in box 2 of Form 1099-B, that gross proceeds (gross sales price) less commissions and option premiums were reported to the IRS, enter that **net sales price** in column (d) of either line 1 or line 9 of Schedule D, whichever applies. If the net amount is entered in column (d), do not include the commissions and option premiums in column (e).

Be sure to add all sales price entries in column (d) on lines 1 and 2 and lines 9 and 10 and enter the totals on lines 3 and 11. Then add these amounts reported to you for 1996 on Forms 1099-B and Forms 1099-S (or on substitute statements):

- 1) Proceeds from transactions involving stocks, bonds, and other securities, and
- 2) Gross proceeds from real estate transactions not reported on another form or schedule.

If this total is more than the total of lines 3 and 11, attach a statement to your return explaining the difference.

**Section 1256 contracts and straddles.** Use Form 6781 to report gains and losses from section 1256 contracts and straddles before entering these amounts on Schedule D. Include a copy of Form 6781 with your income tax return.

**Form 1099-S transactions.** If you sold or exchanged reportable real estate, you should receive from the real estate reporting person a Form 1099-S, *Proceeds From Real Estate Transactions*, showing the gross proceeds from the sale.

“Reportable real estate” is defined as any present or future ownership interest in any of the following:

- 1) Improved or unimproved land, including air space,
- 2) Inherently permanent structures, including any residential, commercial, or industrial building,
- 3) A condominium unit and its accessory fixtures and common elements, including land, and
- 4) Stock in a cooperative housing corporation (as defined in section 216 of the Internal Revenue Code).

A “real estate reporting person” could include the buyer’s attorney, your attorney, the title or escrow company, a mortgage lender, your broker, the buyer’s broker, or the person acquiring the biggest interest in the property.

Your Form 1099-S will show the gross proceeds from the sale or exchange in box 2. Follow the instructions for Schedule D to report these transactions and include them on lines 1 or 9 as appropriate.

Add these amounts reported to you for 1996 on Forms 1099-S and 1099-B (or on substitute statements):

- 1) Proceeds from transactions involving stocks, bonds, and other securities, and
- 2) Gross proceeds from real estate transactions not reported on another form or schedule.

If this total is more than the total of lines 3 and 11 of Schedule D, attach a statement to your return explaining the difference.

**Other transactions.** Enter all sales of stocks, bonds, real estate transactions (other than the sale of your main home), etc., on line 1 or line 9 of Schedule D whichever applies, whether or not you actually received a Form 1099-B or Form 1099-S.

If you had gains or losses from the disposition of **options**, including puts and calls, see *Options* under *Capital or Ordinary Gain or Loss* in Publication 550.

**Sale of property bought at various times.** If you sell a block of stock or other property that you bought at various times, report the short-term gain or loss from the sale on one line in Part I of Schedule D and the long-term gain or loss on one line in Part II. Write “Various” in column (b) for the “Date acquired.” See the *Comprehensive Example* later in this chapter for an example.

**Sale expenses.** Add to your cost or basis any expense of sale such as brokers’ fees, commissions, state and local transfer taxes, and option premiums. Enter this adjusted amount in column (e) of either Part I or Part II of Schedule D, whichever applies, unless you reported the net sales price amount in column (d).

For more information about adjustments to basis, see Chapter 14.

**Property held for personal use.** Property held for personal use is a capital asset. Gain from a sale or exchange of that property is a capital gain. Loss from the sale or exchange of that property is not deductible. You can deduct a loss relating to personal use property only if it results from a casualty loss.

**Short-term gains and losses.** A capital gain or loss on the sale or trade of property held one year or less is a short-term capital gain or loss. Report it in Part I of Schedule D.

You combine your share of short-term capital gains or losses from partnerships, S corporations, and fiduciaries, and any short-term capital loss carryover, with your other short-term capital gains and losses to figure your net short-term capital gain or loss on line 8 of Schedule D.

**Long-term gains and losses.** A capital gain or loss on the sale or trade of property held more than one year is a long-term capital gain or loss. Report it in Part II of Schedule D.

You also report the following in Part II of Schedule D:

- 1) All capital gain distributions from regulated investment companies (mutual funds) and real estate investment trusts,
- 2) Your share of long-term capital gains or losses from partnerships, S corporations, and fiduciaries, and
- 3) Long-term capital loss carryovers.

The result from combining these items with your other long-term capital gains and losses is your net long-term capital gain or loss (line 17 of Schedule D).

**Capital gain distributions.** Report capital gain distributions (box 1c of Form 1099-DIV) on line 14, Part II of Schedule D (Form 1040). If you do not need Schedule D to report any other capital gains or losses, do not use it. Instead, show your capital gain distributions on line 13 of Form 1040. Write "CGD" on the dotted line next to that line.

**Total net gain or loss.** To figure your total net gain or loss, combine your net short-term capital gain or loss (line 8) with your net long-term capital gain or loss (line 17). Enter the result on line 18, Part III of Schedule D. If your losses are more than your gains, see *Capital Losses*, next. If both lines 17 and 18 are gains, see *Capital Gain Tax Computation*, later.

## Capital Losses

If your capital losses are more than your capital gains, you can claim a capital loss deduction. You must figure how much of the loss you can deduct in the year of the loss and how much of it you carry over and use in future tax years.

**Yearly limit.** Your allowable capital loss deduction for any tax year, figured on Schedule D, is limited to the lesser of:

- 1) \$3,000 (\$1,500 if you are married and file a separate return), or

- 2) Your total net loss as shown on line 18 of Schedule D.

You can use your total net loss to reduce your income dollar for dollar, up to the \$3,000 limit.

If you report a capital loss on line 13 of Form 1040, you should enclose the loss in parentheses.

**Capital loss carryover.** If you have a total net loss on line 18 of Schedule D that is more than the yearly limit on capital loss deductions, you can carry over the unused part to later years until it is completely used up. When you carry over a loss, it remains long term or short term. A long-term capital loss you carry over to the next tax year will reduce that year's long-term capital gains before it reduces that year's short-term capital gains.

You can carry over a capital loss that is more than the amount of allowable loss to the next year and treat it as if you had incurred it in that year. When you figure the amount of any capital loss carryover to a later tax year, you must take into account any deductions for capital losses allowed in earlier years, whether or not you actually claimed them.

**Figuring your carryover.** The amount of your capital loss carryover is the amount of your total net loss that exceeds the lesser of:

- 1) Your allowable capital loss deduction for the year, or
- 2) Your taxable income increased by your allowable capital loss deduction for the year and your deduction for personal exemptions.

If your deductions exceed your gross income for the tax year, use your negative taxable income in computing the amount in item (2).

Complete the *Capital Loss Carryover Worksheet* in the Schedule D (Form 1040) instructions to determine the part of your capital loss for 1996 that you can carry over to 1997.

**Use short-term losses first.** When you figure your capital loss carryover, use your short-term capital losses first, even if you incurred them after a long-term loss. If you have not reached the limit on the capital loss deduction after using short-term losses, use the long-term losses until you reach the limit.

**Example.** Bob and Gloria sold securities in 1996. The sales resulted in a capital loss of \$7,000. They had no other capital transactions. On their joint 1996 return, they can deduct \$3,000. The unused part of the loss, \$4,000 (\$7,000 - \$3,000), can be carried over to 1997.

If their capital loss had been \$2,000, their capital loss deduction would have been \$2,000. They would have no carryover to 1997.

**Joint and separate returns.** If you are married and filing a separate return, your yearly capital loss deduction is limited to \$1,500.

If you and your spouse once filed separate returns and are now filing a joint return, combine your capital loss carryovers. However, if you and your spouse once filed a joint return and are now filing separate returns, any capital loss carryover can be deducted only on the return of the person who actually had the loss.

**A decedent's capital loss.** A capital loss sustained by a decedent during his or her last tax year can only be deducted on the final income tax return filed for the decedent. The capital loss limits discussed earlier still apply in this situation. This loss cannot be deducted by the decedent's estate or carried over to following years.

## Capital Gain Tax Computation

The 31%, 36%, and 39.6% income tax rates for individuals do not apply to a net capital gain. Your net capital gain is taxed at a maximum tax rate of 28% even if you have ordinary income that is taxed at a higher rate.

If both lines 17 and 18 of Schedule D are gains, or if you reported capital gain distributions on line 13, Form 1040, you have a net capital gain. You may need to use the *Capital Gain Tax Worksheet* in the Form 1040 instructions for line 38 to figure your tax.

First complete your Form 1040 through line 37. If your taxable income (line 37 of Form 1040) is over the amount shown for your filing status in the following table, complete the *Capital Gain Tax Worksheet*.

Filing Status	Amount
Single	\$58,150
Married filing jointly	\$96,900
Married filing separately	\$48,450
Head of household	\$83,050
Qualifying widow(er)	\$96,900

**Example.** Aretha Johnson, a single taxpayer, had 1996 taxable income of \$60,000, including a long-term capital gain of \$15,000 on the sale of stock. She had no other capital gains or losses. She enters her \$15,000 gain on line 9 of Schedule D, then enters the same amount on lines 16, 17, and 18 of Schedule D and line 13 of Form 1040. Since Aretha's taxable income is more than \$58,150, her maximum tax rate will be higher than 28%. To figure her 1996 tax, Aretha completes the *Capital Gain Tax Worksheet*. Her filled-in worksheet is shown in *Table 17-1*.

**Investment interest deducted.** If you claim a deduction for investment interest, you may have to reduce the amount of your net capital gain that is eligible for the 28% maximum tax rate. Reduce it by the amount of the net capital gain you choose to include in investment income when figuring the limit on your investment interest deduction. For more information about deducting investment interest, see Chapter 3 of Publication 550.



**Table 17-1. Filled-in Capital Gain Tax Worksheet**

Use this worksheet to figure your tax **only** if **(a)** you are filing Schedule D and both lines 17 and 18 of Schedule D are gains, or **(b)** you reported capital gain distributions directly on Form 1040, line 13, **and**:

Your filing status:	AND	Form 1040, line 37, is over:	Your filing status:	AND	Form 1040, line 37, is over:
Single .....		\$58,150	Head of household .....		\$83,050
Married filing jointly or Qualifying widow(er) .....		\$96,900	Married filing separately .....		\$48,450

1. Enter the amount from Form 1040, line 37 .....	1. <u>60,000</u>
2. If you are filing Schedule D, enter the <b>smaller</b> of Schedule D, line 17 or line 18. Otherwise, enter capital gain distributions reported on Form 1040, line 13 ....	2. <u>15,000</u>
3. If you are filing Form 4952, enter the amount from Form 4952, line 4e .....	3. <u>-0-</u>
4. Subtract line 3 from line 2. If zero or less, <b>stop here</b> ; you <b>cannot</b> use this worksheet to figure your tax. Instead, use the Tax Table or Tax Rate Schedules, whichever applies .....	4. <u>15,000</u>
5. Subtract line 4 from line 1 .....	5. <u>45,000</u>
6. Enter: \$40,100 (\$24,000 if single; \$20,050 if married filing separately; \$32,150 if head of household) .....	6. <u>24,000</u>
7. Enter the <b>larger</b> of line 5 or line 6 .....	7. <u>45,000</u>
8. Subtract line 7 from line 1 .....	8. <u>15,000</u>
9. Figure the tax on the amount on line 7. Use the Tax Table or Tax Rate Schedules, whichever applies .....	9. <u>9,487</u>
10. Multiply line 8 by 28% (.28) .....	10. <u>4,200</u>
11. Add lines 9 and 10 .....	11. <u>13,687</u>
12. Figure the tax on the amount on line 1. Use the Tax Table or Tax Rate Schedules, whichever applies .....	12. <u>13,743</u>
13. <b>Tax.</b> Enter the <b>smaller</b> of line 11 or line 12 here and also include on Form 1040, line 38. ....	13. <u>13,687</u>

## Comprehensive Example

Emily Jones is single and, in addition to wages from her regular employment, she has income from some stocks and other securities. For the 1996 tax year, she had the following capital gains and losses, which she

reports on Schedule D. All the Forms 1099 she received showed net sales prices. Her filled-in Schedule D and *Capital Loss Carryover Worksheet* are shown in this chapter.

**Capital gains and losses — Schedule D.** Emily sold stock in two different companies that she held for less than a year. In June, she sold 100 shares of Trucking Co. stock

that she had purchased in May. She had an adjusted basis of \$650 in the stock and sold it for \$900, for a gain of \$250. In June, she sold 25 shares of Computer Co. stock that she bought in March. She had an adjusted basis in the stock of \$2,500 and she sold it for \$2,000, for a loss of \$500. She reports these short-term transactions on Part I of Schedule D.

During the year, Emily also sold securities in two other corporations. In February, she sold 60 shares of Car Co. for \$2,100. She had inherited the Car stock from her father. Its fair market value at the time of his death was \$700, which became her basis. Her gain on the sale was \$1,400. Because she had inherited the stock, she reports this as a long-term gain, regardless of how long she and her father actually held the stock.

On June 28, 1996, she sold 500 shares of Furniture Co. stock for \$4,100. She bought 100 of those shares on June 25, 1987, for \$7,000. She bought 100 more shares on September 10, 1987, for \$9,000, and an additional 300 shares on January 30, 1991, for \$18,000. Her total basis in the stock is \$34,000. She realized a \$29,900 (\$34,000 – \$4,100) loss on this sale. She reports these long-term transactions in Part II of Schedule D.

**Capital loss carryover — Schedule D.** Emily has a capital loss carryover to 1996 of \$800, of which \$300 is short-term capital loss, and \$500 is long-term capital loss.

She kept the completed *Capital Loss Carryover Worksheet* in her 1995 Schedule D instructions so she could properly report her loss carryover for the 1996 tax year without refiguring it. She completes the *Capital Loss Carryover Worksheet* in the 1996 Schedule D instructions to figure her carryover to 1997. On line 1 of that worksheet, she enters the amount from line 35 of her Form 1040, \$34,580. Her filled-in worksheet is shown later.

**Reconciliation of Forms 1099–B.** Emily makes sure that the total of the amounts reported in column (d) of lines 3 and 11 of Schedule D is not less than the total of the amounts shown on the Forms 1099–B she received from her stockbroker. For 1996, the total of each is \$9,100.

**SCHEDULE D  
(Form 1040)**

Department of the Treasury  
Internal Revenue Service

**Capital Gains and Losses**

▶ Attach to Form 1040. ▶ See instructions for Schedule D (Form 1040).  
▶ Use lines 20 and 22 for more space to list transactions for lines 1 and 9.

OMB No. 1545-0074

**1996**

Attachment  
Sequence No. 12

Name(s) shown on Form 1040

*Emily Jones*

Your social security number

*111 000 1111*

**Part I Short-Term Capital Gains and Losses—Assets Held One Year or Less**

(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-3)	(e) Cost or other basis (see page D-3)	(f) LOSS If (e) is more than (d), subtract (d) from (e)	(g) GAIN If (d) is more than (e), subtract (e) from (d)
1 100 sh Trucking Co.	5-10-96	6-28-96	900	650		250
25 sh Computer Co.	3-15-96	6-28-96	2,000	2,500	500	
2 Enter your short-term totals, if any, from line 21 . . . . .	2					
3 Total short-term sales price amounts. Add column (d) of lines 1 and 2 . . . . .	3	2,900				
4 Short-term gain from Forms 2119 and 6252, and short-term gain or loss from Forms 4684, 6781, and 8824 . . . . .	4					
5 Net short-term gain or loss from partnerships, S corporations, estates, and trusts from Schedule(s) K-1 . . . . .	5					
6 Short-term capital loss carryover. Enter the amount, if any, from line 9 of your 1995 Capital Loss Carryover Worksheet . . . . .	6	300				
7 Add lines 1 through 6 in columns (f) and (g) . . . . .	7	( 800 )				250
8 Net short-term capital gain or (loss). Combine columns (f) and (g) of line 7 . . . . . ▶	8					(550)

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

9 60 sh Car Co.	Inherited	2-12-96	2,100	700		1,400
500 sh Furniture Co.	Various	6-28-96	4,100	34,000	29,900	
10 Enter your long-term totals, if any, from line 23 . . . . .	10					
11 Total long-term sales price amounts. Add column (d) of lines 9 and 10 . . . . .	11	6,200				
12 Gain from Form 4797; long-term gain from Forms 2119, 2439, and 6252; and long-term gain or loss from Forms 4684, 6781, and 8824 . . . . .	12					
13 Net long-term gain or loss from partnerships, S corporations, estates, and trusts from Schedule(s) K-1 . . . . .	13					
14 Capital gain distributions . . . . .	14					
15 Long-term capital loss carryover. Enter the amount, if any, from line 14 of your 1995 Capital Loss Carryover Worksheet . . . . .	15	500				
16 Add lines 9 through 15 in columns (f) and (g) . . . . .	16	(30,400)				1,400
17 Net long-term capital gain or (loss). Combine columns (f) and (g) of line 16 . . . . . ▶	17					(29,000)

**Part III Summary of Parts I and II**

18 Combine lines 8 and 17. If a loss, go to line 19. If a gain, enter the gain on Form 1040, line 13. Note: If both lines 17 and 18 are gains, see the Capital Gain Tax Worksheet on page 23 . . . . .	18	(29,550)
19 If line 18 is a loss, enter here and as a (loss) on Form 1040, line 13, the smaller of these losses: a The loss on line 18; or b (\$3,000) or, if married filing separately, (\$1,500) . . . . . Note: See the Capital Loss Carryover Worksheet on page D-3 if the loss on line 18 exceeds the loss on line 19 or if Form 1040, line 35, is a loss.	19	( 3,000 )

**Capital Loss Carryover Worksheet**  
(keep for your records)



You may deduct capital losses up to the amount of your capital gains plus \$3,000 (\$1,500 if married filing separately). Capital losses that exceed this amount are carried forward to later years. Use this worksheet to figure your capital loss carryovers from 1996 to 1997 if Schedule D, line 19, is a loss and (a) that loss is a smaller loss than the loss on Schedule D, line 18, or (b) Form 1040, line 35, is a loss.

1. Enter the amount from Form 1040, line 35. If a loss, enclose the amount in parentheses . . . . .	1. <u>34,580</u>
2. Enter the loss from Schedule D, line 19, as a positive amount . . . . .	2. <u>3,000</u>
3. Combine lines 1 and 2. If zero or less, enter -0- . . . . .	3. <u>37,580</u>
4. Enter the smaller of line 2 or line 3 . . . . .	4. <u>3,000</u>
<i>Note: If line 8 of Schedule D is a loss, go to line 5; otherwise, enter -0- on line 5 and go to line 10.</i>	
5. Enter the loss from Schedule D, line 8, as a positive amount . . . . .	5. <u>550</u>
6. Enter the gain, if any, from Schedule D, line 17 . . . . .	6. _____
7. Enter the amount from line 4 . . . . .	7. <u>3,000</u>
8. Add lines 6 and 7 . . . . .	8. <u>3,000</u>
9. Short-term capital loss carryover to 1997. Subtract line 8 from line 5. If zero or less, enter -0- . . . . .	9. <u>0</u>
<i>Note: If line 17 of Schedule D is a loss, go to line 10; otherwise, skip lines 10 through 14.</i>	
10. Enter the loss from Schedule D, line 17, as a positive amount . . . . .	10. <u>29,000</u>
11. Enter the gain, if any, from Schedule D, line 8 . . . . .	11. _____
12. Subtract line 5 from line 4. If zero or less, enter -0- . . . . .	12. <u>2,450</u>
13. Add lines 11 and 12 . . . . .	13. <u>2,450</u>
14. Long-term capital loss carryover to 1997. Subtract line 13 from line 10. If zero or less, enter -0- . . . . .	14. <u>26,550</u>

# Part Four.

## Adjustments to Income

The three chapters in this part discuss three deductions that are used to figure adjusted gross income. They are deductions for:

- Payments to an individual retirement arrangement (IRA) — Chapter 18,
- Moving expenses you pay — Chapter 19, and
- Alimony you pay — Chapter 20.

Other adjustments to income are discussed in other parts of this publication or in other publications. They are deductions for:

- Self-employment tax — Chapter 24,
- Self-employed health insurance — Chapter 23,
- Payments to a Keogh retirement plan or self-employed SEP— Publication 560, *Retirement Plans for the Self-Employed*, and
- Penalty on early withdrawal of savings — Chapter 8.

You can also write in certain deductions in figuring adjusted gross income on Form 1040. They are discussed in other parts of this publication or in other publications and instructions. These write-in deductions include the following:

- Amortization of the costs of reforestation —Chapter 12 of Publication 535, *Business Expenses*,
- Contributions to Internal Revenue Code Section 501(c)(18) pension plans — Instructions for Form 1040, line 30,
- Expenses from the rental of personal property —Chapter 13,
- Expenses of certain performing artists — Chapter 28,
- Certain required repayments of supplemental unemployment benefits (sub-pay) — Chapter 6,
- Foreign housing deduction — Publication 54, *Tax Guide for U.S. Citizens and Resident Aliens Abroad*,
- Jury duty pay given to your employer — Chapter 13, and
- Part of the cost of qualified clean-fuel vehicle property — Publication 535, *Business Expenses*.

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## 18.

### Individual Retirement Arrangements (IRAs)

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#### Important Change for 1996

**Excise tax on prohibited transactions.** The excise tax on the amount of a prohibited transaction that takes place after August 20, 1996, has increased from 5% to 10%. For

more information, see *Prohibited Transactions*, later.

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#### Important Changes for 1997

The following changes will not affect your 1996 tax return. They are effective beginning in 1997. For more information on these and other changes to the tax law, get Publication 553, *Highlights of 1996 Tax Changes*.

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**Contributions to spousal IRAs.** For tax years beginning after 1996, in the case of a married couple filing a joint return, up to \$2,000 can be contributed to each spouse's

IRA, even if one spouse has little or no compensation. This means that the total combined contributions that can be made to both IRAs can be as much as \$4,000 for the year. Previously, if one spouse had no compensation or elected to be treated as having no compensation, the total combined contributions to both IRAs could not be more than \$2,250. See *Spousal IRA*, under *Contribution Limits*, later.

**Deduction for contributions to spousal IRA.** For tax years beginning after 1996, in the case of a married couple with unequal compensation who file a joint return, the limit on the deductible contributions to the IRA of the spouse with less compensation is the smaller of:

- 1) \$2,000, or
- 2) The total compensation of both spouses, reduced by any deduction allowed for contributions to IRAs of the spouse with more compensation.

The deduction for contributions to both spouses' IRAs may be further limited if either spouse is covered by an employer retirement plan. See *Deduction Limits*, later.

**No additional tax on early withdrawals for medical expenses.** Beginning in 1997, the 10% additional tax on premature distributions (early withdrawals) from an IRA will not apply to distributions up to the amount you pay for unreimbursed medical expenses that are more than 7½% of your adjusted gross income.

Also beginning in 1997, the 10% tax may not apply to distributions up to the amount you paid for medical insurance for yourself, your spouse, and your dependents. See *Premature Distributions (Early Withdrawals)*.

**Temporary suspension of tax on excess distributions.** For IRA distributions made after 1996 and before the year 2000, the 15% tax on excess distributions has been suspended.

**Salary reduction arrangements for SEPs repealed.** Effective for tax years beginning after 1996, an employer cannot start a simplified employee pension (SEP) that includes a salary reduction arrangement. Only SEPs that allowed employees to choose elective deferrals as of December 31, 1996, can include salary reduction arrangements.

**Savings Incentive Match Plans for Employees (SIMPLE).** Beginning in 1997, certain employers can set up SIMPLE retirement plans. A SIMPLE plan can be set up by an employer who had no more than 100 employees who received at least \$5,000 in compensation from the employer last year. Generally, the SIMPLE plan must be the only retirement plan of the employer.

SIMPLE plans are written qualified salary reduction arrangements that allow an employee to elect to reduce his or her compensation by a certain percentage each pay period and have the employer contribute the salary reductions to the SIMPLE plan on behalf of the employee. For 1997, the amount of the employee's salary reductions cannot exceed \$6,000. Employers are also required to make contributions to the SIMPLE plan on behalf of eligible employees. Contributions to a SIMPLE plan are not subject to income tax until they are distributed.

SIMPLE plan can be set up either as an IRA or as part of a qualified cash or deferred arrangement (401(k) plan). SIMPLE plans are not subject to the nondiscrimination rules that generally apply to qualified plans. For more information on this new plan, get Publication 560, *Retirement Plans for the Self-Employed*.

## Important Reminders

**Interest earned.** Although interest earned from your IRA(s) is generally not taxed in the year earned, it is **not tax-exempt** interest.

**Do not** report this interest on your tax return as tax-exempt interest.

**Penalty for failure to file Form 8606.** If you make nondeductible IRA contributions and you do not file Form 8606, *Nondeductible IRAs (Contributions, Distributions, and Basis)*, with your tax return, you may have to pay a \$50 penalty.

## Introduction

This chapter discusses:

- Who can set up an IRA,
- When and how an IRA can be set up,
- How much you can contribute and deduct,
- How retirement plan assets can be transferred,
- When IRA assets can be withdrawn,
- What acts result in penalties, and
- Simplified Employee Pensions (SEPs).

**What is an individual retirement arrangement (IRA)?** An individual retirement arrangement (IRA) is a personal savings plan that offers you tax advantages to set aside money for your retirement. Two advantages are that you may be able to deduct your contributions to your IRA in whole or in part, depending on your circumstances, and, generally, amounts in your IRA, including earnings and gains, are not taxed until they are distributed.

If you work for yourself, you may be able to deduct contributions to a Simplified Employee Pension (SEP), which involves the use of IRAs (SEP-IRAs), or the new SIMPLE plan, which can be set up in the form of an IRA (SIMPLE retirement account). You may also be able to deduct contributions to other retirement plans for the self-employed (sometimes called Keogh or HR-10 plans). Only self-employed individuals can deduct such contributions. For details, get Publication 560.

## Useful Items

You may want to see:

### Publication

- **590** Individual Retirement Arrangements (IRAs)

### Form (and Instructions)

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

- **8606** Nondeductible IRAs (Contributions, Distributions, and Basis)

## Who Can Set Up an IRA?

You can set up and make contributions to an IRA if you received taxable compensation during the year and were not age 70½ by the end of the year.

**Compensation** includes wages, salaries, commissions, tips, professional fees, bonuses, and other amounts you receive for providing personal services. The IRS treats as compensation any amount properly shown in box 1 (Wages, tips, other compensation) of Form W-2, provided that amount is reduced by any amount properly shown in box 11 (Nonqualified plans). Compensation also includes taxable alimony and separate maintenance payments.

**If you are self-employed** (a sole proprietor or a partner), compensation is your net earnings from your trade or business (provided your personal services are a material income-producing factor) reduced by your deduction for contributions on your behalf to retirement plans and the deduction allowed for one-half of your self-employment taxes.

Compensation includes earnings from self-employment that are not subject to self-employment tax because of your religious beliefs. See Publication 533, *Self-Employment Tax*, for more information.

Compensation does **not** include any of the following items:

- Earnings and profits from property, such as rental income, interest income, and dividend income,
- Pension or annuity income,
- Deferred compensation received (compensation payments postponed from a past year),
- Foreign earned income and housing cost amounts that you exclude from income, or
- Any other amounts that you exclude from income.

**IRA for your spouse.** You may be eligible to set up and contribute to an IRA for your spouse, whether or not he or she received compensation. This is called a spousal IRA and is generally set up for a nonworking spouse. (See *How Much Can I Contribute and Deduct?* later.)

**Eligibility requirements.** To contribute to a spousal IRA for tax years beginning before 1997, all five of the following conditions must be met:

- 1) You must be married at the end of the tax year.
- 2) Your spouse must not have reached age 70½ by the end of the tax year.
- 3) You must file a joint return for the tax year.
- 4) You must have taxable compensation for the tax year.

- 5) Your spouse must either have no compensation or choose to be treated as having no compensation for the tax year.



For years beginning after 1996, requirement (5) above is changed to read "Your compensation for the year is more than your spouse's compensation for the year."

## When and How Can an IRA Be Set Up?

You can set up an IRA at any time. However, the time for making contributions for any year is limited. See *When To Contribute*, later.

You can set up different kinds of IRAs with a variety of organizations. You can set up an IRA at a bank or other financial institution or with a mutual fund or life insurance company. You can also set up an IRA through your stockbroker. Any plan must meet Internal Revenue Code requirements.

**Kinds of IRAs.** Your IRA can be an individual retirement account or annuity. It can be either a part of a simplified employee pension (SEP) or a part of an employer or employee association trust account.

**Inherited IRAs.** If you inherit an IRA, that IRA becomes subject to special rules. For example, if you are a surviving spouse, you can elect to treat an IRA inherited from your spouse as your own. For more information, see the discussions of inherited IRAs under *Contribution Limits* and *Rollovers*, later.

## How Much Can I Contribute and Deduct?

Contributions to an IRA must be in the form of money (cash, check, or money order). You cannot contribute property.

### Contribution Limits

The most that you can contribute for any year to your IRA is the smaller of the following amounts:

- 1) Your compensation (defined earlier) that you must include in income for the year, or
- 2) \$2,000.

This is the most you can contribute regardless of whether your contributions are to one or more IRAs or whether all or part of your contributions are nondeductible. (See *Nondeductible Contributions*, later.)

**Example 1.** Betty, who is single, earns \$24,000 in 1996. Her IRA contributions for 1996 are limited to \$2,000.

**Example 2.** John, a college student working part time, earns \$1,500 in 1996. His IRA contributions for 1996 are limited to \$1,500, the amount of his compensation.

**Spousal IRA.** The total combined contributions you can make **for 1996** to your IRA and a spousal IRA (discussed earlier) is the smaller of:

- 1) Your taxable compensation for the year, or
- 2) \$2,250.

You can divide your IRA contributions between your IRA and the spousal IRA any way you choose, but you cannot contribute more than \$2,000 to either IRA. (See the examples below.)

**Spousal IRAs after 1996.** For tax years beginning after 1996, in the case of a married couple filing a joint return, up to \$2,000 can be contributed to each spouse's IRA, even if one spouse has little or no compensation. This means that the total combined contributions that can be made to both IRAs can be as much as \$4,000 for the year.

**Spouse has compensation during the year.** If your spouse also has taxable compensation during the year and each of you is under age 70½ at the end of the year, you each can have regular IRAs. You each can contribute up to the \$2,000 limit, unless, for 1996, your taxable compensation (or your spouse's) is less than \$2,000.

However, you or your spouse can choose to be treated as having no compensation for 1996 and use the 1996 rules for spousal IRAs. Generally, if one spouse has compensation of less than \$250 for 1996, a spousal IRA is more advantageous than a regular IRA.

**Example 1.** Bill and Linda file a joint return for 1996. He earned \$37,000 and she earned \$190. She chose to be treated as having no compensation. Bill set up a spousal IRA for her. Because he contributed \$1,800 to his IRA, the most he can contribute to the spousal IRA is \$450 (\$2,250 minus \$1,800).

**Example 2.** Assume the same facts as in Example 1 except that Bill's contribution to the spousal IRA is \$2,000 (the limit for either IRA). The most he can contribute to his own IRA is \$250 (\$2,250 minus \$2,000).

**Spouse under age 70½.** You cannot make contributions to your IRA for the year in which you reach age 70½ or any later year. However, for any year you have compensation, you can continue to make contributions of up to \$2,000 to a spousal IRA. You can contribute to a spousal IRA until the year your spouse reaches age 70½.

**Contributions not required.** You do not have to contribute to your IRA or a spousal IRA for every tax year, even if you can.

**If you and your spouse each contribute to an IRA,** the contribution limit for each of you is figured separately.

**IRA contributions under community property laws.** Contributions cannot be made to your IRA based on the earnings of your spouse (unless your IRA is a spousal IRA). The contributions must be based on your own compensation, even in community property states.

**Inherited IRAs.** If you inherit an IRA from your spouse, you can choose to treat it as your own by making contributions to that IRA.

If, however, you inherit an IRA and you are not the decedent's spouse, you cannot contribute to that IRA, because you cannot treat it as your own.

## When To Contribute

You can make contributions to your IRA (or to a spousal IRA) for a year at any time during the year or by the due date of your return for that year, **not** including extensions. For most people, this means that contributions for 1996 must be made by April 15, 1997.

**Designating year for which contribution is made.** If you contribute an amount to your IRA between January 1, 1997, and April 15, 1997, tell the sponsor (the trustee or issuer) to which year (1996 or 1997) the contribution applies. If you do not tell the sponsor, the sponsor can assume, for reporting to IRS, that the contribution is for 1997, the year the sponsor received it.

**Filing before making your contribution.** You can file your return claiming an IRA contribution before you actually make the contribution. You must, however, make the contribution by the due date of your return, **not** including extensions.

## Deductible Contributions

Generally, you can take a deduction for the contributions that you are allowed to make to your IRA. However, if you or your spouse were covered by an employer retirement plan at any time during the year for which you make the contribution, your allowable IRA deduction may be less than your contribution. Your deduction may be reduced or eliminated, depending on your filing status and the amount of your income, as discussed later under *Deduction Limits*.

### Who Is Covered by an Employer Plan?

The Form W-2, *Wage and Tax Statement*, you receive from your employer has a box used to indicate whether you were covered for the year. The "Pension Plan" box should have a mark in it if you were covered.

You are also covered by a plan if you are self-employed and participate in a qualified retirement plan (such as a Keogh plan) or a simplified employee pension (SEP) plan.

If you are not certain whether you were covered by your employer's retirement plan, you should ask your employer.

**Table 18-1. Can You Take An IRA Deduction?**

This chart sums up whether you can take a full deduction, a partial deduction, or no deduction as discussed in this chapter.

If Your Modified AGI <sup>1</sup> is:	If You Are Covered by a Retirement Plan at Work and Your Filing Status is:			If You Are Not Covered by a Retirement Plan at Work and Your Filing Status is:			
	• Single • Head of Household	• Married Filing Jointly (even if your spouse is not covered by a plan at work) • Qualifying Widow(er)	Married Filing Separately <sup>2</sup>	Married Filing Jointly (and your spouse is covered by a plan at work)	• Single • Head of Household	• Married Filing Jointly or Separately (and your spouse is not covered by a plan at work) • Qualifying Widow(er)	Married Filing Separately (even if your spouse is covered by a plan at work) <sup>3</sup>
At Least      But Less Than	You Can Take	You Can Take	You Can Take	You Can Take	You Can Take	You Can Take	You Can Take
\$0.01      \$10,000.00	Full deduction	Full deduction	Partial deduction	Full deduction			
\$10,000.00      \$25,000.01	Full deduction	Full deduction	No deduction	Full deduction			
\$25,000.01      \$35,000.00	Partial deduction	Full deduction	No deduction	Full deduction	Full Deduction	Full Deduction	Full Deduction
\$35,000.00      \$40,000.01	No deduction	Full deduction	No deduction	Full deduction			
\$40,000.01      \$50,000.00	No deduction	Partial deduction	No deduction	Partial deduction			
\$50,000.00 or over	No deduction	No deduction	No deduction	No deduction			

<sup>1</sup>**Modified AGI** (adjusted gross income) is: (1) for Form 1040A—the amount on line 14 increased by any excluded series EE bond interest shown on Form 8815, *Exclusion of Interest from Series EE U.S. Savings Bonds Issued after 1989*, or (2) for Form 1040—the amount on line 31, figured without taking into account any IRA deduction or any foreign earned income exclusion and foreign housing exclusion (deduction), or any series EE bond interest exclusion from Form 8815.

<sup>2</sup>If you did not live with your spouse at any time during the year, your filing status is considered, for this purpose, as Single (therefore your IRA deduction is determined under the “Single” column).

<sup>3</sup>You are entitled to the full deduction only if you did not live with your spouse at any time during the year. If you did live with your spouse during the year, you are, for this purpose, treated as though you are covered by a retirement plan at work (therefore, your IRA deduction is determined under the “Married Filing Separately” column in the “If You Are Covered by a Retirement Plan...” section of the chart).

**Employer plans.** An employer retirement plan is one that an employer sets up for the benefit of the employees. For purposes of the IRA deduction rules, an employer retirement plan is any of the following:

- A qualified pension, profit-sharing, stock bonus, money purchase, etc., plan (including Keogh plans),
- A 401(k) plan (generally a profit-sharing or stock bonus plan to which contributions can be made under an arrangement allowing you to choose to take your income in cash or have your employer pay it into the plan),
- A union plan (a qualified stock bonus, pension, or profit-sharing plan created by a collective bargaining agreement between employee representatives and one or more employers),
- A qualified annuity plan,
- A plan established for employees by a federal, state, or local government, or any of their political subdivisions, agencies, or instrumentalities (other than an eligible state deferred compensation plan (section 457 plan)),

- A tax-sheltered annuity plan for employees of public schools and certain tax-exempt organizations (403(b) plan),
- A simplified employee pension (SEP) plan,
- A 501(c)(18) trust (a certain type of tax-exempt trust created before June 25, 1959, that is funded only by employee contributions) if you made deductible contributions during the year, or
- Any SIMPLE retirement account.

A **qualified plan** is one that meets the requirements of the Internal Revenue Code.

**Effects of marital status.** Generally, you are considered covered by an employer retirement plan if your spouse is covered by one. To determine whether you are considered covered for the year because of your spouse, you must wait until the last day of the year. This is because your filing status (whether you are considered married or single) for the year depends on your marital status on the last day of the tax year.

**Spouse died during year.** If your spouse died during the year, and you file a joint return as the surviving spouse, coverage by an employer retirement plan for the

year is determined as if your spouse were still alive at the end of the year.

**Married filing a joint return.** Both you and your spouse are considered covered by a plan for the entire year if either of you is covered by a plan and you file a joint return.

**Married filing a separate return.** If you are not covered by an employer retirement plan, but your spouse is, you are not considered covered if you and your spouse file separate returns and you did not live together at any time during the year.

**Effect of amounts.** Even if your employer sets aside only a very small amount for you under a retirement plan, you are considered covered by a plan for the year.

**Nonvested employees.** If, for a plan year, an amount is allocated to your plan account in a defined contribution plan, or you accrue a benefit in a defined benefit plan, but you have **no vested interest** (legal right) in such account or accrual, you are still an active participant in (covered by) such plan.

**Judges.** Federal judges are considered covered by an employer retirement plan.

## When Are You Not Covered?

You are not covered by an employer plan if neither you nor your spouse is covered for any part of the year. You are also not covered for this purpose in the following situations.

**Married filing a separate return.** If you are married filing a separate return and you are not covered but your spouse is covered by an employer retirement plan, you are not considered covered by a plan. This rule applies only if you and your spouse did not live together at any time during the year.

**Social security or railroad retirement.** Coverage under social security or railroad retirement (Tier I and Tier II) does not count as coverage under an employer retirement plan.

**Benefits from a previous employer's plan.** If you receive retirement benefits from a previous employer's plan and you are not covered (or considered covered because of your spouse) under your current employer's plan, you are not considered covered.

**Reservists.** If the only reason you participate in a plan is because you are a member of a reserve unit of the armed forces, you may not be considered covered by the plan. You are not considered covered by the plan if both of the following conditions are met.

- 1) The plan you participate in is established for its employees by:
  - a) The United States,
  - b) A state or political subdivision of a state, or
  - c) An instrumentality of either (a) or (b) above.
- 2) You did not serve more than 90 days on active duty during the year (not counting duty for training).

**Volunteer firefighters.** If the only reason you participate in a plan is because you are a volunteer firefighter, you may not be considered covered by the plan. You are not considered covered by the plan if both of the following conditions are met.

- 1) The plan you participate in is established for its employees by:
  - a) The United States,
  - b) A state or political subdivision of a state, or
  - c) An instrumentality of either (a) or (b) above.
- 2) Your accrued retirement benefits at the beginning of the year will not provide more than \$1,800 per year at retirement.

## Social Security Recipients

If you received social security benefits, received taxable compensation, contributed to your IRA, and were covered (or considered covered) by an employer retirement plan, complete the worksheets in Appendix B of Publication 590. Use those worksheets to figure your IRA deduction and the taxable portion, if any, of your social security benefits.

## Deduction Limits

As discussed under *Deductible Contributions*, earlier, the deduction you can take for contributions made to your IRA depends on whether you or your spouse was covered for any part of the year by an employer retirement plan. But your deduction is also affected by how much income you had and your filing status, as discussed below under *Adjusted Gross Income Limit*.

**Full deduction.** If neither you nor your spouse was covered for any part of the year by an employer retirement plan, you can take a deduction for your total contributions to one or more IRAs of up to \$2,000, or 100% of your compensation, whichever is less. This limit is reduced by any contributions to a 501(c)(18) plan (generally, a plan created before June 25, 1959, funded entirely by employee contributions).

**Spousal IRA.** For tax years beginning after 1996, in the case of a married couple with unequal compensation who file a joint return, the limit on the deductible contributions to the IRA of the spouse with less compensation is the smaller of:

- 1) \$2,000, or
- 2) The total compensation of both spouses, reduced by any deduction allowed for contributions to IRAs of the spouse with more compensation.

This limit is reduced by any contributions to a 501(c)(18) plan (generally, a plan created before June 25, 1959, funded entirely by employee contributions).

**Reduced or no deduction.** If either you or your spouse was covered by an employer retirement plan, your deduction may be reduced or eliminated, depending on your income and your filing status. The deduction begins to decrease (**phase out**) when your income rises above a certain amount, and is eliminated altogether when it reaches a higher amount. The amounts vary depending on your filing status.

## Adjusted Gross Income Limit

The effect of income on your deduction, as just described, is sometimes called the adjusted gross income limit (AGI limit). To compute your reduced IRA deduction, you must first determine your "modified adjusted gross income" and your filing status.

**Modified adjusted gross income.** Your modified adjusted gross income (modified AGI) is:

- If you file **Form 1040**—the amount on the page 1 "adjusted gross income" line, but modified (changed) by figuring it without taking any:
  - a) IRA deduction,
  - b) Foreign earned income exclusion,
  - c) Foreign housing exclusion or deduction, and
  - d) Exclusion of Series EE bond interest shown on Form 8815, *Exclusion of Interest From Series EE U.S. Savings Bonds Issued After 1989*.
- If you file **Form 1040A**—the amount on the page 1 "adjusted gross income" line, but modified by figuring it without any IRA deduction, or any exclusion of series EE bond interest shown on Form 8815.



*Do not assume modified AGI is the same as your compensation. You will find that your modified AGI may include income in addition to your taxable compensation (discussed earlier), such as interest, dividends, and taxable IRA distributions.*

**Filing status.** Your filing status depends primarily on your marital status. For this purpose, you need to know if your filing status is single or head of household, married filing jointly or qualifying widow(er), or married filing separately. If you need more information on filing status, see Chapter 2.

**Married filing separately exception.** If you did not live with your spouse at any time during the year and you file a separate return, your filing status is considered, for this purpose, as single.

**Deduction phaseout.** Your IRA deduction is reduced or eliminated depending on your filing status and modified AGI as follows:

If your <b>filing status</b> is:	Your deduction is reduced if your <b>modified AGI</b> is within the <b>phaseout range</b> of:	Your deduction is eliminated if your <b>modified AGI</b> is:
Single, or Head of household	\$25,000.01 to \$35,000	\$35,000 or more
Married—joint return, or Qualifying widow(er)	\$40,000.01 to \$50,000	\$50,000 or more
Married—separate return	\$0.01 to \$10,000	\$10,000 or more

Also, see Table 18–1 earlier.

## How To Figure Your Reduced IRA Deduction



You can figure your reduced IRA deduction **for either** Form 1040 or Form 1040A by using the following worksheet. Also, the instructions for these tax forms include similar worksheets.

**Note.** If you were married and both you and your spouse worked and you both contributed to IRAs, use separate worksheets to figure your deductions.

If you were divorced or legally separated (and did not remarry) before the end of the year, you cannot deduct any contributions you made to your spouse's IRA. You can deduct only the contributions you made to your own IRA, and your deductions are subject to the adjusted gross income limit rules for single individuals.

**Deductible (and nondeductible) IRA contributions for an IRA other than a spousal IRA.** Complete lines 1 through 8 to figure your deductible and nondeductible contributions for the year.

### Worksheet for Reduced IRA Deduction

Use only if you are covered or considered covered by an employer retirement plan and your modified AGI is within the phaseout range that applies.

If your filing status is:	And your modified AGI is over:	Enter on line 1 below:
Single, or Head of household	\$25,000	\$35,000
Married—joint return, or Qualifying widow(er)	\$40,000	\$50,000
Married—separate return	\$—0—	\$10,000

- Enter the amount from above that applies \_\_\_\_\_
- Enter your modified AGI (combined, if married filing jointly) \_\_\_\_\_

**Note:** If line 2 is equal to or more than the amount on line 1, **stop here**; your IRA contributions are not deductible. See *Non-deductible Contributions*, later.

- Subtract line 2 from line 1. (If line 3 is \$10,000 or more, stop here; you can take a full IRA deduction for contributions of up to \$2,000 or 100% of your compensation, whichever is less.) \_\_\_\_\_

- Multiply line 3 by .20. If the result is not a multiple of \$10, round it to the next highest multiple of \$10. (For example, \$611.40 is rounded to \$620.) However, if the result is less than \$200, enter \$200 \_\_\_\_\_
- Enter your compensation. Do not include your spouse's compensation, and, if you file Form 1040, do not reduce your compensation by any losses from self-employment. \_\_\_\_\_
- Enter contributions you made, or plan to make, to your IRA for 1996, but do not enter more than \$2,000. (If contributions are more than \$2,000, see *Excess Contributions*, later.) \_\_\_\_\_
- IRA deduction.** Compare lines 4, 5, and 6. Enter the smallest amount (or a smaller amount if you choose) here and on the Form 1040 or 1040A line for your IRA, whichever applies. (If line 6 is more than line 7 and you want to make a nondeductible contribution, go to line 8.) \_\_\_\_\_
- Nondeductible contributions.** Subtract line 7 from line 5 or 6, whichever is smaller. Enter the result here and on line 1 of your Form 8606 \_\_\_\_\_

**Deductible (and nondeductible) IRA contributions for spousal IRA.** The deduction phaseout rules that reduce or eliminate your IRA deduction also apply to a spousal IRA. If you have a spousal IRA, are covered by an employer retirement plan, and your modified AGI is within the phaseout range, you can take only a reduced spousal IRA deduction. Complete lines 9 through 17 to figure deductible and nondeductible contributions (discussed later) for 1996 to a spousal IRA (see *IRA for your spouse* and *Spousal IRA*, earlier).

- Enter the smaller of \$2,250 or the amount on line 5 \_\_\_\_\_
- Add lines 7 and 8. Enter the total. If this amount is equal to or more than line 9, stop here; you cannot make contributions to a spousal IRA. Also, see *Excess Contributions*, later. \_\_\_\_\_
- Subtract line 10 from line 9 \_\_\_\_\_
- Enter the smallest of:
  - contributions for 1996 to your spouse's IRA; (b) \$2,000; or (c) line 11. (If contributions are more than \$2,000, see *Excess Contributions*, later.) \_\_\_\_\_
- Multiply line 3 by .225. If the result is not a multiple of \$10, round it to the next highest multiple of \$10. However, if the result is less than \$200, enter \$200 \_\_\_\_\_
- Enter the amount from line 7 \_\_\_\_\_
- Subtract line 14 from line 13. Enter the result, but not more than line 12 \_\_\_\_\_

- Spousal IRA deduction.** Compare lines 4, 5, and 15. Enter the smallest amount (or a smaller amount if you choose) here and on your Form 1040 or 1040A. (If line 12 is more than line 16 and you want to make a nondeductible contribution for your spouse, go to line 17) \_\_\_\_\_
- Spousal IRA nondeductible contributions.** Subtract line 16 from line 12. Enter the result here and on line 1 of your spouse's Form 8606. \_\_\_\_\_

## Reporting Deductible Contributions

You do not have to itemize deductions to claim your deduction for IRA contributions. If you file **Form 1040**, deduct your IRA contributions for 1996 on line 23a and, if you file a joint return, deduct your spouse's IRA contributions on line 23b.

If you file **Form 1040A**, deduct your contributions on line 15a and, if you file a joint return, deduct contributions to your spouse's IRA on line 15b.

**Form 1040EZ** does not provide for IRA deductions.

**Form 5498.** You should receive by June 2, 1997, Form 5498, *Individual Retirement Arrangement Information*, or similar statement, from plan sponsors, showing all the contributions made to your IRA for 1996.

**Trustee's fees.** Trustee's administrative fees that are billed separately and paid by you in connection with your IRA are deductible. They are deductible (if they are ordinary and necessary) as a miscellaneous deduction on Schedule A (Form 1040). The deduction is subject to the 2% of adjusted gross income limit (see Chapter 30).

**Broker's commissions** that you paid in connection with your IRA are subject to the IRA contribution limit. They are not deductible as a miscellaneous deduction on Schedule A (Form 1040).

## Nondeductible Contributions

Although your deduction for IRA contributions may be reduced or eliminated because of the adjusted gross income limit (See *Deductible Contributions*, earlier.), you can still make contributions of up to \$2,000 (\$2,250 for a regular IRA and a spousal IRA for 1996) or 100% of compensation, whichever is less. Often, the difference between your total permitted contributions and your total deductible contributions, if any, is your nondeductible contribution.

**Example.** Sonny Jones is single. In 1996, he is covered by a retirement plan at work. His salary is \$52,312. His modified AGI is \$55,000. Sonny makes a \$2,000 IRA contribution for that year. Because he is covered by a retirement plan and his modified AGI is

over \$35,000, he cannot deduct his \$2,000 IRA contribution. However, he can choose to either:

- 1) Designate this contribution as a nondeductible contribution by reporting it on his tax return, as explained later under *Reporting Nondeductible Contributions*, or
- 2) Withdraw the contribution as explained later under *Tax-Free Withdrawal of Contributions*.

As long as your contributions are within the contribution limits just discussed, none of the earnings on those contributions (deductible or nondeductible) or gains will be taxed until they are distributed. See *When Can I Withdraw or Use Assets From an IRA?* later.

**Cost basis.** You will have a cost basis in your IRA if you make nondeductible contributions. Your basis is the sum of the nondeductible amounts you have contributed to your IRA less any distributions of those amounts. When you withdraw (or receive distributions of) those amounts as discussed later under *Distributions Fully or Partly Taxable*, you can do so tax free.

## Reporting Nondeductible Contributions

You must report nondeductible contributions to the IRS, but you do not have to designate a contribution as nondeductible until you file your tax return. When you file, you can even designate otherwise deductible contributions as nondeductible.

**Designating nondeductible contributions.** To designate contributions as nondeductible, you must file Form 8606, *Nondeductible IRAs (Contributions, Distributions, and Basis)*. You must file Form 8606 to report nondeductible contributions even if you do not have to file a tax return for the year.

**Form 8606.** You must file Form 8606 if either of the following applies.

- You made nondeductible contributions to your IRA for 1996, or
- You received IRA distributions in 1996 and you have ever made nondeductible contributions to any of your IRAs.

**Contribution and distribution in the same year.** If you receive a distribution from an IRA in the same year that you make an IRA contribution that may be partly nondeductible, use the worksheet in chapter 6 of Publication 590 to figure the taxable portion of the distribution. Then you can figure the amount of nondeductible contributions to report on Form 8606.

**Failure to report nondeductible contributions.** If you do not report nondeductible contributions, all of your IRA contributions will be treated as deductible. When you make withdrawals from your IRA, they will be taxed unless you can show, with satisfactory

evidence, that nondeductible contributions were made.

**Penalty for overstatement.** If you overstate nondeductible contributions on your Form 8606, you must pay a penalty of \$100 for each overstatement, unless it was due to reasonable cause.

**Penalty for failure to file Form 8606.** You will have to pay a \$50 penalty if you do not file a required Form 8606, unless you can prove that the failure was due to reasonable cause.

## Tax-Free Withdrawal of Contributions

If you made IRA contributions for 1996, you can withdraw them tax free by the due date of your return. If you have an extension of time to file your return, you can withdraw them tax free by the extended due date. You must include in your income any earnings on the contributions you withdraw. You can do this if both the following apply.

- You did not take a deduction for the contributions you withdraw.
- You also withdraw any interest or other income earned on the contributions. You must report this income on your return for the year in which you made the withdrawn contributions.

IRA trustees must include these amounts in box 1 and, if applicable, in box 2a of Form 1099-R. You must report these amounts on line 15a, Form 1040. If there is an amount in box 2a of Form 1099-R, include it on line 15b of Form 1040.

**Premature withdrawal tax.** The 10% additional tax on withdrawals made before you reach age 59½ does not apply to these withdrawals of your contributions. However, your early withdrawal of interest or other income must be reported on Form 5329 and may be subject to this tax.

**Excess contribution tax.** If any part of these contributions is an excess contribution for 1995, it is subject to a 6% excise tax, unless you withdrew it from your IRA by April 15, 1996 (plus extensions). An excess contribution for 1996 must be withdrawn by April 15, 1997, to avoid the excise tax. See *Excess Contributions* under *What Acts Result in Penalties?*, later.

## Examples – Deductible and Nondeductible Contributions

The following examples illustrate the use of the IRA deduction worksheet shown earlier under *How To Figure Your Reduced IRA Deduction*.

**Example 1.** For 1996, Tom and Betty Smith file a joint return on Form 1040. They both work and he is covered by a retirement plan at work. His salary is \$40,000 and hers is \$6,555. They each have an IRA and their combined modified AGI is \$46,555. Since

their modified AGI is between \$40,000 and \$50,000 and Tom is covered by an employer plan, each of them is subject to the deduction limits. See *Deduction Limits*, earlier.

For 1996, Tom contributed \$2,000 to his IRA and Betty contributed \$500 to hers. They must use separate worksheets to figure the reduced IRA deduction for each of them because both had IRAs.

Tom can take a deduction of only \$690. See the worksheet below. Even though he contributed the maximum amount allowable (\$2,000), \$1,310 (\$2,000 minus \$690) of his contributions must be treated as nondeductible.

He can choose to treat the \$690 as either deductible or nondeductible contributions. He can also either leave the \$1,310 of nondeductible contributions in his IRA or withdraw them by April 15, 1997. He decides to treat the \$690 as deductible contributions and leave the \$1,310 of nondeductible contributions in his IRA.

Betty can treat all or part of her contributions as either deductible or nondeductible. This is because her \$500 contribution for 1996 is less than the \$690 deduction limit for her IRA contributions that year. See line 4 of her worksheet, later. She decides to treat her \$500 IRA contributions as deductible.

Using the *Worksheet for Reduced IRA Deduction*, Tom figures his deductible and nondeductible amounts as follows:

### Worksheet for Reduced IRA Deduction

Use only if you are covered or considered covered by an employer retirement plan and your modified AGI is within the phaseout range that applies.

If your filing status is: _____	And your modified AGI is over: _____	Enter on line 1 below: _____
Single, or Head of household	\$25,000	\$35,000
Married—joint return, or Qualifying widow(er)	\$40,000	\$50,000
Married—separate return	\$—0—	\$10,000
1. Enter the amount from above that applies ..... <u>50,000</u>		
2. Enter your modified AGI (combined, if married filing jointly) ..... <u>46,555</u>		

**Note:** If line 2 is equal to or more than the amount on line 1, **stop here**; your IRA contributions are not deductible; see *Nondeductible Contributions*, earlier.

3. Subtract line 2 from line 1. (If line 3 is \$10,000 or more, **stop here**; you can take a full IRA deduction for contributions of up to \$2,000 or 100% of your compensation, whichever is less.) ..... 3,445

4. Multiply line 3 by .20. If the result is not a multiple of \$10, round it to the next highest multiple of \$10. (For example, \$611.40 is rounded to \$620.) However, if the result is less than \$200, enter \$200 ..... 690
5. Enter your compensation. Do not include your spouse's compensation, and, if you file Form 1040, do not reduce your compensation by any losses from self-employment. .... 40,000
6. Enter contributions you made, or plan to make, to your IRA for 1996, but do not enter more than \$2,000. (If contributions are more than \$2,000, see *Excess Contributions*, later.) ..... 2,000
7. **IRA deduction.** Compare lines 4, 5, and 6. Enter the smallest amount (or a smaller amount if you choose) here and on the Form 1040 or 1040A line for your IRA, whichever applies. (If line 6 is more than line 7 and you want to make a nondeductible contribution, go to line 8.) ..... 690
8. **Nondeductible contributions.** Subtract line 7 from line 5 or 6, whichever is smaller. Enter the result here and on line 1 of your Form 8606 ..... 1,310

Betty figures her IRA deduction as follows:

#### Worksheet for Reduced IRA Deduction

Use only if you are covered or considered covered by an employer retirement plan and your modified AGI is within the phaseout range that applies.

If your filing status is:	And your modified AGI is over:	Enter on line 1 below:
Single, or Head of household	\$25,000	\$35,000
Married—joint return, or Qualifying widow(er)	\$40,000	\$50,000
Married—separate return	\$—0—	\$10,000

1. Enter the amount from above that applies ..... 50,000
2. Enter your modified AGI (combined, if married filing jointly) ..... 46,555

**Note:** If line 2 is equal to or more than the amount on line 1, **stop here**; your IRA contributions are not deductible; see *Nondeductible Contributions*, earlier.

3. Subtract line 2 from line 1. (**If line 3 is \$10,000 or more, stop here**; you can take a full IRA deduction for contributions of up to \$2,000 or 100% of your compensation, whichever is less.) ..... 3,445
4. Multiply line 3 by .20. If the result is not a multiple of \$10, round it to the next highest multiple of \$10. (For example, \$611.40 is rounded to \$620.) However, if the result is less than \$200, enter \$200 ..... 690
5. Enter your compensation. Do not include your spouse's compensation, and, if you file Form 1040, do not reduce your compensation by any losses from self-employment. .... 6,555
6. Enter contributions you made, or plan to make, to your IRA for 1996, but do not enter more than \$2,000. (If contributions are more than \$2,000, see *Excess Contributions*, later.) ..... 500
7. **IRA deduction.** Compare lines 4, 5, and 6. Enter the smallest amount (or a smaller amount if you choose) here and on the Form 1040 or 1040A line for your IRA, whichever applies. (If line 6 is more than line 7 and you want to make a nondeductible contribution, go to line 8.) ..... 500
8. **Nondeductible Contributions.** Subtract line 7 from line 5 or 6, whichever is smaller. Enter the result here and on line 1 of your Form 8606 ..... 0

The IRA deductions of \$690 and \$500 on the joint return for Tom and Betty total \$1,190. Betty's unused IRA deduction limit of \$190 (\$690 – \$500) cannot be transferred to Tom to increase his deduction.

**Example 2.** Assume the facts in Example 1, except that Tom contributed \$250 to a spousal IRA because Betty had no compensation for the year and did not contribute to an IRA. Their modified AGI remains at \$46,555. Tom uses lines 1 through 8 of his worksheet to complete the spousal IRA portion of the *Worksheet for Reduced IRA Deduction* as follows.

9. Enter the smaller of \$2,250 or the amount on line 5 ..... 2,250
10. Add lines 7 and 8. Enter the total. **If this amount is equal to or more than line 9, stop here**; you cannot make contributions to a spousal IRA. Also, see *Excess Contributions*, later. .... 2,000
11. Subtract line 10 from line 9 ..... 250
12. Enter the smallest of:
  - (a) contributions for 1996 to your spouse's IRA; (b) \$2,000; or (c) line 11. (If contributions are more than \$2,000, see *Excess Contributions*, later.) ..... 250

13. Multiply line 3 by .225. If the result is not a multiple of \$10, round it to the next highest multiple of \$10. However, if the result is less than \$200, enter \$200 ..... 780
14. Enter the amount from line 7 ..... 690
15. Subtract line 14 from line 13. Enter the result, but not more than line 12 ..... 90
16. **Spousal IRA deduction.** Compare lines 4, 5, and 15. Enter the smallest amount (or a smaller amount if you choose) here and on your Form 1040 or 1040A. (If line 12 is more than line 16 and you want to make a nondeductible contribution for your spouse, go to line 17.) ..... 90
17. **Spousal IRA nondeductible contributions.** Subtract line 16 from line 12. Enter the result here and on line 1 of your spouse's Form 8606. .... 160

Although Tom contributed the maximum amount (a total of \$2,250) to his and Betty's IRAs, because of the adjusted gross income limit, their allowable IRA deductions total only \$780 (\$690 + \$90).

## Can Retirement Plan Assets Be Transferred?

IRA rules permit you to transfer, tax free, assets (money or property) from other retirement plans (including IRAs) to an IRA. The rules permit the following kinds of transfers:

- Transfers from one trustee to another,
- Rollovers, and
- Transfers incident to a divorce.

### Transfer From One IRA Trustee to Another

A transfer of funds in your IRA from one trustee directly to another, either at your request or at the trustee's request, is not a rollover. Because there is no distribution to you, the transfer is tax free. Because it is not a rollover, it is not affected by the one-year waiting period that is required between rollovers, discussed next. For information about direct transfers to IRAs from retirement programs other than IRAs, see Publication 590.

### Rollovers

Generally, a rollover is a tax free distribution to you of cash or other assets from one retirement plan that you contribute (roll over) to another retirement plan. The amount you roll over tax free, however, is generally taxable later when the new plan pays that amount to you or your beneficiary.

**Kinds of rollovers to an IRA.** There are two kinds of rollover contributions to an IRA. In one, you put amounts you receive from

one IRA into another. In the other, you put amounts from an employer's qualified (meets certain requirements) retirement plan for its employees, such as a qualified pension plan, into an IRA.

**Treatment of rollovers.** You cannot deduct a rollover contribution but you must report the rollover distribution on your tax return as discussed later under *Reporting Your Rollover*.

**Time limit for making a rollover contribution.** You must make the rollover contribution by the 60th day after the day you receive the distribution from your IRA or your employer's plan.

**Extension of rollover period.** If the amount distributed to you from an IRA or a qualified employer retirement plan becomes a frozen deposit in a financial institution during the 60-day period allowed for a rollover, a special rule extends the rollover period. For more information, get Publication 590.

## Rollover From One IRA Into Another

You can withdraw, tax free, all or part of the assets from one IRA if you reinvest them within 60 days in another IRA.

**Waiting period between rollovers.** You can take (receive) a distribution from a particular IRA and make a rollover contribution to another IRA only once in any one-year period. The one-year period begins on the date you receive the IRA distribution, not on the date you roll it over into another IRA.

This rule applies separately to each IRA you own. For example, if you have two IRAs, IRA-1 and IRA-2, and you roll over assets of IRA-1 into a new IRA-3, you may also make a rollover from IRA-2 into IRA-3, or into any other IRA, within one year after the rollover distribution from IRA-1. These are both allowable rollovers because you have not received more than one distribution from either IRA within one year. However, you cannot, within the one-year period, again roll over the assets you rolled over into IRA-3 into any other IRA.

**Exception.** There is an exception to this rule for distributions from certain failed financial institutions. Get Publication 590 for more information.

**Partial rollovers.** If you withdraw assets from an IRA, you can roll over part of the withdrawal into another IRA and keep the rest of it. The amount you keep is generally taxable (except for the part that is a return of nondeductible contributions) and may be subject to the 10% additional tax on premature distributions and for 1996, the 15% tax on excess distributions, discussed later.

**Required distributions.** Amounts that must be distributed during a particular year under the required distribution rules (discussed later) are not eligible for rollover treatment.

**Inherited IRAs.** If you inherit an IRA from your spouse, you generally can roll it over into an IRA established for you.

**Not inherited from spouse.** If you inherit an IRA from someone other than your spouse you cannot roll it over or allow it to receive a rollover contribution. You must withdraw the IRA assets within a certain period. For more information, get Publication 590.

**Reporting rollovers from IRAs.** Report any rollover from one IRA to another IRA on lines 15a and 15b, Form 1040, or lines 10a and 10b, Form 1040A. Enter the total amount of the distribution on line 15a, Form 1040, or line 10a, Form 1040A. If the total amount on line 15a, Form 1040, or line 10a, Form 1040A, was rolled over, enter zero on line 15b, Form 1040, or line 10b, Form 1040A. Otherwise, enter the taxable portion of the part that was not rolled over on line 15b, Form 1040, or line 10b, Form 1040A.

## Rollover From Employer's Plan Into an IRA

Special rules apply to distributions made from qualified employer plans that are rolled over or transferred to IRAs. The rules primarily relate to requirements affecting rollovers, income tax withholding, and notices to recipients. Get Publication 590 for more information.

Generally, if you receive an **eligible rollover distribution** from your (or your deceased spouse's) employer's qualified plan (defined earlier), you can roll over all or part of it into an IRA.

**Eligible rollover distribution.** Generally, an eligible rollover distribution is the taxable part of any distribution of all or part of the balance to your credit as the employee-participant in a qualified retirement plan **except:**

- 1) A required minimum distribution, or
- 2) Any of a series of substantially equal periodic distributions paid at least once a year over:
  - a) Your lifetime or life expectancy,
  - b) The lifetimes or life expectancies of you and your beneficiary, or
  - c) A period of 10 years or more.

The taxable parts of most other distributions from qualified retirement plans are eligible rollover distributions. See Publication 575 for additional exceptions.

**Maximum rollover.** The most that you can roll over is the taxable part of any eligible rollover distribution from your employer's qualified plan. The distribution you receive generally will be all taxable unless you have made nondeductible employee contributions to the plan.

**Reporting rollovers from employer plans.** Do not use lines 15a or 15b, Form 1040, or lines 10a or 10b, Form 1040A, to report a rollover from an employer retirement plan to an IRA; use lines 16a and 16b, Form 1040, or lines 11a and 11b, Form 1040A instead.

For further information on rollovers, get Publication 590.

## Transfers Incident to Divorce

If an interest in an IRA is transferred from your spouse or former spouse to you by a decree of divorce or separate maintenance, or a written document related to such a decree, the interest in the IRA, starting from the date of the transfer, is treated as your IRA. The transfer is tax free. For detailed information, get Publication 590.

## When Can I Withdraw or Use Assets From an IRA?

There are rules limiting the withdrawal and use of your IRA assets. Violation of the rules generally results in additional taxes in the year of violation. See *Prohibited Transactions*, *Premature Distributions (Early Withdrawals)*, *Excess Accumulations (Insufficient Distributions)* and *Excess Distributions*, later.

**Age 59½ rule.** Generally, until you reach the age of 59½, you cannot withdraw assets (money or other property) from your IRA without having to pay an additional tax. However, there are a number of exceptions to that rule. See *Premature Distributions (Early Withdrawals)*, later.

## Required Distributions

You cannot keep funds in your IRA indefinitely. Eventually you must withdraw them. If you do not, or if you withdraw an amount that is less than the required minimum distribution for a year, you may have to pay a 50% excise tax on the amount not withdrawn as required. See *Excess Accumulations (Insufficient Distributions)*, later. However, there is also a penalty if you withdraw more than \$155,000 from your IRA during 1996. See *Excess Distributions*, later. The requirements for withdrawing IRA funds differ depending on whether you are the IRA owner or the beneficiary of a decedent's IRA.

**IRA owners.** If you are an IRA owner, you must choose to withdraw the balance in your IRA in one of the following two ways:

- 1) By withdrawing the entire balance in your IRA by the required beginning date (defined below), **or**
- 2) By starting to withdraw periodic distributions of the balance in your IRA by the required beginning date.

**Required beginning date (RBD)—Age 70½ rule.** You must receive the entire balance in your IRA or begin receiving periodic distributions from your IRA by April 1 of the year following the year in which you reach age 70½.

If you choose to receive periodic distributions, you must receive at least a minimum amount for each year starting with the year you reach age 70½ (your 70½ year). If you did not receive the minimum in your 70½ year, then you must receive distributions for your 70½ year that reach the minimum amount by April 1 of the next year.

**Distributions after the RBD.** The required minimum distribution for any year after your 70½ year must be made by December 31 of each year.

**Beneficiaries.** If you are the beneficiary of a decedent's IRA, the requirements you must satisfy for withdrawing funds from that IRA depend on whether distributions have begun that satisfy the minimum distribution requirement.

**For more information,** including how to figure your required minimum distribution each year and how to figure your required distribution if you are a beneficiary of a decedent's IRA, get Publication 590.

## Tax Treatment of Distributions

In general, include IRA distributions in your gross income in the year you receive them. Exceptions to this general rule are rollovers and timely withdrawals of contributions, discussed earlier, and the return of nondeductible contributions, discussed next under *Distributions Fully or Partly Taxable*.

**Failed financial institutions.** The general rule applies to distributions made (with or without your consent) by the receiver of a savings institution that is placed in receivership. This means you must include such distributions in your gross income unless you roll them over. For an exception to the one-year waiting period rule for rollovers of certain distributions from failed financial institutions, see Publication 590.

**Ordinary income.** IRA distributions that you must include in income are taxed as ordinary income.

**No special treatment.** In figuring your tax, you cannot use the special averaging or capital gain treatment that applies to lump-sum distributions from qualified employer plans.

## Distributions Fully or Partly Taxable

Your IRA distributions may be fully or partly taxable, depending on whether your IRA includes any nondeductible contributions.

**Fully taxable.** If only deductible contributions were made to your IRA (or IRAs, if you have more than one) since it was set up, you have no basis in your IRA. Because you have no basis in your IRA, any distributions are fully taxable when received. See *Reporting taxable distributions on your return*, later.

**Partly taxable.** If you made nondeductible contributions to any of your IRAs, you have a cost basis (investment in the contract) equal to the amount of those contributions. These nondeductible contributions are not taxed when they are distributed to you. They are a return of your investment in your IRA.

When IRA distributions are made, special rules apply in figuring the tax on the distributions if:

- Only nondeductible IRA contributions were made and there are earnings or gains, or
- Both deductible and nondeductible IRA contributions were made.

Only the part of the distribution that represents nondeductible contributions (your cost basis) is not taxable. Once nondeductible contributions have been made, distributions consist partly of nondeductible contributions (basis) and partly of deductible contributions, earnings, or gains. Until you run out of basis, each distribution is partly taxable and partly nontaxable.

**Form 8606.** You must complete, and attach to your return, Form 8606 if you receive an IRA distribution and have ever made nondeductible IRA contributions. Using the form, you will figure the nontaxable distributions for 1996, and your total IRA basis for 1996 and earlier years.

**Distributions reported on Form 1099-R.** You will receive Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, Etc.*, or similar statement, if you receive a distribution from your IRA. IRA distributions are shown in boxes 1 and 2 of Form 1099-R. A number or letter code in box 7 tells you what type of distribution you received from your IRA.

**Reporting taxable distributions on your return.** Report fully taxable distributions, including taxable premature distributions, on line 15b, Form 1040 (no entry is required on line 15a), or line 10b, Form 1040A. If only part of the distribution is taxable, enter the total amount on line 15a, Form 1040 (or line 10a, Form 1040A), and the taxable part on line 15b, Form 1040 (or line 10b, Form 1040A). You cannot report distributions on Form 1040EZ.

**Withholding.** Federal income tax is withheld from IRA distributions unless you choose not to have tax withheld. See chapter 5.

**IRA distributions delivered outside the United States.** In general, if you are a U.S. citizen or resident alien and your home address is outside the United States or its possessions, you cannot choose exemption from withholding on your IRA payments.

## What Acts Result in Penalties?

The tax advantages of using IRAs for retirement savings can be offset by additional taxes and penalties if you do not follow the rules. For example, there are additions to the regular tax for using your IRA funds in prohibited transactions. There are also additional taxes for:

- Making excess contributions,
- Making early withdrawals (taking premature distributions),
- Allowing excess amounts to accumulate (failing to make required withdrawals), or
- Receiving excess distributions.

There are penalties for overstating the amount of nondeductible contributions and for failure to file a required Form 8606. See *Reporting Nondeductible Contributions*, earlier.

## Prohibited Transactions

Generally, a prohibited transaction is any improper use of your IRA by you or any disqualified person.

Examples of disqualified persons include your fiduciary, and members of your family (a spouse, ancestor, lineal descendant, and any spouse of a lineal descendant).

Some examples of prohibited transactions with an IRA are:

- Borrowing money from it,
- Buying property for personal use (present or future) with IRA funds,
- Selling property to it,
- Receiving unreasonable compensation for managing it, or
- Using the IRA as collateral for a loan.

**Effect on an IRA account.** Generally, if you or your beneficiary engage in a prohibited transaction at any time during the year with your IRA account, it will not be treated as an IRA as of the first day of the year.

**Effect on you (or your beneficiary).** If you (or your beneficiary) engage in a prohibited transaction with your IRA account at any time during the year, you (or your beneficiary) must include the fair market value of all (or part, in certain cases) of the IRA assets in your gross income for that year. The fair market value is the price at which the IRA assets would change hands between a willing buyer and a willing seller, when neither has any need to buy or sell, and both have reasonable knowledge of the relevant facts.

You must use the fair market value of the assets as of the first day of the year you engaged in the prohibited transaction. You may also have to pay the 10% additional tax on premature distributions and, for 1996, the 15% tax on excess distributions, discussed later.

**Excise taxes.** If someone other than the owner or beneficiary of an IRA engages in a prohibited transaction, that person may be liable for certain excise taxes. In general, there is a 10% tax on the amount of the prohibited transaction and a 100% additional tax if the transaction is not corrected. For transactions that occurred before August 21, 1996, the tax was 5%.

**Investment in collectibles.** If your IRA invests in collectibles, the amount invested is considered distributed to you in the year invested. You may have to pay the 10% additional tax on premature distributions and the excise taxes discussed above may apply.

**Collectibles.** These include art works, rugs, antiques, metals, gems, stamps, coins, alcoholic beverages, and other tangible personal property if specified by the IRS.

**Exception.** Your IRA can invest in one, one-half, one-quarter, or one-tenth ounce U.S. gold coins, or one ounce silver coins minted by the Treasury Department.

**For more information** on prohibited transactions, get Publication 590.

## Excess Contributions

Generally, an excess contribution is the amount contributed to your IRA(s) for the year that is more than the smaller of:

- Your taxable compensation for the year, or
- \$2,000.

**Example.** You were single and earned \$30,000 in 1996. You contributed \$2,500 to your IRA for 1996. Your contribution limit is \$2,000. Your reduced IRA deduction, figured using the *Worksheet for Reduced IRA Deduction*, is \$1,000. You made an excess contribution for 1996 of \$500 (\$2,500 minus \$2,000).

**Tax on excess contributions.** In general, if the excess contribution and any earnings on it are not withdrawn by the date your return for the year is due (including extensions), as explained later, you are subject to a 6% tax. You must pay the 6% tax each year on excess amounts that remain in your IRA at the end of your tax year. The excess is taxed for the year the excess contribution is made and for each year after that until you correct it. The tax cannot be more than 6% of the value of your IRA as of the end of your tax year.

**Excess contributions you withdraw by the date your return is due.** You will not have to pay the 6% tax if you withdraw an excess contribution made during a tax year and interest or other income earned on it by the date your return for that year is due, including extensions.

Do not include in your gross income an excess contribution that you withdraw from your IRA before your tax return is due if both the following conditions are met.

- 1) No deduction was allowed for the excess contribution.
- 2) The interest or other income earned on the excess was also withdrawn.

However, you must include in your gross income any interest or other income earned on the excess contribution (whether a deductible or nondeductible contribution). Report it on your return for the year in which the excess contribution was made. Your withdrawal of interest or other income may be subject to an additional 10% tax on early withdrawals, discussed later.

**Excess contributions you withdraw after your return is due.** If the total contributions (other than rollover contributions) for the year were \$2,250 or less and there were no employer contributions, you may withdraw any excess contribution after the due date for filing your return for that year, including extensions. You do not include the withdrawn contribution in your income. This exclusion from income applies only to the part of the withdrawn excess contribution for which you did not take a deduction. The 6% tax applies to the excess contribution amount that remains in your IRA at the end of a year. This includes the year of the contribution and any later year.

## Premature Distributions (Early Withdrawals)

You must include premature distributions in your gross income and, because they are premature, there will be an **additional 10% tax** on them. See the discussion of Form 5329 under *Reporting Additional Taxes*, later, to figure and report the tax.

**Premature distributions defined.** Premature distributions are amounts you withdraw from your IRA before you are 59½.

**Exceptions.** The 10% tax will not apply to the following distributions:

- Portions of any distributions treated as a return of nondeductible contributions.
- Distributions made to your beneficiary or your estate after your death,
- Distributions made because of your disability.
- Distributions that are a part of a series of substantially equal payments over your life (or life expectancy), or over the lives (or life expectancies) of you and your beneficiary. For this exception to apply, you must use an IRS-approved distribution method and take at least one distribution annually. Also, the payments must continue for at least 5 years, or until you reach age 59½, whichever is the longer period. This 5-year rule does not apply if a change from an approved distribution method is because of the death or disability of the IRA owner.
- Distributions that are rolled over, as discussed earlier under *Rollovers*.



**Beginning in 1997, the 10% additional tax on premature distributions from an IRA will not apply to distributions up to the amount you paid for unreimbursed medical expenses that were more than 7½% of your adjusted gross income.**

Also beginning in 1997, the 10% tax may not apply to distributions up to the amount you paid for medical insurance for yourself, your spouse, and your dependents. The tax will not apply if all four of the following conditions apply.

- 1) You lost your job.
- 2) You received unemployment compensation under any Federal or State law for 12 consecutive weeks.
- 3) The distributions are made during either the year you received the unemployment compensation or the following year.
- 4) The distributions are made no later than 60 days after you have been reemployed.

**For more information** on premature distributions, get Publication 590.

## Excess Accumulations (Insufficient Distributions)

You cannot keep amounts in your IRA indefinitely. Generally, you must begin receiving distributions by April 1 of the year following the year in which you reach age 70½.

**Tax on excess.** If distributions are less than the required minimum distribution for the year, you may have to pay a 50% excise tax for that year on the amount not distributed as required.

**Request to excuse the tax.** If the excess accumulation is due to reasonable error and you have taken, or are taking, steps to remedy the insufficient distribution, you can request that the tax be excused.

**Exemption from tax.** IRAs invested in contracts issued by insurance companies may be unable to make required distributions because the insurance company is in state insurer delinquency proceedings. In this case, the 50% excise tax for failure to make required IRA distributions will not apply. However, to qualify for this exemption, the conditions and requirements of Revenue Procedure 92-10 must be satisfied.

**More information.** For more information on excess accumulations, get Publication 590.

## Excess Distributions

If you received retirement distributions during 1996 of more than \$155,000, you may have to pay a **15% tax** on the distributions

that are more than \$155,000. The term "retirement distributions" means your distributions from any qualified employer plan (including a tax-sheltered annuity plan, or IRA).

**Reduction of 15% tax.** This additional tax is reduced by any tax on premature distributions that applies to the excess distribution. See *Premature Distributions*, discussed earlier.



*For IRA distributions received after 1996 and before the year 2000, the 15% tax on excess distributions has been suspended.*

For more information on excess distributions, get Publication 590.

## Reporting Additional Taxes

Generally you must use Form 5329, to report the tax on excess contributions, premature (early) distributions, excess distributions, and excess accumulations.

**Form 5329 required.** You must file Form 5329 if you receive excess distributions from a qualified retirement plan, whether or not you owe tax on them.

**Form 5329 not required.** You do not have to use Form 5329 if any of the following conditions exist.

- Distribution code 1 (early distribution) is shown in box 7 of Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.* Instead, multiply the taxable part of the distribution by 10% and enter the result on line 48 of Form 1040. Write "No" on the dotted line next to line 48 to indicate that you do not have to file Form 5329. However, if you owe this tax and also owe any other additional tax on a distribution, do not enter this 10% additional tax directly on your Form 1040. You must file Form 5329 to report your additional taxes.
- You qualify for an exception to the tax. You need not report the exception if distribution code 2, 3, or 4 is shown in box 7 of Form 1099-R. However, if one of those codes is not shown, or the code shown is incorrect, you must file Form 5329 to report the exception.
- You properly rolled over all distributions you received during the year.

**Filing Form 1040.** If you file Form 1040, complete Form 5329 and attach it to your Form 1040. Enter the total amount of IRA tax due on line 48, Form 1040.

**Note:** If you have to file an individual income tax return and Form 5329, you must use Form 1040.

**Not filing Form 1040.** If you do not have to file a Form 1040 but do have to pay one of

the IRA taxes mentioned earlier, file the completed Form 5329 with IRS at the time and place you would have filed your Form 1040. Be sure to include your address on page 1 and your signature on page 2. Enclose, but do not attach, a check or money order payable to the Internal Revenue Service for the tax you owe, as shown on Form 5329. Write your social security number and "1996 Form 5329" on your check or money order.

## Simplified Employee Pension (SEP)

A simplified employee pension (SEP) is a written arrangement (a plan) that allows an employer to make contributions toward his or her own (if a self-employed individual) and employees' retirement without becoming involved in more complex retirement plans. The contributions are made to IRAs (SEP-IRAs) of the participants in the plan.

**Contribution limit.** The SEP rules permit an employer to contribute (and deduct) each year to each participating employee's SEP-IRA up to 15% of the employee's compensation or \$30,000, whichever is less. The contributions are funded by the employer.

**Figuring the 15% limit.** For purposes of determining the 15% limit, compensation is generally limited to \$150,000, not including your employer's contribution to your SEP-IRA.

**Note.** For employees in a collective bargaining unit covered by a SEP for which the \$150,000 limit is not effective for the plan year beginning in 1996, the compensation limit is \$250,000.

**Deduction limit for a self-employed person.** If you are self-employed and contribute to your own SEP-IRA, special rules apply when figuring your maximum deduction for these contributions.

**Compensation for self-employed.** For determining the 15% limit, discussed above, your compensation is your net earnings from self-employment. See *Net earnings from self-employment*, later. Note that, for SEP purposes, your net earnings (compensation) must take into account your deduction for contributions to your own SEP-IRA. Because your deduction amount and your net earnings amount are each dependent on the other, this adjustment presents a problem.

To solve this problem, you make the adjustment to net earnings indirectly by reducing the contribution rate called for in the plan. Use the following worksheets to find this reduced contribution rate and your maximum deduction. Make no reduction to the

contribution rate for any common-law employees.

### Self-Employed Person's Rate Worksheet

- 1) Plan contribution rate as a decimal (for example, 10½% would be 0.105) .....
- 2) Rate in line 1 plus one (for example, 0.105 plus one would be 1.105) .....
- 3) Self-employed rate as a decimal (Divide line 1 by line 2.) .....

### Self-Employed Person's Deduction Worksheet

#### Step 1

Enter your rate from the *Self-Employed Person's Rate Worksheet* .....

#### Step 2

Enter your net earnings from line 3, Schedule C-EZ (Form 1040), line 31, Schedule C (Form 1040), line 36, Schedule F (Form 1040), or line 15a, Schedule K-1 (Form 1065) .....

#### Step 3

Enter your deduction for self-employment tax from line 25, Form 1040 .....

#### Step 4

Subtract Step 3 from Step 2 and enter the result .....

#### Step 5

Multiply Step 4 by Step 1 and enter the result .....

#### Step 6

Multiply \$150,000 by your plan contribution rate. Enter the result but not more than \$30,000 .....

#### Step 7

Enter the smaller of Step 5 or Step 6. This is your **maximum deductible contribution**. Enter your deduction on line 27, Form 1040 .....

**Example.** You are a sole proprietor and have employees. The terms of your plan provide that you contribute 10½% (.105) of your compensation, and 10½% of your common-law employees' compensation. Your net earnings from line 31, Schedule C (Form 1040) is \$200,000. In figuring this amount, you deducted your common-law employees' compensation of \$100,000 and contributions for them of \$10,500 (10½% × \$100,000). This net earnings amount is now reduced to \$193,434 by subtracting your self-employment tax deduction of \$6,566. You figure your self-employed rate and maximum deduction for employer contributions on behalf of yourself as follows:

**Self-Employed Person's Rate Worksheet**

1) Plan contribution rate as a decimal (for example, 10½% would be 0.105) .....	0.105
2) Rate in line 1 plus one, (for example, 0.105 plus one would be 1.105) .....	1.105
3) Self-employed rate as a decimal (Divide line 1 by line 2.) .....	<u>0.0950</u>

**Self-Employed Person's Deduction Worksheet**

**Step 1**

Enter your rate from the *Self-Employed Person's Rate Worksheet* .....

	0.0950
--	--------

**Step 2**

Enter your net earnings from line 3, Schedule C-EZ (Form 1040), line 31, Schedule C (Form 1040), line 36, Schedule F (Form 1040), or line 15a, Schedule K-1 (Form 1065) .....

	\$ 200,000
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**Step 3**

Enter your deduction for self-employment tax from line 25, Form 1040 .....

	\$ 6,566
--	----------

**Step 4**

Subtract Step 3 from Step 2 and enter the result .....

	\$ 193,434
--	------------

**Step 5**

Multiply Step 4 by Step 1 and enter the result .....

	\$ 18,376
--	-----------

**Step 6**

Multiply \$150,000 by your plan contribution rate. Enter the result but not more than \$30,000 .....

	\$ 15,750
--	-----------

**Step 7**

Enter the smaller of Step 5 or Step 6. This is your **maximum deductible contribution**. Enter your deduction on line 27, Form 1040. ....

	<u>\$ 15,750</u>
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**Net earnings from self-employment.**

For SEP purposes, your net earnings are your gross income from your business that has the plan minus your allowable deductions for that business. Your personal services must be a material income-producing

factor in that business. Allowable deductions include contributions to the SEP-IRAs of your employees. You must also reduce your earnings by the deduction for one-half of your self-employment tax and the deduction for contributions to your own SEP-IRA. Net earnings do not include tax-free items or deductions related to them, but do include foreign earned income and housing cost amounts. Net earnings include a partner's distributive share of partnership income or loss (other than separately treated items such as capital gains or losses). If paid for services to or for the partnership, net earnings include guaranteed payments to a limited partner. They do not include distributions of income or loss to a limited partner.

**Contributions you make to your SEP-IRA.**

If you make contributions to your SEP-IRA independent of employer SEP contributions, you can deduct them the same way as contributions to a regular IRA. However, your deduction may be reduced or eliminated because, as a participant in a SEP, you are covered by an employer retirement plan. See *How Much Can I Contribute and Deduct?*, earlier.

**Salary reduction arrangement.**

A SEP may include a salary reduction arrangement. Under it, you can elect to have your employer contribute part of your pay to the SEP-IRA. Only the remaining portion of your pay is currently taxable. The tax on the contribution is deferred. This choice is called an elective deferral.



*Effective for tax years beginning after 1996, an employer cannot start a simplified employee pension (SEP) that includes a salary reduction arrangement. Only SEPs that allowed employees to choose elective deferrals as of December 31, 1996, can include salary reduction arrangements.*

**Limits on deferrals.** In general, the total income you can defer under a salary reduction arrangement included in your SEP and certain other elective deferral arrangements, for

1996, is limited to \$9,500. This limit applies only to the amounts that represent a reduction from your salary, not to any contributions from employer funds.

**Overall limits on SEP contributions.** Contributions, including elective deferrals (salary reductions), made by your employer to the SEP-IRA are subject to the overall limit of 15% of your compensation (generally up to \$150,000 for 1996) or \$30,000, whichever is less.

**Tax treatment of employer's contributions.**

Your employer's contributions to your SEP-IRA are generally excluded from your income rather than deducted from it. Therefore, your employer's contributions should not be included in your Form W-2 wages, unless there are contributions under a salary reduction arrangement. Form W-2 should include contributions under a salary reduction arrangement for social security and Medicare tax purposes only.

**Tax treatment by self-employed individuals.**

If you are self-employed (a sole proprietor or partner) with a SEP, take your deduction for employer contributions to your own SEP-IRA on line 27, Form 1040. If you also make deductible contributions to your SEP-IRA (or any other IRA you own), independent of your employer contributions, take your deduction on line 23, Form 1040.

**Excess contributions.**

If your employer contributes more to your SEP-IRA than 15% of your compensation or \$30,000, whichever is less, you will not have to pay the 6% tax on it if you withdraw this excess amount (and interest or other income earned on it) from your SEP-IRA before the due date for filing your tax return, plus extensions. However, you must include the excess contribution in your gross income.

**For more information on a SEP-IRA,** get Publication 590.

# Moving Expenses

## Important Change for 1996

**Standard mileage rate.** The standard mileage rate allowed for moving expenses has been increased to 10 cents a mile. See *Travel by car* under *Deductible moving expenses*.

## Important Reminders

**No deduction allowed for certain moving expenses.** You cannot deduct as moving expenses amounts you pay for:

- Meals while moving from your old residence to your new residence,
- Travel expenses, meals, and lodging for pre-move househunting trips,
- Meals and lodging while occupying temporary quarters in the area of your new job, and
- Qualified residence sale, purchase, and lease expenses.

**Distance test.** To deduct moving expenses, your new main job location must be at least 50 miles farther from your former home than your old main job location.

**Moving expenses no longer an itemized deduction.** Allowable moving expenses are no longer an itemized deduction. You can deduct these expenses in figuring your adjusted gross income.

**Reimbursements.** If you are reimbursed by your employer for allowable moving expenses, your employer should exclude these reimbursements from your income. You can only deduct allowable moving expenses that were not reimbursed by your employer.

**Change of address.** If you change your mailing address, be sure to notify the IRS using Form 8822, *Change of Address*. Mail it to the Internal Revenue Service Center for your old address. Addresses for the Service Centers are on the back of the form.

## Introduction

This chapter discusses what expenses you can deduct when you move because of a job. The following topics are covered:

- When moving expenses qualify for a deduction,

- Which moving expenses can be claimed, and
- How to report moving expenses on Form 3903, *Moving Expenses*.

You may be able to deduct some of your expenses for moving to a new home because you changed job locations or started a new job. You can qualify for the deduction whether you are self-employed or an employee. However, you must meet the *Requirements*, explained later.

This chapter contains two charts that may help you determine whether your move qualifies for a deduction, and if so, how much you can deduct. The charts are:

- Figure 19–A, *Illustration of Distance Test*, which covers the minimum distance you must move before you qualify to deduct moving expenses, and
- Figure 19–B, *Qualifying Moves Within the United States*, which covers general qualifications.

**Moves to the United States.** If you retire while living and working overseas, you may be able to deduct your expenses of moving back to the United States. If you are the survivor (spouse or dependent) of a person whose main job location at the time of death was outside the United States, you may be able to deduct your expenses of moving back to the United States. See *Retirees or Survivors Who Move to the United States*, later.

**Moves outside the United States.** This chapter does not discuss moves outside the United States. If you are a United States citizen or resident alien who moved outside the United States or its possessions because of your job or business, see Publication 521 for special rules that apply to your move.

## Useful Items

You may want to see:

### Publication

- 521** Moving Expenses

### Form (and Instructions)

- 3903** Moving Expenses
- 3903–F** Foreign Moving Expenses
- 8822** Change of Address

## Requirements

You can deduct your allowable moving expenses if your move is closely related to the start of work and if you meet the distance test and the time test. These two tests are discussed later.

### Related to Start of Work

Your move must be closely related, both in time and in place, to the start of work at your new job location.

**Closely related in time.** In general, moving expenses incurred within one year from the date you first reported to work are considered closely related in time to the start of work at the new location. It is not necessary that you arrange to work before moving to a new location, as long as you actually do go to work.

If you do not move within one year, you ordinarily cannot deduct the expenses unless you can show that circumstances existed that prevented the move within that time.

**Example.** Your family moved more than a year after you started work at a new location. Their move was delayed because you allowed your child to complete high school. You can deduct your allowable moving expenses.

**Closely related in place.** A move is generally considered closely related in place to the start of work if the distance from your new home to the new job location is not more than the distance from your former home to the new job location. A move that does not meet this requirement can qualify if you can show that:

- 1) A condition of employment requires you to live at your new home, or
- 2) You will spend less time or money commuting from your new home to your new job.

**Home defined.** Your *home* means your main home (residence). It can be a house, apartment, condominium, houseboat, house trailer, or similar dwelling. Your home does not include other homes owned or kept up by you or members of your family. It also does not include a seasonal home, such as a summer beach cottage. Your *former home* means your home before you left for your new job location. Your *new home* means your home within the area of your new job location.

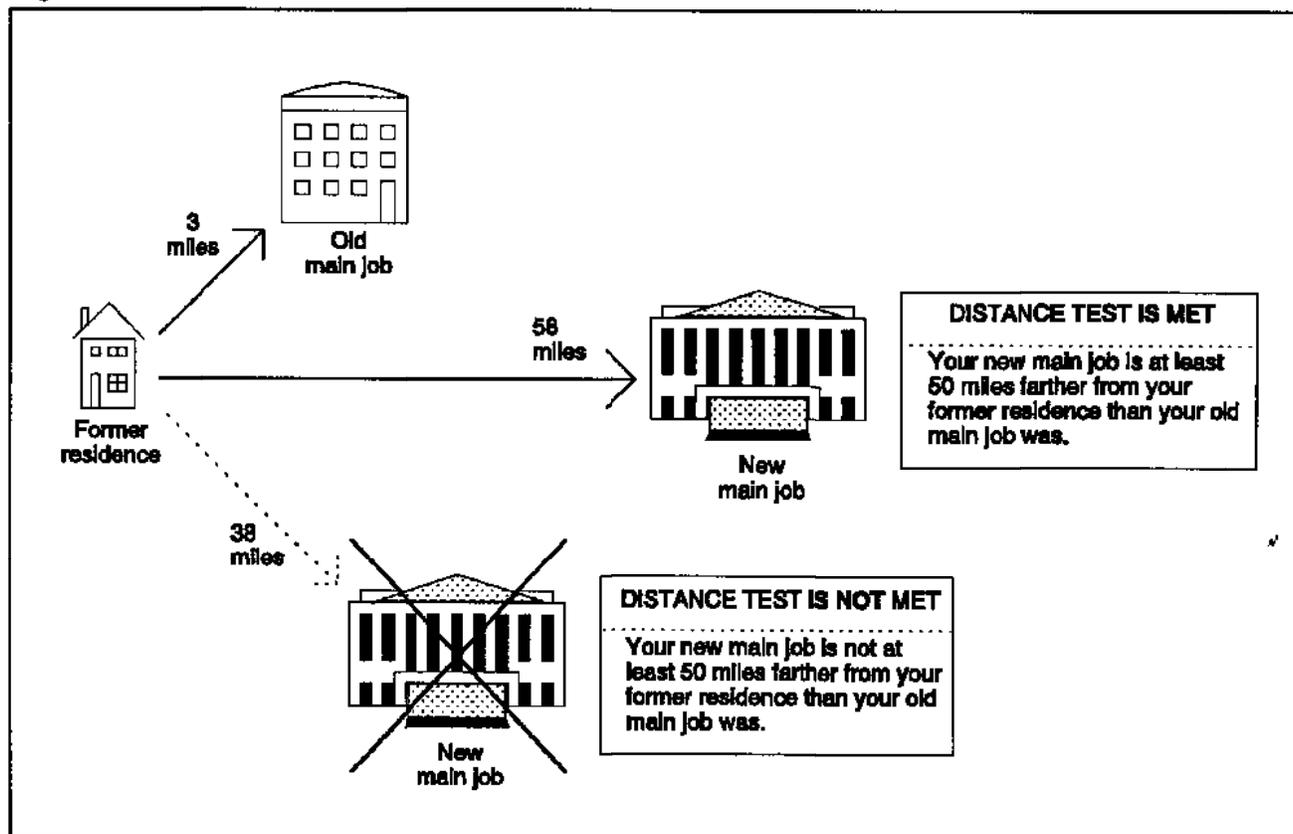
## Distance Test

Your move will meet the distance test if your new main job location is **at least 50 miles** farther from your former home than your old main job location. For example, if your old job was 3 miles from your former home, your new job must be at least 53 miles from that former home.

The distance between a job location and your home is the shortest of the more commonly traveled routes between them. The distance test considers only the location of your former home. It does not apply to the location of your new home.

**Example.** You moved to a new home less than 50 miles from your former home because you changed job locations. Your old job was 3 miles from your former home. Your new job is 60 miles from that home. Because your new job is 57 miles farther from your former home than the distance from

**Figure 19-A. Illustration of Distance Test**



your former home to your old job, you meet the 50-mile distance test.

**First job or return to full-time work.** If you go to work full time for the first time, your place of work must be at least 50 miles from your former home to meet the distance test.

If you go back to full-time work after a substantial period of part-time work or unemployment, your place of work must also be at least 50 miles from your former home.

**Exception for Armed Forces.** If you are in the Armed Forces and you moved because of a permanent change of station, you do not have to meet the distance test. See *Members of the Armed Forces*, later.

**Main job location.** Your main job location is usually the place where you spend most of your working time. A new job location is a new place where you will work permanently or indefinitely rather than temporarily. If there is no one place where you spend most of your working time, your main job location is the place where your work is centered—for example, where you report for work or are otherwise required to “base” your work.

**Union members.** If you work for a number of employers on a short-term basis and you get work under a union hall system (such as a construction or building trades worker), your main job location is the union hall.

**More than one job.** If you have more than one job at any time, your main job location depends on the facts in each case. The more important factors to be considered are:

- The total time you spend at each place,
- The amount of work you do at each place, and
- The money you earn at each place.

### Time Test

To deduct your moving expenses, you also must meet one of the following time tests.

**Time test for employees.** If you are an employee, you must work full time for at least **39 weeks during the first 12 months** after you arrive in the general area of your new job location. For this time test, count only your full-time work as an employee; do not count any work you do as a self-employed person. You do not have to work for the same employer for the 39 weeks. You do not have to work 39 weeks in a row. However, you must work full time within the same general commuting area. Full-time employment depends on what is usual for your type of work in your area.

**Temporary absence from work.** You are considered to be working full time during any week you are temporarily absent from work because of illness, strikes, lockouts, layoffs, natural disasters, or similar causes.

You are also considered to be a full-time employee during any week you are absent from work for leave or vacation that is provided for in your work contract or agreement.

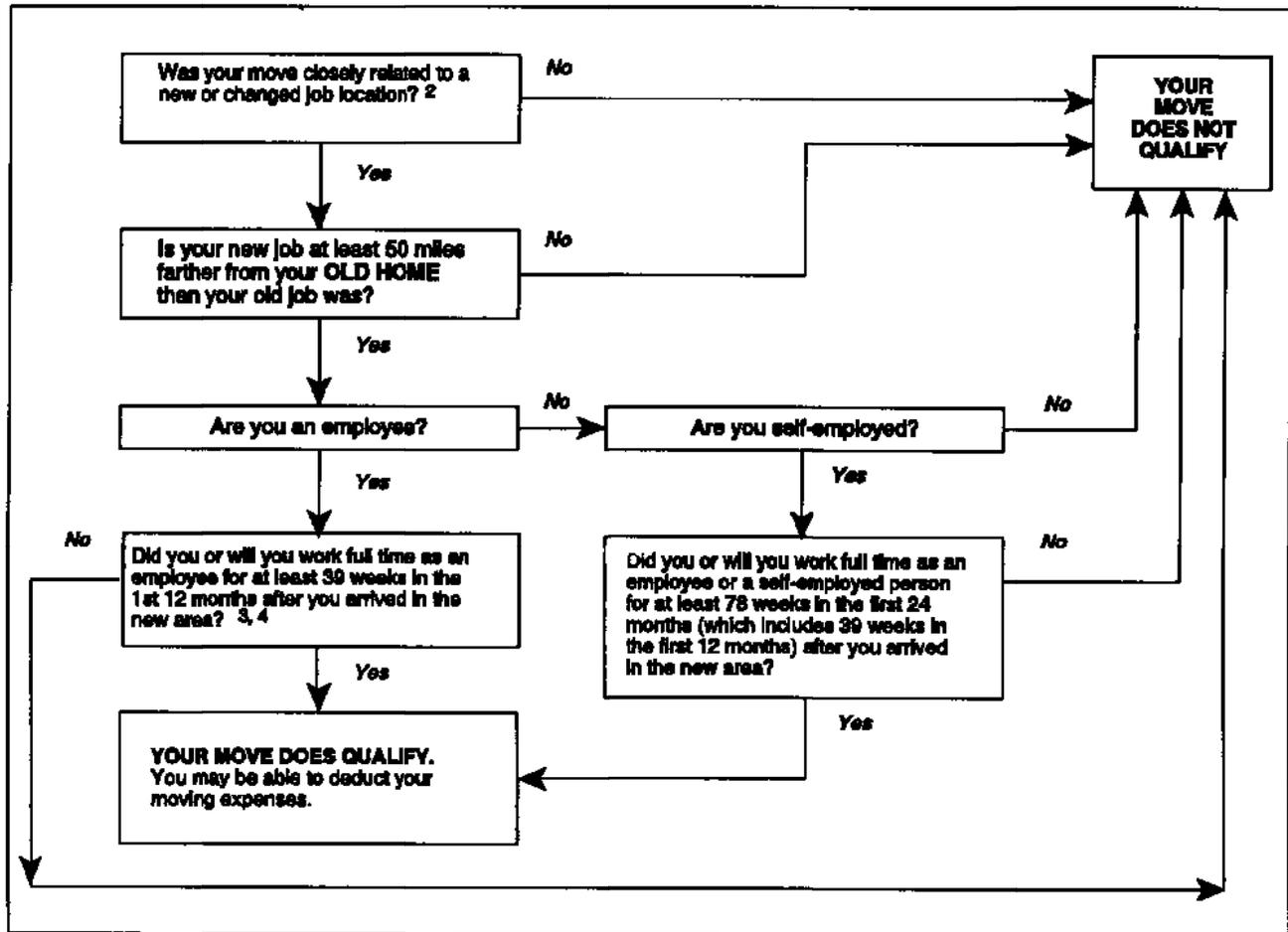
**Seasonal work.** If your work is seasonal, you are considered to be working full time during the off-season only if your work contract or agreement covers an off-season period and that period is less than 6 months. For example, a school teacher on a 12-month contract who teaches on a full-time basis for more than 6 months is considered a full-time employee for 12 months.

**Time test for self-employed persons.** If you are self-employed, you must work full time for at least **39 weeks during the first 12 months AND** for a total of at least **78 weeks during the first 24 months** after you arrive in the area of your new job location. For this time test, count any full-time work you do as an employee or as a self-employed person. You do not have to work for the same employer or be self-employed in the same trade or business for the 78 weeks.

**Self-employment.** You are self-employed if you work as the sole owner of an unincorporated business or as a partner in a partnership carrying on a business. You are not considered self-employed if you are semiretired, a part-time student, or work only a few hours each week.

**Full-time work.** Whether you perform services full time during any week depends

**Figure 19-B. Qualifying Moves Within the United States (Non-Military) <sup>1</sup>**



1. Military persons should see *Members of the Armed Forces* for special rules that apply to them.
2. Your move must be closely related to the start of work at your new job location. See *Related to Start of Work*.
3. If you deduct expenses and do not meet this test later, you must either file an amended tax return or report your moving expense deduction as other income. See *Time test not yet met*.
4. If you became self-employed during the first 12 months, answer YES if your combined time as a full-time employee and self-employed person equals or will equal at least 78 weeks in the first 24 months (including 39 weeks in the first 12 months) after you arrived in the new area.

on what is usual for your type of work in your area.

**If you are an employee and become self-employed** before satisfying the 39-week test for employees, you meet the time test if you satisfy the 78-week test for self-employed persons. Under the 78-week test, you still have to work full time for 39 weeks during the first 12 months. However, you can count any full-time work you do as an employee or as a self-employed person.

**If you are self-employed and become an employee** before satisfying the 78-week test, but you work as an employee for at least 39 weeks during the first 12 months after you arrived at the new job location, you will satisfy the time test for employees. If you cannot satisfy that time test, you can use the time spent as a full-time employee to satisfy the 78-week test. Under the 78-week test, you still have to work full time for 39 weeks during the first 12 months. However, you can count any full-time work you do as an employee or as a self-employed person.

**If you are both self-employed and an employee**, the amount of time you spend as each determines whether you must meet the 78-week test for self-employed persons or the 39-week test for employees. If you spend most of your working time as a self-employed person, you must meet the 78-week test (which includes a requirement to work 39 weeks during the first 12 months). If you spend most of your working time as an employee, you must meet the 39-week test.

For more information, see *Time test for self-employed persons* in Publication 521.

**Joint return.** If you are married and file a joint return and both you and your spouse work full time, either of you can satisfy the full-time work test. However, you cannot combine the weeks your spouse worked with the weeks you worked to satisfy that test.

**Time test not yet met.** You can deduct your moving expenses even if you have not

yet met the time test by the date your 1996 return is due. You can do this if you expect to meet the 39-week test in 1997, or the 78-week test in 1997 or 1998. If you deduct moving expenses but do not meet the time test within 12 or 24 months (whichever applies) you must either:

- 1) Report your moving expense deduction as other income on your Form 1040 for the year you determine you cannot meet the test, or
- 2) Amend your 1996 return.

Use Form 1040X, *Amended United States Individual Income Tax Return*, to amend your return.

If you do not deduct your moving expenses on your 1996 return and you later meet the time test, you can file an amended return for 1996 to take the deduction.

## Exceptions to the Time Test

You do not have to meet the time test if one of the following applies.

- 1) You are in the Armed Forces and you moved because of a permanent change of station—see *Members of the Armed Forces*, later.
- 2) You moved to the United States because you retired—see *Retirees or Survivors Who Move to the United States*, later.
- 3) You are the survivor of a person whose main job location at the time of death was outside the United States—see *Retirees or Survivors Who Move to the United States*, later.
- 4) Your job at the new location ends because of death or disability.
- 5) You are transferred for your employer's benefit or laid off for a reason other than willful misconduct. For this exception, you must have obtained full-time employment, and you must have expected to meet the test at the time you started the job.

## Members of the Armed Forces

If you are a member of the Armed Forces on active duty and you move because of a permanent change of station, you do not have to meet the **distance and time tests**, discussed earlier. You can deduct your unreimbursed allowable moving expenses.

A permanent change of station includes:

- 1) A move from your home to the area of your first post of duty when you begin active duty,
- 2) A move from one permanent post of duty to another, or
- 3) A move from your last post of duty to your home or to a nearer point in the United States. The move must occur within one year of ending your active duty or within the period allowed under the Joint Travel Regulations.

**Spouse and dependents.** If a member of the Armed Forces deserts, is imprisoned, or dies, a permanent change of station for the spouse or dependent includes a move to the place of enlistment, or to the member's, spouse's, or dependent's home of record, or to a nearer point in the United States.

If the military moves you and your spouse and dependents to or from separate locations, the moves are treated as a single move to your new main job location.

**More information.** For more information on moving expenses for members of the Armed Forces, and instructions for completing Form 3903, see *Members of the Armed Forces* in Publication 521.

## Retirees or Survivors Who Move to the United States

You may be able to deduct your allowable moving expenses if you move to the United States or to a possession of the United States. You do not have to meet the **time test**, discussed earlier, but you must meet the requirements discussed below.

**Retirees.** You can deduct moving expenses for a move to a new home in the United States when you permanently retire. However, both your former main job location and your former home must have been outside the United States.

**Permanently retired.** You are considered permanently retired when you cease gainful full-time employment or self-employment. If at the time you retire, you intend your retirement to be permanent, you will be considered retired even though you later return to work. Your intention to retire permanently will be determined by:

- 1) Your age and health,
- 2) The customary retirement age for people who do similar work,
- 3) Whether you are receiving retirement payments from a pension or retirement fund, and
- 4) The length of time before you return to full-time work.

**Survivors.** You can deduct moving expenses for a move to a home in the United States if you are the spouse or the dependent of a person whose main job location at the time of death was outside the United States. The move must begin within 6 months after the decedent's death. It must be from the decedent's former home outside the United States. That home must also have been your home.

A move begins when:

- 1) You contract for your household goods and personal effects to be moved to your home in the United States, but only if the move is completed within a reasonable time,
- 2) Your household goods and personal effects are packed and on the way to your home in the United States, or
- 3) You leave your former home to travel to your new home in the United States.

## Deductible Expenses

If you meet the *Requirements* discussed earlier, you can deduct the reasonable expenses of:

- 1) Moving your household goods and personal effects (including in-transit storage expenses), and
- 2) Traveling (including lodging) to your new home.

However, you cannot deduct any part of these expenses that is for meals.

**Reasonable expenses.** You can deduct only those expenses that are reasonable for the circumstances of your move. For example, the cost of traveling from your former home to your new one should be by the shortest, most direct route available by conventional transportation. If, during your trip to your new home, you make side trips for sightseeing, the additional expenses for your side trips are not deductible as moving expenses.

**Travel by car.** If you use your car to take yourself, members of your household, or your belongings to your new home, you can figure your expenses by deducting either:

- 1) Your **actual expenses**, such as gas and oil for your car, if you keep an accurate record of each expense, or
- 2) **10 cents a mile.**

You can deduct parking fees and tolls you paid in moving. You cannot deduct any part of general repairs, general maintenance, insurance, or depreciation for your car.

**Member of household.** You can deduct moving expenses you pay for yourself and members of your household. A member of your household is anyone who has both your former and new home as his or her home. It does not include a tenant or employee, unless you can claim that person as a dependent.

**Location of move.** There are different rules for moving within or to the United States than for moving outside the United States. This chapter only discusses moves within or to the United States. The rules for moves outside the United States can be found in Publication 521.

## Household Goods and Personal Effects

You can deduct the cost of packing, crating, and transporting your household goods and personal effects and those of the members of your household from your former home to your new home. If you use your own car to move your things, see *Travel by car*, earlier. You can include the cost of storing and insuring household goods and personal effects **within any period of 30 consecutive days** after the day your things are moved from your former home and before they are delivered to your new home.

You can deduct any costs of connecting or disconnecting utilities required because you are moving your household goods, appliances, or personal effects.

You can deduct the cost of shipping your car and household pets to your new home.

You can deduct the cost of moving household goods and personal effects from a place other than your former home. Your deduction is limited to the amount it would

have cost to move them from your former home.

**You cannot deduct** the cost of moving furniture you buy on the way to your new home.

## Travel Expenses

You can deduct the cost of transportation and lodging for yourself and members of your household while traveling from your former home to your new home. This includes expenses for the day you arrive. You can include any lodging expenses you had in the area of your former home within one day after you could not live in your former home because your furniture had been moved. You can deduct expenses for only one trip to your new home for yourself and members of your household. However, all of you do not have to travel together. If you use your own car, see *Travel by car*, earlier.

## Nondeductible Expenses

You cannot deduct the following items as moving expenses:

- Pre-move househunting expenses,
- Temporary living expenses,
- Meal expenses,
- Expenses of buying or selling a home,
- Expenses of getting or breaking a lease,
- Security deposits (including any given up due to the move),
- Home improvements to help sell your home,
- Loss on the sale of your home,
- Mortgage penalties,
- Losses from disposing of memberships in clubs,
- Any part of the purchase price of your new home,
- Real estate taxes,
- Car tags,
- Driver's license,
- Refitting carpets and draperies, and
- Storage charges except those incurred in transit.

**Temporary employment.** You cannot take a moving expense deduction and a business expense deduction for the same expenses. You must determine if your expenses are deductible as moving expenses or as business expenses. For example, expenses you have for travel, meals, and lodging while temporarily working at a place away from your regular place of work are deductible as business expenses if you are considered away from home on business. Generally, your work is considered temporary if it does not last more than one year at a single location. See *Temporary Assignment or Job* in Chapter 28 for information on deducting your expenses.

## How To Report

The following discussions explain how to report your moving expenses and any reimbursements or allowances you received for your move.

**Form 3903.** Use Form 3903 to report your moving expenses if your move was within or to the United States or its possessions. A filled-in Form 3903 is shown in Chapter 39.

**Where to deduct.** Deduct your moving expenses on line 24 of Form 1040. The amount of moving expenses you can deduct is shown on line 8 of Form 3903.

You cannot deduct moving expenses if you file Form 1040A or Form 1040EZ.

**Reimbursements.** If you received an advance, allowance, or reimbursement for your allowable moving expenses, how you report this amount and your expenses depends on whether the reimbursement was paid to you under an accountable plan or a nonaccountable plan.

For more information on reimbursements, see Publication 521.

**Form 4782.** Your employer must give you an itemized list of payments, reimbursements, or allowances that have been paid to you for moving expenses. Form 4782, *Employee Moving Expense Information*, may be used for this purpose. See Publication 521 for a filled-in Form 4782.

## When To Deduct Expenses

If you were not reimbursed, deduct your allowable moving expenses in the year you had them or paid them.

**Example.** In December 1996, your employer transferred you to another city in the United States, where you still work. You are single and were not reimbursed for your moving expenses. In 1996 you paid for moving your furniture. You deducted these expenses in 1996. In January 1997, you paid for travel to the new city. You can deduct these additional expenses in 1997.

**Reimbursed expenses.** If you are reimbursed for your expenses, you can also deduct your allowable expenses in the year you had them or paid them. If you use the cash method of accounting, you can choose to deduct the expenses in the year you are reimbursed even though you paid the expenses in a different year. For more information, see Publication 521.

**Choosing when to deduct.** If you use the cash method of accounting, which is used by most individuals, you can choose to deduct moving expenses in the year your employer reimburses you, if:

- 1) You paid the expenses in a year before the year of reimbursement, or
- 2) You paid the expenses in the year immediately after the year of reimbursement but by the due date, including extensions, for filing your return for the reimbursement year.

**How to make the choice.** You can choose to deduct moving expenses in the year you received reimbursement by taking the deduction on your return, or amended return, for that year.



**You cannot deduct any moving expenses for which you received a reimbursement that was excluded from your income. (Reimbursements are discussed in Publication 521.)**

# Alimony

## Introduction

This chapter discusses the rules that apply if you pay or receive alimony and covers the following topics:

- What is alimony
- What payments are not alimony, such as child support
- How to deduct alimony you paid
- How to report alimony income you received
- Whether you must recapture the tax benefits of alimony (Recapture means a deduction was taken in a prior year and part of it had to be added back in your income in 1996.)

Alimony is a payment to or for a spouse or former spouse under a divorce or separation instrument. It does not include voluntary payments that are not made pursuant to a divorce or separation instrument.

Alimony is deductible by the payer and must be included in the spouse's or former spouse's income. Although this chapter is generally written for the payer of the alimony, the recipient can use the information to determine whether an amount received is alimony.

To be alimony, a payment must meet certain requirements. Different requirements apply to payments under instruments executed after 1984 and to payments under instruments executed before 1985. This chapter discusses the rules for payments under instruments executed after 1984. For the rules for payments under pre-1985 instruments, see Publication 504, *Divorced or Separated Individuals*.

Use *Table 20-1* in this chapter as a guide to determine whether certain payments are considered alimony.

**Definitions.** The following definitions apply throughout this chapter.

**Spouse or former spouse.** Unless otherwise stated in the following discussions about alimony, the term "spouse" includes "former spouse."

**Divorce or separation instrument.** The term "divorce or separation instrument" means:

- 1) A decree of divorce or separate maintenance or a written instrument incident to that decree,
- 2) A written separation agreement, or
- 3) A decree or any type of court order requiring a spouse to make payments for the support or maintenance of the other spouse, including a temporary decree, an interlocutory (not final) decree, and a

decree of alimony *pendente lite* (while awaiting action on the final decree or agreement).

## Useful Items

You may want to see:

### Publication

- **504** Divorced or Separated Individuals

## General Rules

The following rules apply to alimony regardless of when the divorce or separation instrument was executed.

**Payments not alimony.** Not all payments under a divorce or separation instrument are alimony. Alimony does not include:

- 1) Child support,
- 2) Noncash property settlements,
- 3) Payments that are your spouse's part of community income (See *Community Property* in Publication 504.),
- 4) Use of property, or
- 5) Payments to keep up the payer's property.

**Payments to a third party.** Payments to a third party on behalf of your spouse under the terms of your divorce or separation instrument may be alimony, if they otherwise qualify. These include payments for your spouse's medical expenses, housing costs (rent, utilities, etc.), taxes, tuition, etc. The payments are treated as received by your spouse and then paid to the third party.

**Life insurance premiums.** Premiums you must pay under your divorce or separation instrument for insurance on your life qualify as alimony to the extent your spouse owns the policy.

**Payments for jointly-owned home.** If your divorce or separation instrument states that you must pay expenses for a home owned by you and your spouse, some of your payments may be alimony.

**Mortgage payments.** If you must make all the mortgage payments (principal and interest) on a jointly-owned home, and they otherwise qualify, you can deduct one-half of the total payments as alimony. If you itemize deductions and the home is a qualified home, you can include half of the interest in figuring your deductible interest. Your spouse must report one-half of the payments as alimony received. If your spouse itemizes deductions and the home is a qualified home, he or she can include one-half of the interest on the mortgage in figuring deductible interest.

**Taxes and insurance.** If you must pay all the real estate taxes or insurance on a home held as **tenants in common**, you can

deduct one-half of these payments as alimony. Your spouse must report one-half of these payments as alimony received. If you and your spouse itemize deductions, you can each deduct one-half of the real estate taxes.

If your home is held as **tenants by the entirety** or **joint tenants** (with the right of survivorship), none of your payments for taxes or insurance are alimony. But if you itemize deductions, you can deduct all of the real estate taxes.

**Other payments to a third party.** If you made other third-party payments, see Publication 504 to see whether any part of the payments qualify as alimony.

## Instruments Executed After 1984

The following rules for alimony apply to payments under divorce or separation instruments executed after 1984. They also apply to payments under earlier instruments that were modified after 1984 to:

- 1) Specify that these rules will apply, or
- 2) Change the amount or period of payment or add or delete any contingency or condition.

The rules in this section do not apply to divorce or separation instruments executed after 1984 if the terms for alimony are unchanged from an instrument executed before 1985.

**Example 1.** In November 1984, you and your former spouse executed a written separation agreement. In February 1985, a decree of divorce was substituted for the written separation agreement. The decree of divorce did not change the terms for the alimony you pay your former spouse. The decree of divorce is treated as executed before 1985. Alimony payments under this decree are not subject to the rules for payments under instruments executed after 1984.

**Example 2.** Assume the same facts as in Example 1 except that the decree of divorce changed the amount of the alimony. In this example, the decree of divorce is not treated as executed before 1985. The alimony payments are subject to the rules for payments under instruments executed after 1984.

**Alimony requirements.** A payment to or for a spouse under a divorce or separation instrument is alimony if the spouses do not file a joint return with each other and all the following requirements are met.

- 1) The payment is in cash.
- 2) The instrument does not designate the payment as not alimony.
- 3) The spouses are not members of the same household (if separated under a decree of divorce or separate maintenance),

- 4) There is no liability to make any payment (in cash or property) after the death of the recipient spouse.
- 5) The payment is not treated as child support.

Each of these requirements is discussed below.

**Payment must be in cash.** Only cash payments, including checks and money orders, qualify as alimony. Transfers of services or property (including a debt instrument of a third party or an annuity contract), execution of a debt instrument, or the use of property do not qualify as alimony.

**Payments to a third party.** Cash payments to a third party under the terms of your divorce or separation instrument can qualify as a cash payment to your spouse. See *Payments to a third party* under *General Rules*, earlier.

Also, cash payments made to a third party at the written request of your spouse qualify as alimony if all the following requirements are met.

- 1) The payments are in lieu of payments of alimony directly to your spouse.
- 2) The written request states that both spouses intend the payments to be treated as alimony.
- 3) You receive the written request from your spouse before you file your return for the year you made the payments.

**Payments designated as not alimony.**

You and your spouse may designate that otherwise qualifying payments are not alimony by including a provision in your divorce or separation instrument that the payments are not deductible by you and are excludable from your spouse's income. For this purpose, any writing signed by both of you that makes this designation and that refers to a previous written separation agreement is treated as a written separation agreement. If you are subject to temporary support orders, the designation must be made in the original or a later temporary support order.

To exclude the payments from income, your spouse must attach a copy of the instrument designating them as not alimony to his or her return for each year the designation applies.

**Spouses cannot be members of the same household.**

Payments to your spouse while you are members of the same household are not alimony if you are separated under a decree of divorce or separate maintenance. A home you formerly shared is considered one household, even if you physically separate yourselves in the home.

You are not treated as members of the same household if one of you is preparing to leave the household and does leave not more than one month after the date of the payment.

**Exception.** If you are not legally separated under a decree of divorce or separate maintenance, a payment under a written

separation agreement, support decree, or other court order may qualify as alimony even if you are members of the same household when the payment is made.

**Liability for payments after death of recipient spouse.** If you must continue to make payments for any period after your spouse's death, none of the payments made before or after the death are alimony.

The divorce or separation instrument does not have to expressly state that the payments cease upon the death of your spouse if, for example, the liability for continued payments would end under state law.

**Example.** You must pay your former spouse \$10,000 in cash each year for 10 years. Your divorce decree states that the payments will end upon your former spouse's death. You must also pay your former spouse or your former spouse's estate \$20,000 in cash each year for 10 years. The death of your spouse would not terminate the payments under state law.

The \$10,000 annual payments are alimony. But because the \$20,000 annual payments will not end upon your former spouse's death, they are not alimony.

**Substitute payments.** If you must make any payments in cash or property after your spouse's death as a substitute for continuing otherwise qualifying payments, the otherwise qualifying payments are not alimony. To the extent any payments are to increase in amount or begin or accelerate as a result of your spouse's death, the payment may be treated as a substitute for continuing the otherwise qualifying payments.

**Example 1.** Under your divorce decree, you must pay your former spouse \$30,000 annually. The payments will stop at the end of 6 years or upon your former spouse's death, if earlier.

Your former spouse has custody of your minor children. The decree provides that if any child is still a minor at your spouse's death, you must pay \$10,000 annually to a trust until the youngest child reaches the age of majority. The trust income and corpus (principal) are to be used for your children's benefit.

These facts indicate that the payments to be made after your former spouse's death are a substitute for \$10,000 of the \$30,000 annual payments. \$10,000 of each of the \$30,000 annual payments is not alimony.

**Example 2.** Under your divorce decree, you must pay your former spouse \$30,000 annually. The payments will stop at the end of 15 years or upon your former spouse's death, if earlier. The decree provides that if your former spouse dies before the end of the 15-year period, you must pay the estate the difference between \$450,000 (\$30,000 × 15) and the total amount paid up to that time. For example, if your spouse dies at the end of the tenth year, you must pay the estate \$150,000 (\$450,000 – \$300,000).

These facts indicate that the lump-sum payment to be made after your former spouse's death is a substitute for the full

amount of the \$30,000 annual payments. None of the annual payments are alimony. The result would be the same if the payment required at death were to be discounted by an appropriate interest factor to account for the prepayment.

**Child support.** A payment that is specifically designated as child support or treated as specifically designated as child support under your divorce or separation instrument is not alimony. The designated amount or part may vary from time to time. Child support payments are neither deductible by the payer nor taxable to the payee.

A payment will be **treated as specifically designated** as child support to the extent that the payment is reduced either:

- 1) On the happening of a contingency relating to your child, or
- 2) At a time that can be clearly associated with a contingency.

A payment may be treated as specifically designated as child support even if other separate payments are specifically designated as child support.

**Contingency relating to your child.** A contingency relates to your child if it depends on any event relating to that child. It does not matter whether the event is certain or likely to occur. Events relating to your child include the child's:

- Reaching a specified age or income level,
- Dying,
- Marrying,
- Leaving school,
- Leaving the household, or
- Becoming employed.

**Clearly associated with a contingency.** Payments are presumed to be reduced at a time clearly associated with the happening of a contingency relating to your child only in the following situations.

- 1) The payments are to be reduced not more than 6 months before or after the date the child will reach 18, 21, or local age of majority.
- 2) The payments are to be reduced on two or more occasions that occur not more than one year before or after a different child reaches a certain age from 18 to 24. This certain age must be the same for each child, but need not be a whole number of years.

In all other situations, reductions in payments are not treated as clearly associated with the happening of a contingency relating to your child.

Either you or the IRS can overcome the presumption in the two situations above. This is done by showing that the time at which the payments are to be reduced was determined independently of any contingencies relating to your children. For example, if you can show that the period of alimony payments is customary in the local jurisdiction,

Table 20-1. **Alimony Requirements (Instruments executed after 1984)**

<p><b>Payments ARE Alimony if <u>all</u> of the following are true:</b></p> <ul style="list-style-type: none"> <li>Payments are required by a divorce or separation instrument.</li> <li>Payer and recipient spouse do not file a joint return.</li> <li>Payment is in cash (including checks or money orders).</li> <li>Payment is not designated in the instrument as not alimony.</li> <li>Spouses separated under a decree of divorce or separate maintenance are not members of the same household.</li> <li>Payments are not required after death of the recipient spouse.</li> <li>Payment is not designated as child support.</li> </ul>	<p><b>Payments ARE NOT Alimony if <u>any</u> of the following are true:</b></p> <ul style="list-style-type: none"> <li>Payment is designated as child support.</li> <li>Payment is a noncash property settlement.</li> <li>Payments are spouse's part of community income.</li> <li>Payments are to keep up the payer's property.</li> <li>Payments are not required by a divorce or separation instrument.</li> </ul>
<p><i>These payments are deductible by the payer and includible in income by the recipient.</i></p>	<p><i>These payments are neither deductible by the payer nor includible in income by the recipient.</i></p>

such as a period equal to one-half of the duration of the marriage, you can treat the amount as alimony.



*You must give the person who paid the alimony your social security number. If you do not, you may have to pay a \$50 penalty.*

## How To Deduct Alimony Paid

You can deduct alimony you paid, whether or not you itemize deductions on your return. You must file Form 1040; you cannot use Form 1040A or Form 1040EZ.

Enter the alimony on line 29 of Form 1040.



*In the space provided on line 29, enter your spouse's or former spouse's social security number. If you do not, you may have to pay a \$50 penalty and your deduction may be disallowed.*

If you paid alimony to more than one person, enter the social security number of one of the recipients. Show the social security number and amount paid for each other recipient on an attached statement. Enter your total payments on line 29.

## How To Report Alimony Received

Report alimony you received on line 11 of Form 1040; you cannot use Form 1040A or Form 1040EZ.

- A failure to make timely payments,
- A change in your instrument,
- A reduction in your spouse's support needs, or
- A reduction in your ability to provide support.

**Subject to the recapture rule.** You are subject to the recapture rule in the third year if the alimony you pay in either the second year or the third year decreases by more than \$15,000 from the prior year.

To figure a decrease in alimony, do not include payments made under a temporary support order. Also, do not include payments required over a period of at least 3 calendar years of a fixed part of your income from a business or property, or from compensation for employment or self-employment. These payments are not subject to the recapture rule.

**Exception.** You are not subject to the recapture rule if your payments decrease because of the death of either spouse or the remarriage of the spouse receiving the payments.

**Figuring the recapture.** Both you and your spouse can use *Table 20-2*, substituting your own figures, to figure recaptured alimony. Publication 504 has a blank worksheet for your use.

**Example.** Myrna pays Phil the following amounts of alimony under their divorce decree:

Year	Amount
1	\$60,000
2	40,000
3	20,000

The recaptured alimony is \$22,500, as shown in *Table 20-2*.

Myrna shows \$22,500 as income on line 11 of her Form 1040 for Year 3. Phil deducts \$22,500 on line 29 of his Form 1040 for Year 3.

**Including the recapture in income.** If you must include a recapture amount in income, show it on Form 1040, line 11 ("Alimony received"). Cross out "received" and write "recapture." On the dotted line next to the amount, enter your spouse's last name and social security number.

**Deducting the recapture.** If you can deduct a recapture amount, show it on Form 1040, line 29 ("Alimony paid"). Cross out "paid" and write "recapture." In the space provided, enter your spouse's social security number.

Table 20-2. **Worksheet for Recapture of Alimony**

**Note:** Do not enter less than zero on any line.

1. Alimony paid in <b>2nd year</b> .....	<u>40,000</u>	
2. Alimony paid in <b>3rd year</b> .....	<u>20,000</u>	
3. Floor .....	<u>\$15,000</u>	
4. Add lines 2 and 3 .....	<u>35,000</u>	
5. Subtract line 4 from line 1 .....		<u>5,000</u>
6. Alimony paid in <b>1st year</b> .....	<u>60,000</u>	
7. Adjusted alimony paid in <b>2nd year</b> (line 1 less line 5) .....	<u>35,000</u>	
8. Alimony paid in <b>3rd year</b> .....	<u>20,000</u>	
9. Add lines 7 and 8 .....	<u>55,000</u>	
10. Divide line 9 by 2 .....	<u>27,500</u>	
11. Floor .....	<u>\$15,000</u>	
12. Add lines 10 and 11 .....	<u>42,500</u>	
13. Subtract line 12 from line 6 .....		<u>17,500</u>
14. <b>Recaptured alimony.</b> Add lines 5 and 13 .....		<u>* 22,500</u>

\* If you deducted alimony paid, report this amount as income on line 11, Form 1040.  
 If you reported alimony received, deduct this amount on line 29, Form 1040.

# Part Five.

## Standard Deduction and Itemized Deductions

After you have figured your adjusted gross income, you are ready to subtract the deductions used to figure taxable income. You can subtract either the standard deduction or itemized deductions. For the most part, itemized deductions are deductions for various kinds of personal expenses that are listed on Schedule A (Form 1040). See Chapter 21 for the factors to consider when deciding whether to subtract the standard deduction or itemized deductions.

The ten chapters in this part discuss the standard deduction, each itemized deduction, and the limit on some of your itemized deductions if your adjusted gross income exceeds certain amounts.

### 21.

## Standard Deduction

### Important Changes for 1996

**Increase in standard deduction.** The standard deduction for taxpayers who do not itemize deductions on Schedule A of Form 1040 is higher in 1996 than it was in 1995. The amount depends upon your filing status. See *1996 Standard Deduction Tables*, later.

**Itemized deductions.** The amount you can deduct for itemized deductions is limited if your adjusted gross income is more than \$117,950 (\$58,975 if you are married filing separately). See Chapter 22 for more information.

### Introduction

This chapter discusses:

- Who can take the standard deduction,
- How to figure the amount of your standard deduction,
- What additional amounts there are for age or blindness,
- How to claim the standard deduction on your return,
- What different rules apply to dependents, and
- Whether to take the standard deduction or to itemize your deductions.

The standard deduction is a dollar amount that reduces the amount of income on which you are taxed.

The standard deduction is a benefit that reduces the need for many taxpayers to itemize actual deductions, such as medical

expenses, charitable contributions, or taxes. The benefit is higher for taxpayers who are 65 or older or blind. If you have a choice, you should use the method that gives you the lower tax.

You benefit from the standard deduction if your standard deduction is more than the total of your allowable itemized deductions.

### Figuring the Amount

Most taxpayers have a choice of either taking a standard deduction or itemizing their deductions.

**Persons not eligible for the standard deduction.** Your standard deduction is **zero** and you should itemize any deductions you have if:

- 1) You are married and filing a separate return, and your spouse itemizes deductions,
- 2) You are filing a tax return for a short tax year on account of a change in your annual accounting period, or
- 3) You are a nonresident or dual-status alien during the year. You are considered a dual-status alien if you were both a nonresident and resident alien during the year.

**Note.** If you are a nonresident alien who is married to a U.S. citizen or resident at the end of the year, you can choose to be treated as a U.S. resident. (See Publication 519, *U.S. Tax Guide for Aliens*.) You can take the standard deduction.



If you can be claimed as a dependent on another person's return (such as your parents' return), your standard deduction may be limited. See *Standard Deduction for Dependents*, later.

**Standard deduction amount.** The standard deduction amounts for most taxpayers are shown in *Table 21-1*.

The amount of the standard deduction for a decedent's final return is the same as it

would have been had the decedent continued to live. However, if the decedent was not 65 or older at the time of death, the higher standard deduction for age cannot be claimed.

**Higher standard deduction for age (65 or older).** If you do not itemize deductions, you are entitled to a higher standard deduction if you are age 65 or older at the end of the year. You are considered 65 on the day before your 65th birthday. Therefore, you may take a higher standard deduction for 1996 if your 65th birthday was on or before January 1, 1997.

Use *Table 21-2* to figure the standard deduction amount.

**Higher standard deduction for blindness.** If you are blind on the last day of the year and you do not itemize deductions, you are entitled to a higher standard deduction as shown in *Table 21-2*. You qualify for this benefit if you are totally or partly blind.

**Totally blind.** If you are totally blind, attach a statement to this effect to your return.

**Partly blind.** If you are partly blind, you must submit with your return each year a certified statement from an eye physician or registered optometrist that:

- 1) You cannot see better than 20/200 in the better eye with glasses or contact lenses, or
- 2) Your field of vision is not more than 20 degrees.

If your eye condition will never improve beyond these limits, you can avoid having to get a new certified statement each year by having the examining eye physician include this fact in the certification you attach to your return. In later years just attach a statement referring to the certification. You should keep a copy of the certification in your records.

If your vision can be corrected beyond these limits only by contact lenses that you can wear only briefly because of pain, infection, or ulcers, you can take the higher standard deduction for blindness if you otherwise qualify.

**Spouse 65 or older or blind.** You may take the higher standard deduction if your spouse is age 65 or older or blind and:

- 1) You file a joint return, or
- 2) You file a separate return, and your spouse had no gross income and could not be claimed as a dependent by another taxpayer.

You cannot claim the higher standard deduction for an individual, other than your spouse, for whom you can claim an exemption.

**Example 1.** Larry, 46, and Donna, 43, are filing a joint return for 1996. Neither is blind. They decide not to itemize their deductions. They use *Table 21-1*. Their standard deduction is \$6,700.

**Example 2.** Assume the same facts as in Example 1, except that Larry is blind at the end of 1996. Larry and Donna use *Table 21-2*. Their standard deduction is \$7,500.

**Example 3.** Bill and Terry are filing a joint return for 1996. Both are over age 65. Neither is blind. If they do not itemize deductions, they use *Table 21-2*. Their standard deduction is \$8,300.

**How to report.** After you find your standard deduction amount, enter it on line 19 of Form 1040A or line 34 of Form 1040. If you use Form 1040EZ, check the appropriate box on line 5. If the total of your standard deduction and personal exemptions is more than \$6,550 (\$11,800 if married filing a joint return), you must file Form 1040A or Form 1040.

## Standard Deduction for Dependents

The standard deduction for an individual who can be claimed as a dependent on another person's tax return is generally limited to the greater of (a) \$650, or (b) the individual's earned income for the year (but not more than the regular standard deduction amount, generally \$4,000).

However, if you are a dependent who is 65 or older or blind, your standard deduction may be higher.

If you are a dependent, use *Table 21-3* to determine your standard deduction.

**Earned income defined.** Earned income is salaries, wages, tips, professional fees, and other amounts received as pay for work you actually perform.

For purposes of the standard deduction, earned income also includes any part of a **scholarship or fellowship grant** that you must include in your gross income. See *Scholarship and Fellowship Grants* in Chapter 13 for more information on what qualifies as a scholarship or fellowship grant.

**Where to report your standard deduction.** After you find your standard deduction

amount, enter it on line 19 of Form 1040A or line 34 of Form 1040. If you use Form 1040EZ, figure your standard deduction on the back of the form and check the "Yes" box on line 5. If your standard deduction is more than \$4,000 (\$6,700 if married filing a joint return), you must file Form 1040A or Form 1040.

**Example 1.** Michael, who is single, is claimed as a dependent on his parents' 1996 tax return. He has interest income of \$780 and wages of \$150. He has no itemized deductions. Michael uses *Table 21-3* to find his standard deduction. It is \$650 because the greater of \$650 and his earned income (\$150) is \$650.

**Example 2.** Joe, a 22-year-old full-time college student, is claimed as a dependent on his parents' 1996 tax return. Joe is married and files a separate return. His wife does not itemize deductions on her separate return.

Joe has \$1,500 in interest income and wages of \$3,600. He has no itemized deductions. Joe finds his standard deduction by using *Table 21-3*. He enters his earned income, \$3,600, on line 1. On line 3 he enters \$3,600, the larger of his earned income and \$650. Since Joe is married filing a separate return, he enters \$3,350 on line 4. On line 5a he enters \$3,350 as his standard deduction because it is smaller than \$3,600, his earned income.

**Example 3.** Amy, who is single, is claimed as a dependent on her parents' 1996 tax return. She is 18 years old and blind. She has interest income of \$1,300 and wages of \$3,000. She has no itemized deductions. Amy uses *Table 21-3* to find her standard deduction. She enters her wages of \$3,000 on line 1. On line 3 she enters \$3,000, the larger of her wages on line 1 and the \$650 on line 2. Since she is single, Amy enters \$4,000 on line 4. She enters \$3,000 on line 5a. This is the smaller of the amounts on lines 3 and 4. Because she checked one box in the top part of the worksheet, she enters \$1,000 on line 5b. She then adds the amounts on lines 5a and 5b and enters her standard deduction of \$4,000 on line 5c.

## Who Should Itemize

You should itemize deductions if your total deductions are more than the standard deduction amount. You should itemize if you do not qualify for the standard deduction, as discussed earlier under *Persons not eligible for the standard deduction*.

You should first figure your itemized deductions and compare that amount to your standard deduction to make sure you are using the method that gives you the greater benefit.

**Note:** You may be subject to a limit on some of your itemized deductions if your adjusted gross income (AGI) is more than

\$117,950 (\$58,975 if you are married filing separately). See Chapter 22 and the instructions for Schedule A (Form 1040), line 28, for more information on figuring the correct amount of your itemized deductions.

**When to itemize.** You may benefit from itemizing your deductions if you:

- 1) Do not qualify for the standard deduction, or the amount you can claim is limited,
- 2) Had large uninsured medical and dental expenses during the year,
- 3) Paid interest and taxes on your home,
- 4) Had large unreimbursed employee business expenses or other miscellaneous deductions,
- 5) Had large casualty or theft losses not covered by insurance,
- 6) Made large contributions to qualified charities, or
- 7) Have total itemized deductions that are more than the highest standard deduction to which you otherwise are entitled.

These deductions are explained in Chapters 23-30.

If you decide to itemize your deductions, complete Schedule A and attach it to your Form 1040. Enter the amount from Schedule A, line 28, on Form 1040, line 34.

**Itemizing for state tax or other purposes.** If you choose to itemize even though your itemized deductions are less than the amount of your standard deduction, write "IE" (itemized elected) next to line 34 (Form 1040).

**Changing your mind.** If you do not itemize your deductions and later find that you should have itemized — or if you itemize your deductions and later find you should not have — you can change your return by filing Form 1040X, *Amended U.S. Individual Income Tax Return*. See *Amended Returns and Claims for Refund* in Chapter 1 for more information on amended returns.

**Married persons who filed separate returns.** You can change methods of taking deductions only if you and your spouse both make the same changes. Both of you must file a consent to assessment for any additional tax either one may owe as a result of the change.

You and your spouse can use the method that gives you the lower total tax, even though one of you may pay more tax than the other. You both must use the same method of claiming deductions. If one itemizes deductions, the other should itemize because he or she will not qualify for the standard deduction (see *Persons not eligible for the standard deduction*, earlier).

## 1996 Standard Deduction Tables

**Caution:** If you are married filing a separate return and your spouse itemizes deductions, or if you are a dual-status alien, you cannot take the standard deduction even if you were 65 or older or blind.

Table 21-1. **Standard Deduction Chart for Most People\***

If Your Filing Status is:	Your Standard Deduction Is:
Single	\$4,000
Married filing joint return or Qualifying widow(er) with dependent child	6,700
Married filing separate return	3,350
Head of household	5,900

\* DO NOT use this chart if you were 65 or older or blind, OR if someone can claim you (or your spouse if married filing jointly) as a dependent.

Table 21-2. **Standard Deduction Chart for People Age 65 or Older or Blind\***

Check the correct number of boxes below. Then go to the chart.		
You	65 or older <input type="checkbox"/>	Blind <input type="checkbox"/>
Your spouse, if claiming spouse's exemption	65 or older <input type="checkbox"/>	Blind <input type="checkbox"/>
Total number of boxes you checked <input type="checkbox"/>		
If Your Filing Status is:	And the Number in the Box Above is:	Your Standard Deduction is:
Single	1	\$5,000
	2	6,000
Married filing joint return or Qualifying widow(er) with dependent child	1	7,500
	2	8,300
	3	9,100
	4	9,900
Married filing separate return	1	4,150
	2	4,950
	3	5,750
	4	6,550
Head of household	1	6,900
	2	7,900

\* If someone can claim you (or your spouse if married filing jointly) as a dependent, use Table 21-3, instead.

Table 21-3. **Standard Deduction Worksheet for Dependents\***

If you were 65 or older or blind, check the correct number of boxes below. Then go to the worksheet.	
You	65 or older <input type="checkbox"/> Blind <input type="checkbox"/>
Your spouse, if claiming spouse's exemption	65 or older <input type="checkbox"/> Blind <input type="checkbox"/>
Total number of boxes you checked <input type="checkbox"/>	
1. Enter your <b>earned income</b> (defined below). If none, enter -0-.	1. _____
2. Minimum amount	2. <u>\$650</u>
3. Enter the <b>larger</b> of line 1 or line 2.	3. _____
4. Enter the amount shown below for your filing status. <ul style="list-style-type: none"> <li>• Single, enter \$4,000</li> <li>• Married filing separate return, enter \$3,350</li> <li>• Married filing jointly or Qualifying widow(er) with dependent child, enter \$6,700</li> <li>• Head of household, enter \$5,900</li> </ul>	4. _____
5. <b>Standard deduction.</b> <p>a. Enter the <b>smaller</b> of line 3 or line 4. If under 65 and not blind, stop here. This is your standard deduction. Otherwise, go on to line 5b.</p> <p>b. If 65 or older or blind, multiply \$1,000 (\$800 if married or qualifying widow(er) with dependent child) by the number in the box above.</p> <p>c. Add lines 5a and 5b. This is your standard deduction for 1996.</p>	5a. _____ 5b. _____ 5c. _____
<b>Earned income</b> includes wages, salaries, tips, professional fees, and other compensation received for personal services you performed. It also includes any amount received as a scholarship that you must include in your income.	

\* Use this worksheet ONLY if someone can claim you (or your spouse if married filing jointly) as a dependent.

# Limit on Itemized Deductions

## Introduction

This chapter discusses an overall limit on itemized deductions. The topics include:

- Who is subject to the limit,
- Which itemized deductions are limited, and
- How to figure the limit.

## Useful Items

You may want to see:

### Form (and Instructions)

- Schedule A (Form 1040)** Itemized Deductions

## Are You Subject to the Limit?

You are subject to the limit on certain itemized deductions if your AGI is more than \$117,950 (\$58,975 if you are married filing separately). Your AGI is the amount on line 32 of your Form 1040.

This limit does not apply to estates or trusts.

## Which Deductions Are Affected

All itemized deductions on Schedule A (Form 1040) are subject to the overall limit, with four exceptions discussed next. Itemized deductions are discussed in Part Five of this publication.

### Exceptions

The Schedule A (Form 1040) deductions listed next are not subject to the overall limit on itemized deductions. However, they are still subject to other applicable limits.

- Medical and dental expenses — line 4
- Investment interest expense — line 13

- Nonbusiness casualty and theft losses — line 19
- Gambling losses — line 27

Check the index at the back of this publication to locate discussions of these deductions.

## How To Figure the Limit

If your itemized deductions are subject to the limit, the total of all your itemized deductions is reduced by the smaller of:

- 1) 3% of the amount by which your AGI exceeds \$117,950 (\$58,975 if married filing separately), or
- 2) 80% of your itemized deductions that are affected by the limit. See *Which Deductions Are Affected*, earlier.

Before you figure the overall limit on itemized deductions, you must first complete lines 1 through 27 of Schedule A (Form 1040), including any appropriate forms (such as Form 2106, Form 4684, etc.).

The overall limit on itemized deductions is figured after you have applied all other limits. Other limits figured first include charitable contribution limits ( Chapter 26), the limit on certain meals and entertainment ( Chapter 28), and the 2% of AGI limit on certain miscellaneous deductions ( Chapter 30).

**Itemized Deductions Worksheet.** After you have completed Schedule A (Form 1040) through line 27, you can use the *Itemized Deductions Worksheet* in the Instructions for Form 1040 to figure your limit. Enter the result on line 28 of Schedule A (Form 1040). Keep the worksheet for your records.

**TIP** You should compare the amount of your itemized deductions after applying the limit to the amount of your standard deduction. Use the greater amount when completing line 34 of your Form 1040. See Chapter 21 for information on how to figure your standard deduction.

## Example

For tax year 1996, Bill and Terry Willow are filing a joint return on Form 1040 and have adjusted gross income of \$255,250. Their Schedule A itemized deductions consist of the following.

State income and real estate taxes ...	\$17,900
Home mortgage interest .....	45,000
Charitable contributions .....	21,000
Investment interest expense .....	41,000
Miscellaneous deductions .....	17,240
<b>Total</b> .....	<u>\$142,140</u>

The Willows' investment interest expense is not subject to the overall limit on itemized deductions. Their deduction for miscellaneous deductions is the total after applying the 2% of AGI limit and does not include any gambling losses.

The Willows figure their overall limit as follows:

### Itemized Deductions Worksheet—Line 28 (Keep for your records)

1. Add the amounts on Schedule A, lines 4, 9, 14, 18, 19, 26, and 27.	<u>142,140</u>
2. Add the amounts on Schedule A, lines 4, 13, and 19, plus any gambling losses included on line 27.	<u>41,000</u>
3. Subtract line 2 from line 1. (If the result is zero, stop here; enter the amount from line 1 above on Schedule A, line 28.)	<u>101,140</u>
4. Multiply the amount on line 3 by 80% (.80).	<u>80,912</u>
5. Enter the amount from Form 1040, line 32	<u>255,250</u>
6. Enter \$117,950 (\$58,975 if married filing separately)	<u>117,950</u>
7. Subtract line 6 from line 5. (If the result is zero or less, stop here; enter the amount from line 1 above on Schedule A, line 28.)	<u>137,300</u>
8. Multiply the amount on line 7 by 3% (.03).	<u>4,119</u>
9. Enter the smaller of line 4 or line 8.	<u>4,119</u>
10. <b>Total itemized deductions.</b> Subtract line 9 from line 1. Enter the result here and on Schedule A, line 28	<u>138,021</u>

Of their \$142,140 total itemized deductions, the Willows can deduct only \$138,021. They enter \$138,021 on Schedule A, line 28.

# Medical and Dental Expenses

## Important Change for 1996

**Standard mileage rate.** The standard amount you can deduct for the use of your car for medical reasons has been increased to 10 cents a mile beginning January 1, 1996.

## Important Reminder

**Self-employed health insurance.** The special rule that allowed self-employed individuals to deduct 25% of health insurance premiums from gross income expired December 31, 1993. It was reinstated for all tax years beginning after 1993.

If you were entitled to claim this deduction in 1994 but did not do so, file Form 1040X, *Amended U.S. Individual Income Tax Return*, to amend your 1994 return. Use the worksheet in the 1994 Form 1040 Instructions, or get the 1995 Publication 535, *Business Expenses*, if one of the exceptions applies.

Beginning in 1995, the deduction was increased from 25% to 30%. For more information, see *Health insurance costs for self-employed persons*.

## Introduction

This chapter discusses how to claim a deduction for your medical and dental expenses. It contains a list of items that you can or cannot include in figuring your deduction. It also explains how to treat insurance reimbursements and other reimbursements you may receive for medical care.

It will help you determine:

- Whose expenses you can include,
- What expenses you can include,
- How to claim expenses of a decedent, and
- How to figure your deduction.

To deduct any medical and dental expenses, you must itemize your deductions on **Schedule A** (Form 1040). You must reduce the amount of your medical expenses by any reimbursement you receive for these expenses.

There are limits on the amount you can deduct. You can deduct only the amount of your medical and dental expenses that is **more than 7.5%** of your adjusted gross income shown on line 32, Form 1040. See *How To Figure Your Deduction*.

## Useful Items

You may want to see:

### Publication

- 502** Medical and Dental Expenses

### Form (and Instructions)

- Schedule A (Form 1040)** Itemized Deductions

## Whose Expenses Can You Include?

You can include medical expenses you pay for yourself and for the individuals discussed in this section.

**Spouse.** You can include medical expenses you paid for your spouse. To claim these expenses, you must have been married either at the time your spouse received the medical services or at the time you paid the medical expenses.

**Example 1.** Mary received medical treatment before she married Bill. Bill paid for the treatment after they married. Bill can include these expenses in figuring his medical expense deduction even if Bill and Mary file separate returns.

If Mary had paid the expenses before she and Bill married, Bill could not include Mary's medical expenses on his separate return. Mary would include all the medical expenses she paid during the year on her separate return. If they filed a joint return, the medical expenses both paid during the year would be used to figure their medical expense deduction.

**Example 2.** This year John paid medical expenses for his wife Louise who died last year. John married Belle this year and they file a joint return. Because John was married to Louise when she incurred the medical expenses, he can include those expenses in figuring his medical deduction for this year.

**Dependents.** You can include medical expenses you paid for your dependent. To claim these expenses, the person must have been your dependent either at the time the medical services were provided or at the time you paid the expenses. A person generally qualifies as your dependent for purposes of the medical expense deduction if:

- 1) That person lived with you for the entire year as a member of your household or is related to you, and
- 2) That person was a U.S. citizen or resident, or a resident of Canada or Mexico for some part of the calendar year in which your tax year began, and
- 3) You provided over half of that person's total support for the calendar year.

You can include the medical expenses of any person who is your dependent even if you cannot claim an exemption for him or her on your return only because the dependent

received \$2,550 or more of gross income or filed a joint return.

**Example 1.** Last year your son was your dependent. This year he no longer qualifies as your dependent. However, you paid \$800 this year for medical expenses your son incurred last year when he was your dependent. You can include the \$800 in figuring this year's medical expense deduction. You cannot include this amount on last year's return.

**Example 2.** You provided more than half of your married daughter's support, including her medical expenses of \$1,200. She and her husband file a joint return. Although you may not be able to claim an exemption for your daughter, she is still your dependent and you can include in your medical expenses the \$1,200 you paid.

**Adopted child.** You can include medical expenses that you paid for a child before adoption, if the child qualified as your dependent when the medical expenses were provided or when the expenses were paid. If you pay back an adoption agency or other persons for medical expenses they paid under an agreement with you, you are treated as having paid those expenses provided you clearly substantiate the payment is directly attributable to the medical care of the child. But if you pay back medical expenses incurred and paid before adoption negotiations began, you cannot include them as medical expenses.

**Child of divorced or separated parents.** If either parent can claim a child as a dependent under the rules for divorced or separated parents, each parent can include the medical expenses he or she pays for the child even if an exemption for the child is claimed by the other parent.

**Support claimed under a multiple support agreement.** A multiple support agreement is used when two or more people provide more than half of a person's support, but no one alone provides more than half. If you are considered to have provided more than half under such an agreement, you can include medical expenses you pay, even if you cannot claim the person because he or she had gross income of \$2,550 or more or filed a joint return.

Any medical expenses paid by others who joined you in the agreement cannot be included as medical expenses by anyone. However, you can include the entire unreimbursed amount you paid for medical expenses.

**Example.** You and your three brothers each provide one-fourth of your mother's total support. Under a multiple support agreement, you claim your mother as a dependent. You paid all of her medical expenses. Your brothers repaid you for three-fourths of these expenses. In figuring your medical expense deduction, you can include only one-fourth of your mother's medical expenses.

Table 23-1. **Medical and Dental Expenses Checklist**

You can include		You cannot include	
<ul style="list-style-type: none"> <li>• Birth control pills prescribed by your doctor</li> <li>• Capital expenses for equipment or improvements to your home needed for medical care (see Publication 502)</li> <li>• Cost and care of guide dogs or other animals aiding the blind, deaf, and disabled</li> <li>• Cost of lead-based paint removal (see Publication 502)</li> <li>• Expenses of an organ donor</li> <li>• Hospital services fees (lab work, therapy, nursing services, surgery, etc.)</li> <li>• Legal abortion</li> <li>• Legal operation to prevent having children</li> <li>• Meals and lodging provided by a hospital during medical treatment</li> <li>• Medical and hospital insurance premiums (see discussion)</li> <li>• Medical services fees (from doctors, dentists, surgeons, specialists, and other medical practitioners)</li> <li>• Oxygen equipment and oxygen</li> </ul>	<ul style="list-style-type: none"> <li>• Part of life-care fee paid to retirement home designated for medical care</li> <li>• Prescription medicines (those requiring a prescription by a doctor for their use by an individual) and insulin</li> <li>• Psychiatric care at a specially equipped medical center (includes meals and lodging)</li> <li>• Social Security tax, Medicare tax, FUTA, and state employment tax for worker providing medical care (see <i>Wages for nursing services</i>, below)</li> <li>• Special items (artificial limbs, false teeth, eyeglasses, contact lenses, hearing aids, crutches, wheelchair, etc.)</li> <li>• Special school or home for mentally or physically disabled persons (see Publication 502)</li> <li>• Transportation for needed medical care (see discussion)</li> <li>• Treatment at a drug or alcohol center (includes meals and lodging provided by the center)</li> <li>• Wages for nursing services (see Publication 502)</li> </ul>	<ul style="list-style-type: none"> <li>• Diaper service</li> <li>• Expenses for your general health (even if following your doctor's advice) such as— <ul style="list-style-type: none"> <li>—Health club dues</li> <li>—Household help (even if recommended by a doctor)</li> <li>—Social activities, such as dancing or swimming lessons</li> <li>—Stop smoking program</li> <li>—Trip for general health improvement</li> <li>—Weight loss program</li> </ul> </li> <li>• Funeral, burial or cremation expenses</li> <li>• Illegal operation or treatment</li> </ul>	<ul style="list-style-type: none"> <li>• Life insurance or income protection policies, or policies providing payment for loss of life, limb, sight, etc.</li> <li>• Maternity clothes</li> <li>• Medical insurance included in a car insurance policy covering all persons injured in or by your car</li> <li>• Medicine you buy without a prescription</li> <li>• Nursing care for a healthy baby</li> <li>• Surgery for purely cosmetic reasons</li> <li>• Toothpaste, toiletries, cosmetics, etc.</li> </ul>

Your brothers cannot include any part of the expenses.

However, if you and your brothers share the nonmedical support items and you separately pay all of your mother's medical expenses, you can include the amount you paid for her medical expenses in your medical expenses.

## Medical Expenses

Medical care expenses include amounts paid for the diagnosis, cure, mitigation, treatment, or prevention of disease, and for treatments affecting any part or function of the body. The expenses must be primarily to alleviate or prevent a physical or mental defect

or illness. Expenses for solely cosmetic reasons generally are not expenses for medical care. Also, expenses that are merely beneficial to one's general health (for example, vacations) are not expenses for medical care.

Use *Table 23-1* in this chapter as a guide to determine which medical and dental expenses you can include on Schedule A (Form 1040). See Publication 502, *Medical and Dental Expenses*, for information about other expenses you can include.

## Medical Insurance Premiums

You can include in medical expenses premiums you pay for policies that provide payment for:

- Hospitalization, surgical fees, and other medical and dental expenses,
- Prescription drugs,
- Replacement of lost or damaged contact lenses, or
- Membership in an association that gives cooperative or so-called "free-choice" medical service, or group hospitalization and clinical care.

If you have a policy that provides more than one kind of payment, you can include the premiums for the medical care part of the policy if the charge for the medical part is reasonable. The cost of the medical portion must be separately stated in the insurance

contract or given to you in a separate statement.

**Cafeteria plans.** Do not include in medical and dental expenses (line 1 of Schedule A) insurance premiums paid by an employer-sponsored health insurance plan (cafeteria plan) unless the premiums are included in box 1 of your Form(s) W-2. Also, do not include any other medical and dental expenses paid by the plan unless the amount paid is included in box 1 of your Form(s) W-2.

**Medicare A.** If you are covered under social security (or if you are a government employee who paid Medicare tax), you are enrolled in Medicare A. The tax paid for Medicare A is not a medical expense.

If you are not covered under social security (or were not a government employee who paid Medicare tax), you can voluntarily enroll in Medicare A. In this situation the premiums paid in 1996 for Medicare A can be included as a medical expense on your tax return.

**Medicare B.** Medicare B is supplemental medical insurance. Premiums you pay for Medicare B are a medical expense. If you applied for it at age 65, you can deduct \$42.50 for each month in 1996 for which you paid a premium. If you were over age 65 when you first enrolled, check the information you received from the Social Security Administration to find out your premium.

**Prepaid insurance.** Premiums you pay before you are 65 for insurance covering medical care for yourself, your spouse, or your dependents after you reach 65 are medical care expenses in the year paid if they are:

- 1) Payable in equal yearly installments, or more often, and
- 2) Payable for at least 10 years, or until you reach 65 (but not for less than 5 years).

**Unused sick leave used to pay premiums.** You must include in gross income cash payments you receive at the time of retirement for unused sick leave.

You must also include in gross income the value of unused sick leave that, at your option, your employer applies to the cost of your continuing participation in your employer's health plan after you retire. You can include this cost of continuing participation in the health plan as a medical expense.

If you participate in a health plan where your employer automatically applies the value of unused sick leave to the cost of your continuing participation in the health plan (and you do not have the option to receive cash), you do not include the value of the unused sick leave in gross income. You cannot include this cost of continuing participation in that health plan as a medical expense.

## Health Insurance Costs for Self-Employed Persons

If you were self-employed and had a net profit for the year, were a general partner (or a limited partner receiving guaranteed payments) or if you received wages from an S corporation in which you were a more than 2% shareholder (who is treated as a partner), you may be able to deduct up to 30% of the amount paid for health insurance on behalf of yourself, your spouse, and dependents. Do this on line 26 of Form 1040. If you itemize your deductions, include the remaining premiums with all other medical care expenses on Schedule A, subject to the 7.5% limit.

You cannot take the deduction for any month in 1996 in which you were eligible to participate in any subsidized health plan maintained by your employer or your spouse's employer.

If you qualify to take the deduction, use the worksheet in the Form 1040 instructions to figure the amount you can deduct. But, if either of the following applies, do not use the worksheet. Instead, use the worksheet in Publication 535 to figure your deduction.

- You had more than one source of income subject to self-employment tax.
- You file Form 2555, *Foreign Earned Income*, or Form 2555-EZ.

## Meals and Lodging

Payment for meals and lodging provided by a hospital or similar institution as a necessary part of medical care is a medical expense if the main reason for being in the hospital is to receive medical care.

You may be able to include in medical expenses the cost of lodging not provided in a hospital or similar institution. You can include the cost of such lodging while away from home if you meet all of the following requirements.

- 1) The lodging is primarily for and essential to medical care.
- 2) The medical care is provided by a doctor in a licensed hospital or in a medical care facility related to, or the equivalent of, a licensed hospital.
- 3) The lodging is not lavish or extravagant under the circumstances.
- 4) There is no significant element of personal pleasure, recreation, or vacation in the travel away from home.

The amount you include in medical expenses for lodging cannot exceed \$50 for each night for each person. Lodging is included for a person for whom transportation expenses are a medical expense because that person is traveling with the person receiving the medical care. For example, if a parent is traveling with a sick child, up to \$100 per night for lodging is included as a medical expense. (Meals are not deductible.)

**Nursing home.** You can include in medical expenses the cost of medical care in a nursing home or home for the aged for yourself, your spouse, or your dependents. This includes the cost of meals and lodging in the home if the main reason for being there is to get medical care.

**Do not include** the cost of meals and lodging if the reason for being in the home is personal. You can, however, include in medical expenses the part of the cost that is for medical or nursing care.

**Medical trip.** You cannot include the cost of your meals and lodging while you are away from home for medical treatment if you do not receive the treatment at a medical facility, or if the lodging is not primarily for or essential to the medical care.

## Transportation

Amounts paid for transportation primarily for, and essential to, medical care qualify as medical expenses.

### Include:

- Bus, taxi, train, and plane fares,
- Ambulance service,
- Car expenses,
- Transportation expenses of a parent who must go with a child who needs medical care,
- Transportation expenses of a nurse or other person who can give injections, medications, or other treatment required by a patient who is traveling to get medical care and is unable to travel alone, and
- Transportation expenses for regular visits to see a mentally ill dependent, if these visits are recommended as part of treatment.

### Do not include:

- Transportation expenses to and from work even if your condition requires an unusual means of transportation, or
- Transportation costs if, for nonmedical reasons only, you choose to travel to another city, such as a resort area, for an operation or other medical care prescribed by your doctor.

**Car expenses.** You can include out-of-pocket expenses for your car, such as gas and oil. You cannot include depreciation, insurance, general repair, or maintenance expenses.

If you do not want to figure your actual expenses, you can use a standard rate of **10 cents a mile** for use of your car for medical reasons.

Either way, you can include the cost of parking fees and tolls.

## Disabled Dependent Care Expenses

Some disabled dependent care expenses may qualify as medical expenses or as work-related expenses for purposes of taking a credit for dependent care. (See Chapter 33.) You can choose to apply them either way as long as you do not use the same expenses to claim both a credit and a medical expense deduction.

## Impairment-Related Work Expenses

Certain unreimbursed expenses may appear to be deductible as either medical or business expenses. Deduct them as business deductions if they are:

- Necessary for you to do your work satisfactorily,
- For goods or services not required or used, other than incidentally, in your personal activities, and
- Not specifically covered under other income tax laws.

**Example.** You are blind. To do your work, you must use a reader. You use the reader both during your regular working hours at your place of work and outside your regular working hours away from your place of work. The reader's services are only for your work. You can deduct your expenses for the reader as business expenses.

## Decedents

The survivor or personal representative of a decedent can choose to treat certain expenses paid by the decedent's estate for the decedent's medical care as paid by the decedent at the time the medical services were provided. The expenses must be paid within the one-year period beginning with the day after the date of death. If you are the survivor or personal representative making this choice, you must attach a statement to the decedent's Form 1040 (or the decedent's amended return, Form 1040X), saying that the expenses have not been and will not be claimed on the estate tax return.

Amended returns and claims for refund are discussed in Chapter 1.

**Example.** John properly filed last year's income tax return. He died this year with unpaid medical expenses of \$1,500 from last year and \$2,000 from this year. His executor will pay the expenses in January of next year. The executor can file an amended return for last year claiming the \$1,500 medical expenses. The \$2,000 medical expenses from this year can be included on this year's return, which will be the decedent's final return.

**Expenses for deceased spouse or dependent.** If you paid medical expenses for your deceased spouse or dependent, include them as medical expenses on your Form

1040 in the year paid, whether they are paid before or after the decedent's death. The expenses can be included if the person was your spouse or dependent either at the time the medical services were provided or at the time you paid the expense.

## How To Figure Your Deduction

To figure your medical expense deduction, complete Schedule A (Form 1040). If you need more information on itemized deductions or you are not sure whether you can itemize, see Chapters 21 and 22.

Write in the amounts you paid for medical and dental care expenses after reducing the amount by payments you received from insurance and other sources. You can deduct only the amount of your medical and dental expenses that is more than 7.5% of your adjusted gross income shown on line 32, Form 1040.

Write the amount of your unreimbursed medical expenses on line 1, Schedule A (Form 1040). For an example, see *Medical and dental expenses (lines 1–4, Schedule A) under Itemized Deductions (Schedule A)* in Chapter 39.

**Separate returns.** If you and your spouse live in a noncommunity property state and file separate returns, each of you can include only the medical expenses each actually paid. Any medical expenses paid out of a joint checking account in which you and your spouse have the same interest are considered to have been paid equally by each of you, unless you can show otherwise.

**Community property states.** If you and your spouse live in a community property state and file separate returns, any medical expenses paid out of community funds are divided equally. Each of you should include half the expenses. If medical expenses are paid out of the separate funds of one spouse, only the spouse who paid the medical expenses can include them. If you live in a community property state, are married, and file a separate return, see Publication 555, *Community Property*.

### What expenses can you include in 1996?

You can include medical expenses only in the year you paid them. (But see *Decedents*, earlier.) If you pay medical expenses by check, the day you mail or deliver the check generally is the date of payment. If you use a "pay-by-phone", or "on-line" account, the date reported on the statement of the financial institution showing when payment was made is the date of payment. You can include medical expenses you charge to your credit card in the year the charge is made. It does not matter when you actually pay the amount charged.

## Reimbursements

You must reduce your total medical expenses for the year by all reimbursements for medical expenses that you receive from insurance or other sources during the year. This includes payments from Medicare.

Do not reduce medical expenses by any payment you received for loss of earnings or damages for personal injury or sickness.

**Excess reimbursement.** If the total reimbursement you received during the year is the same as or more than your total medical expenses for the year, you cannot take a medical deduction. The following discussions explain whether you need to include excess reimbursement in income.

**Premiums paid by you.** If you pay the entire premium for your medical insurance or all of the cost of a plan similar to medical insurance, do not include an excess reimbursement in your gross income.

**Premiums paid by you and your employer.** If both you and your employer contribute to your medical insurance plan and your employer's contributions are not included in your gross income, you must include in your gross income on line 21 of Form 1040 the part of an excess reimbursement that is from your employer's contributions.

**Example.** You are covered by your employer's medical insurance policy. The annual premium is \$2,000. Your employer pays \$600 of that amount and the balance of \$1,400 is taken out of your wages. The part of any excess reimbursement you receive under the policy that is from your employer's contributions is figured like this:

Total annual cost of policy .....	\$2,000
Amount paid by employer .....	\$ 600

### Employer's contribution in relation to the annual cost of the policy

(\$600 ÷ \$2,000)	30%
-------------------	-----

You must include in your gross income on line 21 of Form 1040 30% of any excess reimbursement you received for medical expenses under the policy.

**Premiums paid by your employer.** If your employer or your former employer pays the total cost of your medical insurance plan and your employer's contributions are not included in your income, you must report all excess reimbursements as other income on line 21 of Form 1040.

**More than one policy.** If you are covered under more than one policy, the costs of which are paid by both you and your employer, you must first divide the medical expense among the policies to figure the excess reimbursement from each policy. Then divide the policy costs to figure the part of any excess reimbursement that is from your employer's contribution.

**Example.** You are covered by your employer's health insurance policy. The annual premium is \$1,200. Your employer pays \$300, and the balance of \$900 is deducted from your wages. You also paid the entire

premium of \$250 for a personal health insurance policy.

During the year, you paid medical expenses of \$3,600. In the same year, you were reimbursed \$2,500 under your employer's policy and \$1,500 under your personal policy.

You figure the part of any excess reimbursement you receive that is from your employer's contribution like this:

Reimbursement from employer's policy	\$2,500
Reimbursement from your policy	1,500
<b>Total reimbursement</b>	<u>\$4,000</u>

Amount of medical expenses from your policy  $[(\$1,500 \div \$4,000) \times \$3,600$  total medical expenses] ..... \$1,350

Amount of medical expenses from your employer's policy  $[(\$2,500 \div \$4,000) \times \$3,600$  total medical expenses] .... 2,250

**Total medical expenses** ..... \$3,600

**Excess reimbursement from your employer's policy**  $(\$2,500 - \$2,250)$  ..... \$ 250

Because both you and your employer contribute to the cost of this policy, you must divide the cost to determine the excess reimbursement from your employer's contribution.

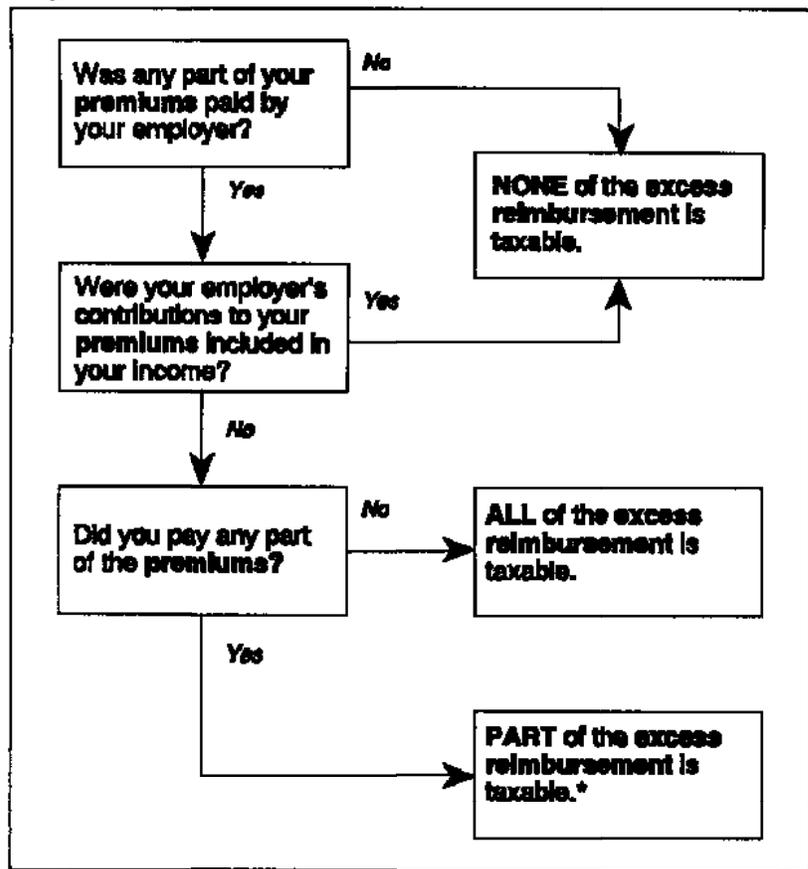
Employer's contribution in relation to the annual cost of the policy  $(\$300 \div \$1,200)$  ..... 25%

**Amount to report as income**  $(25\% \times \$250)$  ..... \$62.50

**Reimbursement in a later year.** If you are reimbursed in a later year for medical expenses you deducted in an earlier year, you must report as income the amount you received from insurance or other sources that is equal to, or less than, the amount you previously deducted as medical expenses. However, you do not have to report the reimbursement you received up to the amount of your medical deductions that did not reduce your tax for the earlier year. For more information about the recovery of an amount that you claimed as an itemized deduction in an earlier year, see *Itemized Deduction Recoveries* in Chapter 13.

**Medical expenses not deducted.** If you did not deduct a medical expense in the year you paid it because you did not itemize deductions or because your medical expenses

**Figure 29-A. Is Your Excess Medical Reimbursement Taxable?**



\* See *Premiums paid by you and your employer* in this chapter.

were not more than 7.5% of your adjusted gross income, do not include in income the reimbursement for this expense that you receive in a later year. However, if the reimbursement is more than the expense, see *Excess reimbursement*, earlier.

**Example.** In 1996, you have medical expenses of \$500. You cannot deduct the \$500 because it is not more than 7.5% of your adjusted gross income. If, in a later year, you are reimbursed for any of the \$500 medical expenses, you do not include that amount in your gross income.

**Damages.** If you receive an amount in settlement of a personal injury suit, the part that

is for medical expenses deducted in an earlier year is included as income in the later year if your medical deduction in the earlier year reduced your income tax in that year. See *Reimbursement in a later year*, earlier.

**Future medical expenses.** If you receive an amount in settlement of a damage suit for personal injuries that is properly allocable or determined to be for future medical expenses, you must reduce any medical expenses for these injuries until the amount you received has been completely used.

## Important Reminder

**Limit on itemized deductions.** If your adjusted gross income is more than \$117,950 (\$58,975 if you are married filing separately), the overall amount of your itemized deductions may be limited. See Chapter 22 for more information about this limit.

## Introduction

This chapter discusses which taxes you can deduct if you itemize deductions on Schedule A (Form 1040). It also explains which taxes you can deduct on other schedules or forms and which taxes you cannot deduct.

The chapter covers:

- Income taxes (state, local, or foreign)
- Real estate taxes (state, local, or foreign)
- Personal property taxes (state or local)
- Taxes that are expenses of a business or of producing income
- Taxes and fees you cannot deduct

The end of the chapter explains which form you use to deduct the different types of taxes.

**Table.** Use *Table 24–1* as a guide to determine which taxes you can deduct.

**State or local taxes.** These are taxes imposed by the 50 states, U.S. possessions, or any of their political subdivisions (such as a county or city), or by the District of Columbia.

**Indian tribal government.** An Indian tribal government that is recognized by the Secretary of the Treasury as performing substantial government functions will be treated as a state for this purpose. Income taxes, real estate taxes, and personal property taxes imposed by that Indian tribal government (or by any of its subdivisions that are treated as political subdivisions of a state) are deductible.

**Foreign taxes.** These are taxes imposed by a foreign country or any of its political subdivisions.

### Useful Items

You may want to see:

#### Publication

- 514** Foreign Tax Credit for Individuals

#### Form (and Instructions)

- Schedule A (Form 1040)** Itemized Deductions

- Schedule E (Form 1040)**  
Supplemental Income and Loss
- Form 1116** Foreign Tax Credit

## Tests to Deduct Any Tax

The following two tests must be met for any tax to be deductible by you.

- 1) The tax must be imposed on you.
- 2) The tax must be paid during your tax year.

**The tax must be imposed on you.** Generally, you can deduct only taxes that are imposed on you.

Generally, you can deduct property taxes only if you are the property owner. If real estate taxes are paid by your spouse who owns a home, they are deductible on your spouse's separate return or on your joint return.

**The tax must be paid during your tax year.** If you are a cash basis taxpayer, you can deduct only those taxes paid during the calendar year for which you file a return. If you pay your taxes by check, the day you mail or deliver the check is generally the date of payment. If you use a pay-by-phone account, the date reported on the statement of the financial institution showing when payment was made is the date of payment.

If you question a tax liability and use the cash method of accounting, you can deduct the tax only in the year it is actually paid. If you use an accrual method of accounting, you must use special rules for determining when you can deduct the tax liability you are questioning. See *Contested Liabilities* in Publication 538, *Accounting Periods and Methods*, for more information.

## Income Taxes

This section discusses the deductibility of state and local income taxes, employee contributions to state benefit funds, and foreign income taxes.

**State and local income taxes.** You can deduct state and local income taxes. However, you cannot deduct state and local income taxes you pay on income that is exempt from federal income tax, unless the exempt income is interest income. For example, you cannot deduct the part of a state's income tax that is on a cost-of-living allowance that is exempt from federal income tax.

**What to deduct.** Deduct state and local income taxes withheld from your salary in the year they are withheld. For 1996, these taxes will be shown in boxes 18 and 21 of your Form W-2. You may also have state or local income tax withheld on Form 1099-MISC (box 11) or Form 1099-R (boxes 10 and 13). Deduct payments made on taxes for an earlier year in the year they are paid.

Deduct estimated tax payments you made during the year under a pay-as-you-go plan of a state or local government. However, you must have a reasonable basis for making the estimated tax payments. Any estimated state or local tax payments you make that are not reasonably determined in good faith at the time of payment are not deductible. For example, if you made an estimated state income tax payment, but the estimate of your state tax liability for the year shows that you will get a refund of the full amount of your estimated payment, then you had no reasonable basis to believe you had any additional liability for state income taxes, and you cannot deduct it.

Deduct any part of a refund of prior-year state or local income taxes that you chose to have credited to your 1996 estimated state or local income taxes.

Do not reduce your deduction by either of the following:

- Any state or local income tax refund (or credit) you expect to receive for 1996, or
- Any refund of (or credit for) prior year state and local income taxes you actually received in 1996.

**Refund (or credit) of state or local income taxes.** If you receive a refund of (or credit for) state or local income taxes in a year after the year in which you paid them, you may have to include all or part of the refund in income on line 10 of Form 1040, in the year you receive it. This includes refunds resulting from taxes that were overwithheld, applied from a prior year return, not figured correctly, or figured again as a result of an amended return. However, if you did not itemize your deductions in the previous year, you do not have to include the refund in income. For a discussion of how much to include, see *Recoveries* in Chapter 13.

**Separate returns.** If you and your spouse file separate state, local, and federal income tax returns, you each can deduct on your federal return only the amount of your own state and local income tax.

If you file separate state and local returns and a joint federal return, you can deduct on your joint federal return the total of the state and local income taxes both of you paid.

If you and your spouse file joint state and local returns and separate federal returns, each of you can deduct on your separate federal return part of the state and local income taxes. You can deduct only the amount of the total taxes that is proportionate to your gross income compared to the combined gross income of you and your spouse. But you cannot deduct more than the amount you actually paid during the year. If you and your spouse are jointly and individually liable for the full amount of the state and local income taxes, you and your spouse can deduct on your separate federal returns the amount you each actually paid.

**State benefit funds.** As an employee, you can deduct mandatory contributions to state benefit funds that provide protection against

Table 24-1. Which Taxes Can You Deduct?

	You Can Deduct	You Cannot Deduct
<b>Income Taxes</b>	State and local income taxes Foreign income taxes Employee contributions to state funds listed under <i>State benefit funds</i>	Federal income taxes Employee contributions to private or voluntary disability plans
<b>Real Estate Taxes</b>	State and local real estate taxes Foreign real estate taxes Tenant's share of real estate taxes paid by cooperative housing corporation	Taxes for local benefits Trash and garbage pickup fees Rent increase due to higher real estate taxes Homeowners association charges
<b>Personal Property Taxes</b>	State and local personal property taxes	
<b>Other Taxes</b>	Taxes that are expenses of your trade or business or producing income One-half of self-employment tax paid Taxes on property producing rent or royalty income Occupational taxes	Many taxes, such as state and local sales taxes and federal excise taxes, generally are not deductible. See <i>Taxes and Fees You Cannot Deduct</i> , later.
<b>Fees and Charges</b>		Fees and charges, such as for driver's licenses or water bills, generally are not deductible. See <i>Taxes and Fees You Cannot Deduct</i> , later.

loss of wages. Mandatory payments made to the following state benefit funds are deductible as state income taxes on line 5 of Schedule A (Form 1040).

- California
- New Jersey
- New York Nonoccupational Disability Benefit Fund
- Rhode Island Temporary Disability Benefit Fund
- Washington State Supplemental Workmen's Compensation Fund



*Employee contributions to private or voluntary disability plans are not deductible.*

**Foreign income taxes.** Generally, you can take either a deduction or a credit for income taxes imposed on you by a foreign country or a U.S. possession. However, you cannot take a deduction or credit for foreign income taxes paid on income that is exempt from U.S. tax under the foreign earned income exclusion or the foreign housing exclusion. For information on these exclusions, get Publication 54, *Tax Guide for U.S. Citizens and Resident Aliens Abroad*.

## Real Estate Taxes

Deductible real estate taxes are any state, local, or foreign taxes on real property levied for the general public welfare. The taxes must be based on the assessed value of the real property and must be charged uniformly against all property under the jurisdiction of the taxing authority. Deductible real estate taxes generally do not include taxes charged

for local benefits and improvements that increase the value of the property. See *Real Estate Items You Cannot Deduct*, later.

An itemized charge for services to specific property or people is not a tax, even if the charge is paid to the taxing authority. You cannot deduct the charge as a real estate tax if it is:

- 1) A unit fee for the delivery of a service (such as a \$5 fee charged for every 1,000 gallons of water you use),
- 2) A periodic charge for a residential service (such as a \$20 per month or \$240 annual fee charged to each homeowner for trash collection), or
- 3) A flat fee charged for a single service provided by your government (such as a \$30 charge for mowing your lawn because it was allowed to grow higher than permitted under your local ordinance).



*You must look at your real estate tax bill to determine if any nondeductible itemized charges, such as those just listed, are included in the bill. If your taxing authority (or mortgage lender) does not furnish you a copy of your real estate tax bill, ask for it.*

**Tenant-shareholders in a cooperative housing corporation.** Generally, you can deduct your share of the real estate taxes the corporation paid or incurred on the property. The corporation should provide you with a statement showing you your share of the taxes. For more information, see *Special Rules for Cooperatives* in Publication 530.

**Purchase or sale of real estate.** If you bought or sold real estate during the year,

the real estate taxes must be divided between the buyer and the seller.

The buyer and the seller must divide the real estate taxes according to the number of days in the **real property tax year** (the period to which the tax imposed relates) that each owned the property. The seller is treated as paying the taxes up to the date of sale. The buyer is treated as paying the taxes beginning with the date of sale. This applies regardless of the lien dates under local law. Generally, this information is included on the settlement statement provided at closing.

If you (the seller) cannot deduct taxes until they are paid because you use the cash method of accounting, and the buyer of your property is personally liable for the tax, **you are considered to have paid your part of the tax at the time of the sale.** This lets you deduct the part of the tax to the date of sale even though you did not actually pay it. However, you must also include the amount of that tax in the selling price of the property.

You figure your deduction for taxes on each property bought or sold during the real property tax year as follows.

1. Enter the total real estate taxes for the real property tax year ..... \_\_\_\_\_
2. Enter the number of days in the real property tax year that you owned the property ..... \_\_\_\_\_
3. Divide line 2 by 366 ..... \_\_\_\_\_
4. Multiply line 1 by line 3. This is your deduction. Enter it on line 6 of Schedule A (Form 1040) ..... \_\_\_\_\_

**Note.** Repeat steps 1 through 4 for each property you bought or sold during the real property tax year.

**Delinquent taxes.** Do not divide delinquent taxes between the buyer and seller if the taxes are for any real property tax year before the one in which the property is sold. Even if the buyer agrees to pay the delinquent taxes, the buyer cannot deduct them. The buyer must add them to the cost of the property. The seller can deduct these taxes paid by the buyer. However, the seller must include them in the selling price.

The following examples illustrate how real estate taxes are divided between buyer and seller.

**Example 1.** Dennis and Beth White's real property tax year for both their old home and their new home is the calendar year, with payment due August 1. The tax on their old home, sold on May 6, was \$620. The tax on their new home, bought on May 3, was \$732. Dennis and Beth are considered to have paid a proportionate share of the real estate taxes on the old home even though they did not actually pay them to the taxing authority. On the other hand, they can claim only a proportionate share of the taxes they paid on their new property even though they paid the entire amount.

Dennis and Beth owned their old home during the real property tax year for 126 days (January 1 to May 5, the day before the sale). They figure their deduction for taxes on their old home as follows.

**TAXES ON OLD HOME**

1.	Enter the total real estate taxes for the real property tax year .....	<u>\$620</u>
2.	Enter the number of days in the real property tax year that you owned the property .....	<u>126</u>
3.	Divide line 2 by 366 .....	<u>.34</u>
4.	Multiply line 1 by line 3. This is your deduction. Enter it on line 6 of Schedule A (Form 1040) .....	<u>\$211</u>

Since the buyers of their old home paid all of the taxes, Dennis and Beth also include the \$211 in the selling price of the old home. (The buyers add the \$211 to their cost of the home.)

Dennis and Beth owned their new home during the real property tax year for 243 days (May 3 to December 31, including their date of purchase). They figure their deduction for taxes on their new home as follows.

**TAXES ON NEW HOME**

1.	Enter the total real estate taxes for the real property tax year .....	<u>\$732</u>
2.	Enter the number of days in the real property tax year that you owned the property .....	<u>243</u>
3.	Divide line 2 by 366 .....	<u>.66</u>
4.	Multiply line 1 by line 3. This is your deduction. Enter it on line 6 of Schedule A (Form 1040) .....	<u>\$483</u>

Since Dennis and Beth paid all of the taxes on the new home, they add \$249 (\$732 paid

less \$483 deduction) to their basis of the new home. (The sellers add this \$249 to their selling price and deduct the \$249 as a real estate tax.)

Dennis and Beth's real estate tax deduction for their old and new homes is the sum of \$211 and \$483, or \$694. They will enter this amount on line 6 of Schedule A (Form 1040).

**Example 2.** George and Helen Brown bought a home on May 2, 1996. Their real property tax year is the calendar year. Real estate taxes for 1995 were assessed in their state on January 1, 1996. The taxes became due on May 31, 1996, and October 31, 1996.

The Browns agreed to pay all taxes due after the date of purchase. Real estate taxes for 1995 were \$680. They paid \$340 on May 31, 1996, and \$340 on October 31, 1996. These taxes were for the 1995 real property tax year. The Browns cannot deduct them since they did not own the property until 1996. Instead, they must add \$680 to the basis (cost) of their home.

In January 1997, the Browns receive their 1996 property tax statement for \$752, which they will pay in 1997. The Browns owned their new home during the 1996 real property tax year for 244 days (May 2 to December 31). They will figure their 1997 deduction for taxes as follows.

1.	Enter the total real estate taxes for the real property tax year .....	<u>\$752</u>
2.	Enter the number of days in the real property tax year that you owned the property .....	<u>244</u>
3.	Divide line 2 by 366 .....	<u>.67</u>
4.	Multiply line 1 by line 3. This is your deduction. Claim it on line 6 of Schedule A (Form 1040) .....	<u>\$504</u>

The remaining \$248 (\$752 paid less \$504 deduction) of taxes paid in 1997, along with the \$680 paid in 1996, is added to the cost of their home.

Because the taxes up to the date of sale are considered paid by the seller on the date of sale, the seller is entitled to a 1996 tax deduction of \$928. This is the sum of the \$680 for 1995 and the \$248 for the 122 days the seller owned the home in 1996. The seller must also include the \$928 in the selling price when he or she completes **Form 2119, Sale of Your Home**, (which must be attached to the seller's 1996 tax return). The seller should contact the Browns in January 1997 to find out how much real estate tax is due for 1996.

**Form 1099-S.** For certain sales or exchanges of real estate, the person responsible for closing the sale (generally the settlement agent) prepares Form 1099-S, *Proceeds From Real Estate Transactions*, to report certain information to the IRS and to the seller of the property. The gross proceeds from the sale appears in box 2 of the form. Generally, gross proceeds includes cash, notes, and liabilities assumed by the buyer, such as any portion of the seller's real estate tax liability that the buyer will pay after

the date of sale. The buyer includes this amount in the cost basis of the property, and the seller both deducts this amount as a tax expense and includes it in the sales price of the property.

For a real estate transaction that involves a residence, any real estate tax the seller paid in advance but that is the liability of the buyer appears in box 5 of Form 1099-S. The buyer deducts this amount as a real estate tax expense, and the seller reduces his or her real estate tax expense by the same amount. See *Refund (or rebate)*, later.

**Taxes placed in escrow.** If your monthly mortgage payment includes an amount placed in escrow (put in the care of a third party) for real estate taxes, you cannot deduct the total of these amounts placed in escrow. You can deduct only the real estate tax that the lender actually paid to the taxing authority. If the lender does not notify you of the amount of real estate tax that was paid for you, contact the lender or the taxing authority to find the proper amount to show on your return.

**Tenants by the entirety.** If you and your spouse held property as tenants by the entirety and you file separate returns, each of you can deduct only the taxes each of you paid on the property.

**Divorced individuals.** If your divorce or separation agreement states that you must pay the real estate taxes for a home owned by you and your spouse, part of your payments may be deductible as alimony and part as real estate taxes. See Publication 504, *Divorced or Separated Individuals*, for information.

**Minister's and military personnel housing allowances.** If you are a minister or a member of the uniformed services and receive a housing allowance that you can exclude from income, you still can deduct all of the real estate taxes you pay on your home.

**Refund (or rebate).** If you receive a refund or rebate in 1996 of real estate taxes you paid in 1996, you must reduce your deduction by the amount refunded to you. If you receive a refund or rebate in 1996 of real estate taxes you deducted in an earlier year, you generally must include the refund or rebate in income in the year you receive it. However, you only need to include the amount of the deduction that reduced your tax in the earlier year.

For more information, see *Recoveries* in Chapter 13. If you did not itemize deductions in the year you paid the tax or you filed Form 1040A or Form 1040EZ, do not report the refund as income.

**Real Estate Items You Cannot Deduct**

The following are not deductible as real estate taxes:

- Taxes for local benefits,
- Trash and garbage pickup fees,
- Transfer taxes (or stamp taxes),
- Rent increases due to higher real estate taxes, and
- Homeowners association charges.

**Taxes for local benefits.** Deductible real estate taxes generally do not include taxes charged for local benefits and improvements that increase the value of your property. These include assessments for streets, sidewalks, water mains, sewer lines, public parking facilities, and similar improvements. You should increase the basis of your property by the amount of the assessment.

Local benefit taxes are deductible only if they are for maintenance, repair, or interest charges related to those benefits. If only a part of the taxes is for maintenance, repair, or interest, you must be able to show the amount of that part to claim the deduction. If you cannot determine what part of the tax is for maintenance, repair, or interest, none of it is deductible.

Taxes for local benefits may be included in your real estate tax bill. If your taxing authority (or mortgage lender) does not furnish you a copy of your real estate tax bill, ask for it. You should use the rules above to determine if the local benefit tax is deductible.

**Trash and garbage pickup fees.** Fees charged for trash and garbage pickup services are not deductible as taxes, even if the fees are paid to your local taxing authority. However, service charges used to maintain or improve services (such as trash collection or police and fire protection) are deductible as real estate taxes if:

- The fees or charges are imposed at a like rate against all property in the taxing jurisdiction,
- The funds collected are not earmarked; instead, they are commingled with general revenue funds, and
- Funds used to maintain or improve services are not limited to or determined by the amount of these fees or charges collected.

**Transfer taxes (or stamp taxes).** Transfer taxes and similar taxes and charges on the sale of a personal home are not deductible. If they are paid by the seller, they are expenses of the sale and reduce the amount realized on the sale. If paid by the buyer, they are included in the cost basis of the property.

**Rent increase due to higher real estate taxes.** If your landlord increases your rent in the form of a tax surcharge because of increased real estate taxes, you cannot deduct the increase as taxes.

**Homeowners association charges.** These charges are not deductible because

they are imposed by the homeowners association, rather than the state or local government.

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## Personal Property Taxes

Personal property tax is deductible if it is a state or local tax that is:

- 1) Charged on personal property,
- 2) Based **only** on the value of the personal property, and
- 3) Charged on a yearly basis, even if it is collected more than once a year, or less than once a year.

A tax that meets the above requirements can be considered charged on personal property even if it is for the exercise of a privilege. For example, a yearly tax based on value qualifies as a personal property tax even if it is called a registration fee and is for the privilege of registering motor vehicles or using them on the highways.

**Example.** Your state charges a yearly motor vehicle registration tax of 1% of value plus 50 cents per hundredweight. You paid \$32 based on the value (\$1,500) and weight (3,400 lbs.) of your car. You can deduct \$15 ( $1\% \times \$1,500$ ) as a personal property tax, since it is based on the value. The remaining \$17 ( $\$50 \times 34$ ), based on the weight, is not deductible.

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## Business Taxes And Fees

You can deduct certain taxes and fees not previously listed as deductible in this chapter only if they are ordinary and necessary expenses of your trade or business or of producing income. For a discussion of business taxes, see Chapter 9 of Publication 535, *Business Expenses*. In some cases, these taxes are not deducted on Schedule A (Form 1040), but are deducted on other schedules or forms. See *Where To Deduct*, later.

Taxes and fees that may be deductible only as business or income-producing expenses include the following items.

**Car registration fees,** inspection fees, and license plates. However, see *Personal Property Taxes*, earlier.

**Cigarette,** tobacco, liquor, beer, wine, etc. taxes

**Excise taxes or customs duties.** These include the federal taxes on telephone service, gasoline and other motor fuels, and luxury cars.

**Occupational taxes.** You can deduct as a business expense an occupational tax

charged at a flat rate by a locality for the privilege of working or conducting a business in the locality.

**Sales taxes.** If you buy supplies or other items for your trade or business and can deduct their cost as a business expense, you can deduct the sales tax as part of the cost. Sales tax on the purchase of property whose cost you cannot deduct as a business expense is added to the property's cost. See *Cost Basis* in Chapter 14.

**Self-employment tax.** If you work for yourself, you can deduct half of the self-employment tax you figured on your 1996 Schedule SE (Form 1040), *Self-Employment Tax*.

**Tax connected with purchase or sale.** Generally, any tax paid in connection with the purchase or sale of property must be treated as part of the cost basis of the property or, in the case of a sale, as a reduction in the amount realized. But if the cost of the property is deductible as a business expense, such as the cost of supplies, any tax you paid is deductible as part of the business expense.

**Tolls** for bridges and roads, and parking fees.

**Utility taxes and fuel adjustment charges.**

**Water bills,** sewer, and other service charges.

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## Taxes and Fees You Cannot Deduct

You cannot deduct any tax or fee unless it is in one of the categories of taxes that are specifically allowable as a deduction. The categories include:

- State, local, or foreign income or real estate taxes,
- State or local personal property taxes, or
- Expenses of a business or income-producing activity.

These categories are all discussed earlier in this chapter.

Many federal, state, and local government taxes are not deductible because they do not fall within the categories listed above. (Examples are sales taxes and excise taxes that are treated as part of the cost of personal-use property.) Other taxes and fees are not deductible because they are specifically denied a deduction. (Examples are federal income taxes and employee social security taxes that are personal, nondeductible expenses.)

Listed next are certain taxes and fees that are generally not deductible.

Nondeductible taxes and fees include:

- **Estate, inheritance, legacy, or succession taxes.** These taxes are generally not deductible. However, you generally can

deduct the estate tax attributable to income in respect of a decedent if you must include that income in gross income. In that case, the estate tax can be deducted as a miscellaneous deduction that is not subject to the 2%-of-adjusted-gross-income limit. For more information, see *Estate Tax Deduction* in Publication 559, *Survivors, Executors, and Administrators*.

- **Federal income taxes**, including those withheld from your pay.
- **Fines** (such as for parking or speeding) and penalties for violation of any law, including forfeiture of related collateral deposits.
- **Gift taxes**.
- **License fees** for personal purposes (such as marriage, driver's, dog, etc.).
- **Social security**, Medicare, or railroad retirement taxes withheld from your pay.
- **Social security and other employment taxes for household workers**. You generally cannot deduct the social security or other employment taxes you pay on the wages of a household worker. However, you may be able to include them in medical or child care expenses. For more information, see Chapters 23 and 33.

Many taxes and fees other than those listed above are also nondeductible, unless

they are ordinary and necessary expenses of a business or income-producing activity. For other nondeductible items, see *Real Estate Items You Cannot Deduct*, earlier.

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## Where To Deduct

You deduct taxes on the following schedules:

**State and local income taxes.** These taxes are deducted on line 5 of Schedule A (Form 1040), even if your only source of income is from business, rents, or royalties.

**Foreign income taxes.** Generally, income taxes you pay to a foreign country or U.S. possession can be claimed as an itemized deduction on line 8 of Schedule A (Form 1040), or as a credit against your U.S. income tax on Form 1116. For more information, get Publication 514.

**Real estate taxes and personal property taxes.** These taxes are deducted on lines 6 and 7 of Schedule A (Form 1040), unless they are paid on property used in your business or on property that produces rent or royalty income. See *Business taxes*, next, and *Taxes on property producing rent or royalty income*, later.

**Business taxes.** Taxes that you must pay in operating your business, or on your property used in your business, are generally deducted on Schedule C or C-EZ (Form 1040) or Schedule F (Form 1040).

**Taxes that are employee business expenses.** Taxes you paid that are deductible as unreimbursed employee expenses are generally claimed on line 20 of Schedule A (Form 1040) as a miscellaneous itemized deduction subject to the 2%-of-adjusted-gross-income limit. If you also deduct certain other unreimbursed employee expenses or if you are reimbursed by your employer, you may also have to file Form 2106 or 2106-EZ. See the instructions for line 20 of Schedule A (Form 1040) for more information.

**Self-employment tax.** Deduct one-half of your self-employment tax on line 25, Form 1040.

**Taxes on property producing rent or royalty income.** These taxes generally are deducted on Schedule E (Form 1040).

**Other taxes.** All other deductible taxes are deducted on line 8 of Schedule A (Form 1040).

# Interest Expense

## Important Reminders

**Personal interest.** Personal interest is not deductible. Examples of personal interest include interest charged on credit cards, car loans, and installment plans.

**Limit on itemized deductions.** Certain itemized deductions (including home mortgage interest) are limited if your adjusted gross income is more than \$117,950 (\$58,975 if you are married filing a separate return). For more information, see Chapter 22.

**Points paid by seller.** You may be able to deduct points paid on your mortgage by the person who sold you your home. See *Points* later in this chapter.

## Introduction

This chapter discusses interest. Interest is the amount you pay for the use of borrowed money.

The types of interest you can deduct as itemized deductions on Schedule A (Form 1040) are:

- Home mortgage interest, including certain points, and
- Investment interest.

This chapter explains the deduction for home mortgage interest. It also explains where to deduct other types of interest and lists some types of interest you cannot deduct.

Use *Table 25–1* to find out where to get more information on other types of interest, including investment interest.

### Useful Items

You may want to see:

#### Publication

- 936** Home Mortgage Interest Deduction

#### Form (and Instructions)

- 8396** Mortgage Interest Credit

## Home Mortgage Interest

Generally, home mortgage interest is any interest you pay on a loan secured by your

home (main home or a second home). The loan may be a mortgage to buy your home, a second mortgage, a line of credit, or a home equity loan.

To deduct home mortgage interest, you must file Form 1040 and itemize deductions on Schedule A. Report your deductible home mortgage interest on lines 10–12 of Schedule A (Form 1040).

**Legally liable.** To deduct interest on a debt, you must be legally liable for that debt. You cannot deduct payments you make for someone else if you are not legally liable to make them. Both you and the lender must intend that the loan be repaid. In addition, there must be a true debtor-creditor relationship between you and the lender.

### Limit on the Deduction of Mortgage Interest

In most cases, you will be able to deduct all of your home mortgage interest. Whether you can deduct all of it depends on the date you took out the mortgage, the amount of the mortgage, and your use of its proceeds.

**Fully deductible interest.** If all of your mortgages fit into one or more of the following three categories at all times during the year, you can deduct ALL of the interest on those mortgages. If any one mortgage fits into more than one category, add the debt that fits in each category to your other debt in the same category. (If one or more of your mortgages does not fit into any of these three categories, get Publication 936 to figure the amount of interest you can deduct.)

- 1) Mortgages you took out on or before October 13, 1987 (called grandfathered debt).
- 2) Mortgages you took out after October 13, 1987, to buy, build, or improve your home (called home acquisition debt), but only if these mortgages plus any grandfathered debt totaled \$1 million or less (\$500,000 or less if married filing separately) throughout 1996.
- 3) Mortgages you took out after October 13, 1987, other than to buy, build, or improve your home (called home equity debt), but only if throughout 1996 these mortgages totaled \$100,000 or less (\$50,000 or less if married filing separately) and all mortgages on the home totaled no more than its fair market value.

The dollar limits for the second and third categories apply to the combined mortgages on your main home and second home.

**Note.** You cannot deduct the interest in (1) or (3) above if you used the proceeds of the mortgage to purchase securities or certificates that produce tax-free income.

You can use *Figure 25–A* to check whether your interest is fully deductible.

## Which Category Your Mortgage Fits In

This section further discusses which of the three categories of mortgage (grandfathered debt, home acquisition debt, or home equity debt) your mortgage fits in. Remember that grandfathered mortgages were taken out on or before October 13, 1987, and that home acquisition and home equity mortgages were taken out after October 13, 1987.

**Refinanced grandfathered debt.** If you refinanced grandfathered debt after October 13, 1987, for an amount that was not more than the mortgage principal left on the debt, then you still treat it as grandfathered debt. To the extent the new debt is more than that mortgage principal, it is treated as home acquisition or home equity debt, and the mortgage is a mixed-use mortgage (discussed later). The debt must be secured by the qualified home.

You treat grandfathered debt that was refinanced after October 13, 1987, as grandfathered debt only for the term left on the debt that was refinanced. After that, you treat it as home acquisition debt or home equity debt, depending on how you used the proceeds.

**Exception.** If the debt before refinancing was like a balloon note (the principal on the debt was not amortized over the term of the debt), then you treat the refinanced debt as grandfathered debt for the term of the first refinancing. This term cannot be more than 30 years.

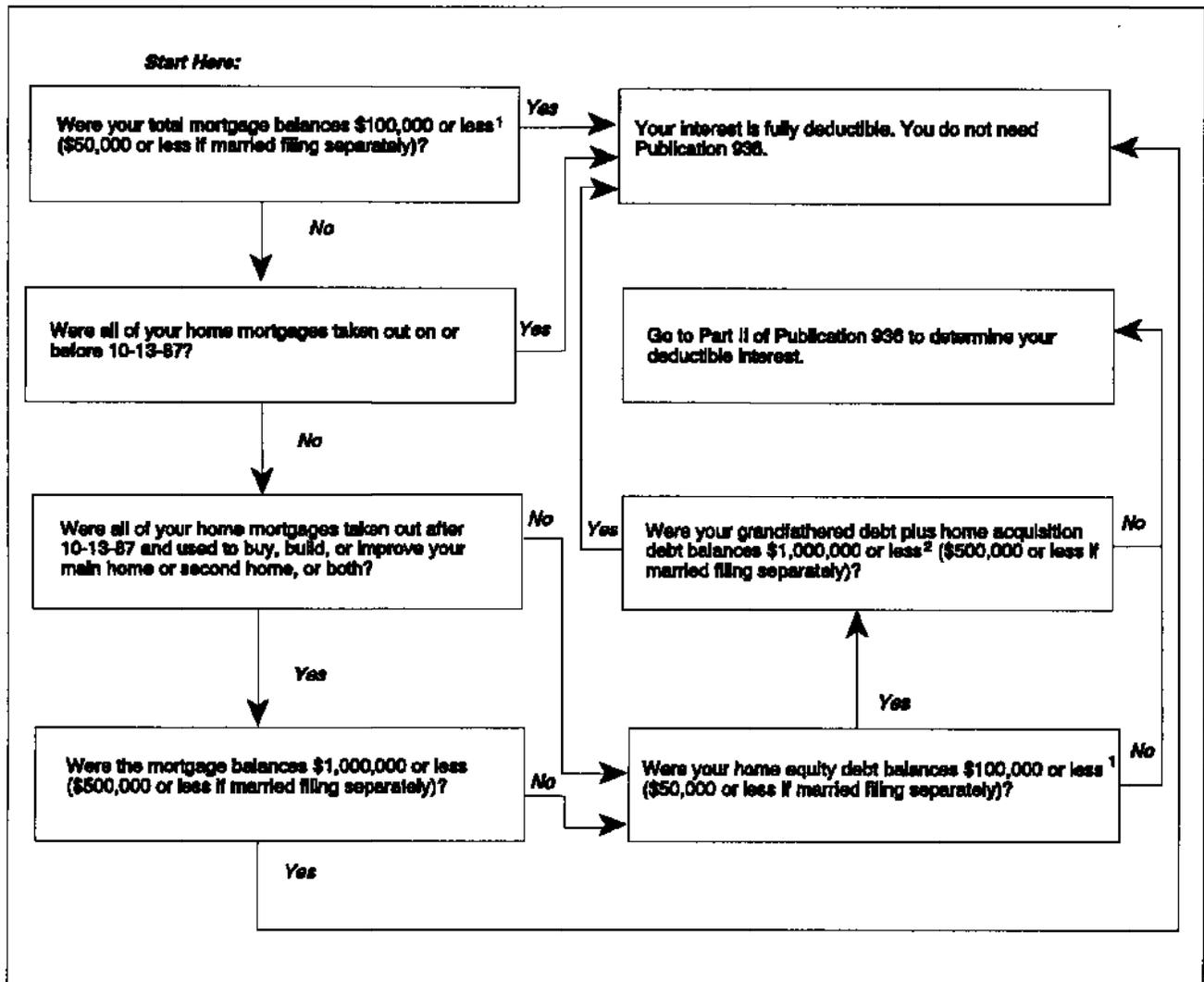
**Example.** Chester took out a \$200,000 first mortgage on his home in 1985. The mortgage was a 5-year balloon note and the entire balance on the note was due in 1990. Chester refinanced the debt in 1990 with a new 20-year mortgage. The refinanced debt is treated as grandfathered debt for its entire term (20 years).

**Line-of-credit mortgage.** If you had a line-of-credit mortgage on October 13, 1987, and borrowed additional amounts against it after that date, then the additional amounts are either home acquisition debt or home equity debt depending on how you used the proceeds. This is also considered a mixed-use mortgage. The balance on the mortgage before you borrowed the additional amounts is grandfathered debt. The newly borrowed amounts are not grandfathered debt because the funds were borrowed after October 13, 1987.

**Mixed-use mortgages.** A mixed-use mortgage is a loan that consists of more than one of the three categories of debt (grandfathered debt, home acquisition debt, and home equity debt). If the total amount of your mixed-use mortgage plus your other home mortgages is more than the loan limits discussed earlier under *Limit on the Deduction of Mortgage Interest*, be sure to get Publication 936.

## Figure 25-A. Is My Interest Fully Deductible?

(Instructions: include balances of ALL mortgages secured by your main home and second home. Answer YES only if the answer is true at ALL times during the year.)



<sup>1</sup> If all mortgages on your main or second home exceed the home's fair market value, a lower limit may apply. See *Home equity debt limit* under *Home Equity Debt* in Part II of Publication 936.

<sup>2</sup> Amounts over the \$1,000,000 limit (\$500,000 if married filing separately) qualify as home equity debt if they are not more than the total home equity debt limit. See Publication 936 for more information about grandfathered debt, home acquisition debt, and home equity debt.

**More than one home.** If you had a main home and a second home, the home acquisition and home equity debt dollar limits explained earlier apply to the total mortgages on both homes. Your main home is the property you live in most of the time. It may be a house, condominium, cooperative, mobile home, boat, or similar property that has sleeping, toilet, and cooking facilities. Your second home is similar property that you select to be your second home.

### Special Situations

This section describes certain items that can be included as home mortgage interest and others that cannot. It also describes certain special situations that may affect your deduction.

**Late payment charge on mortgage payment.** You can deduct as home mortgage interest a late payment charge if it was not for a specific service performed by your mortgage holder.

**Mortgage prepayment penalty.** If you pay off your qualified home mortgage early, you may have to pay a penalty. You can deduct that penalty as home mortgage interest.

**Sale of home.** If you sell your home, you can deduct your allowable home mortgage interest paid up to, but not including, the date of sale.

**Example.** John and Peggy Harris sold their home on May 7. Through April 30, they made home mortgage interest payments of \$1,220. The settlement sheet for the sale of

the home showed \$50 interest for the 6-day period in May up to, but not including, the date of sale. Their mortgage interest deduction is \$1,270 (\$1,220 + \$50).

**Prepaid interest.** If you pay interest in advance for a period that goes beyond the end of the tax year, you must spread this interest over the tax years to which it applies. You can deduct in each year only the interest that qualifies as home mortgage interest for that year. However, see *Points*, later.

**Mortgage interest credit.** You may be able to claim a mortgage interest credit if you were issued a mortgage credit certificate (MCC) by a state or local government. Figure the credit on **Form 8396, Mortgage Interest**

**Credit.** If you take this credit, you must reduce your mortgage interest deduction by the amount of the credit.

For information on how to figure the credit, see Chapter 36.

**Ministers' and military housing allowance.** If you are a minister or a member of the uniformed services and receive a housing allowance that is not taxable, you can still deduct all of the deductible interest on your home mortgage.

**Graduated payment mortgages (GPM).** GPMs under section 245 of the National Housing Act provide that monthly payments increase every year for a number of years and then stay the same. During the early years, payments are less than the amount of interest owed on the loan. The interest that is not paid becomes part of the principal. Future interest is figured on the increased unpaid mortgage loan balance.

Subject to any limits that apply, you can deduct the interest you actually paid during the year if you are a cash method taxpayer. For example, if the interest owed is \$2,551 but your payment for the year is \$2,517, you can deduct \$2,517. Add \$34 to the loan principal.

**Mortgage assistance payments.** If you qualify for mortgage assistance payments under section 235 of the National Housing Act, part or all of the interest on your mortgage may be paid for you. You cannot deduct the interest that is paid for you. Do not include these payments in your income. These payments do not reduce other deductions, such as taxes.

**Divorced or separated individuals.** If a divorce or separation agreement requires you or your spouse or former spouse to pay home mortgage interest on a home owned by both of you, see the discussion of *Payments for jointly-owned home* in Chapter 20.

**Redeemable ground rents.** If you make annual or periodic rental payments on a redeemable ground rent, you can deduct them as mortgage interest.

Payments made to end the lease and to buy the lessor's entire interest in the land are not ground rents. You cannot deduct them. For more information, see Publication 936.

**Nonredeemable ground rent.** Payments on a nonredeemable ground rent are not interest. You can deduct them as rent if they are a business expense or if they are for rental property held to produce income.

**Refunds of interest.** If you receive a refund of interest in the same tax year you paid it, you must reduce your interest expense by the amount refunded to you. If you receive a refund of interest you deducted in an earlier year, you generally must include the refund in income in the year you receive it. But you need to include it only up to the amount of the deduction that reduced your tax in the earlier year.

If you received a refund of interest you overpaid in an earlier year, you generally will receive a Form 1098, *Mortgage Interest Statement*, showing the refund in box 3. For information about Form 1098, see *Mortgage Interest Statement*, later.

For more information on how to treat refunds of interest deducted in earlier years, see *Recoveries* in Chapter 13.

**Rental payments.** If you live in a house before your final settlement, any payments you make for that period are rent, not interest, even if the settlement papers call them interest. You cannot deduct these payments.

**Reverse mortgage loans.** A reverse mortgage loan is a loan that is based on the value of your home and is secured by a mortgage on your home. The lending institution pays you the proceeds of the loan in installments over a period of months or years. The loan agreement may provide that interest will be added to the outstanding loan balance monthly as it accrues. If you are a cash method taxpayer, you deduct the interest on a reverse mortgage loan when you actually pay it, not when it is added to the outstanding loan balance.

Your deduction may be limited because a reverse mortgage loan generally is subject to the limit on *Home Equity Debt* discussed in *Part II* of Publication 936.

## Points

The term "points" is used to describe certain charges paid, or treated as paid, by a borrower to obtain a home mortgage. Points may also be called loan origination fees, maximum loan charges, loan discount, or discount points.

A borrower is treated as paying any points that a home seller pays for the borrower's mortgage. See *Points paid by a seller*, later.

**General rule.** You cannot deduct the full amount of points in the year paid. Because they are prepaid interest, you must spread the points over the life (term) of the mortgage. Generally, you can deduct an equal portion in each year of the mortgage.

**Exception.** You can fully deduct in 1996 the amount paid on your loan as points if all the following are true.

- 1) Your loan is secured by your main home. (Your main home is the one you live in most of the time.)
- 2) Paying points is an established business practice in the area where the loan was made.
- 3) The points paid were not more than the points generally charged in that area.
- 4) You use the cash method of accounting. This means you report income in the year you receive it and deduct expenses in the year you pay them. (If you want more information about this

method, see *Accounting Methods* in Chapter 1.)

- 5) You use your loan to buy or build your main home.
- 6) The points were computed as a percentage of the principal amount of the mortgage.
- 7) The points were not paid in place of amounts that ordinarily are stated separately on the settlement statement, such as appraisal fees, inspection fees, title fees, attorney fees, and property taxes.
- 8) The amount is clearly shown on the settlement statement ( for example, Form HUD-1) as points charged for the mortgage. The points may be shown as paid from either your funds or the seller's.
- 9) The funds you provided at or before closing, plus any points the seller paid, were at least as much as the points charged. The funds you provided do not have to have been applied to the points. They can include a down payment, an escrow deposit, earnest money, and other funds you paid at or before closing for any purpose. You cannot have borrowed these funds from your lender or mortgage broker.

You can also fully deduct in 1996 points paid on a loan to improve our main home, if statements (1) through (4) above are true.

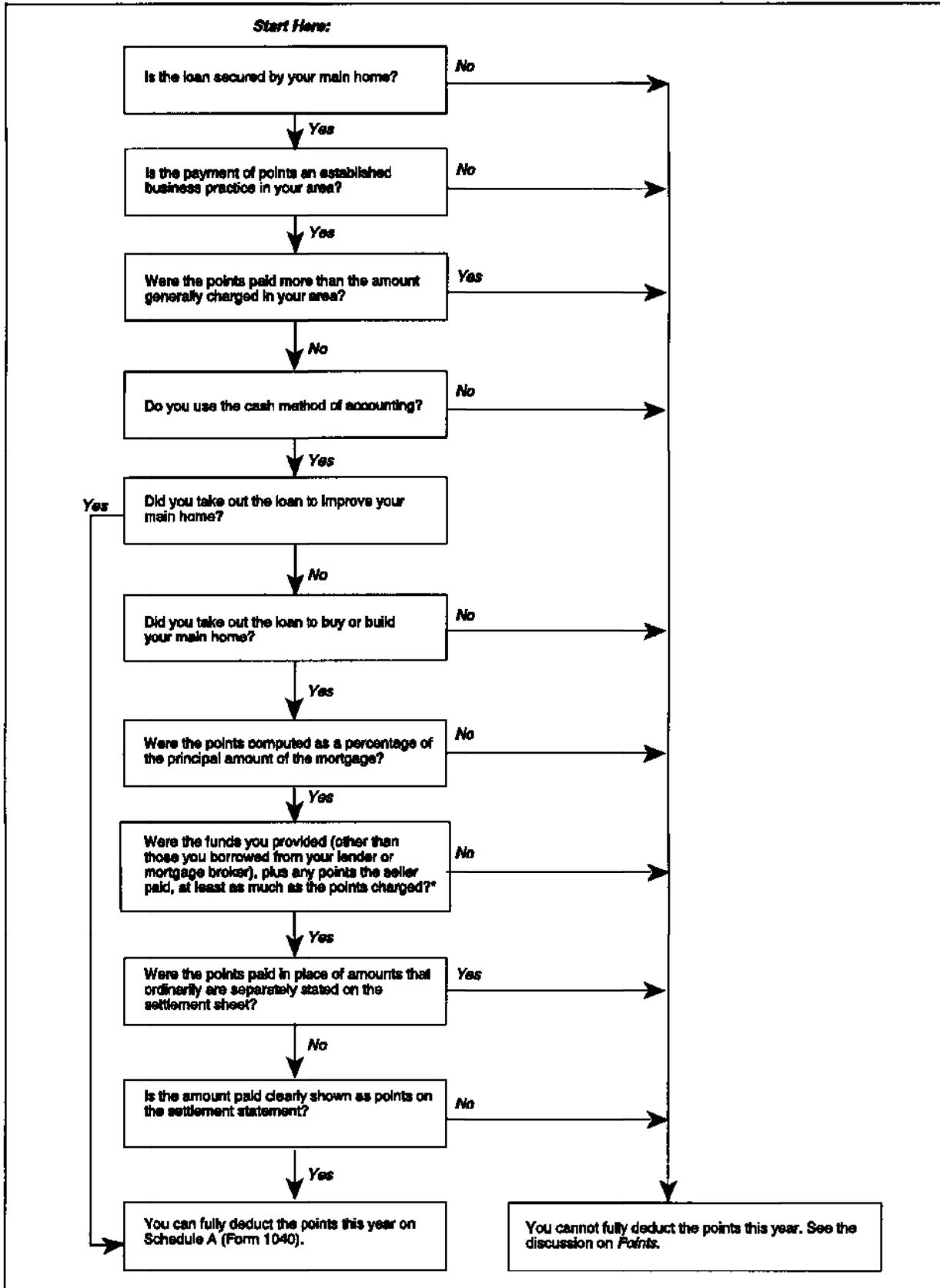
**Amounts charged for services.** Amounts charged by the lender for specific services connected to the loan are not interest. Examples are appraisal fees, notary fees, and preparation costs for the mortgage note or deed of trust. You cannot deduct these amounts as points under either the *General rule* or the *Exception*. For information about the tax treatment of these amounts and other settlement fees and closing costs, see Chapter 14.

However, an amount shown on your settlement statement as points may be deductible under the *Exception* to the *General rule*, even if it is for services in connection with your mortgage (whether VA, FHA, or conventional). The services must not be any of the specific services for which a charge ordinarily is stated separately on the settlement statement, as described in test (7) of the *Exception*. The other tests under the *Exception* also must be met.

**Points paid by a seller.** The term "points" includes loan placement fees that the seller pays to the lender to arrange financing for the buyer. The seller **cannot** deduct these fees as interest. But they are a selling expense that reduces the seller's amount realized. See Chapter 16 for information on how to treat the expenses of selling your home.

The buyer reduces the basis of the home by the amount of the seller-paid points and treats the points as if he or she had paid them. If all the tests under the *Exception* are met, the buyer deducts the points in the year

**Figure 25-B. Are My Points Fully Deductible This Year?**



\*The funds you provided do not have to have been applied to the points. They can include a down payment, an escrow deposit, earnest money, and other funds you paid at or before closing for any purposes.

paid. If any of those tests is not met, the buyer deducts the points over the life of the loan.

For information about basis, see Chapter 14.

**Funds provided are less than points.** If you meet all the tests in the *Exception* except that the funds you provided were less than the points charged to you, you can deduct the points in the year paid up to the amount of funds you provided. In addition, you can deduct any points paid by the seller.

**Example 1.** When you took out a \$100,000 mortgage loan to buy your home in December 1996, you were charged one point (\$1,000). You meet all the tests for deducting points in the *Exception*, except the only funds you provided were a \$750 down payment. Of the \$1,000 charged for points, you can deduct \$750 in 1996.

**Example 2.** The facts are the same as in Example 1, except that the person who sold you your home also paid one point (\$1,000) to help you get your mortgage. In 1996, you can deduct \$1,750 (\$750 of the amount you were charged plus the \$1,000 paid by the seller). You must reduce the basis of your home by the \$1,000 paid by the seller.

**Excess points.** If you meet all the tests in the *Exception* except that the points paid were more than are generally paid in your area, your deduction in 1996 is limited to the points generally charged. Any additional amount of points paid is interest paid in advance, and the deduction must be spread over the life of the mortgage.

**Second home.** The *Exception* does not apply to points you pay on loans secured by your second home. You can deduct these points only over the life of the loan.

**Mortgage ending early.** If you spread your deduction for points over the life of the mortgage, you can deduct any remaining balance in the year the mortgage ends. A mortgage may end early due to a prepayment, refinancing, foreclosure, or similar event.

**Example.** Dan refinanced his mortgage in 1991 and paid \$3,000 in points that he had to spread out over the life of the mortgage. He had deducted \$1,000 of these points through 1995.

Dan prepaid his mortgage in full in 1996. He can deduct the remaining \$2,000 of points in 1996.

**Refinancing.** Generally, points you pay to refinance a mortgage are not deductible in full in the year you pay them. This is true even if the new mortgage is secured by your main home. However, if you use part of the refinanced mortgage proceeds to **improve your main home** and you meet the first four tests listed under the *Exception*, earlier, you can fully deduct the part of the points related to the improvement in the year paid. You can deduct the remainder of the points over the life of the loan.

For more information on refinancing, see Publication 936.

**Limits on deduction.** You cannot fully deduct points on a mortgage that exceeds the *Limit on the Deduction of Mortgage Interest* discussed earlier. See Publication 936 for details.

## Mortgage Interest Statement

If you paid \$600 or more of mortgage interest (including certain points) during the year on any one mortgage, you generally will receive a **Form 1098, Mortgage Interest Statement**, or a similar statement. You will receive the statement if you pay interest to a person (including a financial institution or a cooperative housing corporation) in the course of that person's trade or business. A governmental unit is a person for purposes of furnishing the statement.

You should receive the statement by January 31, 1997. The mortgage interest information will also be sent to the IRS.

The statement will show the total interest you paid during the year. If you purchased a main home during 1996, it will also show the deductible points paid during the year, including seller-paid points. However, it should not show any interest that was paid for you by a government agency.

As a general rule, Form 1098 will not include points that you cannot fully deduct in the year paid. However, certain points not included on Form 1098 may be deductible, either in the year paid or over the life of the loan. See *Points*, earlier, to determine whether you can deduct points not shown on Form 1098.

**Prepaid interest on Form 1098.** If you prepaid interest in 1996 that accrued in full by January 15, 1997, this prepaid interest may be included in box 1 of Form 1098. However, even though the prepaid amount may be included in box 1, you cannot deduct the prepaid amount in 1996. (See *Prepaid interest*, earlier.) You will have to figure the interest that accrued for 1997 and subtract it from the amount in box 1. You will include the interest for 1997 with the other interest you pay for 1997. See *Where To Deduct*, later.

**More than one borrower.** If you and at least one other person (other than your spouse if you file a joint return) were liable for, and paid, interest on a mortgage that was for your home and the other person received a Form 1098 showing the interest that was paid during the year, attach a statement to your return explaining this. Show how much of the interest each of you paid, and give the name and address of the person who received the form. Deduct your share of the interest on line 11, Schedule A, and write "See attached."

If you are the payer of record on a mortgage on which there are other borrowers entitled to a deduction for the interest shown

on the Form 1098 you received, deduct only your share of the interest on line 10, Schedule A. You should tell each of the other borrowers what their share is.

**Refunded interest.** If you received a refund of interest you overpaid in an earlier year, you generally will receive a Form 1098 showing the refund in box 3. See *Refunds of interest*, earlier.

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## Items You Cannot Deduct

Some interest payments are not deductible. Certain expenses similar to interest also are not deductible. These items include:

- Personal interest
- "Points" if you are a seller
- Nonredeemable ground rent
- Service charges (however, see *Other Expenses* in Chapter 30)
- Annual fees for credit cards
- Loan fees
- Credit investigation fees
- FHA mortgage insurance premiums and VA funding fees
- Interest relating to tax-exempt income
- Interest to purchase or carry tax-exempt securities
- Interest to purchase or carry certain straddle positions
- Premium due to the conversion feature of a convertible bond

**Penalties.** You cannot deduct fines and penalties for violations of law, regardless of their nature.

## Personal Interest

Personal interest is not deductible. Personal interest is any interest that is not home mortgage interest, investment interest, or business interest.

**Personal interest includes** such items as:

- Interest on car loans,
- Interest on income tax paid to the IRS or to a state or local tax agency,
- Installment plan interest,
- Credit card finance charges,
- Retail installment contract finance charges,
- Revolving charge account finance charges,
- Late payment charge by a public utility, and
- Interest on certain below-market loans (see Chapter 1 of Publication 550).

Table 25-1. **Where To Deduct Your Interest**

Type of interest	Where to deduct	Where to find information
Deductible home mortgage interest and points reported on Form 1098	Schedule A (Form 1040), line 10	Publication 936
Deductible home mortgage interest <i>not</i> reported on Form 1098	Schedule A (Form 1040), line 11	Publication 936
Points <i>not</i> reported on Form 1098	Schedule A (Form 1040), line 12	Publication 936
Investment interest (other than interest incurred to produce rents or royalties)	Schedule A (Form 1040), line 13	Publication 550
Business interest (non-farm)	Schedule C or C-EZ (Form 1040)	Publications 334 and 535
Farm business interest	Schedule F (Form 1040)	Publications 225 and 535
Interest incurred to produce rents or royalties	Schedule E (Form 1040)	Publications 527 and 535
Personal Interest	Not Deductible	

## Allocation of Interest

If you use the proceeds of a loan for more than one purpose (for example, personal and business), you must allocate the interest on the loan to each use. However, you do not have to allocate home mortgage interest if it is fully deductible regardless of how the funds are used.

You allocate interest (other than fully deductible home mortgage interest) on a loan in the same way as the loan itself is allocated. You do this by tracing disbursements of the debt to specific uses. For details on how to do this, see Chapter 8 of Publication 535.

## Where To Deduct

You must file Form 1040 to deduct any interest expense on your tax return. Where you deduct your interest expense generally depends on how you use the loan proceeds.

See *Table 25-1* for a summary of where to deduct your interest expense.

**Home mortgage interest and points.** Deduct the interest and points reported to you on Form 1098 on line 10 of Schedule A (Form 1040). If you paid more deductible interest to the financial institution than the amount shown on Form 1098, show the larger deductible amount on line 10. Attach a statement explaining the difference and write "See attached" next to line 10.

Deduct home mortgage interest that was *not* reported to you on Form 1098 on line 11 of Schedule A (Form 1040). If you paid home mortgage interest to the person from whom you bought your home, show that person's name, address, and taxpayer identification number (TIN) on the dotted lines next to line 11. The seller must give you this number and you must give the seller your TIN. Failure to meet any of these requirements may result

in a \$50 penalty for each failure. The TIN can be either a social security number, an individual taxpayer identification number (issued by the Internal Revenue Service), or an employer identification number. See *Social Security Number* in Chapter 1 for more information about TINs.

If you can take a deduction for points that were *not* reported to you on Form 1098, deduct those points on line 12 of Schedule A (Form 1040).

**Mortgage proceeds used for business or investment.** If your home mortgage interest deduction is limited by the *Limit on the Deduction of Mortgage Interest* explained earlier, but all or part of the mortgage proceeds were used for business or investment activities, see *Table 25-1*. It shows where to deduct the part of your excess interest that is for those activities.

**Investment interest.** Deduct investment interest, subject to certain limits discussed in Publication 550, on line 13, Schedule A (Form 1040).

**Amortization of bond premium.** There are various ways to treat the premium you pay to buy taxable bonds. See *Bond Premium Amortization* in Publication 550.

**Non-farm business interest.** Deduct interest on non-farm business loans on Schedule C or C-EZ (Form 1040).

**Farm business interest.** Deduct interest on farm business loans on Schedule F (Form 1040).

**Income-producing rental or royalty interest.** Deduct interest on a loan for income-producing rental or royalty property that is not used in your business in Part I of Schedule E (Form 1040).

**Example.** You rent out part of your home and borrow money to make repairs. You can deduct only the interest payment for the rented part in Part I of Schedule E (Form 1040). Deduct the rest of the interest payment on Schedule A (Form 1040) if it is deductible home mortgage interest.

# Contributions

## Important Reminders

**Disaster relief.** You can deduct contributions earmarked for “Earthquake Disaster Relief” or other disaster relief to a qualified organization (defined later under *Organizations That Qualify To Receive Deductible Contributions*). However, you cannot deduct contributions earmarked for relief of a particular individual or family.

**Written acknowledgement required.** You can claim a deduction for a contribution of \$250 or more only if you have a written acknowledgement of your contribution from the qualified organization. For more information, see *Records To Keep*, later in this chapter.

**Payment partly for goods or services.** A qualified organization that receives a payment from you must give you a written statement if the payment is more than \$75 and is partly a contribution and partly for goods or services. The statement must tell you that you can deduct only the amount of your payment that is more than the value of the goods or services you received. See *Contributions From Which You Benefit*, later in this chapter, for more information.

## Introduction

This chapter discusses:

- Organizations that are qualified to receive charitable contributions,
- The types of contributions you can deduct,
- How much you can deduct,
- What records to keep, and
- How to report your charitable contributions.

A **charitable contribution** is a donation or gift to, or for the use of, a qualified organization. It is voluntary and is made without getting, or expecting to get, anything of equal value.

To deduct a charitable contribution, you must file Form 1040 and itemize deductions on Schedule A. The amount of your deduction may be limited if certain rules and limits explained in this chapter apply to you.

## Useful Items

You may want to see:

### Publication

- 78** Cumulative List of Organizations
- 526** Charitable Contributions

- 561** Determining the Value of Donated Property

### Form (and Instructions)

- Schedule A (Form 1040)** Itemized Deductions
- 8283** Noncash Charitable Contributions

## Organizations That Qualify To Receive Deductible Contributions

You can deduct your contributions only if you make them to a **qualified organization**. To become a qualified organization, most organizations other than churches and governments, as described below, must apply to the IRS.



*You can ask any organization whether it is a qualified organization, and most will be able to tell you. Or you can check IRS Publication 78, which lists most qualified organizations. You may find Publication 78 in your local library's reference section. If not, you can call the IRS tax help telephone number for your area listed in your tax forms package to find out if an organization is qualified.*

## Types of Qualified Organizations

Generally, only the five following types of organizations can be qualified organizations:

- 1) **A community chest, corporation, trust, fund, or foundation** organized or created in or under the laws of the United States, any state, the District of Columbia, or any possession of the United States (including Puerto Rico). **It must be organized and operated only for:**
  - a) Charitable,
  - b) Religious,
  - c) Scientific,
  - d) Literary, or
  - e) Educational purposes, or
  - f) The prevention of cruelty to children or animals.

Certain organizations that foster national or international sports competition also qualify.

- 2) **War veterans' organizations**, including posts, auxiliaries, trusts, or foundations, organized in the United States or any of its possessions.
- 3) **Domestic fraternal societies**, orders, and associations operating under the lodge system.

**Note:** Your contribution to this type of organization is deductible only if it is to be used solely for charitable, religious, scientific, literary, or educational

purposes, or for the prevention of cruelty to children or animals.

- 4) **Certain nonprofit cemetery** companies or corporations.

**Note:** Your contribution is not deductible if it can be used for the care of a specific lot or mausoleum crypt.

- 5) **The United States or any state**, the District of Columbia, a U.S. possession (including Puerto Rico), a political subdivision of a state or U.S. possession, or an Indian tribal government or any of its subdivisions that perform substantial government functions.

**Note:** To be deductible, your contribution to this type of organization must be made solely for public purposes.

**Examples.** Qualified organizations include:

- Churches, a convention or association of churches, temples, synagogues, mosques, and other religious organizations. However, if such religious organizations were not organized in the United States or its possessions, they are not qualified organizations. There are exceptions for certain contributions to **Canadian** and **Mexican** charities discussed later.
- Most nonprofit charitable organizations such as the Red Cross and the United Way.
- Most nonprofit educational organizations, including the Girl (and Boy) Scouts of America, colleges, museums, and day care centers if substantially all the child care provided is to enable individuals (the parents) to be gainfully employed and the services are available to the general public. However, if your contribution is a substitute for tuition or other enrollment fee, it is not deductible as a charitable contribution, as explained later under *Contributions You Cannot Deduct*.
- Nonprofit hospitals and medical research organizations.
- Utility company emergency energy programs, if the utility company is an agent for a charitable organization that assists individuals with emergency energy needs.
- Nonprofit volunteer fire companies.
- Public parks and recreation facilities.
- Civil defense organizations.

**Canadian charities.** You may be able to deduct contributions to certain Canadian charitable organizations covered under an income tax treaty with Canada. To deduct your contribution to a Canadian charity, you must generally have income from sources in Canada. See Publication 597, *Information on the United States–Canada Income Tax Treaty*, for information on how to figure your deduction.

**Mexican charities.** You may be able to deduct contributions to certain Mexican charitable organizations under an income tax

treaty with Mexico. The organization must meet tests that are essentially the same as the tests that qualify U.S. organizations to receive deductible contributions. To deduct your contribution, you must have income from sources in Mexico. If you need more information, see Publication 526.

## Contributions You Can Deduct

Generally, you can deduct your contributions of money or property that you make to, or for the use of, a qualified organization. A gift or contribution is “for the use of” a qualified organization when it is held in a legally enforceable trust for the qualified organization or in a similar legal arrangement.

If you give property to a qualified organization, you generally can deduct the fair market value of the property at the time of the contribution. See *Contributions of Property*, later in this chapter.

Your deduction for charitable contributions is generally limited to 50% of your adjusted gross income, but in some cases 20% and 30% limits may apply. See *Limit on Deductions*, later.

Table 26-1 lists some examples of contributions you can deduct and some that you cannot deduct.

## Contributions From Which You Benefit

If you receive a benefit as a result of making a contribution to a qualified organization, you can **deduct only the amount** of your contribution **that is more than the value of the benefit** you receive. Also see *Contributions From Which You Benefit*, under *Contributions You Cannot Deduct*, later.

If you pay more than fair market value to a qualified organization for merchandise, goods, or services, the amount you pay that is more than the value of the item can be a charitable contribution. For the excess amount to qualify, you must pay it with the intent to make a charitable contribution.

**Example 1.** You pay \$65 for a ticket to a dinner-dance at a church. All of the proceeds of the function go to the church. The ticket to the dinner-dance has a fair market value of \$25. When you buy your ticket you know that its value is less than your payment. To figure the amount of your charitable contribution, you subtract the value of the benefit you received (\$25) from your total payment (\$65). You can deduct \$40 as a contribution to the church.

**Example 2.** At a fund-raising auction conducted by a charity, you pay \$600 for a week’s stay at a beach house. The amount you pay is no more than the fair rental value. You have not made a deductible charitable contribution.

**Athletic events.** If you make a payment to, or for the benefit of, a college or university and, as a result, you receive the right to buy

Table 26-1. Examples of Charitable Contributions—A Quick Check

Use the following lists for a <b>quick check</b> of contributions you can or cannot deduct. See the rest of this chapter for more information and additional rules and limits that may apply.	
<b>Deductible As Charitable Contributions</b>	<b>Not Deductible As Charitable Contributions</b>
<p>Money or property you give to:</p> <ul style="list-style-type: none"> <li>• Churches, synagogues, temples, mosques, and other religious organizations</li> <li>• Federal, state, and local governments, if your contribution is solely for public purposes (for example, a gift to reduce the public debt)</li> <li>• Nonprofit schools and hospitals</li> <li>• Public parks and recreation facilities</li> <li>• Salvation Army, Red Cross, CARE, Goodwill Industries, United Way, Boy Scouts, Girl Scouts, Boys and Girls Clubs of America, etc.</li> <li>• War veterans’ groups</li> </ul> <p>Costs you pay for a student living with you, sponsored by a qualified organization</p> <p>Out-of-pocket expenses when you serve a qualified organization as a volunteer</p>	<p>Money or property you give to:</p> <ul style="list-style-type: none"> <li>• Civic leagues, social and sports clubs, labor unions, and chambers of commerce</li> <li>• Foreign organizations (except certain Canadian and Mexican charities)</li> <li>• Groups that are run for personal profit</li> <li>• Groups whose purpose is to lobby for law changes</li> <li>• Homeowners’ associations</li> <li>• Individuals</li> <li>• Political groups or candidates for public office</li> </ul> <p>Cost of raffle, bingo, or lottery tickets</p> <p>Dues, fees, or bills paid to country clubs, lodges, fraternal orders, or similar groups</p> <p>Tuition</p> <p>Value of your time or services</p> <p>Value of blood given to a blood bank</p>

tickets to an athletic event in the athletic stadium of the college or university, you can deduct 80% of the payment as a charitable contribution.

If any part of your payment is for tickets (rather than the right to buy tickets), that part is not deductible. In that case, subtract the price of the tickets from your payment. 80% of the remaining amount is a charitable contribution.

**Example 1.** You pay \$300 a year for membership in an athletic scholarship program maintained by a university (a qualified organization). The only benefit of membership is that you have the right to buy one season ticket for a seat in a designated area of the stadium at the university’s home football games. You can deduct \$240 (80% of \$300) as a charitable contribution.

**Example 2.** The facts are the same as in Example 1 except that your \$300 payment included the purchase of one season ticket for the stated ticket price of \$120. You must subtract the usual price of a ticket (\$120) from your \$300 payment. The result is \$180. Your deductible charitable contribution is \$144 (80% of \$180).

**Charity benefit events.** If you pay a qualified organization more than fair market value for the right to attend a charity ball, banquet, show, sporting event, or other benefit event, you can deduct only the amount that is more than the value of the privileges or other benefits you receive.

If there is an established charge for the event, that charge is the value of your benefit. If there is no established charge, your contribution is that part of your payment that is more than the reasonable value of the right to attend the event. Whether you use the tickets or other privileges has no effect on the amount you can deduct. However, if you return the ticket to the qualified organization for resale, you can deduct the entire amount you paid for the ticket.

Even if the ticket or other evidence of payment indicates that the payment is a “contribution,” this does not necessarily mean you can deduct the entire amount. If the ticket shows the price of admission and the amount of the contribution, you can deduct the contribution amount.

**Example.** You pay \$40 to see a special showing of a movie for the benefit of a qualified organization. Printed on the ticket is "Contribution—\$40." If the regular price for the movie is \$8, your contribution is \$32 (\$40 payment – \$8 regular price).

**Membership fees or dues.** You may be able to deduct membership fees or dues you pay to a qualified organization. However, you can deduct only the amount that is more than the value of the benefits you receive. You cannot deduct dues, fees, or assessments paid to country clubs and other social organizations. They are not qualified organizations.

**Certain membership benefits can be disregarded.** Both you and the organization can disregard certain membership benefits when they are provided in return for an annual payment of \$75 or less to the qualified organization. You can pay more than \$75 to the organization, if the organization does not require a larger payment for you to receive the benefits. The benefits covered under this rule are:

- Any rights or privileges, other than those discussed under *Athletic events* earlier, that you can use frequently while you are a member, such as:
  - a) Free or discounted admission to the organization's facilities or events,
  - b) Free or discounted parking,
  - c) Preferred access to goods or services, and
  - d) Discounts on the purchase of goods and services;
- Admission, while you are a member, to events that are open only to members of the organization, if the organization reasonably projects that the cost per person (excluding any allocated overhead) is not more than \$6.70 (for 1996 events). This amount may be adjusted annually for inflation.

**Token items.** You can deduct your entire payment to a qualified organization as a charitable contribution, if both of the following are true:

- 1) You receive:
  - a) As a result of the payment, low-cost items such as bookmarks, calendars, mugs, or caps that have on them the organization's name or logo, or
  - b) A low-cost item that you did not order and can keep even if you do not make a contribution.
- 2) The qualified organization correctly informs you that the value of the item you received is not substantial and that you can deduct your payment in full.

**Written statement.** A qualified organization must give you a written statement if you make a payment to it that is more than \$75 and is partly a contribution and partly for goods or services. The statement must tell

you that you can deduct only the amount of your payment that is more than the value of the goods or services you received. It must also give you a good faith estimate of the value of those goods or services.

The organization can give you the statement either when it solicits or when it receives the payment from you.

An organization will not have to give you this statement if one of the following is true:

- 1) The organization is:
  - a) The type of organization described in (5) under *Types of Qualified Organizations*, earlier, or
  - b) Formed only for religious purposes, and the only benefit you receive is an intangible religious benefit (such as admission to a religious ceremony) that generally is not sold in commercial transactions outside the donative context.
- 2) You receive only low-cost items as described under *Token items*, earlier.

## Expenses Paid for Student Living With You

You may be able to deduct some expenses of having a student live with you. You can deduct **qualifying expenses** for a foreign or American student who:

- 1) Lives in your home under a written agreement between you and a **qualified organization** as part of a program of the organization to provide educational opportunities for the student,
- 2) Is not your dependent or relative, and
- 3) Is a full-time student in the twelfth or any lower grade at a school in the United States.

**You can deduct up to \$50 a month** for each full calendar month the student lives with you. Any month when conditions (1) through (3) above are met for 15 days or more counts as a full month.

**Mutual exchange program.** You cannot deduct the costs of a foreign student living in your home under a mutual exchange program through which your child will live with a family in a foreign country.

For additional information, see *Expenses Paid for Student Living With You* in Publication 526, *Charitable Contributions*.

## Out-of-Pocket Expenses in Giving Services

You may be able to deduct some amounts you pay in giving services to a qualified organization. The amounts must be:

- Unreimbursed,
- Directly connected with the services,

- Expenses you had only because of the services you gave, and
- Not personal, living, or family expenses.

Table 26–2 contains questions and answers that apply to some individuals who volunteer their services.

**Conventions.** If you are a **chosen representative** attending a convention of a qualified organization, you can deduct actual unreimbursed expenses for travel and transportation, including a reasonable amount for meals and lodging, while away from home overnight in connection with the convention. However, see *Travel*, later.

**You cannot deduct** personal expenses for sightseeing, fishing parties, theater tickets, or nightclubs. You also cannot deduct travel, meals and lodging, and other expenses for your spouse or children.

You cannot deduct your expenses in attending a church convention if you go only as a member of your church rather than as a chosen representative. You can deduct unreimbursed expenses that are directly connected with giving services for your church during the convention, but you cannot claim the cost of your evening at the theater.

**Uniforms.** You can deduct the cost and upkeep of uniforms that are not suitable for everyday use and that you must wear while performing donated services for a charitable organization.

**Foster parents.** You can deduct some of the costs of being a foster parent (foster care provider) if you have no profit motive in providing the foster care and are not, in fact, making a profit.

You can deduct expenses that are:

- 1) Greater than any nontaxable payments you receive to provide foster care for individuals placed in your home by a charitable organization, and
- 2) Spent to provide support for those individuals.

For more information, see *Foster-care providers* under *Income Not Taxed* in Chapter 13.

**Car expenses.** You can deduct unreimbursed out-of-pocket expenses, such as the cost of gas and oil, that are directly related to the use of your car in giving services to a charitable organization. You cannot deduct any part of general repair and maintenance expenses, depreciation, registration fees, or the costs of tires or insurance.

If you do not want to deduct your actual expenses, you can use a standard rate of **12 cents a mile** to figure your contribution.

You can deduct parking fees and tolls, whether you use your actual expenses or the standard rate.

You must keep reliable written records of your car expenses. For more information, see *Car Expenses* under *Records To Keep*, later.

**Table 26-2. Volunteers' Questions and Answers**

If you do volunteer work for a qualified organization, the following questions and answers may apply to you. All of the rules explained in this chapter also apply. See, in particular, <i>Out-of-Pocket Expenses in Giving Services</i> .	
Question	Answer
I do volunteer work 6 hours a week in the office of a qualified organization. The receptionist is paid \$6 an hour to do the same work I do. Can I deduct \$36 a week for my time?  The office is 30 miles from my home. Can I deduct any of my car expenses for these trips?	No, you cannot deduct the value of your time or services.  Yes, you can deduct the costs of gas and oil that are directly related to getting to the qualified organization where you are a volunteer. If you don't want to figure your actual costs, you can deduct 12 cents for each mile.
I am a Red Cross nurse's aide at a hospital. Can I deduct the cost of uniforms that I must wear?	Yes, you can deduct the cost of buying and cleaning your uniforms if the hospital is a qualified organization, the uniforms are not suitable for everyday use, and you must wear them when volunteering.
I pay a babysitter to watch my children while I do volunteer work for a qualified organization. Can I deduct these costs?	No, you cannot deduct payments for child care expenses as a charitable contribution, even if they are necessary so you can do volunteer work for a qualified organization. (If you have child care expenses so you can work for pay, see Chapter 33.)

**Travel.** Generally, you can claim a charitable contribution deduction for travel expenses necessarily incurred while you are away from home performing services for a charitable organization only **if there is no significant element of** personal pleasure, recreation, or vacation in such travel. This applies whether you pay the expenses directly or indirectly. You are paying the expenses indirectly if you make a payment to the charitable organization and the organization pays for your travel expenses.

The deduction for travel expenses will not be denied simply because you enjoy providing services to the charitable organization. Even if you enjoy the trip, you can take a charitable contribution deduction for your own travel expenses if you are on duty in a genuine and substantial sense throughout the trip. However, if you have only nominal duties relating to the performance of services for the charity, or for significant portions of the trip you are not required to render services, you cannot deduct your travel expenses.

**Example 1.** You are a troop leader for a tax-exempt youth group and take the group on a camping trip. You are responsible for overseeing the setup of the camp and for providing the adult supervision for the other activities during the entire trip. You participate in the activities of the group and really enjoy your time with them. You oversee the breaking of camp and you transport the group home. You can deduct your travel expenses.

**Example 2.** You sail from one island to another and spend 8 hours a day counting whales and other forms of marine life. The project is sponsored by a charitable organization. In most circumstances, you cannot deduct your expenses.

**Example 3.** You work for several hours each morning on an archaeological excavation sponsored by a charitable organization. The rest of the day is free for recreation and sightseeing. You cannot take a charitable

contribution deduction even though you work very hard during those few hours.

**Example 4.** You spend the entire day attending a charitable organization's regional meeting as a chosen representative. In the evening you go to the theater. You can claim your travel expenses as charitable contributions, but you cannot claim the cost of your evening at the theater.

**Daily allowance (per diem).** If you provide services for a charitable organization and receive a daily allowance to cover reasonable travel expenses, including meals and lodging while away from home overnight, include in income the amount that is more than your actual travel expenses. You can deduct your necessary travel expenses that are more than the allowance.

**Deductible travel expenses.** These include:

- Air, rail, and bus transportation,
- Out-of-pocket expenses for your car,
- Taxi fares or other costs of transportation between the airport or station and your hotel,
- Lodging costs, and
- The cost of meals.

Because these travel expenses are not business-related, they are not subject to the same limits business-related expenses are. For information on business travel expenses, see *Travel Expenses* in Chapter 28.

## Contributions You Cannot Deduct

There are some contributions that you cannot deduct, such as those made to individuals (See *Contributions to Individuals*, next.) and those made to nonqualified organizations (See *Contributions to Nonqualified Organizations*, later.). There are others that you can deduct only part of as discussed later

under *Contributions From Which You Benefit*.

## Contributions To Individuals

You cannot deduct contributions to specific individuals, including:

- Contributions to fraternal societies made for the purpose of paying medical or burial expenses of **deceased members**.
- Contributions to **individuals who are needy or worthy**. This includes contributions to a qualified organization if you indicate that your contribution is for a specific person. **But** you can deduct a contribution that you give to a qualified organization that in turn helps needy or worthy individuals if you do not indicate that your contribution is for a specific person.
- Payments to **a member of the clergy** that can be spent as he or she wishes, such as for personal expenses.
- Expenses you paid **for another person** who provided services to a qualified organization.
 

**Example.** Your son does missionary work. You pay his expenses. You cannot claim a deduction for your son's unreimbursed expenses related to his contribution of services.
- Payments to a hospital that are for services for **a specific patient** or for a specific patient's care. You cannot deduct these payments even if the hospital is operated by a city, a state, or other qualified organization.

## Contributions To Nonqualified Organizations

You cannot deduct contributions to organizations that are not qualified to receive tax-deductible contributions, including:

- **Certain state bar associations**, if:
  - a) The state bar is not a political subdivision of a state,
  - b) The bar has private, as well as public, purposes, such as promoting the professional interests of members, and
  - c) Your contribution is unrestricted and can be used for private purposes.
- **Chambers of commerce** and other business leagues or organizations.
- **Civic leagues and associations.**
- **Communist organizations.**
- **Country clubs** and other social clubs.
- **Foreign organizations.** But you can deduct contributions you make to:
  - a) A U.S. organization that transfers funds to a charitable foreign organization if the U.S. organization controls the use of the funds, or if the foreign organization is only an administrative arm of the U.S. organization, or
  - b) Certain Canadian or Mexican charitable organizations. See *Canadian charities* and *Mexican charities* under *Organizations That Qualify To Receive Deductible Contributions*, earlier.
- **Homeowners' associations.**
- **Labor unions.** (But you may be able to deduct union dues as a miscellaneous itemized deduction, subject to the 2% of adjusted gross income limit, on Schedule A (Form 1040). See Chapter 30.)
- **Political organizations and candidates.**

## Contributions From Which You Benefit

If you receive or expect to receive a financial or economic benefit as a result of making a contribution to a qualified organization, you cannot deduct the part of the contribution that represents the value of the benefit you receive. See *Contributions From Which You Benefit* under *Contributions You Can Deduct*, earlier. These contributions include:

- Contributions for **lobbying**. This includes amounts that you earmark for use in or in connection with influencing specific legislation.
- Contributions to a **retirement home** that are clearly for room, board, maintenance, or admittance. Also, if the amount of your contribution depends on the type or size of apartment you will occupy, it is not a charitable contribution.
- Costs of **raffles, bingo, lottery, etc.** You cannot deduct as a charitable contribution amounts you pay to buy raffle or lottery tickets or to play bingo or other games of chance. For more information on how to report gambling winnings and losses, see *Gambling Losses Up To the Amount of Gambling Winnings* in Chapter 30.
- Dues to **fraternal orders** and similar groups. However, see *Membership fees*

or dues earlier under *Contributions From Which You Benefit*.

- **Tuition**, or amounts you pay instead of tuition, even if you pay them for children to attend parochial schools or qualifying nonprofit day care centers. You also cannot deduct any fixed amount you may be required to pay in addition to the tuition fee to enroll in a private school, even if it is designated as a "donation."

## Value of Time or Services

You cannot deduct the value of your time or services, including:

- **Blood donations** to the Red Cross or to blood banks.
- **The value of income lost** while you work as an unpaid volunteer for a qualified organization.

## Personal Expenses

You cannot deduct personal, living, or family expenses, such as:

- **The cost of meals** you eat while you perform services for a qualified organization, unless it is necessary for you to be away from home overnight while performing the services.
- **Adoption expenses**, including fees paid to an adoption agency and the costs of keeping a child in your home before adoption is final. However, you may be able to claim an exemption for the child. See *Adoption* in Chapter 3.

## Appraisal Fees

Fees that you pay to find the fair market value of donated property are not deductible as contributions. You can claim them, subject to the 2% of adjusted gross income limit, as miscellaneous deductions on Schedule A (Form 1040). See Chapter 30.

## Contributions of Property

If you contribute property to a qualified organization, the amount of your charitable contribution is generally the fair market value of the property at the time of the contribution. However, if the property has increased in value, you may have to make some adjustments to the amount of your deduction. See *Giving Property That Has Increased in Value*, later.

For information about the records you must keep and the information you must furnish with your return if you donate property, see *Records To Keep and How To Report*, later.

**Partial interest in property.** Generally, you cannot deduct a charitable contribution, not made by a transfer in trust, of less than your entire interest in property. A contribution of

the right to use property, not made by a transfer in trust, is a contribution of less than your entire interest in that property and is not deductible. For exceptions and more information, see *Partial Interest in Property Not in Trust* in Publication 561.

**Future interests in tangible personal property.** You can deduct the value of a charitable contribution of a future interest in tangible personal property only after all intervening interests in and rights to the actual possession or enjoyment of the property have either expired or been turned over to someone other than yourself, a related person, or a related organization.

**Future interest.** A future interest is any interest that is to begin at some future time, regardless of whether it is designated as a future interest under state law.

## Determining Fair Market Value

This section discusses general guidelines for determining the fair market value of various types of donated property. Fair market value is the price at which property would change hands between a willing buyer and a willing seller, neither having to buy or sell, and both having reasonable knowledge of all the relevant facts. Publication 561, *Determining the Value of Donated Property*, contains a more complete discussion.

### Used clothing and household goods.

Generally, the fair market value of used clothing and household goods is far less than its original cost.

For used clothing, you should claim as the value the price that buyers of used items actually pay in used clothing stores, such as consignment or thrift shops.

See *Household Goods* in Publication 561 for information on the valuation of household goods, such as furniture, appliances, and linens.

**Cars, boats, and aircraft.** If you contribute a car, boat, or aircraft, you must determine its fair market value.

Certain commercial firms and trade organizations publish guides, commonly called "blue books," containing complete dealer sale prices or dealer average prices for recent model years. The guides may be published monthly or seasonally, and for different regions of the country. These guides also provide estimates for adjusting for unusual equipment, unusual mileage, and physical condition. The prices are not "official" and these publications are not considered an appraisal of any specific donated property. But they do provide clues for making an appraisal and suggest relative prices for comparison with current sales and offerings in your area.

**Example.** You donate your car to a local high school for use by their students studying automobile repair. Your credit union told you that the "blue book" value of the car is \$1,600. However, your car needs extensive

repairs and, after some checking, you find that you could sell it for \$750. You can deduct \$750, the **true** fair market value of the car, as a charitable contribution.

**Large quantities.** If you contribute a large number of the same item, fair market value is the price at which comparable numbers of the item are being sold.

## Giving Property That Has Decreased in Value

If you contribute property with a fair market value that is less than your basis in it, your deduction is limited to fair market value. You cannot claim a deduction for the difference between the property's basis and its fair market value.

## Giving Property That Has Increased in Value

If you contribute property with a fair market value that is more than your basis in it, you may have to reduce the fair market value by the amount of appreciation (increase in value) when you figure your deduction.

Your "basis" in property is generally what you paid for it. See Chapter 14 if you need more information about basis.

Different rules apply to figuring your deduction, depending on whether the property is:

- 1) Ordinary income property, or
- 2) Capital gain property.

**Ordinary income property.** Property is ordinary income property if its sale at fair market value on the date it was contributed would have resulted in ordinary income or in short-term capital gain. Examples of ordinary income property are inventory, works of art created by the donor, manuscripts prepared by the donor, and capital assets held one year or less.

The amount you can deduct for a contribution of ordinary income property is its fair market value less the amount that would be ordinary income or short-term capital gain if you sold the property for its fair market value. Generally, this rule limits the deduction to your basis in the property.

**Example.** You donate stock that you held for 5 months to your church. The fair market value of the stock on the day you donate it is \$1,000, but you paid only \$800 (your basis). Because the \$200 of appreciation would be short-term capital gain if you sold the stock, your deduction is limited to \$800 (fair market value less the appreciation).

**Capital gain property.** Property is capital gain property if its sale at fair market value on the date of the contribution would have resulted in long-term capital gain. It includes capital assets held more than one year, as well as certain real property and depreciable property used in your trade or business and, generally, held more than one year.

### Amount of deduction — general rule

When figuring your deduction for a gift of capital gain property, you usually can use the **fair market value** of the gift.

**Exceptions.** However, in certain situations, you must reduce the fair market value by any amount that would have been long-term capital gain if you had sold the property for its fair market value. Generally, this means reducing the fair market value to the property's cost or other basis.

**Bargain sales.** A bargain sale of property to a qualified organization (a sale or exchange for less than the property's fair market value) is partly a charitable contribution and partly a sale or exchange. A bargain sale may result in a taxable gain.

**For more information** on donated appreciated property, see *Giving Property That Has Increased in Value* in Publication 526.

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## When To Deduct

You can deduct your contributions only in the year you actually make them in cash or other property (or in a later carryover year, as explained later under *Carryovers*). This applies whether you use the cash or an accrual method of accounting.

Usually, you make a contribution at the time of its unconditional delivery. For example, a check that you mail to a charity is considered delivered on the date you mail it. Contributions charged on your bank credit card are deductible in the year you make the charge. If you use a pay-by-phone account, the date you make a contribution is the date the financial institution pays the amount. This date should be shown on the statement the financial institution sends to you.

The gift to a charity of a properly endorsed stock certificate is completed on the date of mailing or other delivery to the charity or to the charity's agent. However, if you give a stock certificate to your agent or to the issuing corporation for transfer to the name of the charity, your gift is not completed until the date the stock is transferred on the books of the corporation.

If you issue and deliver a promissory note to a charitable organization as a contribution, it is not a contribution until you make the note payments. Similarly, if you grant an option to buy real property at a bargain price to a charitable organization, you cannot take a deduction until the organization exercises the option.

If you make a contribution with borrowed funds, you can deduct the contribution in the year you make it, regardless of when you repay the loan.

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## Limit on Deductions

If your total contributions for the year are 20% or less of your adjusted gross income, you do not need to read this section. The limits discussed here do not apply to you.

The amount of your deduction may be limited to either **20%, 30%, or 50%** of your adjusted gross income, depending on the type of property you give and the type of organization you give it to. These limits are described below.

If your contributions are more than any of the limits that apply, see *How To Figure Your Deduction When Limits Apply*, in Publication 526.

### 50% Limit

This limit applies to the total of all charitable contributions you make during the year. This means that your deduction for charitable contributions cannot be more than 50% of your adjusted gross income for the year.

The 50% limit is the only limit that applies to gifts to organizations listed below under *50% limit organizations*. But there is one **exception**. The 30% limit also applies to such gifts if they are gifts of capital gain property for which you figure your deduction using fair market value without reduction for appreciation. (See *30% Limit*, later.)

**50% limit organizations.** You can ask any organization whether it is a 50% limit organization and most will be able to tell you. The following is a partial list of the types of organizations that are 50% limit organizations:

- 1) Churches, and conventions or associations of churches,
- 2) Educational organizations,
- 3) Hospitals and certain medical research organizations associated with these hospitals,
- 4) Publicly supported charities,
- 5) Private operating foundations,
- 6) Private nonoperating foundations that make qualifying distributions of 100% of contributions within 2½ months following the year they receive the contribution, and
- 7) Certain private foundations whose contributions are pooled in a common fund, the income and principal of which are paid to public charities.

### 30% Limit

This limit applies to:

- Gifts (other than capital gain property — see *20% Limit*, later) **for the use of** any organization, and
- Gifts (other than capital gain property — see *20% Limit*, later) to all qualified organizations other than 50% limit organizations (see *Capital gain property given to 50% limit organizations*, below). This includes gifts to veterans' organizations, fraternal societies, nonprofit cemeteries, and certain private nonoperating foundations.

**Capital gain property given to 50% limit organizations.** Generally, the 30% limit applies to gifts of capital gain property to 50%

limit organizations. For gifts to other organizations, see *20% Limit*, later.

**Exception.** There is one exception to this general rule. The 30% limit does not apply when you choose to reduce the fair market value of the property by the amount that would have been long-term capital gain if you had sold the property. Instead, only the 50% limit applies. For more information, see the rules for electing the 50% limit for capital gain property under *How To Figure Your Deduction When Limits Apply* in Publication 526.

## 20% Limit

This limit applies to all gifts of capital gain property to or for the use of qualified organizations other than gifts of capital gain property to 50% limit organizations.

## Carryovers.

You can carry over your contributions that you are not able to deduct in the current year because they exceed your adjusted gross income limits. You can deduct the excess in each of the next 5 years until it is used up, but not beyond that time. For more information, see *Carryovers* in Publication 526.

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## Records To Keep

You must keep records to prove the amount of the cash and noncash contributions you make during the year. The kind of records you must keep depends on the amount of your contributions and whether they are cash or noncash contributions.

**Note.** An organization generally must give you a written statement if it receives a payment from you that is more than \$75 and is partly a contribution and partly for goods or services. (See *Contributions From Which You Benefit* under *Contributions You Can Deduct*, earlier.) Keep the statement for your records. It may satisfy all or part of the recordkeeping requirements explained in the following discussions.

## Cash Contributions

Cash contributions include those paid by cash, check, credit card, or payroll deduction. They also include your out-of-pocket expenses when donating your services.

For a contribution made in cash, the records you must keep depend on whether the contribution is:

- 1) Less than \$250, or
- 2) \$250 or more.

## Contributions of Less Than \$250

For each cash contribution that is less than \$250, you must keep one of the following:

- 1) A canceled check, **or** a legible and readable account statement that shows:

- a) If payment was by check – the check number, amount, date posted, and to whom paid.
  - b) If payment was by electronic funds transfer – the amount, date posted, and to whom paid.
  - c) If payment was charged to a credit card – the amount, transaction date, and to whom paid.
- 2) A receipt (or a letter or other written communication) from the charitable organization showing the name of the organization, the date of the contribution, and the amount of the contribution.
  - 3) Other reliable written records that include the information described in (2). Records may be considered reliable if they were made at or near the time of the contribution, were regularly kept by you, or if, in the case of small donations, you have emblems, buttons, or other tokens that are regularly given to persons making small cash contributions.

## Contributions of \$250 or More

You can claim a deduction for a contribution of \$250 or more only if you have an acknowledgement of your contribution from the qualified organization or adequate payroll deduction records.

**Amount of contribution.** In figuring whether your contribution is \$250 or more, do not combine separate contributions. However, two checks written on the same date to the same qualified organization may be considered one contribution.

If contributions are made by payroll deduction, the deduction from each paycheck is treated as a separate contribution.

**Acknowledgement.** The acknowledgement must meet these tests:

- 1) It must be written.
- 2) It must include:
  - a) The amount of cash you contributed,
  - b) Whether the qualified organization gave you any goods or services (other than token items of little value) as a result of your contribution, and
  - c) A description and good faith estimate of the value of any goods or services described in (b). If the only benefit you received was an intangible religious benefit (such as admission to a religious ceremony) that generally is not sold in a commercial transaction outside the donative context, the acknowledgement must say so and does not need to describe or estimate the value of the benefit.
- 3) You must get it on or before the earlier of:
  - a) The date you file your return for the year you make the contribution, or
  - b) The due date, including extensions, for filing the return.

**Payroll deductions.** If you make a contribution by payroll deduction, you do not need an acknowledgement from the qualified organization. But if your employer deducted \$250 or more from a single paycheck, you must keep:

- 1) A pay stub, Form W-2, or other document furnished by your employer that proves the amount withheld, and
- 2) A pledge card or other document from the qualified organization that states the organization does not provide goods or services in return for any contribution made to it by payroll deduction.

**Out-of-pocket expenses.** If you render services to a qualified organization and have unreimbursed out-of-pocket expenses related to those services, you can satisfy the written acknowledgement requirement just discussed if:

- 1) You have adequate records to substantiate the amount of the expenditures, and
- 2) By the required date, you get an acknowledgement from the qualified organization that contains:
  - a) A description of the services you provided,
  - b) The date the services were provided,
  - c) A statement of whether or not the organization provided you any goods or services to reimburse you for the expenses you incurred,
  - d) A description and a good faith estimate of the value of any goods or services (other than intangible religious benefits) provided to reimburse you, and
  - e) A statement of any intangible religious benefits provided to you.

**Car expenses.** If you claim expenses directly related to use of your car in giving services to a qualified organization, you must keep reliable written records of your expenses. Whether your records are considered reliable depends on all the facts and circumstances. Generally, they may be considered reliable if you made them regularly and at or near the time you had the expenses.

Your records must show the name of the organization you were serving each time you used your car for a charitable purpose. If you use the standard mileage rate of 12 cents a mile, your records must show the miles you drove your car for the charitable purpose. If you deduct your actual expenses, your records must show the costs of operating the car that are directly related to a charitable purpose.

See *Car expenses*, earlier under *Out-of-Pocket Expenses in Giving Services*, for the expenses you can deduct.

## Noncash Contributions

For a contribution not made in cash, the records you must keep depend on whether your deduction for the contribution is:

- 1) Less than \$250,
- 2) At least \$250 but not more than \$500,
- 3) Over \$500 but not more than \$5,000, or
- 4) Over \$5,000.

### Deductions of Less Than \$250

If you make any noncash contribution, you must get and keep a receipt from the charitable organization showing:

- 1) The name of the charitable organization,
- 2) The date and location of the charitable contribution, and
- 3) A reasonably detailed description of the property.

A letter or other written communication from the charitable organization acknowledging receipt of the contribution and containing the information in (1), (2), and (3) will serve as a receipt.

You are not required to have a receipt where it is impractical to get one (for example, if you leave property at a charity's unattended drop site).

**Additional records.** You must also keep reliable written records for each item of donated property. Your written records must include the following:

- 1) The name and address of the organization to which you contributed.
- 2) The date and location of the contribution.
- 3) A description of the property in detail reasonable under the circumstances. For a security, keep the name of the issuer, the type of security, and whether it is regularly traded on a stock exchange or in an over-the-counter market.
- 4) The fair market value of the property at the time of the contribution, and how you figured the fair market value. If it was determined by appraisal, keep a signed copy of the appraisal.

- 5) The cost or other basis of the property if you must reduce its fair market value by appreciation. Your records should also include the amount of the reduction and how you figured it. If you choose the 50% limit instead of the special 30% limit on certain capital gain property, you must keep a record showing the years for which you made the choice, contributions for the current year to which the choice applies, and carryovers from preceding years to which the choice applies. See *How To Figure Your Deduction When Limits Apply* in Publication 526 for information on how to make the capital gain property election.
- 6) The amount you claim as a deduction for the tax year as a result of the contribution, if you contribute less than your entire interest in the property during the tax year. Your records must show the amount you claimed as a deduction in any earlier years for contributions of other interests in this property. They must also include the name and address of each organization to which you contributed the other interests, the place where any such tangible property is located or kept, and the name of the person who has possession of the property, if it is someone other than the organization to which you contributed.
- 7) The terms of any conditions attached to the gift of property.

If the gift was a "qualified conservation contribution," your records must also include the fair market value of the underlying property before and after the gift and the conservation purpose furthered by the gift. See *Qualified conservation contribution* in Publication 561 for more information.

### Deductions of At Least \$250 But Not More Than \$500

If you claim a deduction of at least \$250 but not more than \$500 for a noncash charitable contribution, you must get and keep an acknowledgement of your contribution from the qualified organization. This acknowledgement must contain the information in items (1) through (3) listed under *Deductions of Less Than \$250*, earlier, and your written

records must include the information listed in that discussion under *Additional records*.

The acknowledgement must also meet these tests:

- 1) It must be written.
- 2) It must include:
  - a) A description (but not the value) of any property you contributed,
  - b) Whether the qualified organization gave you any goods or services (other than token items of little value) as a result of your contribution, and
  - c) A description and good faith estimate of the value of any goods or services described in (b). If the only benefit you received was an intangible religious benefit (such as admission to a religious ceremony) that generally is not sold in a commercial transaction outside the donative context, the acknowledgement must say so and does not need to describe or estimate the value of the benefit.
- 3) You must get the acknowledgement on or before the earlier of:
  - a) The date you file your return for the year you make the contribution, or
  - b) The due date, including extensions, for filing the return.

### Deductions Over \$500

You are required to give additional information if you claim a deduction over \$500 for noncash charitable contributions. See *Records To Keep* in Publication 526 for more information.

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## How To Report

Enter your cash contributions (including out-of-pocket expenses) on line 15, Schedule A (Form 1040).

Enter your noncash contributions on line 16 of Schedule A (Form 1040).

If your total deduction for all noncash contributions for the year is over \$500, you must also file **Form 8283**. See *How To Report* in Publication 526 for more information.

# Nonbusiness Casualty and Theft Losses

## Introduction

This chapter defines and discusses the tax treatment of casualty and theft losses that are personal and **not** business related. It also discusses losses on deposits.

This chapter also explains:

- How to figure the amount of your loss,
- How to treat insurance and other reimbursements you receive,
- The deduction limits,
- How to figure your deduction, and
- How to report a gain or loss.

You must file Form 1040 and itemize your deductions on **Schedule A** (Form 1040) to be able to claim a casualty or theft loss of nonbusiness property. You **cannot** claim these losses if you file Form 1040A or Form 1040EZ.

You must use **Form 4684** to report your loss, but **Publication 584** is available to help you make a list of your damaged goods and figure your loss. That publication can serve as an inventory of your personal goods. It includes schedules to help you figure the loss on your home and its contents, and on your motor vehicles.

You must reduce each casualty or theft loss on nonbusiness property by \$100. You must further reduce the total of your casualty and theft losses for the year on nonbusiness property by 10% of your adjusted gross income. If these **deduction limits** are more than your losses, you do not have a casualty or theft loss deduction.

**Other sources of information.** For information on a casualty or theft loss of business or income-producing property, see Publication 547.

For information on a condemnation of your home, see *Involuntary Conversions* in Publication 544.

## Useful Items

You may want to see:

### Publication

- 544** Sales and Other Dispositions of Assets
- 547** Casualties, Disasters, and Thefts (Business and Nonbusiness)
- 550** Investment Income and Expenses
- 551** Basis of Assets

- 584** Nonbusiness Disaster, Casualty, and Theft Workbook

### Form (and Instructions)

- 4684** Casualties and Thefts

## Loss on Deposits

A loss on deposits can occur when a bank, credit union, or other financial institution becomes insolvent or bankrupt. If you incurred this loss, you have three choices of how to deduct the loss:

- 1) As a nonbusiness bad debt,
- 2) As a casualty loss, or
- 3) As an ordinary loss.

For more information, see *Special Treatment for Losses on Deposits in Insolvent or Bankrupt Financial Institutions* in the instructions for Form 4684.

**Effect of choice on when to deduct.** You can choose to deduct a loss on deposits as a **casualty loss or as an ordinary loss** for any year in which you can reasonably estimate how much of your deposits you have lost in an insolvent or bankrupt financial institution. The choice is generally made on the return you file for that year. Once you treat the loss as a casualty or ordinary loss, **you cannot** treat the same amount of the loss as a nonbusiness bad debt when it actually becomes worthless. Also, the choice applies to all your losses on deposits for the year in that particular financial institution.

If you do not choose to deduct the loss as a casualty loss or as an ordinary loss, you must wait until the actual loss is determined before you can deduct the loss as a **non-business bad debt**. Once you make this choice, you cannot change it without permission from the Internal Revenue Service.

**How to report.** The kind of deduction you choose for loss on deposits determines how you report your loss. If you choose:

- Nonbusiness bad debt — report on Schedule D (Form 1040).
- Casualty loss — report on Form 4684 first and then on Schedule A (Form 1040).
- Ordinary loss — report on Schedule A (Form 1040).

Get the Form 1040 instructions for more information.

## Casualty

A casualty is the damage, destruction, or loss of property resulting from an identifiable event that is sudden, unexpected, or unusual.

- A **sudden** event is one that is swift, not gradual or progressive.
- An **unexpected** event is one that is ordinarily unanticipated and unintended.

- An **unusual** event is one that is not a day-to-day occurrence and that is not typical of the activity in which you were engaged.

A casualty can also include a government-ordered demolition or relocation of a home that is unsafe to use because of a disaster. For more information, see *Disaster Area Losses* in Publication 547.

**Deductible losses.** Deductible casualty losses can result from a number of different causes, including:

### Earthquakes

### Hurricanes

### Tornadoes

### Floods

### Storms

### Volcanic eruptions

### Shipwrecks

### Mine cave-ins

### Sonic booms

### Vandalism

**Fires.** If you willfully set the fire, or pay someone else to set it, you cannot deduct the resulting loss.

**Car accidents.** The loss from an accident to your car is not a casualty loss if your willful negligence or willful act caused the accident. The same is true if the willful act or willful negligence of someone acting for you caused the accident.

**Other accidents.** A loss due to the accidental breakage of articles such as glassware or china under normal conditions is not a casualty loss. Neither is a loss due to damage done by a family pet.

**Nondeductible losses.** There is no casualty loss deduction if the damage or destruction is caused by:

### Termites or moths.

**Disease.** The progressive damage or destruction of trees, shrubs, or other plants by a fungus, disease, insects, worms, or similar pests is not a deductible casualty loss. But, a sudden destruction due to an unexpected or unusual infestation by beetles or other insects may result in a casualty loss. If a storm, flood, or fire damages trees and shrubs, the loss is a casualty.

**Progressive deterioration.** If a steadily operating cause or a normal process damages your property, it is not considered a casualty. For example, the steady weakening of a building due to normal wind and weather conditions is not a casualty. But, the rust and water damage to rugs and drapes caused by the bursting of a water heater qualifies as a casualty. The

deterioration and damage to the water heater itself does not qualify.

**Drought.** In most cases, when drought causes damage or loss through progressive deterioration, it is not a casualty loss. To be deductible, a drought-related loss generally must be incurred in a trade or business or in a transaction entered into for profit.

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## Theft

A theft is the unlawful taking and removing of money or property with the intent to deprive the owner of it. It includes, but is not limited to, larceny, robbery, and embezzlement.

If money or property is taken as the result of extortion, kidnapping, threats, or blackmail, it can also be a theft. In these instances, you need to show that the taking of your property was illegal under the law of the state where it occurred, and that it was done with criminal intent.

**Mislaid or lost property.** The simple disappearance of money or property is not a theft. However, an accidental loss or disappearance of property can qualify as a casualty if it results from an identifiable event that is sudden, unexpected, or unusual.

**Example.** A car door is accidentally slammed on your hand, breaking the setting of your diamond ring. The diamond falls from the ring and is never found. The loss of the diamond is a casualty.

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## Proof of Loss

To take a deduction for a casualty or theft loss, you must be able to show that there was a casualty or theft. You also must be able to support the amount you take as a deduction.

**For a casualty loss,** you should be able to show:

- The type of casualty (car accident, fire, storm, etc.) and when it occurred,
- That the loss was a direct result of the casualty, and
- That you were the owner of the property or, if you leased the property from someone else, that you were contractually liable to the owner for the damage.

**For a theft loss,** you should be able to show:

- When you discovered that your property was missing,
- That your property was stolen, and
- That you were the owner of the property.

**Records.** It is important that you have records that will prove your deduction. If you do not have the actual records to support

your deduction, you can use other satisfactory evidence that is sufficient to establish your deduction.

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## Amount of Loss

Figure your casualty or theft loss by subtracting any insurance or other reimbursement you receive or expect to receive because of your loss from the **smaller** of the following two amounts:

- 1) The **decrease in fair market value** of the property as a result of the casualty or theft, or
- 2) Your **adjusted basis** in the property before the casualty or theft.

**Fair market value (FMV).** FMV is the price for which you could sell your property to a willing buyer when neither of you have to sell or buy and both of you know all the relevant facts.

The decrease in fair market value is the difference between the property's value immediately before and immediately after the casualty or theft.

**Adjusted basis.** Adjusted basis is your basis (usually cost) increased or decreased by various events, such as improvements and casualty losses.

**Theft.** The FMV of property immediately after a theft is considered to be zero, since you no longer have the property. Figure your theft loss using the smaller of the stolen property's FMV or adjusted basis. Also, see *Recovered property*, later.

**Example.** Several years ago, you purchased silver dollars at face value for \$150. This is your adjusted basis in the property. Your silver dollars were stolen this year. The FMV of the coins was \$1,000 when stolen, and insurance did not cover them. Your theft loss is \$150.

**The cost of protection.** The cost of protecting your property against a casualty or theft is not part of a casualty or theft loss. For example, you cannot deduct what you spend on insurance or to board up your house against a storm.

If you make permanent improvements to your property to protect it against a casualty or theft, add the cost of these improvements to your basis in the property. An example would be the cost of a dike to prevent flooding.

**Related expenses.** The incidental expenses you have due to a casualty or theft, such as expenses for the treatment of personal injuries, for temporary housing, or for a rental car, are not part of your casualty or theft loss.

**Repair and replacement costs.** The cost of repairing damaged property or of replacing stolen or destroyed property is not part of a casualty or theft loss. Neither is the cost of

cleaning up after a casualty. But see *Leased property*, later, and *Other measures*, later.

**Example.** You bought a new chair 4 years ago for \$300. In April, a fire destroyed the chair. You estimated that it would cost \$500 to replace it. If you had sold the chair before the fire, you estimate that you could have received only \$100 for it because it was 4 years old. The chair was not insured. Your loss is \$100, the FMV of the chair before the fire. It is not \$500, the replacement value.

**Recovered property.** If you get your stolen property back, your loss is measured like a casualty loss from vandalism. That is, you must consider the actual FMV of the property when you get it back. Your loss is figured using the smaller of:

- The decrease in the FMV of the property from the time it was stolen until the time it is recovered, or
- Your adjusted basis in the property.

**Leased property.** If you are liable for casualty damage to property you lease, your loss is the amount you must pay to repair the property.

**Business or income-producing property.** If business or income-producing property is completely destroyed or lost because of a casualty or theft, your loss is:

Your adjusted basis in the property

MINUS

Any salvage value

MINUS

Any insurance or other reimbursement you receive or expect to receive

The decrease in FMV is not considered.

**Separate computations.** Generally, if a single casualty or theft involves more than one item of property, you must figure the loss on each item separately. Then combine the losses to determine the total loss from that casualty or theft.

**Exception for real property.** In figuring a casualty loss on nonbusiness real property, the entire property (including any improvements, such as buildings, trees, and shrubs) is treated as one item. Figure the loss using the smaller of:

- The decrease in FMV of the entire property, or
- The adjusted basis of the entire property.

**Decrease in fair market value.** To figure the decrease in FMV (defined earlier) because of a casualty or theft, you generally need a competent appraisal. But, other measures can also be used to establish certain decreases. See *Appraisal*, next, and *Other measures*, later.

**Appraisal.** The appraisal to determine the difference between the FMV of the property immediately before a casualty or theft and immediately afterwards should be made by a competent appraiser. The appraiser should be reliable and experienced. The appraiser must recognize the effects of any general market decline that may occur along with the casualty. This is necessary so that any deduction is limited to the actual loss resulting from damage to the property.

Several factors are important in evaluating the accuracy of an appraisal, including the appraiser's:

- Familiarity with your property before and after the casualty or theft,
- Knowledge of sales of comparable property in the area,
- Knowledge of conditions in the area of the casualty, and
- Method of appraisal.

**Appraisal fees.** You can deduct your appraisal fees as a miscellaneous deduction subject to the 2% of adjusted gross income limit on line 22, Schedule A (Form 1040). The appraisal fee is an expense of determining your tax liability. It is not a part of the casualty loss.

**Other measures.** You can use the **cost of cleaning up or of making repairs** after a casualty as a measure of the decrease in FMV if you meet all the following conditions.

- 1) The repairs are necessary to bring the property back to its condition before the casualty.
- 2) The amount spent for repairs is not excessive.
- 3) The repairs take care of the damage only.
- 4) The value of the property after the repairs is not, due to the repairs, more than the value of the property before the casualty.

**Landscaping.** The cost of restoring landscaping to its original condition after a casualty may indicate the decrease in FMV. You may be able to measure your loss by what you spend on the following:

- 1) Removing destroyed or damaged trees and shrubs minus any salvage you receive,
- 2) Pruning and other measures taken to preserve damaged trees and shrubs, and
- 3) Replanting necessary to restore the property to its approximate value before the casualty.

**Cars.** Books issued by various automobile organizations may be useful in figuring the value of your car if your car is listed in the books. You can use the books' retail values and modify them by such factors as mileage and the condition of your car to figure its value. The prices are not "official," but they

may be useful in determining value and suggesting relative prices for comparison with current sales and offerings in your area. If your car is not listed in the books, you determine its value from other sources. A dealer's offer for your car as a trade-in on a new car is not usually a measure of its true value.

**Photographs.** Photographs taken after a casualty will be helpful in establishing the condition and value of the property after it was damaged. Photographs showing the condition of the property after it was repaired, restored, or replaced may also be helpful.

The cost of photographs obtained for this purpose is not a part of the loss. It is an expense of determining your tax liability. You can claim this cost as a miscellaneous deduction subject to the 2% of adjusted gross income limit on Schedule A (Form 1040).

**Items not to be considered.** You generally should not consider the following items when attempting to establish the FMV of your property.

**Sentimental value.** Do not consider sentimental value when determining your loss. If a family portrait, heirloom, or keepsake is damaged, destroyed, or stolen, you must base your loss only on its actual market value.

**General decline in market value.** A decrease in the value of your property because it is in or near an area that suffered a casualty, or that might again suffer a casualty, is not to be taken into consideration. You have a loss only for actual casualty damage to your property. However, if your home is in a federally declared disaster area, see *Disaster Area Losses* in Publication 547.

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## Insurance and Other Reimbursements

If your property is covered by insurance, you should file a timely insurance claim for reimbursement of your loss. Otherwise, you cannot deduct this loss as a casualty or theft loss.

The portion of the loss not covered by insurance (for example, a deductible) is not subject to this rule.

**Example.** You have a car insurance policy with a \$500 deductible. Because your insurance did not cover the first \$500 of an auto collision, the \$500 would be deductible (subject to the \$100 and 10% rules discussed later under *Deduction Limits*). This is true, even if you do not file an insurance claim, since your insurance policy would never have reimbursed you for it.

**Reduction of loss.** If you receive insurance or another type of reimbursement, you must subtract the reimbursement when you figure your loss. You do not have a casualty or theft loss to the extent you are reimbursed.

**If you expect to be reimbursed,** but have not yet received payment, you must still

subtract the expected payment. For more information, see *Reimbursement Claims*, later.

**Gain from reimbursement.** If your reimbursement is more than your adjusted basis in the property, you have a gain. This is true even if the decrease in the FMV of the property is more than your adjusted basis. If you have a gain, you may have to pay tax on it, or you may be able to postpone reporting the gain.

See Publication 547 for more information on how to treat a gain from the reimbursement for a casualty or theft.

**Other reimbursements.** Insurance is the most common way to be reimbursed for a casualty or theft loss. But you may be reimbursed in some other way. See *Types of Reimbursements* in the instructions for Form 4684.

**If you receive money as an employee** from your employer's emergency disaster fund, and you must use that money to rehabilitate or replace property on which you are claiming a casualty loss deduction, then you must take that money into consideration in computing the casualty loss deduction. You take it into consideration to the extent you used it to replace your destroyed or damaged property.

**Example.** Your home was extensively damaged by a tornado. Your loss after reimbursement from your insurance company was \$10,000. Your employer set up a disaster relief fund for its employees. Employees receiving money from the fund had to use it to rehabilitate or replace their damaged or destroyed property. You received \$5,000 from the fund and spent the entire amount on repairs to your home. In figuring your casualty loss, you must reduce your unreimbursed loss (\$10,000) by the \$5,000 you received from your employer's fund. Your casualty loss before applying the deduction limits discussed later is \$5,000.

**Payments not considered reimbursements.** If you are a disaster victim who receives excludable cash gifts, and there are no limits on how you can use the money, you do not reduce your casualty loss deduction by the amount of the excludable cash gifts even if you use the money to pay for repairs to property damaged in the disaster.

**Example.** Your home was damaged by a hurricane. Relatives and neighbors made cash gifts to you which were excludable from your income. You applied part of the cash gifts to the cost of repairing your home. There were no limits or restrictions on how you could use the cash gifts. The money you received as excludable gifts and used to pay for repairs to your home does not reduce the amount that you can deduct as a casualty loss on the damaged home.

**Payments for living costs.** If an insurance company pays you for any of your living expenses after you lose the use of your home

Table 27-1. **Deduction Limit Rules**—These rules apply to a casualty or theft loss to nonbusiness property.

	<b>\$100 Rule</b>	<b>10% Rule</b>
<b>Definition of Rule</b>	You must reduce each casualty or theft loss by \$100 when figuring your deduction. Apply this rule <u>after</u> you reduce your loss by any reimbursement.	You must reduce your total casualty or theft loss by 10% of your adjusted gross income. Apply this rule <u>after</u> you reduce each loss by any reimbursement and by \$100 (the \$100 rule).
<b>Single Event</b>	Apply this rule only once, even if many pieces of property are affected.	Apply the rule only once, even if many pieces of property are affected.
<b>More Than One Event</b>	Apply this rule to the loss from <u>each</u> event.	Apply the rule to the <u>total</u> of all your losses from all events.
<b>More Than One Person—</b> With Loss From the Same Event (other than a married couple filing jointly)	Apply the rule <u>separately</u> to each person.	Apply the rule <u>separately</u> to each person.
<b>Married Couple—</b> With Loss From the Same Event		
Filing jointly	Apply this rule as if you were one person.	Apply this rule as if you were one person.
Filing separately	Apply this rule <u>separately</u> to each spouse.	Apply this rule <u>separately</u> to each spouse.
<b>More Than One Owner</b> (other than a married couple filing jointly)	Apply the rule separately to each owner of jointly owned property.	Apply the rule separately to each owner of jointly owned property.

because of a casualty, the insurance payments are not considered a reimbursement that reduces your deductible casualty loss.

You must report as income insurance payments covering your normal living expenses.

However, the part of insurance payments that pays you for a temporary increase in the living expenses you and your family have during this period does not have to be reported as income.

The same rules apply to insurance payments for living expenses if you are denied access to your home by government authorities due to a casualty or the threat of a casualty.

The increase in your living expenses is the amount of your actual living expenses minus your normal living expenses. Do not include in income the payment you received for your extra expenses for renting suitable housing and for transportation, food, utilities, and miscellaneous services during the period you are unable to use your home because of the casualty.

**Example.** As a result of a fire, you vacated your apartment for a month and moved to a motel. You normally pay \$525 a month rent. None was charged for the month the apartment was vacated. Your motel rent for this month was \$1,200. You received \$1,100 reimbursement from your insurance company for rental expenses.

The part of the insurance payment that reimburses you for the amount of your actual rent minus your normal rent is \$675 (\$1,200 – \$525). You do not include the \$675 (the increase in your living expenses) in income.

But you do include in income the rest of the insurance received, \$425 (\$1,100 – \$675).

**Disaster relief.** Food, medical supplies, and other forms of assistance you receive do not reduce your casualty loss unless they are replacements for lost or destroyed property. These items are not taxable income to you.

## Deduction Limits

After you have figured your casualty or theft loss and subtracted any reimbursements, you must figure how much of the loss you can deduct. If your loss was to property you had for your own or your family's personal use, there are **two limits** on the amount you can deduct for your casualty or theft loss.

- 1) You must reduce your loss by **\$100**. If you had more than one casualty or theft loss, you must reduce each loss by \$100.
- 2) You must further reduce your loss by **10% of your adjusted gross income**. If you had more than one casualty or theft loss, this 10% limit applies to the total of all your losses for the year.

**\$100 rule.** The first \$100 of a casualty or theft loss on nonbusiness property is not allowable. This rule applies after all reimbursements have been subtracted from your total casualty or theft loss.

**Single event.** A single \$100 reduction applies to each casualty or theft, no matter

how many pieces of property are involved. Generally, events closely related in origin cause a single casualty. It is a single casualty when the damage is from two or more closely related causes, such as wind and flood damage caused by the same storm. A single casualty may also damage two or more pieces of property, such as a hailstorm that damages both your home and your car parked in your driveway.

**More than one loss.** If you have more than one casualty or theft loss during the tax year, you must **reduce each loss by \$100**.

**Example.** Your family car was damaged in an accident in January. Your loss after the insurance reimbursement was \$75. In February, your car was damaged in another accident. This time your loss after the insurance reimbursement was \$90. Apply the \$100 rule to each separate casualty loss. Since neither accident resulted in a loss of over \$100, you are not entitled to any deduction for these accidents.

**10% rule.** You must reduce the total of all your casualty or theft losses by 10% of your adjusted gross income. Apply this rule after you reduce each loss by any reimbursements and by \$100. If you have both gains and losses from casualties or thefts, see *Gains and losses*, later in this discussion.

**Example 1.** In June, you discovered that your house had been burglarized. Your loss after insurance reimbursement was \$2,000. Your adjusted gross income is \$29,500. You first apply the \$100 rule and then the 10% rule. Figure your theft loss as follows.

1. Loss after insurance .....	\$2,000
2. Subtract \$100 .....	<u>100</u>
3. Loss after \$100 rule .....	\$1,900
4. Subtract 10% of \$29,500 AGI .....	<u>2,950</u>
5. <b>Theft loss deduction</b> .....	<u><u>-0-</u></u>

When you apply the 10% rule, you find you do not have a casualty or theft loss deduction because your loss (\$1,900) is less than 10% of your adjusted gross income (\$2,950).

**More than one loss.** If you had more than one casualty or theft loss during the year, reduce each loss by any reimbursements and by \$100. Then you **reduce the total of all your losses by 10%** of your adjusted gross income.

**Example 2.** In March, you had a car accident that totally destroyed your car. You did not have collision insurance on your car, so you did not receive any insurance reimbursement. Your loss on the car was \$1,200. In November, you had a fire that damaged your basement and totally destroyed the furniture, washer, dryer, and other items you had stored there. Your loss on the basement items after reimbursement was \$1,700. Your adjusted gross income is \$25,000. You figure your casualty loss deduction as follows.

	<u>Car</u>	<u>Basement</u>
1. Loss .....	\$1,200	\$ 1,700
2. Subtract \$100 per incident .....	<u>100</u>	<u>100</u>
3. Loss after \$100 rule .....	<u>\$1,100</u>	<u>\$ 1,600</u>
4. Total loss .....		\$ 2,700
5. Subtract 10% of \$25,000 AGI .....		<u>2,500</u>
6. <b>Casualty loss deduction</b> .....		<u><u>\$ 200</u></u>

**Gains and losses.** If you had both gains and losses from casualties or thefts to nonbusiness property, **you must compare your total gains to your total losses.** Do this after you have reduced each loss by any reimbursements and by \$100.

**If your losses are more than your gains,** subtract your gains from your losses and reduce the result by 10% of your adjusted gross income. The rest is your deductible loss.

However, **if your gains are more than your losses,** subtract your losses from your gains. The difference is treated as capital gain and must be reported on Schedule D (Form 1040). The 10% rule does not apply to your losses.

Table 27-1 gives a brief explanation of how to apply the \$100 rule and the 10% rule in various situations. For more detailed explanations and examples, get Publication 547.

## Figuring the Deduction

Generally, you must figure your loss **separately for each item** stolen, damaged, or destroyed. However, a special rule applies for nonbusiness real property.

**Real property.** In figuring a loss to real property you own for personal use, all improvements, such as buildings and ornamental trees, are considered together. The loss is the smaller of:

- 1) The decrease in the fair market value of the entire property, or
- 2) The adjusted basis of entire property.

### From this amount subtract:

- 1) The insurance and other reimbursement you receive or expect to receive,
- 2) \$100, and
- 3) 10% of your adjusted gross income.

However, if you have more than one casualty or theft loss, subtract 10% of your adjusted gross income (AGI) from the total of all your losses for the year.

**Deduction.** Any amount remaining after you follow these steps is your personal casualty loss deduction.

**Example.** You bought your home a few years ago. You paid \$50,000 (\$10,000 for the land and \$40,000 for the house). You also spent \$2,000 for landscaping. This year a fire destroyed your home. The fire also damaged the shrubbery and trees in your yard. The fire was your only casualty or theft loss this year. Competent appraisers valued the property as a whole at \$75,000 before the fire, but only \$15,000 after the fire. (The loss to your household furnishings is not shown in this example but would be figured separately, as explained later under *Personal property*.) Shortly after the fire, the insurance company paid you \$45,000 for the loss. Your adjusted gross income is \$48,000. You figure your casualty loss deduction as follows:

1) Adjusted basis of the entire property (cost of land, building, and landscaping) .....	<u>\$ 52,000</u>
2) FMV of entire property before fire .....	\$ 75,000
3) FMV of entire property after fire .....	<u>15,000</u>
4) Decrease in FMV of entire property .....	<u>\$ 60,000</u>
5) Amount of loss (smaller of 1 or 4) .....	\$ 52,000
6. Subtract insurance .....	<u>45,000</u>
7. Loss after reimbursement .....	\$ 7,000
8. Subtract \$100 .....	<u>100</u>
9. Loss after \$100 rule .....	\$ 6,900
10. Subtract 10% of \$48,000 AGI .....	<u>4,800</u>
11. <b>Casualty loss deduction</b> .....	<u><u>\$ 2,100</u></u>

**Personal property.** Personal property is generally any property that is not real property. If your personal property is stolen or is damaged or destroyed by a casualty, you must figure your loss separately for each item of property. The loss is the smaller of the decrease in the FMV of the property or its adjusted basis.

**Example.** A fire in your home destroyed an upholstered chair, an oriental rug, and an

antique table. You did not have fire insurance to cover your loss. (This was the only casualty or theft you had during the year.) The chair cost you \$750, and you established that it had an FMV of \$500 just before the fire. The rug cost you \$3,000 and had an FMV of \$2,500 just before the fire. You bought the table at an auction for \$100, before discovering it was an antique. It had been appraised at \$900 before the fire. You figure your loss on each of these items as follows:

	<u>Chair</u>	<u>Rug</u>	<u>Table</u>
1) Basis (cost) .....	<u>\$ 750</u>	<u>\$3,000</u>	<u>\$ 100</u>
2) FMV before fire .....	\$ 500	\$2,500	\$ 900
3) FMV after fire .....	<u>-0-</u>	<u>-0-</u>	<u>-0-</u>
4) Decrease in FMV .....	<u>\$ 500</u>	<u>\$2,500</u>	<u>\$ 900</u>
5) Loss (smaller of 1 or 4) .....	<u>\$ 500</u>	<u>\$2,500</u>	<u>\$ 100</u>
6) <b>Total loss</b> .....			<u><u>\$3,100</u></u>

**Both real and personal properties.** When a casualty involves both real and personal properties, you must figure the loss separately for each type of property, as shown in the previous examples. But you apply a single \$100 reduction to the total loss. Then you apply the 10% rule.

**Property used partly for business and partly for personal purposes.** When property is used partly for personal (nonbusiness) purposes and partly for business or income-producing purposes, the casualty or theft loss deduction must be figured separately for the nonbusiness portion and for the business portion. You must figure each loss separately because the losses attributed to these two uses are figured in two different ways. The \$100 rule and the 10% rule apply only to the casualty or theft loss on the nonbusiness portion of the property.

## When To Report a Gain or a Loss

If you have insurance or other reimbursement that is more than your basis in the destroyed or stolen property, you have a **gain** from the casualty or theft. You must include this gain in your income in the year you receive the reimbursement, unless you choose to postpone the gain as explained in Publication 547.

If you have a **loss**, see Table 27-2.

**Loss on deposits.** If your loss is a loss on deposits in an insolvent or bankrupt financial institution, see *Loss on Deposits*, earlier.

**Casualty losses.** Generally, you can deduct casualty losses only in the tax year in which the casualty occurred. This is true even if you do not repair or replace the damaged property until a later year.

**Disaster area losses.** If you have a casualty loss in a federally declared disaster

Table 27-2. When to Deduct a Loss

Type of Loss	Tax Year Deducted	Can You Choose Years?
<b>Casualty losses</b>	Year loss occurred	No
<b>Loss on deposits</b>	• Casualty loss	Year a reasonable estimate can be made
	• Bad debt	Year deposits are totally worthless
	• Ordinary loss	Year a reasonable estimate can be made
<b>Federal disasters</b>	Year the disaster occurred or the year immediately before the disaster	Yes
<b>Thefts</b>	Year of discovery of the theft	No

area, you can choose to deduct the loss on your tax return for the year immediately preceding the year in which the disaster occurred. This may enable you to get an immediate refund of taxes you already paid. For more information, see *Disaster Area Losses* in Publication 547.

**Theft losses.** You can generally deduct a theft loss only in the year you discover your property was stolen. You must be able to show that there was a theft, but you do not have to know when the theft took place. However, you should show when you discovered that your property was missing.

### Reimbursement Claims

If there is a reasonable prospect you will be reimbursed for part or all of your loss, you must subtract the expected reimbursement when you figure your loss. You must reduce your loss even if you do not receive payment until a later tax year. You are believed to have a reasonable prospect of reimbursement if you have filed suit for damages.

**If you later receive less reimbursement** than you expected, you include that difference as a loss with your other losses (if any) on your return for the year in which you can reasonably expect no more reimbursement.

**Example.** Your personal car had an FMV of \$2,000 when it was destroyed in a collision with another car last year. The accident was due to the negligence of the other driver. At the end of the year, there was a reasonable prospect that the owner of the other car would reimburse you in full. You did not have a deductible loss in last year.

This January, the court awards you a judgment of \$2,000. However, in July it becomes apparent that you will be unable to collect any amount from the other driver. Since this is your only casualty or theft loss, you can deduct the loss this year that is more than \$100 and 10% of your adjusted gross income for this year.

**If you receive more reimbursement** than you expected after you have claimed a deduction for the loss, you may have to include the extra reimbursement in your income for the year you receive it.

However, if any part of your original deduction did not reduce your tax for the earlier year, do not include that part of the reimbursement in your income. You do not refigure your tax for the year you claimed the deduction. For more information, see *Recoveries* in Chapter 13.

Publication 525 has a worksheet for you to use when only part of your original deduction reduced your tax in the earlier year.

**Note.** If the total of all the reimbursements you receive is more than your adjusted basis in the destroyed or stolen property, you will have a **gain** on the casualty or theft. Get Publication 547 for more information on how to treat a gain from the reimbursement of a casualty or theft.

**If you receive exactly the reimbursement you expected to receive,** you do not have any amount to include in your income or any loss to deduct.

**Example.** Last December, you had a collision while driving your personal car. Repairs to the car cost \$950. You had \$100 deductible collision insurance. Your insurance company agreed to reimburse you for the rest of the damage. As a result of your expected reimbursement from the insurance company, you do not have a casualty loss deduction last year. And because of the \$100 rule, you cannot deduct the \$100 you paid as the deductible.

When you receive the \$850 from the insurance company this year, you do not have to report it as income.

**Deducted loss recovered.** If you recover an amount you already deducted in an earlier year as a loss, you may have to include

the amount recovered in your income for the year of receipt. If any part of the original deduction did not reduce your tax in the earlier year, you do not include that part of the recovery in your income. For more information, see *Recoveries* in Chapter 13.

**Recovered property** is your property that was stolen and later returned to you. If you recovered property after you have already taken a theft loss deduction, you must refigure your loss using the smaller of the property's adjusted basis (explained under *Amount of Loss*, earlier) or the decrease in FMV from the time it was stolen until the time it was recovered. Use this amount to refigure your total loss for the year in which the loss was deducted.

This is your refigured loss. If this amount is less than the loss you deducted, you generally have to report the difference as income in the recovery year. But report the difference only up to the amount of the loss that reduced your tax.

## How To Report Gains or Losses

If you have a **loss** from a casualty or theft of nonbusiness property, use:

- Form 4684, and
- Schedule A (Form 1040).

If you have a **gain** from a casualty or theft of nonbusiness property, report your gain on:

- Form 4684, and
- Schedule D (Form 1040).

**Adjustments to basis.** If you have a casualty or theft loss, you must reduce your basis in the property by any deductible loss and any insurance or other reimbursements. The result is your **adjusted basis** in the property. Amounts you spend to restore your property after a casualty increase your adjusted basis. See *Adjusted Basis* in Publication 551 for more information.

**Net operating loss.** If your casualty or theft loss deduction is more than your income, you may have a net operating loss. You can use a net operating loss to lower your taxes in an earlier year, allowing you to get a refund for taxes that you have already paid. Or, you can use it to lower your taxes in a later year. You do not have to be in business to have a net operating loss from a casualty or theft. For more information, get Publication 536, *Net Operating Losses*.

# Car Expenses and Other Employee Business Expenses

## Important Change for 1996

**Standard mileage rate.** The standard mileage rate for the cost of operating your car in 1996 is 31 cents a mile for all business miles.

## Important Reminders

**Receipts needed for certain business expenses.** You may have to keep documentary evidence, such as receipts, for certain business expenses that are \$75 or more. See *Recordkeeping*.

**Limits that apply to employee deductions.** If you are an employee, deduct your work-related expenses discussed in this chapter as a miscellaneous itemized deduction on Schedule A (Form 1040). Generally, the amount you can deduct is limited to the amount that exceeds 2% of your adjusted gross income. It may be further limited if your adjusted gross income is more than \$117,950 (\$58,975 if you are married filing separately). For more information, see Chapters 22 and 30 and the instructions for Schedule A (Form 1040).

## Introduction

This chapter discusses rules for deducting business-related expenses connected with:

- Travel away from home,
- Entertainment,
- Business gifts,
- Local business transportation, and
- Business use of a car.

This chapter also discusses:

- What records you need to prove your expenses,
- How to handle reimbursements of your employee business expenses, and
- How to report your expenses on Forms 2106 and 2106-EZ.

**Expenses fully reimbursed.** You will not need to read this chapter if *all* of the following are true.

- 1) You fully accounted to your employer for your work-related expenses.
- 2) You received full reimbursement for your expenses.
- 3) Your employer required you to return any excess reimbursement and you did so.
- 4) Box 13 of your Form W-2 shows no amount with a code L.

If you meet these four conditions, there is no need to show the expenses or the reimbursements on your return. See *Reimbursements*, later, if you would like more information on reimbursements and accounting to your employer.

If you do not meet all of these conditions, you must complete Form 2106 or 2106-EZ and itemize your deductions to claim your expenses. See *Completing Forms 2106 and 2106-EZ*, later.



*If you meet these conditions and your employer included reimbursements on your Form W-2 in error, ask your employer for a corrected Form W-2.*

## Useful Items

You may want to see:

### Publication

- 463** Travel, Entertainment, Gift, and Car Expenses
- 535** Business Expenses

### Form (and Instructions)

- Schedule A (Form 1040)** Itemized Deductions
- Schedule C (Form 1040)** Profit or Loss From Business
- Schedule C-EZ (Form 1040)** Net Profit From Business
- Schedule F (Form 1040)** Profit or Loss From Farming
- Form 2106** Employee Business Expenses
- Form 2106-EZ** Unreimbursed Employee Business Expenses

## Travel Expenses

If you temporarily travel away from your tax home, you can use this section to determine if you have deductible travel expenses. This section defines "tax home," "temporary," and different types of travel expenses. It also discusses the rules for travel inside and outside the United States and deductible convention expenses.

**Travel expenses defined.** For tax purposes, travel expenses are the ordinary and necessary expenses of traveling away from home for your business, profession, or job. An ordinary expense is one that is common and accepted in your field of business, trade,

or profession. A necessary expense is one that is helpful and appropriate to your business. An expense does not have to be indispensable to be considered necessary. However, you cannot deduct expenses to the extent they are lavish or extravagant.

You will find examples of deductible travel expenses later in this section.

**Traveling away from home.** You are traveling away from home if:

- 1) Your duties require you to be away from the general area of your tax home (defined later) substantially longer than an ordinary day's work, and
- 2) You need to get sleep or rest to meet the demands of your work while away from home.

This rest requirement is not satisfied by merely napping in your car. You do not have to be away from your tax home for a whole day or from dusk to dawn as long as your relief from duty is long enough to get necessary sleep or rest.

**Example 1.** You are a railroad conductor. You leave your home terminal on a regularly scheduled round-trip run between two cities and return home 16 hours later. During the run, you have 6 hours off at your turnaround point where you eat two meals and rent a hotel room to get necessary sleep before starting the return trip. You are considered to be away from home, and you can deduct travel expenses.

**Example 2.** You are a truck driver. You leave your terminal and return to it later the same day. You get an hour off at your turnaround point to eat. Because you are not off to get necessary sleep and the brief time off is not an adequate rest period, your trip is not considered as travel away from home. You cannot deduct travel expenses.

## Tax Home

To deduct travel expenses, you must first determine the location of your tax home.

Generally, your tax home is your regular place of business or post of duty, regardless of where you maintain your family home. It includes the *entire city or general area* in which your business or work is located. If you have more than one regular place of business, your tax home is your main place of business. If you do not have a regular or a main place of business because of the nature of your work, then your tax home may be the place where you regularly live. See *No main place of business or work*, later.

If you do not fit any of these categories, you are considered a transient (an itinerant) and your tax home is wherever you work. As a transient, you cannot claim a travel expense deduction because you are never considered away from home.

**Main place of business or work.** If you have more than one place of work, you should use the following factors to determine your main place of business or work:

- 1) The total time you ordinarily spend working in each area,
- 2) The degree of your business activity in each area, and
- 3) The relative amount of your income from each area.

**Example.** You live in Cincinnati where you have a seasonal job for 8 months and earn \$15,000. You work the remaining 4 months in Miami, also at a seasonal job, and earn \$4,000. Cincinnati is your main place of work because you spend most of your time there and earn most of your income there.

**No main place of business or work.** You may have a tax home even if you do not have a regular or main place of work. Your tax home may be the home where you regularly live. If you do not have a regular or main place of business or work, use the following three factors to see if you have a tax home.

- 1) You have part of your business in the area of your main home and use that home for lodging while doing business there.
- 2) You have living expenses at your main home that you duplicate because your business requires you to be away from that home.
- 3) You have not left the area in which both your traditional place of lodging and your main home are located; you have a member or members of your family living at your main home; or you often use that home for lodging.

If you meet all three factors, your tax home is the home where you regularly live, and you may be able to deduct travel expenses. If you meet only two of the factors, you may have a tax home depending on all the facts and circumstances. If you meet only one factor, you are a transient; each place you work becomes your tax home and you cannot deduct travel expenses.

**Example.** You are single and live in Boston in an apartment you rent. You have worked for your employer in Boston for a number of years. Your employer enrolls you in a 12-month executive training program. You do not expect to return to work in Boston after you complete your training.

During your training, you do not do any work in Boston. Instead, you receive classroom and on-the-job training throughout the United States. You keep your apartment in Boston and return to it frequently. You use your apartment to conduct your personal business. You also keep up your community contacts in Boston. When you complete your training, you are transferred to Los Angeles.

You have not satisfied factor (1) because you did not work in Boston. You have satisfied factor (2) because you have duplicate living expenses. You also satisfy factor (3) because you do not abandon your apartment in Boston as your traditional home, you keep your community contacts, and you frequently return to live in your apartment. You

have a tax home in Boston for travel expense deduction purposes.

**Transient workers.** If you move from job to job, maintain no fixed home, and are not associated with any particular business locality, each place you work becomes your main place of business and your tax home. You cannot deduct your expenses for meals and lodging.

**Living away from your tax home.** If you (and your family) live in an area outside your tax home (main place of work), you cannot deduct travel expenses between your tax home and your family home. You also cannot deduct the cost of meals and lodging while at your tax home. See *Example 1*, below.

If you are working temporarily in the same city where you and your family live, you may be considered as traveling away from home. See *Example 2*, below.

**Example 1.** You are a truck driver and you and your family live in Tucson. You are employed by a trucking firm that has its terminal in Phoenix. At the end of your long runs, you return to your home terminal in Phoenix and spend one night there before returning home. You cannot deduct any of your travel costs in Phoenix because Phoenix is your tax home.

**Example 2.** Your family home is in Pittsburgh, where you work 12 weeks a year. The rest of the year you work for the same employer in Baltimore. In Baltimore, you eat in restaurants and sleep in a rooming house. Your salary is the same whether you are in Pittsburgh or Baltimore.

Because you spend most of your working time and earn most of your salary in Baltimore, that city is your tax home. You cannot deduct any expenses you have for meals and lodging there. However, when you return to work in Pittsburgh, you are away from your tax home even though you stay at your family home. You can deduct the cost of your round trip between Baltimore and Pittsburgh. You can also deduct your part of your family's living expenses for meals and lodging while you are living and working in Pittsburgh.

### Temporary Assignment or Job

You may regularly work or carry on your business activities within the city or general area of your tax home and also work or conduct business at another location. It may not be practical to return home from this other location at the end of each day's work.

If your assignment or job away from your main place of work is **temporary**, your tax home does not change. You are considered to be away from home for the whole period, and your travel expenses are deductible. Generally, a temporary assignment in a single location is one that is realistically expected to last (and does in fact last) for one year or less.

However, if your assignment or job is **indefinite**, that location becomes your new tax home and you cannot deduct your travel

expenses while there. Your assignment or job in a single location is considered indefinite if it is realistically expected to last for more than one year, whether or not it actually lasts for more than one year.

If your assignment is indefinite, you must include in your income any amounts you receive from your employer for living expenses, even if they are called travel allowances and you account to your employer for them. You may be able to deduct the cost of relocating to your new tax home as a moving expense. See Chapter 19 for more information.

**Determining temporary or indefinite.** You must determine whether your assignment is temporary or indefinite when you start work. If you expect employment to last for one year or less, it is temporary unless there are facts and circumstances that indicate otherwise. Employment that is initially temporary may become indefinite due to changed circumstances. A series of assignments to the same location, all for short periods but that together cover a long period, may be considered an indefinite assignment.

**Going home on days off.** If you go back to your tax home from a temporary assignment on your days off, you are not considered away from home while you are in your hometown. You cannot deduct the cost of your meals and lodging there. However, you can deduct your travel expenses, including meals and lodging, while traveling from the area of your temporary place of work to your hometown and back to work. You can claim these expenses up to the amount it would have cost you for meals and lodging had you stayed at your temporary place of work.

If you keep your hotel room during your visit home, you can deduct the cost of your hotel room. In addition, you can deduct your expenses of returning home up to the amount you would have spent for meals had you stayed at your temporary place of work.

**Probationary work period.** If you take a job that requires you to move, with the understanding that you will keep the job if your work is satisfactory during a probationary period, the job is indefinite. You cannot deduct any expenses for meals and lodging during the probationary period.

**Members of the Armed Forces.** If you are a member of the U.S. Armed Forces on a permanent duty assignment overseas, you are not traveling away from home. You cannot deduct your expenses for meals and lodging. You cannot deduct these expenses even if you have to maintain a home in the United States for your family members who are not allowed to accompany you overseas. If you are transferred from one permanent duty station to another, you may have deductible moving expenses, which are explained in Chapter 19.

A naval officer assigned to permanent duty aboard a ship that has regular eating

and living facilities has a tax home aboard ship for travel expense purposes.

## What Are Travel Expenses?

Once you have determined that you are traveling away from your tax home, you can determine what travel expenses are deductible.



When you travel away from home on business, you should keep records of all the expenses you incur and any advances you receive from your employer. You can use a log, diary, notebook, or any other written record to keep track of your expenses. The types of expenses you need to record, along with supporting documentation, are described later under *Recordkeeping*.

Deductible travel expenses include those ordinary and necessary expenses you incur while traveling away from home on business. The type of expense you can deduct depends on the facts and your circumstances. *Table 28-1* summarizes the expenses you may be able to deduct.

You can use the discussion that follows as a general guideline. You may have other deductible travel expenses that are not covered here, depending on the facts and your circumstances.

**Transportation.** You can generally deduct travel by airplane, train, or bus between your home and your business destination. Your cost is the amount you paid for your ticket. If you were provided with a ticket or you are riding free as a result of a “frequent flyer” or other similar program, you have no deduction.

If you travel by car, you can deduct your expenses using the rules explained later under *Car Expenses*.

If you travel by ship, the amount you can deduct may be limited. See *Luxury Water Travel* and *Cruise ships* (under *Conventions*) in Chapter 1 of Publication 463.

**Taxi, commuter bus, and limousine fares.** You can generally deduct the fares you pay for taxis, airport limousines, buses, or other types of transportation between the airport or station and your hotel. You can also deduct these fares between your hotel and the work location of your customers or clients, your business meeting place, or your temporary work location. You cannot deduct costs of sightseeing, shopping, or similar nonbusiness activities.

**Baggage and shipping costs.** You can deduct the cost of sending baggage and sample or display material between your regular work location and your temporary work location.

**Car expenses.** You can deduct the cost of operating and maintaining your car when traveling away from home on business. See

*Local Transportation Expenses*, later, for information on how to figure this deduction.

**Leasing a car.** You can deduct the cost of leasing a car for business purposes while you are traveling away from home. However, if you lease a car for 30 days or more, you may have to include an amount in your income. This “inclusion amount” is explained in Chapter 4 of Publication 463.

You can also deduct actual operating expenses for a car you lease. Examples are gas, oil, and repairs. However, you cannot claim the standard mileage rate.

**Operating expenses.** For a car you own, you may have a choice of deducting actual business-related expenses or claiming the standard mileage rate. The 1996 standard mileage rate is 31 cents a mile for all business miles. See *Car Expenses*, later, for information about using actual expenses or the standard mileage rate.

**Lodging.** You can deduct the cost of lodging if your business trip is overnight or long enough that you need to stop for sleep or rest to properly perform your duties.

**Meals.** You can deduct the cost of meals only if your business trip is overnight or long enough that you need to stop for sleep or rest to properly perform your duties. You cannot deduct the cost of meals if it is not necessary for you to rest. If you pay for a business meal when you are not traveling, you can deduct the cost only if you meet the rules for business entertainment. These rules are explained later under *Entertainment Expenses*.

The expense of a meal includes amounts you spend for your food, beverages, taxes, and tips relating to the meal. You can deduct either the actual cost or a standard amount. See *Standard Meal Allowance* later in this section.

**50% limit on meals.** You can deduct only 50% of the cost of your unreimbursed business-related meals. If you are reimbursed for these expenses, how you apply the 50% limit depends on whether your employer’s reimbursement plan was accountable or nonaccountable. This limit applies whether the unreimbursed meal expense is for business travel or business entertainment. The 50% limit is explained later under *Entertainment Expenses*. Accountable and nonaccountable plans are discussed later under *Reimbursements*.

**Lavish or extravagant.** You cannot deduct expenses for meals to the extent they are lavish or extravagant. An expense is not considered lavish or extravagant if it is reasonable based on the facts and circumstances. Expenses will not be disallowed merely because they are more than a fixed dollar amount or take place at deluxe restaurants, hotels, nightclubs, or resorts.

**Cleaning and laundry expenses.** You can deduct reasonable dry-cleaning and laundry expenses while traveling away from home on business.

**Telephone expenses.** You can deduct the cost of business calls while you are traveling away from home. This includes the cost of business communication by fax machine or other devices.

**Tips.** You can deduct tips you pay for any of the expenses in this section.

**Other expenses.** You can deduct other similar ordinary and necessary expenses that are related to your business travel. These expenses might include the costs of operating and maintaining a house trailer, public stenographer’s fees, and computer rental fees.

**Travel expenses for another individual.** If a spouse, dependent, or other individual goes with you (or your employee) on a business trip or to a business convention, you generally cannot deduct his or her travel expenses. You can only deduct the travel expenses you pay or incur for an accompanying individual if that individual:

- 1) Is your employee,
- 2) Has a bona fide business purpose for the travel, and
- 3) Would otherwise be allowed to deduct the travel expenses.

**Exception for business associate.** If a business associate travels with you and meets the conditions in (2) and (3) above, you can claim the deductible travel expenses you pay for that person. A business associate is someone with whom you can reasonably expect to actively conduct business. It does not matter if you have already conducted business with the person as long as you reasonably expect to do so. A business associate can be a customer, client, supplier, employee, agent, partner, or professional advisor.

**Bona fide business purpose.** For a bona fide business purpose to exist, you must prove a real business purpose for the individual’s presence. Incidental services, such as typing notes or assisting in entertaining customers, are not enough to warrant a deduction.

**Example.** Jerry drives to Chicago on business and takes his wife, Linda, with him. Linda is not Jerry’s employee. Even if her presence serves a bona fide business purpose, her expenses are not deductible.

Jerry pays \$115 a day for a double room. A single room costs \$90 a day. He can deduct the total cost of driving his car to and from Chicago, but only \$90 a day for his hotel room. If he uses public transportation, he can deduct only his fare.

## Standard Meal Allowance

You generally can deduct a standard amount for your daily meals and incidental expenses while you are traveling away from home on business. Incidental expenses include, but are not limited to, your costs for the following items:

Table 28-1. **Deductible Travel Expenses**

Expense	Description
<b>Transportation</b>	The cost of travel by airplane, train, bus, or car between your home and your business destination.
<b>Taxi, commuter bus, and limousine</b>	Fares for these and other types of transportation between the airport or station and your hotel, or between the hotel and your work location away from home.
<b>Baggage and shipping</b>	The cost of sending baggage and sample or display material between your regular and temporary work locations.
<b>Car</b>	The costs of operating and maintaining your car when traveling away from home on business. You may deduct actual expenses or the standard mileage rate, including business-related tolls and parking. If you lease a car while away from home on business, you can deduct business-related expenses only.
<b>Lodging</b>	The cost of lodging if your business trip is overnight or long enough to require you to get substantial sleep or rest to properly perform your duties.
<b>Meals</b>	The cost of meals only if your business trip is overnight or long enough to require you to stop to get substantial sleep or rest. Includes amounts spent for food, beverages, taxes, and related tips.
<b>Cleaning</b>	Cleaning and laundry expenses while away from home overnight.
<b>Telephone</b>	The cost of business calls while on your business trip, including business communication by fax machine or other communication devices.
<b>Tips</b>	Tips you pay for any expenses in this chart.
<b>Other</b>	Other similar ordinary and necessary expenses related to your business travel such as public stenographer's fees and computer rental fees.

- 1) Laundry, cleaning, and pressing of clothing, and
- 2) Fees and tips for persons who provide services, such as food servers and luggage handlers.

Incidental expenses do not include taxicab fares or the costs of telegrams or telephone calls. In this chapter, "standard meal allowance" refers to the standard amount for meals and incidental expenses.

The standard meal allowance method is an alternative to the actual cost method and allows you to deduct a set amount, depending on where and when you travel, instead of keeping records of actual meal and incidental expenses. If you use the standard meal allowance, you still must keep records to prove the time, place, and business purpose of your travel. See the recordkeeping rules explained later under *Recordkeeping*.

**Who can use the standard meal allowance.** You can use the standard meal allowance whether you are an employee or self-employed. You cannot use the standard meal allowance, however, if you are related to your employer as defined later.

You can use the standard meal allowance whether or not you are reimbursed for your traveling expenses. If you are not reimbursed or if you are reimbursed under a nonaccountable plan for meal expenses, you can deduct only 50% of the standard meal allowance. If you are reimbursed under an accountable plan and you are deducting amounts that are more than your reimbursements, you can deduct only 50% of the excess amount.

This 50% limit is figured when you complete Form 2106, Form 2106-EZ, or Schedule C. If you file Schedule C-EZ, enter the total amount of your business expenses on line 2. You can only include 50% of the standard meal allowance (or the amount of your meals that exceeds your reimbursement for meals) in that total. If you file Schedule F, enter the total amount of your travel, meals and entertainment expenses on line 34. You can only include 50% of the standard meal allowance (or the amount of your meals that exceeds your reimbursement for meals) in that total.

**Related to employer.** You are related to your employer if:

- 1) Your employer is your brother or sister, half-brother or half-sister, spouse, ancestor, or lineal descendant,
- 2) Your employer is a corporation in which you own, directly or indirectly, more than 10% in value of the outstanding stock, or
- 3) Certain fiduciary relationships exist between you and your employer involving grantors, trusts, beneficiaries, etc.

You may be considered to indirectly own stock, for purposes of (2) above, if you have an interest in a corporation, partnership, estate, or trust that owns the stock or if a family member or partner owns the stock.

**Amount of standard meal allowance.** The standard meal allowance is **\$26 a day** for most areas in the United States. Other locations in the United States are designated as high-cost areas, qualifying for higher standard meal allowances.

*Appendices A-1 and A-2* in Publication 463 show the locations qualifying for rates of \$30, \$34, or \$38 a day for travel on or after January 1, 1996.

If you travel to more than one location in one day, use the rate in effect for the area where you stop for sleep or rest. If you work in the transportation industry, however, see *Special rate for transportation workers*, later in this section.

**Example.** You regularly live and work in Chicago. You sometimes travel overnight to Milwaukee for business. Your employer expects you to pay your expenses out of your regular salary and does not separately or specifically reimburse your expenses for business trips. You must keep receipts to prove the amount of your lodging expense. You can claim the standard meal allowance for Milwaukee, \$30, on your Form 2106 or Form 2106-EZ. You are subject to the 50% limit on meal and entertainment expenses. You are also subject to the 2%-of-adjusted-gross-income limit that applies to most other miscellaneous itemized deductions.

**Standard meal allowance for areas outside the continental United States.** The standard meal allowance rates do not apply to travel in Alaska, Hawaii, or any other locations outside the continental United States. The federal per diem rates for these locations are published monthly in the *Maximum Travel Per Diem Allowances for Foreign Areas*.



Your employer may have these rates available, or you can purchase the publication from the:

Superintendent of Documents  
U.S. Government Printing Office  
P.O. Box 371954  
Pittsburgh, PA 15250-7954



You can also order it by calling the Government Printing Office at (202)512-1800 (not a toll-free number).



**Internet addresses.** Per diem rates are also available on the Internet.

If you have a computer and a modem, you can access domestic per diem rates at:

<http://www.policyworks.gov/org/main/mt/homepage/mtt/perdiem/travel.shtml>

You can access foreign per diem rates at either of the following two addresses:

<http://www.state.gov/www/aboutstate/business/index.html>

or

<gopher://dosfan.lib.uic.edu>

### Special rate for transportation workers.

You can use a special standard meal allowance if you work in the transportation industry. You are in the transportation industry if your work:

- 1) Directly involves moving people or goods by airplane, barge, bus, ship, train, or truck, and
- 2) Regularly requires you to travel away from home and, during any single trip, usually involves travel to areas eligible for different standard meal allowance rates.

If this applies to you, you can claim a **\$32 a day** standard meal allowance (\$36 for travel outside the continental United States).

Using the special rate for transportation workers eliminates the need for you to determine the standard meal allowance for every area where you stop for sleep or rest. If you choose to use the special rate for any trip, however, you must continue to use the special rate (and not use the regular standard meal allowance rates) for all trips you take that year.

**Travel for less than 24 hours.** If you are not traveling for the entire 24-hour day, you must prorate the standard meal allowance. You can do so by dividing the day into 6-hour quarters. The 6-hour quarters are:

- 1) Midnight to 6 a.m.,
- 2) 6 a.m. to noon,
- 3) Noon to 6 p.m., and
- 4) 6 p.m. to midnight.

You can claim one-fourth of the full day standard meal allowance for each 6-hour quarter of the day during any part of which you are traveling away from home.

You can also prorate the standard meal allowance by using any method that you consistently apply and that is in accordance with reasonable business practice.

**Example.** Maria is employed in Milwaukee as a convention planner. In April she went on a one-week business trip. She left her home in Milwaukee at 7 a.m. on April 5 and flew to Washington, DC, where she

spent two nights. She then went to Albany, NY, arriving there at 4 p.m. on April 7. After three nights in Albany, she went to New York City to attend a planning seminar at her employer's request. She arrived at 1 p.m. on April 10. On April 12, she flew back to Milwaukee, arriving at her home at 5:45 p.m.

Maria decides to use the standard meal allowance. Because she was not traveling for the entire 24 hours on the days she left and returned, she prorates the standard meal allowance for those days. She decides to do this by dividing the days into quarters. She claims  $\frac{3}{4}$  for both April 5 and April 12. Using the rate in effect for the areas where she stopped for sleep, Maria arrives at her expense as follows:

City	Number of Days	Allowance Amount	Total
Wash., DC	$1\frac{3}{4}$	\$38	\$ 66.50
Apr. 5, 6			
Albany, NY	3	\$34	102.00
Apr. 7, 8, 9			
New York City	$2\frac{3}{4}$	\$38	104.50
Apr. 10-12			
<b>Total</b>			<b>\$273.00</b>

Maria's total standard meal allowance for the trip is \$273.00. Her employer does not reimburse her for her meals. She can deduct 50% of her unreimbursed meals as an itemized deduction. She will figure this limit on Form 2106 or Form 2106-EZ.

**Investment and education expenses.** You can also use the standard meal allowance to prove meal expenses you incurred in connection with investment and other income-producing property and/or qualifying educational expenses while traveling away from home.

**Standard meal allowance not allowed.** You cannot use the standard meal allowance to prove the amount of your meals if you are traveling for medical or charitable purposes.

## Travel in the United States

The following discussion applies to travel in the United States. For this purpose, the United States includes the 50 states and the District of Columbia. The treatment of your travel expenses depends on how much of your trip was business related and on how much of your trip occurred within the United States.

### Trip Primarily for Business

You can deduct all your travel expenses if your trip was entirely business related. If your trip was primarily for business and, while at your business destination, you extended your stay for a vacation, made a nonbusiness side trip, or had other nonbusiness activities, you can deduct your business-related travel expenses. These expenses include the travel costs of getting to and from your business destination, and you can

deduct any business-related expenses at your business destination.

**Example.** You work in Atlanta and take a business trip to New Orleans. On your way home, you stop in Mobile to visit your parents. You spend \$630 for the 9 days you are away from home for travel, meals, lodging, and other travel expenses. If you had not stopped in Mobile, you would have been gone only 6 days, and your total cost would have been \$580. You can deduct \$580 for your trip, including the round-trip transportation to and from New Orleans. The cost of your meals is subject to the 50% limit on meals mentioned earlier.

### Trip Primarily for Personal Reasons

If your trip was primarily for personal reasons, such as a vacation, the entire cost of the trip is a nondeductible personal expense. However, you can deduct any expenses you have while at your destination that are directly related to your business.

A trip to a resort or on a cruise ship may be a vacation even if the promoter advertises that it is primarily for business. The scheduling of incidental business activities during a trip, such as viewing videotapes or attending lectures dealing with general subjects, will not change what is really a vacation into a business trip.

### Part of Trip Outside the United States

If part of your trip is outside the United States, use the rules described later under *Travel Outside the United States* for that part of the trip. For the part of your trip that is inside the United States, use the rules in this section. Travel outside the United States does not include travel from one point in the United States to another point in the United States. The following discussion can help you determine whether your trip was entirely within the United States.

**Public transportation.** If you travel by public transportation, any place in the United States where that vehicle makes a scheduled stop is a point in the United States. Once the vehicle leaves the last scheduled stop in the United States on its way to a point outside the United States, you apply the rules under *Travel Outside the United States*.

**Example.** You fly from New York to Puerto Rico with a scheduled stop in Miami. You return to New York nonstop. The flight from New York to Miami is in the United States, so only the flight from Miami to Puerto Rico is outside the United States. All of the return trip is outside the United States, as there are no scheduled stops between Puerto Rico and New York.

**Private car.** Travel by private car in the United States is travel between points in the United States, even when you are on your way to a destination outside the United States.

**Example.** You travel by car from Denver to Mexico City and return. Your travel from Denver to the border and from the border back to Denver is travel in the United States, and the rules in this section apply. The rules under *Travel Outside the United States* apply to your trip from the border to Mexico City and back to the border.

**Private plane.** If you travel by private plane, any trip, or part of a trip, for which both your takeoff and landing are in the United States is travel in the United States. This is true even if part of your flight is over a foreign country.

**Example.** You fly nonstop from Seattle to Juneau. Although the flight passes over Canada, the trip is considered to be travel in the United States.

## Travel Outside the United States

If any part of your business travel is outside the United States, some of your deductions for the cost of getting to and from your destination may be limited. For this purpose, the United States includes the 50 states and the District of Columbia.

How much of your travel expenses you can deduct depends in part upon how much of your trip outside the United States was business related.

See Chapter 1 of Publication 463 for information on luxury water travel.

## Travel Entirely for Business or Considered Entirely for Business

Even if your trip is not entirely for business, it may be considered entirely for business if certain conditions are met.

**Travel entirely for business.** If you travel outside the United States and you spend the entire time on business activities, all your expenses of getting to and from your business destination are deductible.

**Travel considered entirely for business.** Even if you did not spend your entire time on business activities, your trip is considered entirely for business, and you can deduct all of your business-related travel expenses, if you meet at least one of the following four exceptions.

**Exception 1.** You did not have substantial control over arranging the trip. You are not considered to have substantial control merely because you have control over the timing of your trip.

You are considered not to have substantial control over your trip if you:

- 1) Are an employee who was reimbursed or paid a travel expense allowance,
- 2) Are not related to your employer, and
- 3) Are not a managing executive.

“Related to your employer” was defined earlier in this chapter under *Standard Meal Allowance*. A “managing executive” is an employee who has the authority and responsibility, without being subject to the veto of another, to decide on the need for the business travel.

A self-employed person generally has substantial control over arranging business trips.

**Exception 2.** You were outside the United States for a week or less, combining business and nonbusiness activities. One week means seven consecutive days. In counting the days, do not count the day you leave the United States, but count the day you return to the United States.

**Example.** You traveled to Paris primarily for business. You left Denver on Tuesday and flew to New York. On Wednesday, you flew from New York to Paris, arriving the next morning. On Thursday and Friday, you had business discussions, and from Saturday until Tuesday, you were sightseeing. You flew back to New York, arriving Wednesday afternoon. On Thursday, you flew back to Denver. Although you were away from your home in Denver for more than a week, you were not outside the United States for more than a week. This is because the day of departure does not count as a day outside the United States. You can deduct your cost of the round-trip flight between Denver and Paris. You can also deduct the cost of your stay in Paris for Thursday and Friday while you conducted business. However, you cannot deduct the cost of your stay in Paris from Saturday through Tuesday because those days were spent on nonbusiness activities.

**Exception 3.** You were outside the United States for more than a week, but you spent less than 25% of the total time you were outside the United States on nonbusiness activities. For this purpose, count both the day your trip began and the day it ended.

**Example.** You flew from Seattle to Tokyo, where you spent 14 days on business and 5 days on personal matters. You then flew back to Seattle. You spent one day flying in each direction. Because only  $\frac{1}{21}$  (less than 25%) of your total time abroad was for nonbusiness activities, you can deduct as travel expenses what it would have cost you to make the trip if you had not engaged in any nonbusiness activity. The amount you can deduct is the cost of the round-trip plane fare and 16 days of meals (subject to the 50% limit), lodging, and other related expenses.

**Exception 4.** You can establish that a personal vacation was not a major consideration, even if you have substantial control over arranging the trip.

If you do not meet any of these exceptions, you may still be able to deduct some of your expenses. See *Travel Primarily for Business*, next.

## Travel Primarily for Business

If you traveled outside the United States primarily for business purposes, but spent 25% or more of your time on nonbusiness activities, your travel expense deductions are limited unless you meet one of the four exceptions listed earlier under *Travel considered entirely for business*. If your deductions are limited, you must allocate your travel expenses of getting to and from your destination between your business and nonbusiness activities to determine your deductible amount. These travel allocation rules are discussed in Chapter 1 of Publication 463.

## Travel Primarily for Vacation

If your travel was primarily for vacation, or for **investment** purposes, and you spent some time attending brief professional seminars or a continuing education program, the entire cost of the trip is a nondeductible personal expense. You can, however, deduct your registration fees and any other expenses incurred that were directly related to your business.

**Example.** The university from which you graduated has a continuing education program for members of its alumni association. This program consists of trips to various foreign countries where academic exercises and conferences are set up to acquaint individuals in most occupations with selected facilities in several regions of the world. However, none of the conferences are directed toward specific occupations or professions. It is up to each participant to seek out specialists and organizational settings appropriate to his or her occupational interests.

Three-hour sessions are held each day over a 5-day period at each of the selected overseas facilities where participants can meet with individual practitioners. These sessions are composed of a variety of activities including workshops, mini-lectures, role playing, skill development, and exercises. Professional conference directors schedule and conduct the sessions. Participants can choose those sessions they wish to attend.

You can participate in this program since you are a member of the alumni association. You and your family take one of the trips. You spend about 2 hours at each of the planned sessions. The rest of the time you go touring and sightseeing with your family. The trip lasts less than 1 week.

Your travel expenses for the trip are not deductible since the trip was primarily a vacation. However, registration fees and any other incidental expenses incurred by you for the five planned sessions you attended that are directly related and beneficial to your business are deductible business expenses. These expenses should be specifically stated to ensure proper allocation of your deductible business expenses.

## Conventions

You can deduct your travel expenses when you attend a convention if you can show that your attendance benefits your trade or business. You cannot deduct the travel expenses for your family. If the convention is for **investment**, political, social, or other purposes unrelated to your trade or business, you cannot deduct the expenses. Nonbusiness expenses, such as social or sightseeing expenses, are personal expenses and are not deductible.

Your appointment or election as a delegate does not, in itself, entitle you to or deprive you of a deduction. Your attendance must be connected to your own trade or business.

**Convention agenda.** The agenda of the convention does not have to deal specifically with your official duties or the responsibilities of your position or business. It is enough if the agenda is so related to your active trade or business and your responsibilities that attendance for a business purpose is justified.

**Foreign conventions.** See Chapter 1 of Publication 463 for information on conventions held outside the North American area.

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## Entertainment Expenses

You may be able to deduct business-related entertainment expenses you have for entertaining a client, customer, or employee.

To be deductible, the expense must be both ordinary and necessary. An ordinary expense is one that is common and accepted in your field of business, trade, or profession. A necessary expense is one that is helpful and appropriate for your business. An expense does not have to be indispensable to be considered necessary.

In addition, the entertainment expense must meet one of two tests:

- 1) Directly-related test, or
- 2) Associated test.

You must also meet the requirements discussed later in this chapter under *Recordkeeping*.

Even if you meet all the requirements for claiming a deduction for entertainment expenses, the amount you can deduct may be limited. Generally, you can deduct only 50% of your unreimbursed entertainment expenses. This limit is discussed later under *50% Limit*.

**Club dues and membership fees.** You cannot deduct dues (including initiation fees) for membership in any club organized for business, pleasure, recreation, or other social purpose. This rule applies to any membership organization if one of its principal

purposes is to conduct entertainment activities for members or their guests, or to provide members or their guests with access to entertainment facilities.

The purposes and activities of a club, not its name, will determine whether or not you can deduct the dues. You cannot deduct dues paid to country clubs, golf and athletic clubs, airline clubs, hotel clubs, and clubs operated to provide meals under circumstances generally considered to be conducive to business discussions.

**Entertainment.** Entertainment includes any activity generally considered to provide entertainment, amusement, or recreation. Examples include entertaining guests at nightclubs; at social, athletic, and sporting clubs; at theaters; at sporting events; on yachts; or on hunting, fishing, vacation, and similar trips. You cannot deduct expenses for entertainment to the extent they are lavish or extravagant. If you buy a ticket to an entertainment event for a client, you generally cannot deduct more than the face value of the ticket.

**A meal as a form of entertainment.** Entertainment includes the cost of a meal you provide to a customer, or client, whether the meal is a part of other entertainment or by itself. A meal sold in the normal course of your business is not entertainment. Generally, to deduct an entertainment-related meal, you or your employee must be present when the food or beverages are provided.

A meal expense includes the cost of food, beverages, taxes, and tips for the meal.

**No double deduction allowed for meals.** You cannot claim the cost of your meal as an entertainment expense if you are also claiming the cost of your meal as a travel expense.

**Taking turns paying for meals or entertainment.** Expenses are **not** deductible when a group of business acquaintances take turns picking up each other's meal or entertainment checks without regard to whether any business purposes are served.

**Trade association meetings.** You can deduct expenses for entertainment that are directly related to and necessary for attending business meetings or conventions of certain exempt organizations. These organizations include business leagues, chambers of commerce, real estate boards, trade associations, and professional associations. The expenses of your attendance must be related to your active trade or business. These expenses are subject to the 50% limit on entertainment expenses.

**Additional information.** For more information on entertainment expenses, including discussions of the directly-related and associated tests, see Chapter 2 of Publication 463.

## 50% Limit

In general, you can deduct only 50% of your business-related meal and entertainment expenses. This limit applies to employees or their employers, and to self-employed persons (including independent contractors) or their clients, depending on whether the expenses are reimbursed.

The 50% limit applies to meals or entertainment expenses incurred while:

- 1) Traveling away from home (whether eating alone or with others) on business,
- 2) Entertaining business customers at your place of business, a restaurant, or other location, or
- 3) Attending a business convention or reception, business meeting, or business luncheon at a club.

Taxes and tips relating to a business meal or entertainment activity are included in the amount that is subject to the 50% limit. Expenses such as cover charges for admission to a nightclub, rent paid for a room in which you hold a dinner or cocktail party, or the amount paid for parking at a sports arena are also subject to the 50% limit. However, the cost of transportation to and from a business meal or a business-related entertainment activity is not subject to the 50% limit.

If you pay or incur an expense for goods and services consisting of meals, entertainment, and other services (such as lodging or transportation), you must allocate that expense between the cost of meals and entertainment and the cost of the other services. You must have a reasonable basis for making this allocation. For example, you must allocate your expenses if a hotel includes one or more meals in its room charge, or if you are provided with one per diem amount to cover both your lodging and meal expenses.

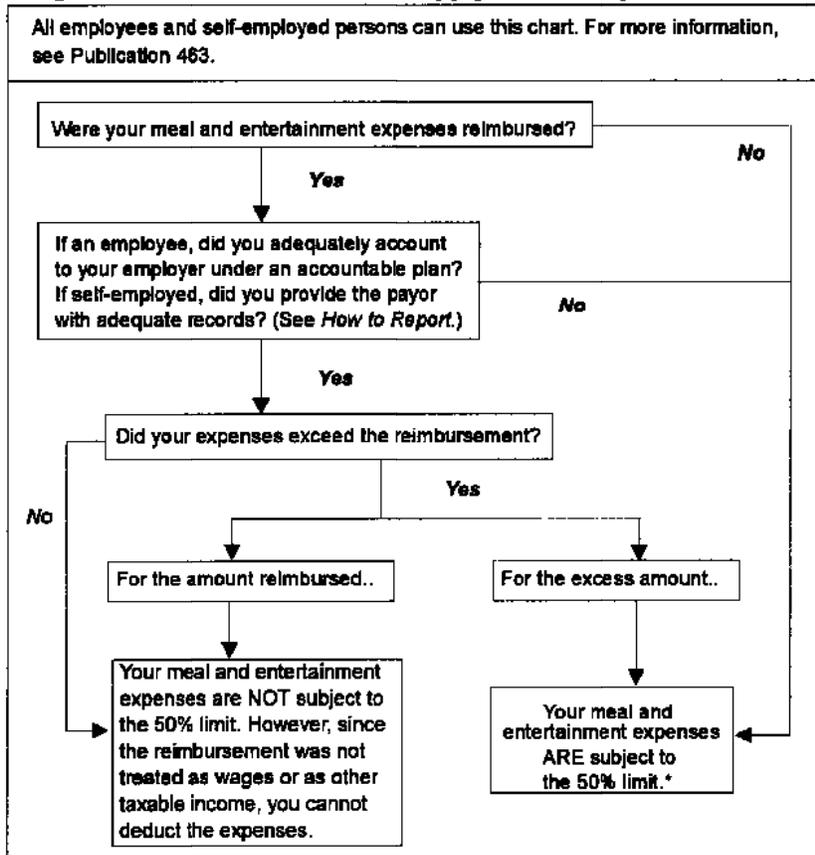
**Application of 50% limit.** The 50% limit on meal and entertainment expenses applies if the expense is otherwise deductible and is not covered by the exception discussed later in this section.

The 50% limit also applies to activities that are not a trade or business. It applies to meal and entertainment expenses incurred for the production of income, including rental or royalty income. It also applies to the cost of meals included in deductible educational expenses.

**When to apply the 50% limit.** You apply the 50% limit after determining the amount that would otherwise qualify for a deduction. You first determine the amount of meal and entertainment expenses that would be deductible under the rules discussed in this chapter.

You then apply the 50% limit. If you are an employee, use Form 2106 or Form 2106-EZ to figure the limit. If you are self-employed, figure the limit on Schedule C. If you file Schedule C-EZ, enter the total amount

**Figure 28-A. Does the 50% Limit Apply to Your Expenses?**



\* There are exceptions to this rule. For example, you are not subject to the 50% limit on meals and entertainment if:

- A) You incur the expenses as a means of advertising to, or promoting goodwill in, the general community.
- B) You pay the expenses as part of a package deal that includes a ticket to a charitable sports event, or
- C) Your business involves the sale of meals and/or entertainment to the public.

of your business expenses on line 2. You can only include 50% of your meal and entertainment expenses in that total. If you file Schedule F, enter 50% of your meal and entertainment expenses on line 34.

Finally, to determine the actual amount you can deduct if you are an employee, you must apply the 2%-of-adjusted-gross-income limit on Schedule A (Form 1040).

**Example 1.** You spend \$100 for a business-related meal. If \$40 of that amount is not allowable because it is considered lavish and extravagant, the remaining \$60 is subject to the 50% limit. Your deduction cannot be more than \$30 (.50 × \$60).

**Example 2.** You purchase two tickets to a concert and give them to a client. You purchased the tickets through a ticket agent. You paid \$150 for the two tickets, which had a face value of \$60 each (\$120 total). Your deduction cannot be more than \$60 (.50 × \$120).

### Exception to the 50% Limit

The 50% limit on meal and entertainment expenses applies if the expense is otherwise deductible based on the tests and rules explained in this chapter.

You can use *Figure 28-A* to help you determine if the 50% limit applies to you. Your meal or entertainment expense is **not** subject to the 50% limit if the expense meets the following exception.

**Employee's reimbursed expenses.** As an employee, you are not subject to the 50% limit if your employer reimburses you under an accountable plan and does not treat your reimbursement as wages. Accountable plans are discussed later under *Reimbursements*.

## Business Gift Expenses

If you give business gifts in the course of your trade or business, you can deduct the cost subject to the limits and rules in this section.

**Limit on business gifts.** You can deduct no more than \$25 for business gifts you give directly or indirectly to any one person during your tax year. A gift to a company that is intended for the eventual personal use or benefit of a particular person or a limited class of people will be considered an indirect gift to that particular person or to the individuals within that class of people who receive the gift.

A gift to the spouse of a business customer or client is an indirect gift to the customer or client. However, if you have an independent bona fide business connection with the spouse, the gift generally will not be considered an indirect gift to the other spouse. It will, however, be considered an indirect gift to the other spouse if it is intended for that spouse's eventual use or benefit. These rules also apply to gifts to any other family member.

If you and your spouse both give gifts, both of you are treated as one taxpayer. It does not matter whether you have separate businesses, are separately employed, or whether each of you has an independent connection with the recipient. If a partnership gives gifts, the partnership and the partners are treated as one taxpayer.

**Incidental costs.** Incidental costs, such as engraving on jewelry, or packaging, insuring, and mailing, are generally not included in determining the cost of a gift for purposes of the \$25 limit.

A related cost is considered incidental only if it does not add substantial value to the gift. For example, the cost of gift wrapping is considered an incidental cost. However, the purchase of an ornamental basket for packaging fruit is not considered an incidental cost of packaging if the basket has a substantial value compared to the value of the fruit.

**Exceptions.** The following items are not included in the \$25 limit for business gifts.

- 1) An item that costs \$4 or less and:
  - a) Has your name clearly and permanently imprinted on the gift, and
  - b) Is one of a number of identical items you widely distribute.
 Examples include pens, desk sets, and plastic bags and cases.
- 2) Signs, display racks, or other promotional material to be used on the business premises of the recipient.

**Gift or entertainment.** Any item that might be considered either a gift or an entertainment expense generally will be considered an entertainment expense. However, if you give a customer packaged food or beverages that you intend the customer to use at a later date, treat it as a gift expense.

If you give a business customer tickets to a theater performance or sporting event and you do not go with the customer to the performance or event, you can choose to treat

the tickets as either a gift or entertainment expense, whichever is to your advantage.

You can change your treatment of the tickets at a later date, but not after the time allowed for the assessment of income tax. In most instances, this assessment period ends 3 years after the due date of your income tax return.

If you go with the customer to the event, you must treat the cost of the tickets as an entertainment expense. You cannot choose, in this case, to treat the tickets as a gift expense.

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## Local Transportation Expenses

This section discusses expenses you can deduct for local business transportation. This includes the cost of transportation by air, rail, bus, taxi, etc., and the cost of driving and maintaining your car.

Local business transportation does **not** include expenses you have while traveling away from home overnight. Those expenses are deductible as travel expenses and are discussed earlier. However, if you use your car while traveling away from home overnight, use the rules in this section to figure your deduction. See *Car Expenses*, later.

Local transportation expenses include the ordinary and necessary expenses of getting from one workplace to another in the course of your business or profession when you are traveling within your tax home. (Tax home is defined earlier.) Other examples include the costs of visiting clients or customers or going to a business meeting away from your regular workplace.

The following discussion applies to you if you have a regular or main job away from your home (residence). If your principal place of business is in your home, see *Office in the home*, later.

Local transportation expenses also include the cost of getting from your home to a temporary workplace when you have one or more regular places of work. These temporary workplaces can be either within the area of your tax home or outside that area.

You can deduct your expenses for local business transportation, including the business use of your car, if the expenses are ordinary and necessary. An ordinary expense is one that is common and accepted in your field of trade, business, or profession. A necessary expense is one that is helpful and appropriate for your business. An expense does not have to be indispensable to be considered necessary.

**Illustration of local transportation.** *Figure 28–B* illustrates the rules for when you can deduct local transportation expenses when you have a regular or main job away from your home. You may want to refer to it when deciding whether you can deduct your local business transportation expenses.

**Temporary work location.** If you have one or more regular places of business and commute to a temporary work location, you

can deduct the expenses of the daily round-trip transportation between your home and the temporary location. The temporary work must be irregular or short term (generally a matter of days or weeks).

If the temporary work location is beyond the general area of your regular place of work, and you stay overnight, you are traveling away from home and may have deductible travel expenses as discussed earlier in this chapter.

If you do not have a regular place of work, but you ordinarily work at different locations in the metropolitan area where you live, you can deduct daily transportation costs between your home and a temporary work site **outside** your metropolitan area. Generally, a metropolitan area includes the area within the city limits and the suburbs that are considered part of that metropolitan area. You cannot deduct daily transportation costs between your home and temporary work sites **within** your metropolitan area. These are nondeductible commuting costs.

**Two places of work.** If you work at two places in a day, whether or not for the same employer, you can deduct the expense of getting from one workplace to the other. However, if for some personal reason you do not go directly from one location to the other, you can deduct only the amount it would have cost you to go directly from the first location to the second. Transportation expenses you have in going between home and a part-time job on a day off from your main job are commuting expenses. You cannot deduct them.

**Armed Forces reservists.** A meeting of an Armed Forces reserve unit is considered a second place of business if the meeting is held on a day on which you work at your regular job. You can deduct the expense of getting to or from one workplace to the other as just discussed under *Two places of work*. You usually cannot deduct the expense if the meeting is held on a day on which you do not work at your regular job. In this case, your transportation is generally considered a nondeductible commuting cost.

For reserve meetings held on days on which you do not work at your regular job, you can deduct your daily round-trip transportation expenses only if the location of the meeting is temporary and you have one or more regular places of work.

If you ordinarily work in a particular metropolitan area but not at any specific location and the reserve meeting is held at a temporary location outside that metropolitan area, you can deduct your daily transportation expenses.

If you travel away from home overnight to attend a guard or reserve meeting, you can deduct your travel expenses. These are discussed earlier under *Travel Expenses*.

**Commuting expenses.** You cannot deduct the costs of taking a bus, trolley, subway, taxi, or driving a car between **your home** and your main or regular place of work.

These costs are personal commuting expenses. You cannot deduct commuting expenses no matter how far your home is from your regular place of work. You cannot deduct commuting expenses even if you work during the commuting trip.

**Example.** You had a telephone installed in your car. You sometimes use that telephone to make business calls while commuting to and from work. Sometimes business associates ride with you to and from work, and you have a business discussion in the car. These activities do not change the trip's expenses from commuting to business. You cannot deduct your commuting expenses.

**Parking fees.** Fees you pay to park your car at your place of business are nondeductible commuting expenses. You can, however, deduct business-related parking fees when visiting a customer or client.

**Advertising display on car.** The use of your car to display material that advertises your business does not change the use of your car from personal use to business use. If you use this car for commuting or other personal uses, you cannot deduct your expenses for those uses.

**Car pools.** You cannot deduct the cost of using your car in a nonprofit car pool. Do not include payments you receive from the passengers in your income. These payments are considered reimbursements of your expenses. However, if you operate a car pool for a profit, you must include these payments from passengers in your income, and you can deduct your car expenses (using the rules in this chapter).

**Hauling tools or instruments.** If you haul tools or instruments in your car while commuting to and from work, this does not make your commuting costs deductible. However, you can deduct additional costs, such as the rent on a trailer that you tow with your vehicle, for carrying equipment to and from your job.

**Union members' trips from a union hall.** If you get your work assignments at a union hall and then go to your place of work, the costs of getting from the union hall to your place of work are nondeductible commuting expenses.

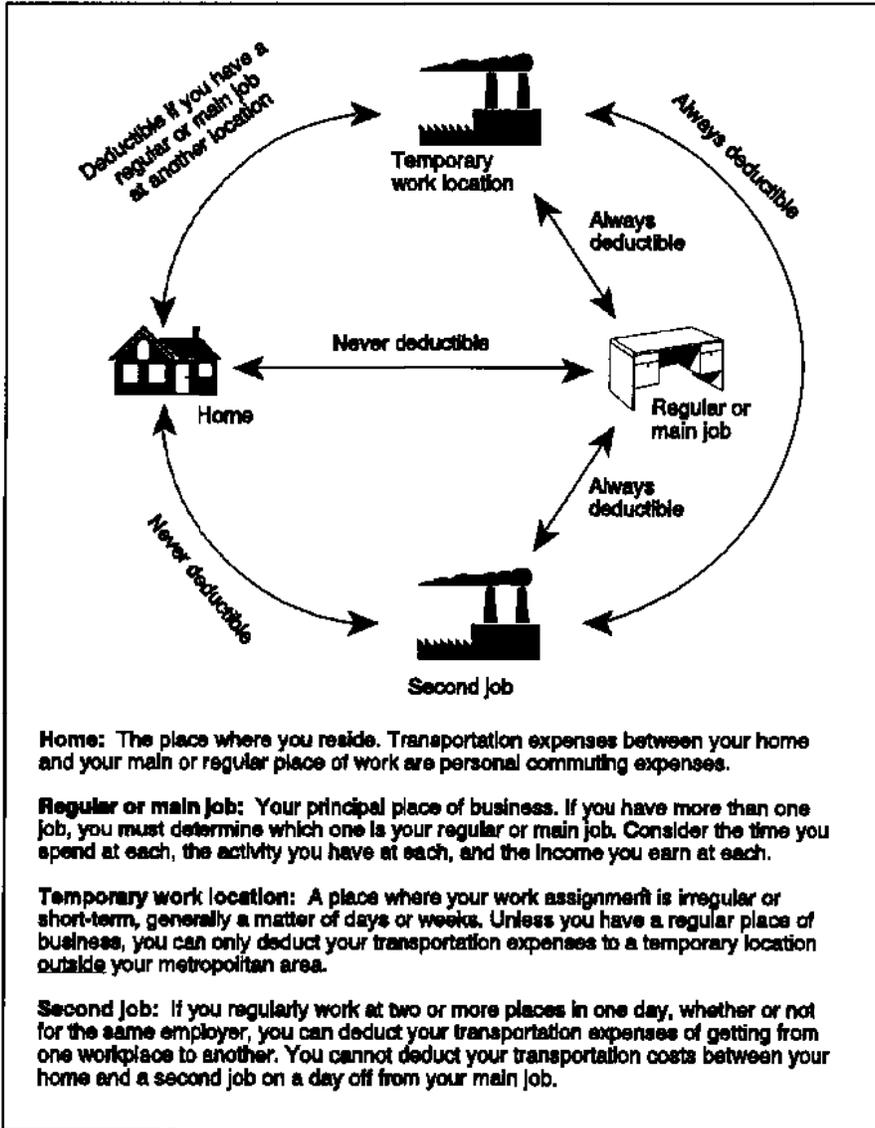
**Office in the home.** If you have an office in your home that qualifies as a **principal place of business**, you can deduct your daily transportation costs between your home and another work location in the same trade or business. (See Chapter 30 for information on determining if your home office qualifies as a principal place of business.)

If your home office does not qualify as a principal place of business, follow the general rules explained earlier.

**Examples of deductible local transportation.** The following examples illustrate when you can deduct local transportation expenses based on the location of your work and your home.

**Example 1.** You regularly work in an office in the city where you live. Your employer

**Figure 28-B. When Are Local Transportation Expenses Deductible?**  
 All employees and self-employed persons can use this chart. (Do not use this chart if your home is your principal place of business. See *Office in the home*.)



sends you to a one-week training session at a different office in the same city. You travel directly from your home to the training location and return each day. You can deduct the cost of your daily round-trip transportation between your home and the training location.

**Example 2.** Your principal place of business is in your home. You can deduct the cost of round-trip transportation between your qualifying home office and your client's or customer's place of business.

**Example 3.** You have no regular office, and you do not have an office in your home. In this case, the location of your first business contact is considered your office. Transportation expenses between your

home and this first contact are nondeductible commuting expenses. In addition, transportation expenses between your last business contact and your home are also nondeductible commuting expenses. Although you cannot deduct the costs of these first and last trips, you can deduct the costs of going from one client or customer to another.

## Car Expenses

If you use your car for business purposes, you may be able to deduct car expenses. You generally can use one of two methods to figure your expenses: actual expenses or the standard mileage rate.



You may be entitled to a tax credit for an electric vehicle or a deduction from gross income for a part of the cost of a clean-fuel vehicle that you place in service during the year. The vehicle must meet certain requirements, and you do not have to use it in your business to qualify for the credit or the deduction. For more information, see Chapter 15 of Publication 535.

**Car expense records.** Whether you use actual expenses or the standard mileage rate, you must keep records to show when you started using your car for business and the cost or other basis of the car. Your records must also show the business miles and the total miles you drove your car during the year.

**Actual expenses.** If you deduct actual expenses, you must keep records of the costs of operating the car, such as car insurance, interest, taxes, licenses, maintenance, repairs, depreciation, gas, and oil. If you lease a car, you must also keep records of that cost.

## Standard Mileage Rate

You may be able to use the standard mileage rate to figure the deductible cost of operating your car, van, pickup, or panel truck for business purposes. You can use the standard mileage rate only for a car that you own.

For 1996, the standard mileage rate is **31 cents** a mile for all business miles (46.5 cents a mile for U.S. Postal Service employees with rural routes). These rates are adjusted periodically for inflation.



If you choose to take the standard mileage rate, you **cannot** deduct your actual car expenses.

You generally can use the standard mileage rate regardless of whether you are reimbursed and whether any reimbursement is more or less than the amount figured using the standard mileage rate. See *Reimbursements* later in this chapter.

**Choosing the standard mileage rate.** If you want to use the standard mileage rate for a car, you must choose to use it in the first year the car is available for use in your business. Then in later years, you can choose to use the standard mileage rate or actual expenses.

If you choose to use the standard mileage rate, you are considered to have made an election not to use the depreciation methods under the modified accelerated cost recovery system (MACRS). This is because the standard mileage rate includes an allowance for depreciation. You also cannot claim the section 179 deduction. If you change to the actual expenses method in a later year, but before your car is considered fully depreciated, you have to estimate the useful life of the car and use straight line depreciation.

For information on how to figure that depreciation, see the exception in *Methods of depreciation* under *Depreciation Deduction* in Chapter 4 of Publication 463.

**Standard mileage rate not allowed.** You cannot use the standard mileage rate if you:

- 1) Do not own the car,
- 2) Use the car for hire (such as a taxi),
- 3) Operate two or more cars at the same time (as in fleet operations),
- 4) Claimed a deduction for the car in an earlier year using ACRS or MACRS depreciation, or
- 5) Claimed a section 179 deduction on the car.

**Two or more cars.** If you own two or more cars that are used for business at the same time, you cannot take the standard mileage rate for the business use of any car. However, you may be able to deduct a part of the actual expenses for operating each of the cars. See *Actual Car Expenses* in Chapter 4 of Publication 463 for information on how to figure your deduction.

You are **not** using two or more cars for business at the same time if you alternate using (use at different times) the cars for business.

The following examples illustrate the rules for when you can and cannot use the standard mileage rate for two or more cars.

**Example 1.** Marcia, a salesperson, owns a car and a van that she alternates using for calling on her customers. She can take the standard mileage rate for the business mileage of the car and the van.

**Example 2.** Tony uses his own pickup truck in his landscaping business. During the year, he traded in his old truck for a newer one. Tony can take the standard mileage rate for the business mileage of both the old and the new trucks.

**Example 3.** Chris owns a repair shop and an insurance business. He uses his pickup truck for the repair shop and his car for the insurance business. No one else uses either the pickup truck or the car for business purposes. Chris can take the standard mileage rate for the business use of the truck and the car.

**Example 4.** Maureen owns a car and a van that are both used in her housecleaning business. Her employees use the car and she uses the van to travel to the various customers. Maureen cannot take the standard mileage rate for the car or the van. This is because both vehicles are used in Maureen's business at the same time. She must use actual expenses for both vehicles.

**Parking fees and tolls.** In addition to using the standard mileage rate, you can deduct any business-related parking fees and tolls. (Parking fees that you pay to park your car at your place of work are nondeductible commuting expenses.)

## Actual Car Expenses

If you do not choose to use the standard mileage rate, you may be able to deduct your actual car expenses.



*If you qualify to use both methods, figure your deduction both ways to see which gives you a larger deduction.*

Actual car expenses include the costs of:

Depreciation	Lease fees	Rental fees
Garage rent	Licenses	Repairs
Gas	Oil	Tires
Insurance	Parking fees	Tolls

**Business and personal use.** If you use your car for both business and personal purposes, you must divide your expenses between business and personal use.

**Example.** You are a contractor and drive your car 20,000 miles during the year: 12,000 miles for business use and 8,000 miles for personal use. You can claim only 60% (12,000 ÷ 20,000) of the cost of operating your car as a business expense.

**Interest on car loans.** If you are an employee, you cannot deduct any interest paid on a car loan. This interest is treated as personal interest and is not deductible. However, if you are self-employed and use your car in that business, see Chapter 8 of Publication 535.

**Taxes paid on your car.** If you are an employee, you can deduct personal property taxes paid on your car if you itemize deductions. Enter the amount paid on line 7 of Schedule A (Form 1040). (See Chapter 24 for more information on taxes.) If you are not an employee, see your form instructions for information on how to deduct personal property taxes paid on your car.

You cannot deduct luxury or sales taxes, even if you use your car 100% for business. Luxury and sales taxes are part of your car's basis and may be recovered through depreciation, discussed later.

**Fines and collateral.** Fines and collateral for traffic violations are not deductible.

**Depreciation and section 179 deductions.** If you use your car for business purposes as an employee or as a sole proprietor, you may be able to recover its cost by claiming a depreciation or section 179 deduction. The amount you may claim depends on the year you placed the car in service and the amount of your business use.

For more information, see the instructions for Form 2106 (if you are an employee) or Form 4562 (if you are self-employed). Also see Chapter 4 of Publication 463 for a detailed discussion of these deductions.

**Leasing a car.** If you lease a car that you use in your business, you can deduct the part of each lease payment that is for the use of the car in your business. You cannot deduct

any part of a lease payment that is for commuting to your regular job or for any other personal use of the car.

You must spread any advance payments over the entire lease period. You cannot deduct any payments you make to buy a car even if the payments are called lease payments.

If you lease a car that you use in your business for 30 days or more, you may have to include an "inclusion amount" in your income for each tax year you lease the car. For information on reporting lease inclusion amounts, see *Leasing a Car* in Chapter 4 of Publication 463.

## Sale, Trade-in, or Other Disposition

If you sell, trade in, or otherwise dispose of your car, you may have a gain or loss on the transaction or an adjustment to the basis of your new car. This is true whether you used the standard mileage rate or actual car expenses to deduct the business use of your car. Chapter 14 has information on basis of assets and Chapter 15 has information on sales of property. For details on adjusting the basis of your car, see *Disposition of a Car* in Chapter 4 of Publication 463.

## Recordkeeping

This section discusses the written records you need to keep if you plan to deduct an expense discussed in this chapter.



By keeping timely and accurate records, you will have support to show the IRS if your tax return is ever examined. Or, your employer may require proof of expenses for which you are reimbursed under an accountable plan, as discussed later under *Adequate Accounting*.

**Proof needed.** You must be able to prove (substantiate) your deductions for travel, entertainment, business gift, and local transportation expenses. You should keep adequate records or have sufficient evidence that will support your own statement. Estimates or approximations do not qualify as proof of an expense.

**Timely recordkeeping.** You do not need to write down the elements of every expense at the time of the expense. However, a record of the elements of an expense or of a business use made at or near the time of the expense or use, supported by sufficient documentary evidence, has more value than a statement prepared later when generally there is a lack of accurate recall. A log maintained on a weekly basis, which accounts for use during the week, is considered a record made at or near the time of the expense or use.

**Duplicate information.** You do not have to record information in your account book or other record that duplicates information shown on a receipt as long as your records

and receipts complement each other in an orderly manner. You do not have to record amounts your employer pays directly for any ticket or other travel item. However, if you charge these items to your employer, through a credit card or otherwise, you must make a record of the amounts you spend.

**Expense accounts.** An expense account statement you give your employer, client, or customer is considered to have been made at or near the time of the expense or use. The statement must be copied from your account book, diary, statement of expense, or similar record.

**Chart that shows proof needed.** *Table 28–2* summarizes the factors to use in proving the elements of your expenses for travel, entertainment, gifts, and local business transportation. These factors are discussed in more detail in Chapter 5 of Publication 463.

To deduct these expenses, you must be able to prove the elements listed in column 1 of the chart. You prove these elements by having the information and receipts (where needed) for the expenses listed in columns 2, 3, 4, or 5.

**Adequate records.** You should keep the proof you need for these elements in an account book, diary, statement of expense, or similar record, and keep adequate documentary evidence (such as receipts, canceled checks, or bills) that together will support each element of an expense. Documentary evidence is explained in more detail later in this discussion. Written evidence has considerably more value than oral evidence alone.

**Separating expenses.** Each separate payment usually is considered a separate expense. If you entertain a customer or client at dinner and then go to the theater, the dinner expense and the cost of the theater tickets are two separate expenses. You must record them separately in your records.

**Totaling items.** You can make one daily entry for reasonable categories of expenses such as taxi fares, telephone calls, gas and oil, or other incidental travel costs. Meals should be in a separate category. You should include tips with the costs of the services you received.

Expenses of a similar nature occurring during the course of a single event are considered a single expense. For example, if during entertainment at a cocktail lounge, you pay separately for each serving of refreshments, the total expense for the refreshments is treated as a single expense.

**Allocating total cost.** If you prove the total cost of travel or entertainment but you cannot prove how much it cost for each person, you must divide the cost among you and your guests if a determination of business and nonbusiness cost is necessary. To do so, divide the total cost by the total number of persons. The result is the amount you use

to figure your deductible expense for each qualifying person. More information on allocating expenses between business and non-business is in Chapter 2 of Publication 463.

**Documentary evidence.** You generally must have documentary evidence, such as receipts, canceled checks, or bills, to support your expenses. However, this evidence is not needed if any of the following apply:

- 1) You have meals or lodging expenses while traveling away from home for which you account to your employer under an accountable plan and you use a per diem allowance method that includes meals and/or lodging,
- 2) Your expense, other than lodging, is less than \$75, or
- 3) You have a transportation expense for which a receipt is not readily available.

Accountable plans and per diem and mileage allowances are discussed later under *Reimbursements*.

**Adequate evidence.** Documentary evidence ordinarily will be considered adequate if it shows the amount, date, place, and essential character of the expense.

For example, a hotel receipt is enough to support expenses for business travel if it has:

- 1) The name and location of the hotel,
- 2) The dates you stayed there, and
- 3) Separate amounts for charges such as lodging, meals, and telephone calls.

A restaurant receipt is enough to prove an expense for a business meal if it has:

- 1) The name and location of the restaurant,
- 2) The number of people served, and
- 3) The date and amount of the expense.

If a charge is made for items other than food and beverages, the receipt must show that this is the case.

**Canceled check.** A canceled check, together with a bill from the payee, ordinarily establishes the cost. However, a canceled check by itself does not prove a business expense without other evidence to show that it was for a business purpose.

**Business purpose.** A written statement of the business purpose of an expense is generally needed. However, the degree of proof varies according to the circumstances in each case. If the business purpose of an expense is clear from the surrounding circumstances, a written explanation is not needed.

**Example.** A sales representative who calls on customers on an established sales route does not have to give a written explanation of the business purpose for traveling that route.

**Confidential information.** You do not need to put confidential information relating to an element of a deductible expense (such as

the place, business purpose, or business relationship) in your account book, diary, or other record. However, you do have to record the information elsewhere at or near the time of the expense and have it available to fully prove that element of the expense.

**Incomplete records.** If you do not have complete records to prove an element of an expense, then you must prove the element by:

- 1) Your own statement, whether written or oral, that contains specific information about the element, and
- 2) Other supporting evidence that is sufficient to establish the element.

#### **Additional information for the IRS.**

You may have to provide additional information to the IRS to clarify or to establish the accuracy or reliability of information contained in your records, statements, testimony, or documentary evidence before a deduction is allowed.

#### **How long to keep records and receipts.**

You must keep proof to support your claim to a deduction as long as your income tax return can be examined. Generally, it will be necessary for you to keep your records for 3 years from the date you file the income tax return on which the deduction is claimed. A return filed early is considered filed on the due date.

**Reimbursed for expenses.** Employees who give their records and documentation to their employers and are reimbursed for their expenses generally do not have to keep duplicate copies of this information. However, you may have to prove your expenses if:

- 1) You claim deductions for expenses that are more than reimbursements,
- 2) Your expenses are reimbursed under a nonaccountable plan,
- 3) Your employer does not use adequate accounting procedures to verify expense accounts, or
- 4) You are related to your employer, as defined earlier under *Standard Meal Allowance*.

See the next section, *How To Report*, for a discussion of reimbursements, adequate accounting, and nonaccountable plans.

**Additional information.** See Chapter 5 of Publication 463 for more information on recordkeeping, including a discussion on how to prove each type of expense discussed in this chapter.

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## How To Report

This section explains how and where to report on your tax return the expenses that are discussed in this chapter. It discusses reimbursements, including treatment of accountable and nonaccountable plans, adequate accounting, per diem allowances, and car or

Table 28-2. Elements To Prove Certain Business Expenses

Element to be proved (1)	Expense			
	Travel (2)	Entertainment (3)	Gift (4)	Transportation (car) (5)
<b>Amount</b>	Amount of each separate expense for travel, lodging, and meals. Incidental expenses may be totaled in reasonable categories, such as taxis, daily meals for traveler, etc.	Amount of each separate expense. Incidental expenses such as taxis, telephones, etc., may be totaled on a daily basis.	Cost of gift.	1) Amount of each separate expense including cost of the car, 2) Mileage for each business use of the car, and 3) Total miles for the tax year.
<b>Time</b>	Date you left and returned for each trip, and number of days for business.	Date of entertainment. For meals or entertainment directly before or after a business discussion, the date and duration of the business discussion.	Date of gift.	Date of the expense or use.
<b>Place</b>	Name of city or other designation.	Name and address or location of place of entertainment. Type of entertainment if not otherwise apparent. Place where business discussion was held if entertainment is directly before or after a business discussion.	Not applicable.	Name of city or other designation if applicable.
<b>Description</b>	Not applicable.	Not applicable.	Description of gift.	Not applicable.
<b>Business Purpose</b>	Business reason for travel or the business benefit gained or expected to be gained.	Business reason or the business benefit gained or expected to be gained. Nature of business discussion or activity.	Business reason for giving the gift or the business benefit gained or expected to be gained.	Business reason for the expense or use of the car.
<b>Business Relationship</b>	Not applicable.	Occupations or other information—such as names or other designations—about persons entertained that shows their business relationship to you. If all people entertained did not take part in business discussion, identify those who did. You must also prove that you or your employee was present if entertainment was a business meal.	Occupation or other information—such as name or other designation—about recipient that shows his or her business relationship to you.	Not applicable.

mileage allowances. This section ends by showing you how to complete Forms 2106 and 2106-EZ.

**Self-employed.** You must report your income and expenses on Schedule C or C-EZ (Form 1040) if you are a sole proprietor, or on Schedule F (Form 1040) if you are a farmer. You do not use Form 2106 or Form 2106-EZ. See Chapter 16 of Publication 535 or Publication 225, *Farmer's Tax Guide*, and your form instructions for information on how to complete your tax return.

**Both self-employed and an employee.** If you are both self-employed and an employee, you must keep separate records for each business activity. Report your business expenses for self-employment on Schedule C, Schedule C-EZ, or on Schedule F, as discussed earlier. Report your business expenses for your work as an employee on

Form 2106 or Form 2106-EZ, as discussed next.

**Employees.** If you are an employee, you generally must complete Form 2106 to deduct your travel, transportation, and entertainment expenses. However, you can use Form 2106-EZ instead of Form 2106 if you meet both of the following conditions.

- 1) You were not reimbursed for your expenses or, if you were reimbursed, the reimbursement was included in your income (box 1 of your Form W-2).
- 2) If you claim car expenses, you use the standard mileage rate.

For more information on how to report your expenses on Forms 2106 and 2106-EZ, see *Completing Forms 2106 and 2106-EZ*, later.

**Gifts.** If you did not receive any reimbursements (or the reimbursements were all

included in box 1 of your Form W-2) and the only business expense you are claiming is for business gifts, do not complete Form 2106 or 2106-EZ. Instead, claim the amount of your deductible business gifts directly on line 20 of Schedule A (Form 1040). Otherwise, you must complete Form 2106 or 2106-EZ.

**Statutory employees.** If you received a Form W-2 and the "Statutory employee" box in box 15 was checked, you report your income and expenses related to that income on Schedule C or C-EZ (Form 1040). Do not complete Form 2106 or Form 2106-EZ.

Statutory employees include full-time life insurance salespersons, certain agent or commission drivers, traveling salespersons, and certain homeworkers.



**CAUTION** If you are entitled to a reimbursement from your employer but you do not claim it (unclaimed reimbursement), you cannot claim a deduction for the

expenses to which that reimbursement applies.

**Reimbursement for personal expenses.** If your employer reimburses you for nondeductible personal expenses, such as for vacation trips, your employer must report the reimbursement as wage income (in box 1 of your Form W-2). You cannot deduct personal expenses.

## Reimbursements

This section explains what to do when you receive an advance or are reimbursed for any of the employee business expenses discussed in this chapter.

If you received an advance, allowance, or reimbursement for your expenses, how you report this amount and your expenses depends on whether the reimbursement was paid to you under an accountable plan or a nonaccountable plan.

This section explains the two types of plans, how per diem and car or mileage allowances simplify proving the amount of your expenses, and the tax treatment of your reimbursements and expenses.

**Reimbursement, allowance, or advance.** A reimbursement or other expense allowance arrangement is a system or plan that an employer uses to pay, substantiate, and recover the expenses, advances, reimbursements, and amounts charged to the employer for employee business expenses. It can also be a system used to keep track of amounts you receive from your employer's agent or a third party. Arrangements include per diem and mileage allowances. If a single payment includes both wages and an expense reimbursement, the amount of the reimbursement must be specifically identified.

Your employer has different options for reimbursing you for business-related expenses:

- 1) Reimbursing you for your actual expenses, as discussed throughout this chapter,
- 2) Reimbursing you for travel expenses:
  - a) Using the meals only allowance (discussed later) to reimburse your meals and incidental expenses and reimbursing you for your actual lodging expenses,
  - b) Using the regular federal per diem rate (discussed later), or
  - c) Using the high-low method (discussed later),
- 3) Reimbursing you for business use of your car:
  - a) At the standard mileage rate, or
  - b) At a flat rate or stated schedule (This can be paid periodically at a fixed rate, at a cents-per-mile rate, at a variable rate based on a stated schedule, or any combination of these rates.), or
- 4) Reimbursing you under any other method that is acceptable to the IRS.

Your employer should tell you what method of reimbursement is used and what records you must provide.

**No reimbursement.** If you are paid a salary or commission with the understanding that you will pay your own expenses, you are not reimbursed or given an allowance for your expenses. In this situation, you have no reimbursement or allowance arrangement, and you deduct your expenses using either Form 2106 or Form 2106-EZ and Schedule A (Form 1040), or only Schedule A (Form 1040) if you are only claiming business gift expenses. You do not have to read this section on reimbursements. Instead, see *Completing Forms 2106 and 2106-EZ*, later, for information on completing your tax return.

## Accountable Plans

To be an accountable plan, your employer's reimbursement or allowance arrangement must include all three of the following rules.

- 1) Your expenses must have a business connection — that is, you must have paid or incurred deductible expenses while performing services as an employee of your employer.
- 2) You must adequately account to your employer for these expenses within a reasonable period of time.
- 3) You must return any excess reimbursement or allowance within a reasonable period of time.

“Adequate accounting” and “returning excess reimbursements” are discussed later.

An **excess reimbursement or allowance** is any amount you are paid that is more than the business-related expenses that you adequately accounted for to your employer. See *Returning Excess Reimbursements*, later, for information on how to handle these excess amounts.

The definition of **reasonable period of time** depends on the facts of your situation. The IRS will consider it reasonable for you to:

- 1) Receive an advance within 30 days of the time you have an expense,
- 2) Adequately account for your expenses within 60 days after they were paid or incurred, and
- 3) Return any excess reimbursement within 120 days after the expense was paid or incurred.

If you are given a periodic statement (at least quarterly) that asks you to either return or adequately account for outstanding reimbursements and you comply within 120 days of the statement, the IRS will consider the amount adequately accounted for or returned within a reasonable period of time.

**Employee meets accountable plan rules.** If you meet the three rules for accountable plans, your employer should not include any reimbursements in your income in box 1 of

your Form W-2. If your expenses equal your reimbursement, you do not complete Form 2106. You have no deduction since your expenses and reimbursement are equal.

**TIP** If your employer included reimbursements in box 1 of your Form W-2 and you meet all three rules for accountable plans, ask your employer for a corrected Form W-2.

**Employee does not meet accountable plan rules.** You may be reimbursed under your employer's accountable plan but only part of your expenses may meet all three rules.

If your expenses are reimbursed under an otherwise accountable plan but you do not return, within a reasonable period of time, any reimbursement of expenses for which you did not adequately account, then only the amount for which you did adequately account is considered as paid under an accountable plan. The remaining expenses are treated as having been reimbursed under a nonaccountable plan (discussed later).

If you received an allowance or advance that was higher than the federal rate, see *Returning Excess Reimbursements*, later. In this chapter, “federal rate” means any of the three per diem allowances or the standard mileage rate.

**Reimbursement of nondeductible expenses.** You may be reimbursed under your employer's accountable plan for expenses related to that employer's business, some of which are deductible as employee business expenses and some of which are not deductible. The reimbursements you receive for the nondeductible expenses are treated as paid under a nonaccountable plan.

**Example.** Your employer's plan may reimburse you for travel expenses you incurred while away from home on business, and for meal expenses you paid when you work late at the office, even though you are not away from home. The part of the arrangement that reimburses you for the nondeductible meals while you work late at the office is treated as a second arrangement. The payments under this second arrangement are treated as paid under a nonaccountable plan.

**Per diem allowances.** If you are reimbursed by a per diem allowance (daily amount) that you received under an accountable plan, two facts affect your reporting:

- The federal rate for the area where you traveled, and
- Whether the allowance or your actual expenses were more than the federal rate.

For this purpose, the **federal rate** can be figured by using any one of the following three methods:

- 1) The regular federal per diem rate (discussed later in this chapter),

- 2) The high-low method (discussed later in this chapter), or
- 3) The standard meal allowance (discussed earlier under *What Are Travel Expenses?*).

The following discussions explain where to report your expenses depending upon how the amount of your per diem allowance compares to the federal rate.

**Per diem allowance LESS than or EQUAL to the federal rate.** If your per diem allowance is less than or equal to the federal rate, the allowance will not be included in box 1 of your Form W-2. You do not need to report the related expenses or the per diem allowance on your return if your expenses are equal to or less than the allowance.

However, if your actual expenses (or your expenses using the standard meal allowance) are more than your per diem allowance, you can complete Form 2106 and deduct the excess amount on Schedule A (Form 1040). If you are using actual expenses, you must be able to prove to the IRS the total amount of your expenses and reimbursements for the entire year. If you are using the standard meal allowance, you do not have to prove that amount.

**Example.** In April Jeremy takes a 2-day business trip to Denver. The federal rate in Denver is \$126 per day. As required by his employer's accountable plan, he accounts for the time (dates), place, and business purpose of the trip. His employer reimburses him \$126 a day (\$252 total) for living expenses. Jeremy's living expenses in Denver are not more than \$126 a day.

Jeremy's employer does not include any of the reimbursement on his Form W-2. Jeremy does not deduct the expenses on his return.

**Per diem allowance MORE than the federal rate.** If your per diem allowance is more than the federal rate, your employer must include the allowance amount up to the federal rate in box 13 (code L) of your Form W-2. This amount is not taxable. However, the per diem allowance that is more than the federal rate will be included in box 1 of your Form W-2. You must report this part of your reimbursement as if it were wage income.

If your actual expenses are less than or equal to the federal rate, you do not complete Form 2106 or claim any of your expenses on your return.

However, if your actual expenses are more than the federal rate, you can complete Form 2106 and deduct those expenses that are more than the federal rate. You must report on Form 2106 your reimbursements up to the federal rate (as shown in box 13 of your Form W-2) and all your expenses. You should be able to prove these amounts to the IRS.

**Example 1.** Laura lives and works in Austin. Her employer sent her to Albuquerque for 2 days on business. Laura's employer paid the hotel directly for her lodging and reimbursed Laura \$40 a day (\$80 total) for meals and incidental expenses. Laura's

actual meal expenses did not exceed the federal rate for Albuquerque, which is \$34 per day.

Her employer included the \$12 that was more than the federal rate  $[(\$40 - \$34) \times 2]$  in box 1 of Laura's Form W-2. Her employer shows \$68  $(\$34 \text{ a day} \times 2)$  in box 13 of her Form W-2. This amount is not included in Laura's income. Laura does not have to complete Form 2106; however, she must include the \$12 in her gross income as wages (by reporting the total amount shown in box 1 of her Form W-2).

**Example 2.** Joe also lives in Austin and works for the same employer as Laura. In May the employer sent Joe to Washington, DC, for 4 days and paid the hotel directly for his hotel bill. The employer reimbursed Joe \$45 a day for his meals and incidental expenses. The federal rate for Washington, DC, is \$38 a day.

Joe can prove that his actual meal expenses totaled \$290. His employer's accountable plan will not pay more than \$45 a day for travel to Washington, DC, so Joe does not give his employer the records that prove that he actually spent \$290. However, he does account for the time, place, and business purpose of the trip. This is Joe's only business trip in 1996.

Joe was reimbursed \$180  $(\$45 \times 4 \text{ days})$ , which is \$28 more than the federal rate of \$152  $(\$38 \times 4 \text{ days})$ . The employer includes the \$28 as income on Joe's Form W-2 in box 1. The employer also enters \$152 in box 13 of Joe's Form W-2, along with a code L.

Joe completes Form 2106 to figure his deductible expenses. He enters the total of his actual expenses for the year (\$290) on Form 2106. He also enters the reimbursements that were not included in his income (\$152). His total deductible expense, before the 50% limit, is \$138. After he figures the 50% limit on his unreimbursed meals and entertainment, he will include the balance, \$69, as an itemized deduction.

**Car or mileage allowances.** How you report a car or mileage allowance that you received under an accountable plan depends on whether the reimbursement or your actual expenses were more than the standard mileage rate of 31 cents a mile for 1996. The standard mileage rate is considered to be the federal rate. If your allowance was equal to or less than 31 cents a mile, see *Per diem allowance LESS than or EQUAL to the federal rate*, earlier. If your allowance was more than 31 cents a mile, see *Per diem allowance MORE than the federal rate*, earlier.

**Example 1.** Nicole drives 10,000 miles a year for business. Under her employer's accountable plan, she accounts for the time (dates), place, and business purpose of each trip. Her employer pays her a mileage allowance of 31 cents a mile. Nicole's expenses of operating her car are not more than 31 cents a mile.

Nicole's employer does not include any of the reimbursement on her Form W-2 because the mileage allowance is not more than the standard mileage rate. Nicole does not deduct the expenses on her return because her expenses are not more than the allowance she received.

**Example 2.** The facts in Debbie's case are the same as in *Example 1*, except Debbie gets reimbursed 35 cents a mile, which is 4 cents a mile more than the standard mileage rate. Her employer must include the reimbursement amount up to the standard mileage rate, \$3,100  $(10,000 \text{ miles} \times 31 \text{ cents})$ , in box 13 (code L) of her Form W-2. That amount is not taxable.

Debbie's employer must also include \$400  $(10,000 \text{ miles} \times 4 \text{ cents})$  in box 1 of her Form W-2. This is the reimbursement that is more than the standard mileage rate. Because her reimbursement is equal to or more than her expenses, Debbie does not complete Form 2106.

**TIP** *The employer makes the decision whether to reimburse employees under an accountable plan or a nonaccountable plan. If you are an employee who receives payments under a nonaccountable plan, you cannot convert these amounts to payments under an accountable plan by voluntarily accounting to your employer for the expenses and voluntarily returning excess reimbursements to the employer.*

## Adequate Accounting

One of the three rules (listed earlier) for a reimbursement or other expense allowance arrangement to qualify as an accountable plan is that you adequately account to your employer for your expenses. You adequately account by giving your employer documentary evidence of your travel, mileage, and other employee business expenses, along with a statement of expense, an account book, a diary, or a similar record in which you entered each expense at or near the time you had it. Documentary evidence includes receipts, canceled checks, and bills. See *Recordkeeping*, earlier.

You must account for **all** amounts received from your employer during the year as advances, reimbursements, or allowances for travel, entertainment, gifts, business use of your car, or any other expenses. This includes amounts that were charged to your employer by credit card or other method. You must give your employer the same type of records and supporting information that you would have to give to the IRS if the IRS questioned a deduction on your return. You must pay back the amount of any reimbursement or other expense allowance for which you do not adequately account or that exceeds the amount for which you accounted.

**Per diem allowance or reimbursement.** You may be able to prove the amount of your

**Table 28-3. Reporting Travel, Entertainment, and Gift Expenses and Reimbursements**

Type of Reimbursement (or Other Expense Allowance) Arrangement	Employer Reports on Form W-2	Employee Shows on Form 2106 <sup>1</sup>
<b>Accountable</b>		
Actual expense reimbursement  Adequate accounting and excess returned	Not reported	Not shown if expenses do not exceed reimbursement
Actual expense reimbursement  Adequate accounting and return of excess required but excess not returned	Excess reported as wages in box 1. Amount adequately accounted for is reported only in box 13—it is <i>not</i> reported in box 1.	All expenses (and reimbursements reported on Form W-2, box 13), <b>only</b> if some or all of the excess expenses are claimed. <sup>2</sup> Otherwise, form is not filed.
Per diem or mileage allowance (up to federal rate)  Adequate accounting and excess returned	Not reported	All expenses and reimbursements <b>only</b> if excess expenses are claimed. <sup>2</sup> Otherwise, form is not filed.
Per diem or mileage allowance (exceeds federal rate)  Adequate accounting up to the federal rate only and excess not returned	Excess reported as wages in box 1. Amount up to the federal rate is reported only in box 13—it is <i>not</i> reported in box 1.	All expenses (and reimbursements equal to the federal rate) <b>only</b> if expenses in excess of the federal rate are claimed. <sup>2</sup> Otherwise, form is not filed.
<b>Nonaccountable</b>		
Either adequate accounting or return of excess, or both, not required by plan	Entire amount is reported as wages in box 1.	All expenses <sup>2</sup>
<b>No reimbursement</b>	Normal reporting of wages, etc.	All expenses <sup>2</sup>

<sup>1</sup> You may be able to use Form 2106-EZ. See *Completing Forms 2106 and 2106-EZ*.

<sup>2</sup> Any allowable business expense is deducted as an itemized deduction.

travel expenses by using a per diem allowance amount. This is a fixed amount of daily reimbursement that your employer gives you for your lodging, meal, and incidental expenses when you are away from home on business. The term “incidental expenses” is defined earlier under *Standard Meal Allowance*.

A per diem allowance satisfies the adequate accounting requirements for the amount in question if all four of the following conditions apply.

- 1) Your employer reasonably limits payments of the travel expenses to those that are ordinary and necessary in the conduct of the trade or business.
- 2) The allowance is similar in form to and not more than the federal per diem (that is, your allowance varies based on where, when, and how long you were traveling).
- 3) You are not related to your employer (as defined earlier under *Standard Meal Allowance*).

- 4) The time, place, and business purpose of the travel are proved, as explained earlier under *Recordkeeping*.

If the IRS finds that an employer’s travel allowance practices are not based on reasonably accurate estimates of travel costs, including recognition of cost differences in different areas, you will not be considered to have accounted to your employer. In this case, you may have to prove your expenses to the IRS.

**Allowance for meals.** These rules also apply if you are reimbursed only for your meal expenses or get a separate per diem allowance for meals and incidental expenses. Your reimbursement or allowance must not be more than the standard meal allowance. A per diem allowance is paid separately for meals and incidental expenses if your employer furnishes lodging in kind, pays you a meal allowance plus the actual cost of your lodging, or pays the hotel, motel, etc. directly for your lodging. A per diem allowance is also paid separately for meals and incidental expenses if your employer does not have

a reasonable belief that you incurred lodging expenses, such as when you stay with friends or relatives or sleep in the cab of your truck.

**Proving your expenses with a per diem allowance.** If your employer pays for your expenses using a per diem allowance, including a meals only allowance, you can generally use the allowance as proof for the amount of your expenses. However, the amount of expense that you can prove this way cannot be more than the regular federal per diem rate or the high-low method, both discussed later.

You can only use the per diem allowance to prove the cost of meals and/or lodging. You must still provide other proof of the time, place, and business purpose for each expense.

**Regular federal per diem rate.** The regular federal per diem rate is the highest amount that the federal government will pay to its employees for lodging, meals, and incidental expenses (or meals and incidental expenses only) while they are traveling away from home in a particular area. The rates are different for different locations. You must use the rate in effect for the area where you stop for sleep or rest. Your employer should have these rates available. (Employers can get Publication 1542, *Per Diem Rates*, which gives the rates in the continental United States for the current year.)

The federal rates for meals and incidental expenses are the same as those rates discussed earlier under *Standard Meal Allowance*.

**High-low method.** This is a simplified method of computing the federal per diem rate for travel within the continental United States. It eliminates the need to keep a current list of the per diem rate in effect for each city in the continental United States.

Under the high-low method, the per diem amount for travel during 1996 is \$152 for certain locations. All other areas have a per diem amount of \$95. Employers can get Publication 1542 that gives the areas eligible for the \$152 per diem amount under the high-low method for all or part of the year.

**Allocation of per diem on partial days of travel.** The federal per diem rate or the federal meals and incidental expenses rate is for a full 24-hour day of travel. If you travel for part of a day, the full day rate must be allocated. You can use either of the following methods to figure the federal per diem rate for that day.

- 1) Count one-fourth of the federal rate for each 6-hour quarter of the day during any portion of which you are traveling away from home for business. The 6-hour quarters are midnight to 6 a.m.; 6 a.m. to noon; noon to 6 p.m.; and 6 p.m. to midnight.
- 2) Prorate the federal rate using any method that is consistently applied and

is in accordance with reasonable business practice. For example, an employer can treat 2 full days of per diem paid for travel away from home from 9 a.m. of one day to 5 p.m. of the next day as being no more than the federal rate. This is true even though a federal employee would be limited to a reimbursement for only 1½ days.

These rules apply whether your employer uses the regular federal per diem rate or the high-low method.

**Car or mileage allowance.** You may be able to prove the amount of your expense by using a car or mileage allowance amount. A car or mileage allowance satisfies the adequate accounting requirements for the amount if all three of the following conditions apply.

- 1) Your employer reasonably limits payments of the car expenses to those that are ordinary and necessary in the conduct of the trade or business.
- 2) The allowance is paid at the standard mileage rate, at another rate per mile, or other acceptable method.
- 3) You prove the time (dates), place, and business purpose of using your car to your employer within a reasonable period of time.

However, if you are related to your employer (as defined earlier under *Standard Meal Allowance*), you must be able to prove your expenses to the IRS. This is true even if you have already adequately accounted to your employer and returned any excess reimbursement. (This does not preclude your use of the standard mileage rate to adequately account to your employer and the IRS.)

**Proving your expenses with a car or mileage allowance.** If your employer pays for your expenses using a car or mileage allowance, you can generally use the allowance as proof for the amount of your expenses. However, the amount of expense that you can prove this way cannot be more than the standard mileage rate or the amount of the fixed and variable rate allowance that your employer does **not** include in box 1 of your Form W-2.

You can only use a car or mileage allowance to prove the amount of business car expense. You must still prove the time (dates), place, and business purpose for each expense.

## Returning Excess Reimbursements

Under an accountable plan, you must be required to return any excess reimbursement for your business expenses to the person paying the reimbursement or allowance. **Excess reimbursement** means any amount for which you did not adequately account within a reasonable period of time. For example, if you received a travel advance and

you did not spend all the money on business-related expenses, or if you do not have proof of all your expenses, you have an excess reimbursement.

“Adequate accounting” and “reasonable period of time” were discussed earlier.

**Travel advance.** If your employer provides you with an expense allowance before you actually have the expense, and the allowance is reasonably calculated not to exceed your expected expenses, you have received a travel advance. Under an accountable plan, you are required to adequately account to your employer for this advance and to return any excess within a reasonable period of time. See *Accountable Plans*, earlier. If you do not adequately account for or do not return any excess advance within a reasonable period of time, the amount you do not account for or return will be treated as having been paid under a nonaccountable plan (discussed later).

**Unproved amounts.** If you do not prove that you actually traveled on each day for which you received a per diem or car allowance (proving the elements described earlier under *Recordkeeping*), you must return this unproved amount of the travel advance within a reasonable period of time. If you fail to do this, your employer will include as income in box 1 of your Form W-2 the unproved amount of per diem or car allowance as excess reimbursement. This unproved amount is considered paid under a nonaccountable plan (discussed later).

**Per diem MORE than federal rate.** If your employer’s accountable plan pays you a per diem or similar allowance that is higher than the federal rate for the area you traveled to, you do not have to return the difference between the two rates for the period you can prove business-related travel expenses. However, the difference will be reported as wages on your Form W-2. This excess amount is considered paid under a nonaccountable plan (discussed later).

**Example.** Your employer sends you on a 5-day business trip to Phoenix and gives you a \$200 ( $\$40 \times 5$  days) advance to cover your meals and incidental expenses. The federal per diem for meals and incidental expenses in Phoenix is \$34. Your trip lasts only 3 days. Under your employer’s accountable plan, you must return the \$80 ( $\$40 \times 2$  days) advance for the 2 days you did not travel. You do not have to return the \$18 difference between the allowance you received and the federal rate for Phoenix [ $(\$40 - \$34) \times 3$  days]. However, the \$18 will be reported on your Form W-2 as wages.

## Nonaccountable Plans

A **nonaccountable plan** is a reimbursement or expense allowance arrangement that does not meet the three rules listed earlier under *Accountable Plans*.

In addition, the following payments made under an accountable plan will be treated as being paid under a nonaccountable plan:

- 1) Excess reimbursements you fail to return to your employer, and
- 2) Reimbursements of nondeductible expenses related to your employer’s business. See *Reimbursement of nondeductible expenses* earlier under *Accountable Plans*.

If you are not sure if the reimbursement or expense allowance arrangement is an accountable or nonaccountable plan, see your employer.

Your employer will combine the amount of any reimbursement or other expense allowance paid to you under a nonaccountable plan with your wages, salary, or other pay. Your employer will report the total in box 1 of your Form W-2.

You must complete Form 2106 or 2106-EZ and itemize your deductions to deduct your expenses for travel, transportation, meals, or entertainment. Your meal and entertainment expenses will be subject to the 50% limit discussed earlier under *Entertainment Expenses*. Also, your total expenses will be subject to the 2%-of-adjusted-gross-income limit that applies to most miscellaneous itemized deductions.

**Example.** Kim’s employer gives her \$500 a month (\$6,000 for the year) for her business expenses. Kim does not have to provide any proof of her expenses to her employer, and Kim can keep any funds that she does not spend.

Kim is being reimbursed under a nonaccountable plan. Her employer will include the \$6,000 on Kim’s Form W-2 as if it were wages. If Kim wants to deduct her business expenses, she must complete Form 2106 or Form 2106-EZ and itemize her deductions. The 50% limit applies to her meal and entertainment expenses, and the 2%-of-adjusted-gross-income limit applies to her total employee business expenses.

**Part of reimbursement paid under accountable plan.** If your expenses are reimbursed under an otherwise accountable plan but you do not return, within a reasonable period of time, any reimbursement for which you do not adequately account, only the amount for which you do not adequately account is considered as paid under a nonaccountable plan. The rest is treated as having been paid under an accountable plan (as discussed earlier).

## Completing Forms 2106 and 2106-EZ

This section briefly describes how employees complete Forms 2106 and 2106-EZ. *Table 28-3* explains what the employer reports on Form W-2 and what the employee reports on Form 2106. The instructions for the forms have more information on completing them.

**Form 2106-EZ.** You may be able to use Form 2106-EZ to claim your employee business expenses. You qualify to use this form if you meet both of the following conditions.

- 1) You were not reimbursed for your expenses or, if you were reimbursed, the reimbursement was included in your income (box 1 of your Form W-2).
- 2) If you claim car expenses, you use the standard mileage rate.

**Car expenses.** If you used a car to perform your job as an employee, you may be able to deduct certain car expenses. Car expenses are generally figured in Part II of Form 2106, and then claimed on line 1, Column A, of Part I of Form 2106. Car expenses using the standard mileage rate can also be figured on Form 2106-EZ by completing Part III and line 1 of Part II.

**Local transportation expenses.** Show your local business transportation expenses that did not involve overnight travel on line 2, Column A, of Form 2106 or on line 2, Part II of Form 2106-EZ. Also include on this line business expenses you have for parking fees and tolls. Do not include expenses of operating your car or expenses of commuting between your home and work.

**Employee business expenses other than meals and entertainment.** Show your other employee business expenses on lines 3 and 4, Column A, of Form 2106 or Form 2106-EZ. Do not include expenses for meals and entertainment on those lines. Line 4 is for expenses such as business gifts, educational expenses (tuition and books), office-in-the-home expenses, and trade and professional publications.



*If line 4 expenses are the only ones you are claiming and you received no reimbursements (or the reimbursements were all included in box 1 of your Form W-2), do not complete Form 2106 or 2106-EZ. Instead, claim these amounts directly on line 20 of Schedule A (Form 1040). List the type and amount of each expense on the dotted lines next to line 20 and include the total on line 20.*

**Meal and entertainment expenses.** Show the full amount of your expenses for business-related meals and entertainment on line 5, Column B, of Form 2106. Include meals you paid for while away from your tax home overnight and other business meals and entertainment. Enter 50% of the line 8 meal and entertainment expenses on line 9, Column B, of Form 2106.

If you file Form 2106-EZ, enter the full amount of your meals and entertainment on the line to the left of line 5 and multiply the total by 50%. Enter the result on line 5.

**Reimbursements.** Enter on line 7 of Form 2106 the amounts your employer (or third

party) reimbursed you for employee business expenses that were **not** included in box 1 of your Form W-2. (You cannot use Form 2106-EZ.) This includes any reimbursement reported under code L in box 13 of Form W-2.

**Allocating your reimbursement.** If you were reimbursed under an accountable plan and want to deduct excess expenses that were not reimbursed, you may have to allocate your reimbursement. If your employer paid you a single amount that covers meals or entertainment, as well as other business expenses, you must allocate the reimbursement so that you know how much to enter in Column A and Column B of line 7 of Form 2106.

**Example.** Rob's employer paid him an expense allowance of \$5,000 during 1996 under an accountable plan. It is not clear how much of the allowance is for the cost of deductible meals. Rob actually spent \$6,500 during the year (\$2,000 for meals and \$4,500 for automobile expenses).

Rob uses the following worksheet from the Instructions for Form 2106 to allocate his reimbursement on line 7 of Form 2106.

1. Enter the total amount of reimbursements your employer gave you that <b>were not</b> reported to you in box 1 of your Form W-2 .....	5,000
2. Enter the total amount of your expenses for the periods covered by this reimbursement .....	6,500
3. Of the amount on line 2, enter your total expense for meals and entertainment .....	2,000
4. Divide line 3 by line 2. Enter the result as a decimal (to at least two places) .....	.31
5. Multiply line 1 by line 4. Enter the result here and in Column B, line 7 ...	1,550
6. Subtract line 5 from line 1. Enter the result here and in Column A, line 7 ...	3,450

After you have completed your Form 2106 or 2106-EZ, follow the directions on that form to deduct your expenses on the appropriate line of your tax return. For most taxpayers this is on line 20 of Schedule A (Form 1040). However, if you are a performing artist or a disabled employee with impairment-related work expenses, see *Special Rules*, later.

**Limits on employee business expenses.** Your employee business expenses may be subject to any of the three limits described next. These limits are figured in the following order on the specified form.

**1. Limit on meals and entertainment.** Certain meal and entertainment expenses are subject to a 50% limit. Employees figure this limit on line 9 of Form 2106 or line 5 of Form 2106-EZ. See *50% Limit* under *Entertainment Expenses*, earlier.

**2. Limit on employee business expenses.** Employees deduct employee business expenses (as figured on Form 2106 or 2106-EZ) on line 20 of Schedule A (Form

1040). Most miscellaneous itemized deductions, including employee business expenses, are subject to a 2%-of-adjusted-gross-income limit. This limit is figured on line 25 of Schedule A (Form 1040).

**3. Limit on total itemized deductions.** If your adjusted gross income (line 32 of Form 1040) is more than \$117,950 (\$58,975 if you are married filing separately), the amount of your overall itemized deductions, including employee business expenses, may be limited. See Chapter 22 for more information on this limit.

## Special Rules

This section discusses special rules that apply only to performing artists and disabled employees with impairment-related work expenses.

**Expenses of certain performing artists.** If you are a performing artist, you may qualify to deduct your employee business expenses as an adjustment to gross income rather than as a miscellaneous itemized deduction. To qualify, you must meet **all** of the following requirements.

- 1) During the tax year, you perform services in the performing arts for at least two employers.
- 2) You receive at least \$200 each from any two of these employers.
- 3) Your related performing-arts business expenses are more than 10% of your gross income from the performance of those services.
- 4) Your adjusted gross income is not more than \$16,000 before deducting these business expenses.

**Special rules for married persons.** If you are married, you must file a joint return unless you lived apart from your spouse at all times during the tax year.

If you file a joint return, you must figure requirements (1), (2), and (3) separately for both you and your spouse. However, requirement (4) applies to your and your spouse's combined adjusted gross income.

**Where to report.** If you meet all of the above requirements, you should first complete Form 2106 or 2106-EZ. Then you include your performing-arts-related expenses from line 10 of Form 2106 or line 6 of Form 2106-EZ in the total on line 30 of Form 1040. Write "QPA" and the amount of your performing-arts-related expenses on the dotted line next to line 30 of Form 1040.

If you do not meet all of the above requirements, you do not qualify to deduct your expenses as an adjustment to gross income. Instead, you must complete Form 2106 or 2106-EZ and deduct your employee business expenses as an itemized deduction on line 20 of Schedule A (Form 1040).

**Impairment-related work expenses of disabled employees.** If you are an employee with a physical or mental disability, your impairment-related work expenses are

not subject to the 2%-of-adjusted-gross-income limit that applies to most other employee business expenses. After you complete Form 2106 or 2106-EZ, enter your impairment-related work expenses from line 10 of Form 2106 or line 6 of Form 2106-EZ on line 27 of Schedule A (Form 1040). Enter your employee business expenses that are **unrelated** to your disability from line 10 of Form 2106 or line 6 of Form 2106-EZ on line 20 of Schedule A.

Impairment-related work expenses are your allowable expenses for attendant care at your workplace and other expenses you have in connection with your workplace that are necessary for you to be able to work. For more information, see Chapter 23.

### Illustrated Example

Bill Wilson is an employee of Fashion Clothing Co. in Manhattan, NY. In a typical week, Bill leaves his home on Long Island on Monday morning and drives to Albany to exhibit the Fashion line for 3 days to prospective customers. Then he drives to Troy to show X Department Store, an old customer, Fashion's new line of merchandise. While in Troy, he talks with Tom Brown, purchasing agent for X Department Store, to discuss the new line. He later takes John Smith of Y Co. out

to dinner to discuss Y Co.'s buying Fashion's new line of clothing.

Bill purchased his car on January 3, 1994. He uses the standard mileage rate for car expense purposes. He records his total mileage, business mileage, parking fees, and tolls for the year. Bill timely records his expenses and other pertinent information in a travel expense log (not shown). He obtains receipts for his expenses for lodging and for any other expenses of \$75 or more.

During the year, Bill drove a total of 25,000 miles of which 20,000 miles were for business. Following the instructions for Part II of Form 2106, he answers all the questions and figures his vehicle expense to be \$6,200 (20,000 business miles × 31 cents standard mileage rate).

His total employee business expenses are shown in the following table.

<u>Type of Expense</u>	<u>Amount</u>
Parking fees and tolls .....	\$ 325
Vehicle expenses .....	6,200
Meals .....	2,632
Lodging, laundry, cleaning .....	8,975
Entertainment .....	1,870
Gifts, education, etc. ....	430
Total	<u><u>\$ 20,432</u></u>

Bill received an allowance of \$3,600 (\$300 per month) to help offset his expenses. Bill did not have to account to his employer for the reimbursement, and the \$3,600 was included as income in box 1 of his Form W-2.

Because Bill's reimbursement was included in his income and he is using the standard mileage rate for his car expenses, he files Form 2106-EZ with his tax return. His filled-in form is shown at the end of this chapter.

Form **2106-EZ**

# Unreimbursed Employee Business Expenses

OMB No. 1545-1441

▶ See instructions on back.

**1996**

Department of the Treasury  
Internal Revenue Service (99)

▶ Attach to Form 1040.

Attachment  
Sequence No. **54A**

Your name <b>Bill Wilson</b>	Social security number <b>555 00 5555</b>	Occupation in which expenses were incurred <b>Sales</b>
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## Part I General Information

**You May Use This Form ONLY if All of the Following Apply:**

- You are an employee deducting expenses attributable to your job.
- You do not get reimbursed by your employer for any expenses (amounts your employer included in box 1 of your Form W-2 are not considered reimbursements).
- If you are claiming vehicle expense,
  - a You own your vehicle, and
  - b You are using the standard mileage rate for 1996 and also used it for the year you first placed the vehicle in service.

## Part II Figure Your Expenses

1	Vehicle expense using the standard mileage rate. Complete Part III and multiply line 8a by 31¢ (.31)	1	6,200
2	Parking fees, tolls, and transportation, including train, bus, etc., that did not involve overnight travel or commuting to and from work	2	325
3	Travel expense while away from home overnight, including lodging, airplanes, car rental, etc. Do not include meals and entertainment	3	8,975
4	Business expenses not included on lines 1 through 3. Do not include meals and entertainment	4	430
5	Meals and entertainment expenses: \$ <u>4,502</u> x 50% (.50)	5	2,251
6	<b>Total expenses.</b> Add lines 1 through 5. Enter here and on line 20 of Schedule A (Form 1040). (Qualified performing artists and individuals with disabilities, see the instructions for special rules on where to enter this amount.)	6	18,181

## Part III Information on Your Vehicle. Complete this part ONLY if you are claiming vehicle expense on line 1.

- 7 When did you place your vehicle in service for business purposes? (month, day, year) ▶ 1 / 3 / 94
- 8 Of the total number of miles you drove your vehicle during 1996, enter the number of miles you used your vehicle for:
- a Business 20,000      b Commuting 2,600      c Other 2,400
- 9 Do you (or your spouse) have another vehicle available for personal use?       Yes     No
- 10 Was your vehicle available for use during off-duty hours?       Yes     No
- 11a Do you have evidence to support your deduction?       Yes     No
- b If "Yes," is the evidence written?       Yes     No

For Paperwork Reduction Act Notice, see back of form.

Cat. No. 20804Q

Form **2106-EZ** (1996)

# Employee's Educational Expenses

## Important Changes for 1996

**Employer-provided educational assistance.** The exclusion from income of up to \$5,250 of employer-provided education assistance benefits, which expired for tax years beginning after December 31, 1994, has been extended. It will now expire for tax years beginning after May 31, 1997. However, the exclusion does not apply to graduate-level courses that begin after June 30, 1996. Even though the exclusion will expire for tax years beginning after May 31, 1997, you can still exclude benefits for courses that begin before July 1, 1997. For more information get Publication 508, *Educational Expenses*. See Publication 553, *Highlights of 1996 Tax Changes* for a possible change to "before July 1, 1997."



*These changes may entitle you to a refund of income, social security, and Medicare taxes. For more information, and for details on refund procedures see Refund Procedure for Employees under Employer-Provided Education, in Publication 508.*

**Standard mileage rate.** Generally, if you use your car for transportation to school, you can deduct 31 cents per mile. For more information see *Using Your Car* under *What Educational Expenses are Deductible*.

**Limit on itemized deductions.** If your adjusted gross income is more than \$117,950 (\$58,975 if you are married filing separately), your itemized deductions may be limited. See Chapter 22 if you need more information about this limit.

## Introduction

This chapter discusses how employees deduct their costs of work-related education. To figure the deduction, you must know:

- Whether the courses qualify,
- What expenses are deductible, and
- How to report the expenses.

First, you must determine whether the courses you are taking are qualifying courses. Not all courses are qualifying education. Courses must meet certain requirements before the related expenses can be

deducted. This is explained under *Qualifying Education*.

If your courses qualify, you can then determine which expenses qualify to be deducted. Only certain expenses of education are deductible. This is explained under *What Educational Expenses Are Deductible*.

If you know which expenses qualify, you can then determine how to report those educational expenses. You may not be able to fully deduct all of your expenses. This is explained under *Where To Report Educational Expenses*.

### Useful Items

You may want to see:

#### Publication

- 508** Educational Expenses

#### Form (and Instructions)

- 2106** Employee Business Expenses

## Qualifying Education

Education must meet certain requirements before the expenses of that education can be deducted. If these requirements are met, the education is qualifying education. You may be able to deduct the costs of qualifying education even though the education may lead to a degree.

**Requirements.** The education must:

- 1) Be required by your employer or the law to keep your present salary, status, or job (and serve a business purpose of your employer), or
- 2) Maintain or improve skills needed in your present work.

**Exception.** Even if your education meets one of the requirements above, it is not qualifying education if it:

- 1) Is needed to meet the minimum educational requirements of your present trade or business, or
- 2) Is part of a program of study that can qualify you for a new trade or business, even if you have no plans to enter that trade or business.

See *Nonqualifying Education*, later.

**Present work.** Your education must relate to your present work. Education that will relate to work you may enter in the future is not qualifying education. Education that prepares you for a future occupation includes any education that keeps you up-to-date for a return to work or that qualifies you to reenter a job you had in the past.

**Temporary absence.** If you stop work for a year or less and then go back to the same kind of work, your absence is ordinarily considered temporary. Education during a vacation, temporary leave, or other temporary absence from your job is considered related to your present job. However, after

your temporary absence you must return to the same kind of work.

**Example.** You quit your biology research job to become a full-time biology graduate student for one year. If you return to work in biology research after completing the courses, the education is related to your present work. You may even choose to take a similar job with another employer.

## Education Required by Employer or by Law

Once you have met the minimum educational requirements for your job, your employer or a law may require you to get more education. This additional education must be required for you to keep your present salary, status, or job. It must serve a business purpose of your employer and not be part of a program that will qualify you for a new trade or business.

When you take more education than your employer or the law requires, the additional education is qualifying only if it maintains or improves skills required in your present work. See *Education To Maintain or Improve Skills*, later.

**Example.** You are a teacher who has satisfied the minimum requirements for teaching. Your employer requires you to take an additional college course each year to keep your teaching job. You take a course and pay for it yourself. This is qualifying education even if you eventually receive a master's degree and an increase in salary because of this extra education.

## Education To Maintain or Improve Skills

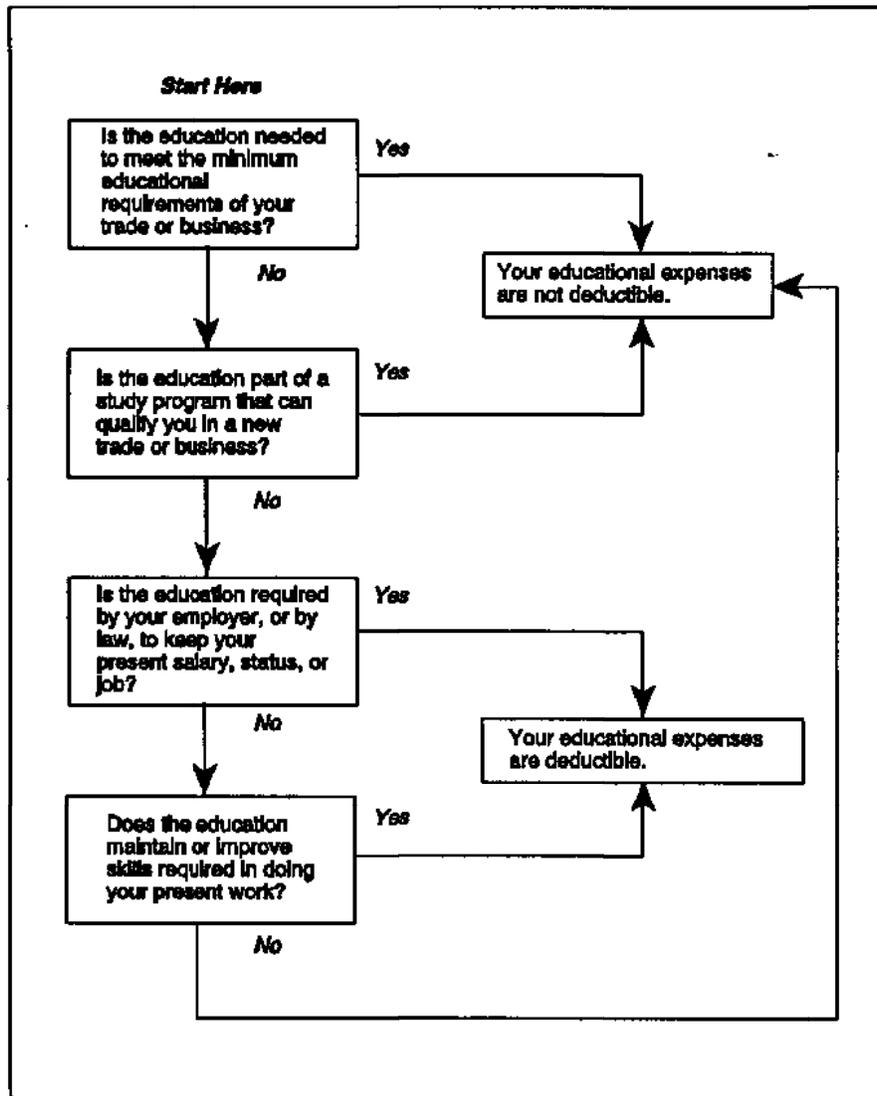
If your education is not required by your employer or a law, it must maintain or improve skills needed in your job to be qualifying education. This includes refresher courses, courses on current developments, and academic or vocational courses. However, courses you take that are needed to meet the minimum educational requirements for your job or to qualify you for a new trade or business are not qualifying education. See *Education To Qualify for a New Trade or Business*, later.

**Example.** You repair televisions, radios, and stereo sets for XYZ Store. To keep up with the latest changes, you take special courses in radio and stereo service. These courses maintain and improve skills required in your work.

## Nonqualifying Education

If you need education to meet the minimum requirements for a trade or business or if the education is part of a program of study that will qualify you for a new trade or business, it is nonqualifying education. You cannot deduct the costs of nonqualifying education.

**Figure 29-A. Are Your Educational Expenses Deductible?**



## Education To Meet Minimum Requirements

Education needed to meet the minimum educational requirements for your present trade or business is nonqualifying education. The minimum education necessary is determined by:

- 1) Laws and regulations,
- 2) Standards of your profession, trade, or business, and
- 3) Your employer's requirements.

You have not necessarily met the minimum educational requirements of your trade or business simply because you are already doing the work.

Once you have met the minimum educational requirements that were in effect when you were hired, you do not have to satisfy this rule again. This means that if the minimum requirements change, any education

you need to meet the new requirements is qualifying education.

**Example 1.** You are a full-time engineering student. You work part time as an engineer for a firm that will employ you full time as an engineer after you finish college. Although your college engineering courses improve your skills in your present job, you have not met the minimum job requirements for a full-time engineer. The education is nonqualifying education.

**Example 2.** You are an accountant and you have met the minimum educational requirements of your employer. Your employer later changes the minimum educational requirements and requires you to take college courses to keep your job. These additional courses are not minimum requirements because you already have satisfied the initial minimum requirements. The education is qualifying education.

However, a new accountant coming into the firm would have to satisfy these new minimum requirements. The education the new accountant would need to meet the new minimum requirements would be nonqualifying education.

**Example 3.** You have your own accounting business. To improve your skills, you take several courses in tax accounting. You already have met the minimum educational requirements to be an accountant. These courses improve skills required in your business and are not part of a program of study that will qualify you for a new trade or business. These courses are qualifying education.

## Requirements for Teachers

This discussion applies to teachers and others employed by educational organizations. The minimum educational requirement for teachers is usually set by the state or school district. It is based upon a minimum number of college hours or a college degree usually required of a person hired for that position.

If no requirements exist, you will have met the minimum educational requirement when you become a faculty member. You generally will be considered a faculty member when one of the following occurs:

- 1) You have tenure,
- 2) Your years of service count toward obtaining tenure,
- 3) You have a vote in faculty decisions, or
- 4) Your school makes contributions for you to a retirement plan other than social security or a similar program.

**Example 1.** Your state law requires beginning secondary school teachers to have a bachelor's degree, including ten professional education courses. In addition, to keep the job, a teacher must complete a fifth year of training within 10 years from the date of hire. If the employing school certifies to the State Department of Education that qualified teachers cannot be found, the school may hire persons with only 3 years of college. However, to keep their jobs, these teachers must get a bachelor's degree and the required professional education courses within 3 years.

Under these facts, the bachelor's degree, whether it includes the ten professional education courses or not, is considered the minimum educational requirement for qualification as a teacher in your state.

If you have all of the required education except the fifth year, you have met the minimum educational requirements. However, if the fifth year will qualify you for a new trade or business, it is nonqualifying education. See *Education To Qualify for a New Trade or Business*, later.

**Example 2.** Assume the same facts as in Example 1. If you have a bachelor's degree and only six professional education courses, the additional four education courses would

be qualifying education. Because a bachelor's degree is the minimum requirement for qualification as a teacher, you have already met the minimum requirements, even though you do not have all of the required courses.

**Example 3.** Assume the same facts as in Example 1. If you are hired with only 3 years of college, the courses you take that lead to a bachelor's degree (including those in education) are nonqualifying education. They are needed to meet the minimum education for employment as a teacher.

**Example 4.** You have a bachelor's degree and you work as a temporary instructor at a university. At the same time, you take graduate courses toward an advanced degree. The rules of the university state that you may become a faculty member only if you get a graduate degree. Also, you may keep your job as an instructor only as long as you show satisfactory progress toward getting this degree. You have not met the minimum educational requirements to qualify you as a faculty member. The graduate courses are nonqualifying education.

**Certification in a new state.** Once you have met the minimum educational requirements for your state, you are considered to have met the minimum educational requirements in a new state, even if you must take additional education to be certified in the new state. Any additional education you need is qualifying education.

**Example.** You hold a permanent teaching certificate in State A and are employed as a teacher in that state for several years. You move to State B and are promptly hired as a school teacher. You are required, however, to complete certain prescribed courses to get a permanent teaching certificate in State B. These additional courses are qualifying education because the teaching position in State B involves the same general kind of work for which you were qualified in State A. You have already met the minimum requirements for teaching and have not entered a new trade or business.

## Education To Qualify for a New Trade or Business

Education that is part of a program of study that can qualify you for a new trade or business is nonqualifying education. This is true even if you are not seeking a new job.

If you are an employee, a change of duties is not a new trade or business if the new duties involve the same general work you did in your old job.

**Example 1.** You are an accountant. Your employer requires you to get a law degree at your own expense. You register at a law school for the regular curriculum that leads to a law degree. Even if you do not intend to become a lawyer, the education is nonqualifying because the law degree will qualify you for a new trade or business.

**Example 2.** You are a general practitioner of medicine. You take a 2-week

course to review new developments in several specialized fields of medicine. The course does not qualify you for a new profession. It is qualifying education because it maintains or improves skills required in your present profession.

**Example 3.** While working in the private practice of psychiatry, you enter a program to study and train at an accredited psychoanalytic institute. The program will lead to qualifying you to practice psychoanalysis. The psychoanalytic training does not qualify you for a new profession. It is qualifying education because it maintains or improves skills required in your present profession.

## Bar or CPA Review Course

Review courses to prepare for the bar examination or the certified public accountant (CPA) examination are nonqualifying education. These are personal expenses that qualify you for a new profession.

## Qualifications for Teachers

All teaching and related duties are considered the same general kind of work. If you change duties in any of the following ways, it is not considered a change to a new business.

- 1) Elementary school teacher to secondary school teacher.
- 2) Teacher of one subject, such as biology, to teacher of another subject, such as art.
- 3) Classroom teacher to guidance counselor.
- 4) Classroom teacher to school administrator.

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## What Educational Expenses Are Deductible

If your education meets the requirements described earlier under *Qualifying Education*, you can generally deduct your educational expenses if you itemize your deductions or if you are self-employed. However, see *Expenses Relating to Tax-Exempt and Excluded Income*, later.

**Deductible expenses.** The following educational expenses can be deducted.

- Tuition, books, supplies, lab fees, and similar items.
- Certain transportation and travel costs.
- Other educational expenses, such as costs of research and typing when writing a paper as part of an educational program.

**Nondeductible expenses.** Educational expenses do not include personal or capital expenses. For example, you cannot deduct the

dollar value of vacation time or annual leave you take to attend classes. This amount is a personal expense.

**Unclaimed reimbursement.** If you do not claim reimbursement that you are entitled to receive from your employer, you cannot deduct the expenses that apply to the reimbursement. For example, your employer agrees to pay your educational expenses if you file a voucher showing your expenses. You do not file a voucher, and you do not get reimbursed. Because you did not file a voucher, you cannot deduct the expenses on your tax return.

## Transportation Expenses

If your education qualifies, you can deduct local transportation costs of going directly from work to school. If you are regularly employed and go to school on a strictly **temporary basis**, you can also deduct the costs of returning from school to home. A temporary basis is irregular or short-term attendance, generally a matter of days or weeks.

If you are regularly employed and go directly from home to school on a temporary basis, you can deduct the round-trip costs of transportation in going from your home to school to home. This is true regardless of the location of the school, the distance traveled, or whether you attend school on non-work days.

Transportation expenses include the actual costs of bus, subway, cab, or other fares, as well as the costs of using your own car. Transportation expenses do not include amounts spent for travel, meals, or lodging while you are away from home overnight.

## Using Your Car

If you use your car for transportation to school, you can deduct your actual expenses or use the standard mileage rate to figure the amount you can deduct. The standard mileage rate for 1996 is 31 cents per mile. If you use either method, you may also deduct parking fees and tolls. See *Car Expenses* in Chapter 28 for information on deducting your actual expenses of using a car.

**Example 1.** You regularly work in Camden, New Jersey, and go directly from work to your home. You also attend school every night for 3 weeks to take a course that improves your job skills. Since you are attending school on a **temporary** basis, you can deduct your daily round-trip transportation expenses in going between home and school. This is true regardless of the distance traveled.

**Example 2.** Assume the same facts as in Example 1 except that on certain nights you go directly from work to school and then home. You can deduct your transportation expenses from your regular work site to school and then home.

**Example 3.** Assume the same facts as in Example 1 except that you attend the school for 6 consecutive Saturdays, non-work days. Since you are attending school on a **temporary** basis, you can deduct your round-trip

transportation expenses in going between home and school.

**Example 4.** Assume the same facts as in Example 1 except that you attend classes twice a week for one year. Since your attendance in school is **not considered temporary**, you cannot deduct your transportation expenses in going between home and school. If you go directly from work to school, you can deduct the one-way transportation expenses of going from work to school. If you go from work to home to school and return home, your transportation expenses cannot be more than if you had gone directly from work to school.

## Travel Expenses

You can deduct expenses for travel, meals (subject to the 50% limit), and lodging if you travel overnight to obtain qualified education and the main purpose of the trip is to attend a work-related course or seminar. However, you cannot deduct expenses for personal activities, such as sight-seeing, visiting, or entertaining.

If your travel away from home is mainly personal, you cannot deduct all of your expenses for travel, meals, and lodging. However, during the time you attend the qualified educational activities, you can deduct your expenses for lodging and 50% of your expenses for meals.

Whether a trip's purpose is mainly personal or educational depends upon the facts and circumstances. An important factor is the comparison of the amount of time spent on personal activities and educational activities. If you spend more time on personal activities, the trip is considered mainly educational only if you can show a substantial nonpersonal reason for traveling to a particular location.

**Example 1.** John works in Newark, New Jersey. He traveled to Chicago to take a deductible one-week course at the request of his employer. While there, he took a sight-seeing trip, entertained some personal friends, and took a side trip to Pleasantville for a day. Since the trip was mainly for business, he can deduct his round-trip airfare to Chicago, but he cannot deduct his transportation expenses of going to Pleasantville. Only the meals and lodging connected with his educational activities can be claimed as educational expenses.

**Example 2.** Dave works in Nashville and recently traveled to California to take a deductible 2-week seminar. While there, he spent an additional 8 weeks on personal activities. The facts, including the extra 8-week stay, indicate that his main purpose was to take a vacation. He cannot deduct his round-trip airfare or his meals and lodging for the 8 weeks. He can deduct only his expenses for meals and lodging for the 2 weeks he attended the seminar.

**Cruises and conventions.** Certain cruises and conventions offer seminars or courses as part of their itinerary. Even if these are

work-related, your deduction for travel may be limited. This applies to:

- 1) Travel by ocean liner, cruise ship, or other form of luxury water transportation, and
- 2) Conventions outside the North American area.

The limits for educational purposes are the same as those that apply to cruises and conventions for other business purposes. These are discussed under *Luxury Water Travel* and *Conventions* in Publication 463.

## Meal Expenses

If your educational expenses qualify for deduction, you can deduct the cost of meals that qualify as travel expenses.

**50% limit.** You can deduct only 50% of your qualifying business-related meals if you were not reimbursed by your employer. This includes meals while traveling away from home to obtain your education. Employees must use Form 2106-EZ or 2106 to apply the 50% limit.

 **TIP** If your educational expenses include expenses for travel, see Travel Expenses in Chapter 28. Travel expenses for qualifying education are treated the same as travel expenses for other employee business purposes.

## Travel as Education

You cannot deduct the cost of travel that in itself is a form of education even though the travel may be directly related to your duties in your work or business.

**Example.** You are a French language teacher. While on sabbatical leave granted for travel, you traveled through France to improve your knowledge of the French language. You chose your itinerary and most of your activities to improve your French language skills. You cannot deduct your travel expenses as educational expenses, even though you spent most of your time visiting French schools and families, attending movies or plays, and learning French in similar activities.

## Expenses Relating to Tax-Exempt and Excluded Income

Some educational assistance you receive may be tax-exempt or excluded from income. This is income you receive that you are not required to report on your tax return. The rules for determining whether any item is taxable or not taxable are not discussed here. See Chapter 13 for information on the rules on tax-exempt income.

Since you do not pay tax on this income, you may not be able to deduct the related expenses. Examples of tax-exempt or excluded income include scholarships, veterans' educational assistance, and the

education savings bond program. If you received assistance from any of these sources, see *Expenses Relating to Tax-Exempt and Excluded Income* in Publication 508.

## Where To Report Educational Expenses

Self-employed persons and employees report their educational expenses differently. The following information explains what forms you must use to deduct your qualified educational expenses, discussed earlier under *What Educational Expenses are Deductible*.

This section explains how to deduct your expenses of qualified education. If you are an employee, you must take into account any reimbursement you receive. How you treat the reimbursement depends on the type of reimbursement arrangement and the amount of the reimbursement. For information on how to report your reimbursement, see Chapter 28.

**Self-employed persons.** If you are self-employed, you must report your educational expenses on the appropriate form used to report your business income and expenses.

For example, if you are a sole proprietor or an independent contractor, use Schedule C, Schedule C-EZ, or Schedule F. If you use Schedule C, list and total your educational expenses for tuition, books, laboratory fees, and similar items in Part V and enter the total on line 27. List your car and truck expenses on line 10. Enter your travel expenses on line 24a. Enter your meal and entertainment expenses on line 24b. See the instructions for the form that you file for more information.

**Employees.** If you are an employee, you generally must report your qualified educational expenses on the forms in the following list of rules for deducting the expenses. To deduct these expenses:

- 1) Your paid expenses must be for qualified education.
- 2) The amount you deduct must be unreimbursed.
- 3) You must file Form 1040.
- 4) You must itemize your deductions on Schedule A (Form 1040). You can deduct only your expenses that are more than 2% of adjusted gross income from line 31 of Form 1040. This 2% limit is applied after all other deduction limits have been applied (such as the 50% limit on meal expenses).
- 5) You generally must first complete Form 2106 or 2106-EZ to figure your expenses for education if they include meal and transportation expenses or if you receive reimbursement from your employer.

**Qualified performing artist.** Even if you were not reimbursed, you must file either Form 2106-EZ or 2106 if you are a qualified performing artist. See Publication 529 for more information about a qualified performing artist.

**Impairment-related work expense.** Even if you were not reimbursed, you must file either Form 2106-EZ or 2106 if you are an individual with a disability claiming impairment-related work expenses. See Publication 529 for more information about impairment-related work expenses.

## Employee Forms (Form 2106 or 2106-EZ)

If you are an employee and item 5 under *Employees* indicates that you must first figure your qualified educational expenses on Form 2106 or 2106-EZ, the following information should help you decide which form to use. You may be able to use the simpler Form 2106-EZ, as explained next.

**Form 2106-EZ.** You can use this **only** if all the following apply:

- 1) You are an employee deducting job-related business expenses (including qualified educational expenses),
- 2) You **are not** reimbursed by your employer for any expenses (amounts your employer included in box 1 of your Form W-2 are not considered reimbursements), and

- 3) If you are claiming vehicle expenses,
  - a) You own your vehicle,
  - b) You use the 1996 standard mileage rate **and** have used the standard mileage rate since you first used the vehicle in your business.

**Form 2106.** You must use this form if:

- 1) You are an employee deducting job-related business expenses (including qualified educational expenses), and
- 2) You were reimbursed by your employer for your expenses (amounts your employer included in box 1 of your W-2 are not considered reimbursements), or
- 3) If you are claiming vehicle expense:
  - a) You used the actual expense method in the first year you used your vehicle for business,
  - b) You used the 1996 standard mileage rate **and** have used the standard mileage rate since you first used the vehicle in your business, or
  - c) You used a depreciation method other than straight line for this vehicle in a prior year.



*If you use Form 2106-EZ or 2106, that form will tell you where to enter on Form 1040 the amount you figure.*

**Forms not required.** You do not have to complete Form 2106 if your reimbursement **not** included in box 1 of Form W-2 is at least as much as your deductible expenses. Do not deduct the expenses or report the reimbursement as income.

If your qualified educational expenses do not include any expenses for travel, transportation, meals or entertainment, and you were not reimbursed for any expenses, you do not have to complete Form 2106-EZ or 2106.

Instead, follow the Form 1040 instructions to enter your unreimbursed expenses for any tuition, books, supplies, or lab fees directly on Form 1040, Schedule A, line 20.

## Recordkeeping

You must keep records as proof of any deduction claimed on your tax return. Generally, you should keep your records for 3 years from the date of filing the return and claiming the deduction. A return filed early is considered as filed on the due date. For specific information about keeping records of business expenses, see *Recordkeeping* in Publication 508.

# Miscellaneous Deductions

## Important Reminder

**Limit on itemized deductions.** For 1996, if your adjusted gross income is more than \$117,950 (\$58,975 if you are married filing separately), you may have to reduce the amount of certain itemized deductions, including your miscellaneous deductions.

## Introduction

This chapter explains what expenses you can claim as miscellaneous itemized deductions on **Schedule A** (Form 1040). You must reduce the total of most miscellaneous itemized deductions by 2% of your adjusted gross income. This chapter identifies:

- Deductions subject to the 2% limit,
- Deductions not subject to the 2% limit, and
- Expenses you cannot deduct.

It also describes how to report your deductions.

Expenses in each category are presented in a list followed by information about items that need more explanation.

**Recordkeeping.** You must keep records to verify your deductions. You should keep receipts, canceled checks, financial account statements, and other documentary evidence. For more information on recordkeeping, get Publication 552, *Recordkeeping for Individuals*.

## Useful Items

You may want to see:

### Publication

- 463** Travel, Entertainment, Gift, and Car Expenses
- 525** Taxable and Nontaxable Income
- 529** Miscellaneous Deductions
- 535** Business Expenses
- 587** Business Use of Your Home (Including Use by Day-Care Providers)
- 946** How To Depreciate Property

### Form (and Instructions)

- 2106** Employee Business Expenses

- 2106-EZ** Unreimbursed Employee Business Expenses

## Deductions Subject to the 2% Limit

You can deduct the following expenses as miscellaneous itemized deductions on Schedule A (Form 1040). You can claim the amount of expenses that is more than 2% of your adjusted gross income. You figure your deduction on Schedule A (Form 1040) by subtracting 2% of your adjusted gross income from the total amount of these expenses. You can find your adjusted gross income on line 31, Form 1040.

Generally, you apply the 2% limit after you apply any other deduction limit (such as the 50% limit on business-related meals and entertainment).

Deductions subject to the 2% limit are discussed in the two general categories that are shown on Schedule A (Form 1040): unreimbursed employee expenses and other expenses.

**Exception for performing artists.** If you are a qualifying performing artist, you may be able to deduct your employee business expenses as an adjustment to gross income rather than as a miscellaneous itemized deduction. See *Special Rules* in Chapter 28 if you need more information about this exception. This exception only applies to performing artists with adjusted gross incomes of not more than \$16,000 before deducting these expenses.

**Exception for impairment-related work expenses.** If you have a physical or mental disability, certain expenses you incur that allow you to work may not be subject to the 2% limit. See *Impairment-Related Work Expenses*, under *Deductions Not Subject to the 2% Limit*, later.

## Unreimbursed Employee Expenses

To be deductible, an unreimbursed employee expense must be:

- 1) Paid or incurred during your tax year,
- 2) For carrying on your trade or business of being an employee, and
- 3) An ordinary and necessary business expense.

An expense is **ordinary** if it is common and accepted in that type of trade or business. An expense is **necessary** if it is appropriate and helpful to your trade or business.

The following unreimbursed expenses that meet these requirements are deductible.

- Business bad debt of employee
- Dues to professional societies
- Education that is employment related (see Chapter 29)
- Laboratory breakage fees

- Malpractice insurance premiums
- Medical examinations required by employer
- Occupational taxes you paid
- Passport for business trip
- Subscriptions to professional journals and trade magazines related to your work
- Travel, transportation, entertainment, gift, and car expenses related to your work (see Chapter 28)

## Business Liability Insurance

You can deduct insurance premiums you paid for protection against personal liability for wrongful acts on the job.

## Damages for Breach of Employment Contract

If you break an employment contract, you can deduct damages you pay your former employer if the damages are attributable to the pay you received from that employer.

## Depreciation on Computers or Cellular Telephones

If you purchased a computer or cellular telephone, you can claim a depreciation deduction if you use these items in your work as an employee and you meet the following two tests. Your use of these items must be:

- 1) For the convenience of your employer, and
- 2) Required as a condition of your employment.

You can deduct depreciation on your home computer based on your use of it to produce income (such as managing your investments).

For more information about the rules and exceptions to the rules affecting the allowable deductions for a home computer or cellular telephone, see *Depreciation on Computers or Cellular Telephones* in Publication 529.

**Reporting and recordkeeping.** To claim the depreciation deduction for your cellular telephone or your home computer not used exclusively in your home office, you must complete Part V of **Form 4562**, *Depreciation and Amortization*, and attach the form to your tax return. You must maintain records to prove your percentage of business use.

For more information about depreciation (including the section 179 deduction) and recordkeeping requirements, get Publication 946.

Do not complete Parts III, V, or VI of Form 4562 to claim the depreciation deduction and/or section 179 deduction for a home computer you placed in service during 1996 and used exclusively in your home office. Complete all other Parts of Form 4562 that apply. See *Business Furniture and Equipment* in Publication 587 for more details.



*Do not complete Form 4562 to claim a depreciation deduction for a home computer you placed in service before 1996 and used exclusively in your home office. See Publication 946 for more information on depreciating this property.*

## Dues to Chamber of Commerce and Professional Societies

You may be able to deduct dues paid to a chamber of commerce, similar organizations, and professional societies, if membership helps you carry out the duties of your job. Similar organizations include:

- 1) Boards of trade,
- 2) Business leagues,
- 3) Civic or public service organizations,
- 4) Professional associations such as bar associations and medical associations,
- 5) Real estate boards, and
- 6) Trade associations.

You **cannot** deduct dues paid to an organization if one of its main purposes is to conduct entertainment activities for members or their guests or to provide members or their guests with access to entertainment facilities.

You may not be able to deduct that part of your dues that is allocable to certain lobbying and political activities. See *Dues under Lobbying Expenses*, later. Dues paid for membership in any club organized for business, pleasure, recreation, or any other social purpose are generally not deductible. See *Club Dues under Nondeductible Expenses* for more information.



*Dues paid to airline, hotel, and luncheon clubs are not deductible.*

## Home Office

If you use a part of your home regularly and exclusively for business purposes, you may be able to deduct a part of the operating and depreciation expenses on your home. You cannot deduct any part of your personal expenses that are for family household purposes.

**Requirements for employees claiming the deduction.** You can deduct certain expenses for operating a part of your home only if that part of your home is used **regularly** and **exclusively** as:

- 1) Your principal place of business for any trade or business in which you engage, or
- 2) A place to meet or deal with your patients, clients, or customers in the normal course of your trade or business.

You can also deduct certain expenses of operating a separate structure not attached

to your home, if you use it regularly and exclusively for your trade or business.

The regular and exclusive business use must be **for the convenience of your employer** and not just appropriate and helpful in your job. For more detailed information and a worksheet, get Publication 587.

**How to report.** If you are an employee, you generally report your expenses for the business use of your home (insurance, maintenance, utilities, depreciation) on **Form 2106** or **Form 2106-EZ**. You then carry over your total expenses to line 20 of Schedule A (Form 1040). If you are not required to file Form 2106 or Form 2106-EZ, enter the amount directly on line 20 of Schedule A.

Include the home office expenses for mortgage interest, real estate taxes, and casualty and theft losses on the appropriate lines of Schedule A (Form 1040).

**Records.** You should keep records that will give the information needed to figure the deduction according to these rules. Also keep canceled checks or account statements, and receipts of the expenses paid, to prove the deductions you claim.

## Job Search Expenses

You may be able to deduct certain expenses you have in looking for a new job in your present occupation, even if you do not get a new job. You cannot deduct these expenses if you are looking for a job in a new occupation, even if you get the job.

If you are unemployed, the kind of work you did for your past employer is your occupation. If there is a substantial break between the time of your past job and your looking for a new one, you cannot deduct your job search expenses.

You cannot deduct your expenses if you are seeking employment for the first time, even if you get the job.

**Employment and outplacement agency fees.** You can deduct employment and outplacement agency fees you pay in looking for a new job in your present occupation.

If, in a later year, your employer pays you back for employment agency fees, you must include the amount you receive in your gross income up to the amount of your tax benefit in the earlier year (which is explained under *Recoveries* in Chapter 13). If your employer pays the fees directly to the employment agency and you were not responsible for them, you do not include them in your gross income.

**Resumé.** You can deduct amounts you spend for typing, printing, and mailing copies of a resumé to prospective employers if you spent the amounts in looking for a new job in your present occupation.

**Travel and transportation expenses.** If you travel to an area and, while there, you look for a new job in your present occupation, you may be able to deduct travel expenses to and from the area. You can deduct the travel expenses if the trip is primarily

to look for a new job. The amount of time you spend on personal activity compared to the amount of time you spend in looking for work is important in determining whether the trip is primarily personal or to look for a new job.

Even if you cannot deduct the travel expenses to and from an area, you can deduct the expenses of looking for a new job in your present occupation, while in the area.

If you use the standard mileage rate to figure your car expenses, use 31 cents per mile. See Chapter 28 for more information.

## Repayment of Income Aid Payment

If you repay a lump-sum income aid payment that you received and included in income in an earlier year, you can deduct the repayment. An "income aid payment" is one that is received under an employer's plan to aid employees who lose their jobs because of lack of work.

## Research Expenses of a College Professor

If you are a college professor, you can deduct research expenses, including travel expenses, for teaching, lecturing, or writing and publishing on subjects that relate directly to the field of your teaching duties. You must have undertaken the research as a means of carrying out the duties expected of a professor and without expectation of profit apart from salary. However, you cannot deduct the cost of travel as a form of education.

## Tools Used in Your Work

Generally, you can deduct amounts you spend for tools used in your work if the tools wear out and are thrown away within one year from the date of purchase. You can depreciate the cost of tools expected to last more than a year. For more information about depreciation, get Publication 946.

## Union Dues and Expenses

You can deduct dues and initiation fees you pay for union membership.

You can also deduct assessments for benefit payments to unemployed union members. However, you cannot deduct the part of the assessments or contributions that provides funds for the payment of sick, accident, or death benefits. Also, you cannot deduct contributions to a pension fund even if the union requires you to make such contributions.

You may not be able to deduct amounts you pay to the union that are related to certain lobbying and political activities. See *Dues under Lobbying Expenses*, later.

## Work Clothes and Uniforms

You can deduct the cost and upkeep of work clothes only if you must wear them as a condition of your employment and they are not suitable for everyday wear. You can deduct cost and upkeep only if both conditions are met. It is not enough that you wear distinctive

clothing; the clothing must be specifically required by your employer. Nor is it enough that you do not in fact wear your work clothes away from work; the clothing must not be suitable for taking the place of your regular clothing.

Examples of workers who may be able to deduct the cost and upkeep of work clothes are: delivery workers, firefighters, health care workers, law enforcement officers, letter carriers, professional athletes, and transportation workers (air, rail, bus, etc.).

Musicians and entertainers can deduct the cost of theatrical clothing and accessories if they are not suitable for everyday wear.

However, work clothing consisting of white cap, white shirt or white jacket, white bib overalls, and standard work shoes, which a painter is required by his union to wear on the job, is not distinctive in character or in the nature of a uniform. Similarly, the costs of buying and maintaining blue work clothes worn by a welder at the request of a foreman are not deductible.

**Protective clothing.** You can deduct the cost of protective clothing required in your work, such as safety shoes or boots, safety glasses, hard hats, and work gloves.

Examples of workers who may be required to wear safety items are: carpenters, cement workers, chemical workers, electricians, fishing boat crew members, machinists, oil field workers, pipe fitters, steamfitters, and truck drivers.

**Military uniforms.** You generally cannot deduct the cost of your uniforms if you are on full-time active duty in the armed forces. However, if you are an armed forces reservist, you can deduct the unreimbursed cost of your uniform if military regulations restrict you from wearing it except while on duty as a reservist. In figuring the deduction, you must reduce the cost by any nontaxable allowance you receive for these expenses.

If local military rules do not allow you to wear fatigue uniforms when you are off duty, you can deduct the amount by which the cost of buying and keeping up these uniforms is more than the uniform allowance you receive.

If you are a student at an armed forces academy, you cannot deduct the cost of your uniforms if they replace regular clothing. However, you can deduct the cost of insignia, shoulder boards, and related items.

You can deduct the cost of your uniforms if you are a civilian faculty or staff member of a military school.

## Other Expenses

You can deduct certain other expenses as miscellaneous itemized deductions subject to the 2%-of-adjusted-gross-income limit. These are expenses you pay:

- 1) To produce or collect income that must be included in your gross income,
- 2) To manage, conserve, or maintain property held for producing such income, or

- 3) To determine, contest, pay, or claim a refund of any tax.

You can deduct expenses you pay for the purposes in (1) and (2) above only if they are reasonably and closely related to these purposes.

These other expenses include:

- Appraisal fees for a casualty loss or charitable contribution
- Clerical help and office rent in caring for investments
- Depreciation on home computers used for investments
- Excess deductions (including administrative expenses) allowed a beneficiary on termination of an estate or trust
- Fees to collect interest and dividends
- Hobby expenses, but generally not more than hobby income
- Indirect miscellaneous deductions of pass-through entities
- Investment fees and expenses
- Legal fees related to producing or collecting taxable income, doing or keeping your job, or getting tax advice
- Loss on deposits in an insolvent or bankrupt financial institution
- Repayments of income
- Repayments of social security benefits
- Safe deposit box rental
- Service charges on dividend reinvestment plans
- Tax advice and preparation fees, including fees for electronic filing
- Trustee's fees for your IRA, if separately billed and paid

If the expenses you pay produce income that is only partially taxable, see *Tax-Exempt Income Expenses*, later, under *Nondeductible Expenses*.

## Appraisal Fees

You can deduct appraisal fees if you pay them to figure a casualty loss or the fair market value of donated property.

## Clerical Help and Office Rent

You can deduct office expenses, such as rent and clerical help, that you have in connection with your investments and collecting the taxable income on them.

## Depreciation on Home Computer

You can deduct depreciation on your home computer if you use it to produce income (for example, managing your investments that produce taxable income). If you work as an employee and use the computer in that work, see *Depreciation on Computers or Cellular Telephones* under *Unreimbursed Employee Expenses*, earlier.

## Excess Deductions of an Estate

If the deductions in the estate's last tax year (other than deductions for personal exemptions and charitable contributions) are more than the estate's gross income for that year, the beneficiaries succeeding to the estate's property can claim such excess as a miscellaneous deduction. The beneficiaries can claim the deduction only for the tax year in which or with which the estate terminates, whether the year of termination is a normal year or a short tax year. For more information, see Publication 559.

## Fees to Collect Interest and Dividends

You can deduct fees you pay to a broker, bank, trustee, or similar agent to collect your taxable bond interest or dividends on shares of stock. But you cannot deduct a fee you pay to a broker to buy investment property, such as stocks or bonds. You must add the fee to the cost of the property.

You cannot deduct the fee you pay to a broker to sell securities unless you are a dealer in securities. You must offset the fee against the selling price.

## Hobby Expenses

You can generally deduct hobby expenses, but only up to the amount of hobby income. A hobby is not a business, because it is not carried on to make a profit. See *Activity not for profit* in Chapter 13 under *Miscellaneous Taxable Income*.

## Indirect Deductions of Pass-Through Entities

Pass-through entities include partnerships, S corporations, and mutual funds. Deductions of pass-through entities are passed through to the partners or shareholders. If the deductions are miscellaneous itemized deductions, they are generally subject to the 2% limit.

**Information returns.** You should receive information returns from pass-through entities. Partnerships and S corporations issue **Schedule K-1**, which lists the items and amounts you must report, and identifies the tax return schedules and lines to use.

**Example.** You are a member of an investment club that is formed solely to invest in securities. The club is treated as a partnership. The partnership's income is solely from taxable dividends, interest, and gains from sales of securities. In this case, you can deduct your share of the partnership's operating expenses as miscellaneous itemized deductions subject to the 2% limit. However, if the investment club partnership has investments that also produce nontaxable income, you cannot deduct your share of the partnership's expenses that produce the nontaxable income. You should receive a copy of Schedule K-1 (Form 1065), *Partner's Share of Income, Credits, Deductions, Etc.*

**Allocated expenses of mutual funds.** The allocable investment expenses of nonpublicly offered mutual funds are subject to the 2% limit. Publicly offered mutual funds do not pass investment expenses through to shareholders.

**Nonpublicly offered mutual funds.** These funds will send you a Form 1099-DIV, *Dividends and Distributions*, or a substitute form, showing your share of gross income and investment expenses. You can claim the expenses only as a miscellaneous itemized deduction subject to the 2% limit.

**Publicly offered mutual funds.** These funds will send you a Form 1099-DIV, or a substitute form, showing the net amount of dividend income (gross dividends minus investment expenses). This net figure is the amount you report on your return. A “publicly offered” mutual fund is one that is:

- 1) Continuously offered pursuant to a public offering,
- 2) Regularly traded on an established securities market, or
- 3) Held by or for at least 500 persons at all times during the tax year.

Contact your mutual fund if you are not sure if your fund is publicly offered.

### Investment Fees and Expenses

You can deduct investment fees, custodial fees, trust administration fees, and other expenses you paid for managing your investments that produce taxable income.

### Legal Expenses

You can usually deduct legal expenses that you incur in attempting to produce or collect taxable income or that you pay in connection with the determination, collection, or refund of any tax.

You can also deduct legal expenses that are:

- 1) Related to either doing or keeping your job, such as those you paid to defend yourself against criminal charges arising out of your trade or business.
- 2) For tax advice related to a divorce if the bill specifies how much is for tax advice and it is determined in a reasonable way.
- 3) To collect taxable alimony.

You deduct expenses of resolving tax issues relating to profit or loss from business (Schedule C or C-EZ), rentals or royalties (Schedule E), or farm income and expenses (Schedule F), on the appropriate schedule. You deduct the expenses of resolving non-business tax issues on Schedule A (Form 1040). See *Tax Preparation Fees*, later.

### Loss on Deposits in an Insolvent or Bankrupt Financial Institution

For information on whether, and if so how, you may deduct a loss on your deposit in a

qualified financial institution, see *Loss on deposits in an insolvent or bankrupt financial institution* in Chapter 15.

### Repayments of Income

If you had to repay an amount that you included in income in an earlier year, you may be able to deduct the amount you repaid. If the amount you had to repay was ordinary income of \$3,000 or less, the deduction is subject to the 2% limit. If it is more than \$3,000, see *Repayments Under Claim of Right under Deductions Not Subject to the 2% Limit*, later.

### Repayments of Social Security Benefits

For information on how to deduct your repayments of certain social security benefits, see *Repayments More Than Gross Benefits* in Chapter 12.

### Safe Deposit Box Rent

You can deduct safe deposit box rent if you use the box to store taxable income-producing stocks, bonds, or investment-related papers and documents. You cannot deduct the rent if you use the box only for jewelry or other personal items or for tax-exempt securities.

### Service Charges on Dividend Reinvestment Plans

You can deduct service charges you pay as a subscriber in a dividend reinvestment plan. These service charges include payments for:

- 1) Holding shares acquired through a plan,
- 2) Collecting and reinvesting cash dividends, and
- 3) Keeping individual records and providing detailed statements of accounts.

### Tax Preparation Fees

You can usually deduct tax preparation fees in the year you pay them. Thus, on your 1996 return, you can deduct fees paid in 1996 for preparing your 1995 return.

These fees include the cost of tax preparation software programs and tax publications. It also includes any fee you paid for electronic filing of your return.

Deduct expenses of preparing tax schedules relating to profit or loss from business (Schedule C or C-EZ), rentals or royalties (Schedule E), or farm income and expenses (Schedule F), on the appropriate schedule. Deduct the expenses of preparing the remainder of the return on line 21, Schedule A (Form 1040).

### Trustee’s Administrative Fees for IRA

You can deduct an IRA trustee’s administrative fees that are billed separately and that you paid in connection with your individual retirement arrangement (IRA). They are deductible (if they are ordinary and necessary)

as a miscellaneous deduction on Schedule A (Form 1040). You cannot separately deduct disguised IRA contributions or capital expenditures such as brokers’ commissions that you must add to the cost of securities you buy through brokers. These trustee’s fees are not subject to the contribution limit. For more information about IRAs, see Chapter 18.

## Deductions Not Subject to the 2% Limit

You can deduct the following expenses as miscellaneous itemized deductions. They are not subject to the 2% limit. Report these expenses on line 27, Schedule A (Form 1040).

### List of Deductions

- Amortizable premium on taxable bonds
- Federal estate tax on income in respect of a decedent
- Gambling losses up to the amount of gambling winnings
- Impairment-related work expenses of persons with disabilities
- Repayments under a claim of right if more than \$3,000
- Unrecovered investment in a pension

### Amortizable Premium on Taxable Bonds

A premium is the amount you pay for a bond that is more than the face value of the bond. You can choose to amortize the premium on taxable bonds.

For a bond purchased before October 23, 1986, the amortization of the premium is a miscellaneous itemized deduction not subject to the 2% limit.

For a bond acquired after October 22, 1986, and before January 1, 1988, the amortization of the premium is investment interest expense subject to the investment interest limit, unless you choose to treat it as an offset to interest income on the bond.

For a bond acquired after December 31, 1987, the amortization of the premium is an offset to interest income on the bond rather than a separate interest deduction item.

For more information, see *Bond Premium Amortization* in Chapter 3 of Publication 550, *Investment Income and Expenses*.

### Federal Estate Tax on Income in Respect of a Decedent

You can deduct the federal estate tax attributable to income in respect of a decedent that you as a beneficiary include in your gross income. Income in respect of the decedent is gross income that the decedent would have received had death not occurred and that was not properly includible in the

decedent's final income tax return. See Chapter 4 for more information.

## Gambling Losses Up to the Amount of Gambling Winnings

You must report the full amount of your gambling winnings on line 21, Form 1040. You deduct your gambling losses on line 27, Schedule A (Form 1040). You cannot deduct gambling losses that are more than your winnings.

**Note.** You cannot reduce your gambling winnings by your gambling losses. You must report the full amount of your winnings as income and claim your losses as an itemized deduction. Therefore, your records should show your winnings separate from your losses. Only gambling losses incurred during the year can be deducted on Schedule A (Form 1040).

**Diary of winnings and losses.** You must keep an accurate diary or similar record of your losses and winnings. Your diary should contain at least the following information:

- 1) The date and type of your specific wager or wagering activity,
- 2) The name and address or location of the gambling establishment
- 3) The names of other persons present with you at the gambling establishment, and
- 4) The amount(s) you lost.

See Publication 529 for more information.

## Impairment-Related Work Expenses

If you have a physical or mental disability that limits your being employed, or substantially limits one or more of your major life activities, such as performing manual tasks, walking, speaking, breathing, learning, and working, you can deduct your impairment-related work expenses.

Impairment-related work expenses are ordinary and necessary business expenses for attendant care services at your place of work and other expenses in connection with your place of work that are necessary for you to be able to work.

If you are an employee, you enter impairment-related work expenses on Form 2106 or Form 2106-EZ. From the amount on line 10 of Form 2106, or line 6 of Form 2106-EZ, you enter the amount that is related to your impairment on line 27, Schedule A (Form 1040). Enter the amount that is unrelated to your impairment on line 20, Schedule A (Form 1040).

## Repayments Under Claim of Right

If you had to repay more than \$3,000 that you included in your income in an earlier year because at the time you thought you had an

unrestricted right to it, you may be able to deduct the amount you repaid, or take a credit against your tax. See *Repayments* in Chapter 13 for more information.

## Unrecovered Investment in Pension

If a retiree had contributed to the cost of a pension or annuity, the retiree can exclude from income a part of each payment received as a tax-free return of the retiree's investment. If the retiree dies before the entire investment is recovered, any unrecovered investment can be deducted on the retiree's final income tax return. See Chapter 11 for more information about the tax treatment of pensions and annuities.

## Nondeductible Expenses

You cannot deduct the following expenses.

### List of Expenses

- Burial or funeral expenses, including the cost of a cemetery lot
- Campaign expenses
- Capital expenses
- Check-writing fees
- Certain club dues
- Commuting expenses
- Fees and licenses, such as car licenses, marriage licenses, and dog tags
- Fines and penalties, such as parking tickets
- Health spa expenses
- Hobby losses
- Home repairs, insurance, and rent
- Illegal bribes and kickbacks—See *Bribes and kickbacks* in Chapter 16 of Publication 535
- Investment-related seminars
- Life insurance premiums
- Lobbying expenses
- Losses from the sale of your home, furniture, personal car, etc.
- Lost or misplaced cash or property
- Lunches with co-workers
- Meals while working late
- Personal disability insurance premiums
- Personal legal expenses
- Personal, living, or family expenses
- Political contributions
- Professional accreditation fees
- Professional reputation, expenses to improve
- Relief fund contributions
- Residential telephone line
- Stockholders' meeting, expenses of attending

- Tax-exempt income expenses
- Travel expenses for another individual
- Voluntary unemployment benefit fund contributions
- Wristwatches

## Campaign Expenses

Campaign expenses of a candidate for any office, even if the candidate is running for reelection to the office, are not deductible. These include qualification and registration fees for primary elections.

**Legal fees.** You cannot deduct legal fees paid to defend charges that arise from participation in a political campaign.

## Check-Writing Fees

If you have a personal checking account, you cannot deduct fees charged by the bank for the privilege of writing checks, even if the account pays interest.

## Club Dues

You cannot deduct the cost of membership in any club organized for business, pleasure, recreation, or other social purpose. This includes business, social, athletic, luncheon, sporting, airline, and hotel clubs. For exceptions, see *Dues to Chamber of Commerce and Professional Societies* under *Unreimbursed Employee Expenses*, earlier.

## Commuting Expenses

You cannot deduct commuting expenses (the cost of transportation between your home and your main or regular place of work). If you haul tools, instruments, etc., in your car to and from work, you can deduct only additional costs, such as renting a trailer you towed with your vehicle.

## Fines or Penalties

You cannot deduct fines or penalties you pay to a governmental unit for violating a law. This includes an amount paid in settlement of your actual or potential liability for a fine or penalty (civil or criminal). Fines or penalties include parking tickets, tax penalties, and penalties deducted from teachers' paychecks after an illegal strike.

## Health Spa Expenses

You cannot deduct health spa expenses, even if there is a job requirement to stay in excellent physical condition, such as might be required of a law enforcement officer.

## Homeowners' Insurance Premiums

You cannot deduct premiums that you pay or that are placed in escrow for insurance on your home, such as fire and liability or mortgage insurance.

## Investment-Related Seminars

You cannot deduct any expenses for attending a convention, seminar, or similar meeting for investment purposes.

## Life Insurance Premiums

You cannot deduct premiums you pay on your life insurance. Premiums you pay on life insurance policies assigned to your ex-spouse may be deductible as alimony. See Chapter 20 for information on alimony.

## Lobbying Expenses

You cannot deduct amounts paid or incurred for lobbying expenses. These include expenses to:

- 1) Influence legislation,
- 2) Participate, or intervene, in any political campaign for, or against, any candidate for public office,
- 3) Attempt to influence the general public, or segments of the public, about elections, legislative matters, or referendums, or
- 4) Communicate directly with covered executive branch officials in any attempt to influence the official actions or positions of such officials.

Lobbying expenses also include any amounts paid or incurred for research, preparation, planning, or coordination of any of these activities.

**Covered executive branch official.** A covered executive branch official includes:

- The President,
- The Vice President,
- Any officer or employee of the White House Office of the Executive Office of the President, and the two most senior level officers of each of the other agencies in the Executive Office, and
- Any individual serving in a position in Level I of the Executive Schedule under Section 5312 of Title 5, United States Code, any other individual designated by the President as having Cabinet-level status, and any immediate deputy of such individual.

**Dues.** You cannot deduct that portion of your dues or other amounts you pay to a tax-exempt organization that notifies you that such amounts are used to pay nondeductible lobbying expenses. See *Lobbying Expenses* in Publication 529 for information on *Exceptions*.

## Lost or Mislaid Cash or Property

You cannot deduct a loss based on the mere disappearance of money or property. However, an accidental loss or disappearance of property can qualify as a casualty if it results from an identifiable event that is sudden, unexpected, or unusual.

**Example.** A car door is accidentally slammed on your hand, breaking the setting of your diamond ring. The diamond falls from the ring and is never found. The loss of the diamond is a casualty.

## Lunches with Co-Workers

You cannot deduct the expenses of lunches with co-workers, except while traveling away from home on business. See Chapter 28 for information on these deductible expenses.

## Meals While Working Late

You cannot deduct the cost of meals while working late. However, you may be able to claim a deduction if it is a deductible entertainment expense or you are traveling away from home. See Chapter 28 for information on these deductible expenses.

## Personal Legal Expenses

You cannot deduct personal legal expenses such as those for the following:

- 1) Custody of children,
- 2) Breach of promise (to marry) suit,
- 3) Civil or criminal charges resulting from a personal relationship,
- 4) Damages for personal injury,
- 5) Preparation of a title (or to defend or perfect title),
- 6) Preparation of a will, and
- 7) Property claims or property settlement in a divorce.

You cannot deduct these expenses even if a result of the legal proceeding is the loss of income-producing property.

## Political Contributions

You cannot deduct contributions made to a political candidate, a campaign committee, or a newsletter fund.

## Professional Accreditation Fees

You cannot deduct professional accreditation fees such as the following:

- 1) Accounting certificate fees paid for the initial right to practice accounting,
- 2) Bar exam fees and incidental expenses in securing admission to the bar, and
- 3) Medical and dental license fees paid to get initial licensing.

## Professional Reputation

You cannot deduct expenses of radio and TV appearances to increase your personal prestige or establish your professional reputation.

## Relief Fund Contributions

You cannot deduct contributions paid to a private plan that pays benefits to any covered employee who cannot work because of any injury or illness not related to the job.

## Residential Telephone Service

You cannot deduct any charge (including taxes) for basic local telephone service for the first telephone line to your residence, even if it is used in a trade or business.

## Stockholders' Meetings

You cannot deduct transportation and other expenses you pay to attend stockholders' meetings of companies in which you own stock but have no other interest. You cannot deduct these expenses even if you are attending the meeting to get information that would be useful in making further investments.

## Tax-Exempt Income Expenses

You cannot deduct expenses to produce tax-exempt income. You cannot deduct interest on a debt incurred or continued to buy or carry tax-exempt securities.

If you have expenses to produce both taxable and tax-exempt income, but you cannot identify the expenses that produce each type of income, you must divide the expenses based on the amount of each type of income to determine the amount that you can deduct.

**Example.** During the year, you received taxable interest of \$4,800 and tax-exempt interest of \$1,200. In earning this income, you had total expenses of \$500 during the year. You cannot identify the amount of each expense item that is for each income item. Therefore, you calculate that 80% (\$4,800/\$6,000) of the expense is for the taxable interest and 20% (\$1,200/\$6,000) is for the tax-exempt interest. You can deduct, subject to the 2% limit, expenses of \$400 (80% of \$500).

## Travel Expenses for Another Individual

You generally cannot deduct travel expenses you pay or incur for a spouse, dependent, or other individual who accompanies you (or your employee) on business travel. See Chapter 28 for more information on deductible travel expenses.

## Voluntary Unemployment Benefit Fund Contributions

You cannot deduct voluntary unemployment benefit fund contributions you make to a union fund or a private fund. However, you can deduct contributions as taxes if state law requires you to make them to a state unemployment fund that covers you for the loss of wages from unemployment caused by business conditions.

## Wristwatches

You cannot deduct the cost of a wristwatch, even if there is a job requirement that you know the correct time to properly perform your duties.

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## How To Report

You must itemize deductions on Schedule A (Form 1040) to be able to claim miscellaneous deductions.

If you have unreimbursed employee business expenses, generally you must first complete **Form 2106** or **Form 2106-EZ**. See Chapter 28 for more information on whether you must file Form 2106 or Form 2106-EZ.

If you file Form 2106 or 2106-EZ, enter the amount of unreimbursed employee business expenses from line 10 of Form 2106 or

line 6 of Form 2106-EZ to line 20 of Schedule A (Form 1040). Attach the completed Form 2106 or Form 2106-EZ to Form 1040.

If you do not fill out Form 2106 or Form 2106-EZ, list the type and amount of your unreimbursed employee business expenses on the dotted lines next to line 20 of Schedule A (Form 1040). If you need more space, attach a statement showing the type and amount of the expense. Enter one total on line 20.

Enter tax preparation fees on line 21 of Schedule A. This includes fees paid for filing your return electronically. Enter other miscellaneous deductions subject to the 2% limit on line 22 of Schedule A (Form 1040).

List the type and amount of each expense on the dotted lines next to line 22. If you need more space, attach a statement showing the type and amount of each expense. Enter one total on line 22.

Enter your total miscellaneous deductions not subject to the 2% limit, on line 27 of Schedule A (Form 1040). List the type and amount of each expense on the dotted line for line 27. If you need more space, attach a statement showing the type and amount of each expense.

# Part Six.

## Figuring Your Taxes and Credits

The six chapters in this part explain how to figure your tax and how to figure the tax of certain children who have more than \$1,300 of investment income. They also discuss tax credits. Credits, unlike deductions, are subtracted directly from your tax and reduce your tax, dollar for dollar. There are tax credits for the elderly or the permanently and totally disabled, for the expense of having your child or disabled dependent cared for so that you can work, for the purchase of a qualified electric vehicle, and for other kinds of expenses. Chapter 35 discusses the earned income credit and how you might be able to get the credit paid to you in advance (from your employer) throughout the year instead of waiting until you file your tax return.

### 31.

## How To Figure Your Tax

### Important Change for 1996

**More persons can file Form 1040EZ.** You can now report Alaska Permanent Fund dividends on line 3 of Form 1040EZ (or on Form 1040A or Form 1040). To find out if you can file the simpler Form 1040EZ, see *Which Form Should I Use?* in Chapter 1.

### Important Reminders

**Household employment taxes.** If you paid cash wages to a household worker, you may have to have an employer identification number (EIN) and pay employment taxes with your income tax return. Use Schedule H (Form 1040), *Household Employment Taxes*, to figure the amount you owe. For details, see the instructions for Schedule H and Publication 926, *Household Employer's Tax Guide*.

**Amount you owe.** If you did not pay enough tax through either withholding or estimated tax payments, you may be charged a penalty for underpayment of estimated tax. If you determine that you owe tax, see *Underpayment Penalty* in Chapter 5.

### Introduction

This chapter discusses the steps you need to take to figure your tax on:

- Form 1040EZ,
- Form 1040A, and
- Form 1040.

Also, this chapter discusses the requirements you must meet to have the IRS figure your tax.

### Form 1040EZ

If you file Form 1040EZ, you must figure your adjusted gross income and taxable income before you can find your tax.

**Adjusted gross income (line 4, Form 1040EZ).** This is the total of your wages, salaries, tips, taxable scholarship or fellowship grants, taxable interest income, unemployment compensation, and Alaska Permanent Fund dividends.

**Taxable income (line 6, Form 1040EZ).** Your taxable income is your adjusted gross income (line 4), minus the total of your standard deduction and the deduction for your personal exemption(s) (line 5). The amount of these deductions depends on whether you (or your spouse if married) can be claimed as a dependent on someone else's return, such as your parents'. The rules for determining whether you are a dependent are in Chapter 3.

**Not a dependent.** If you (and your spouse if married) cannot be claimed as a dependent by another taxpayer, the total of your standard deduction and your personal exemption(s) is \$6,550 if single or \$11,800 if married. Check the *No* box and enter the appropriate amount on line 5.

**Dependent.** If you (or your spouse if married) can be claimed as a dependent by another taxpayer, check the *Yes* box on line 5 and complete the worksheet on the back of Form 1040EZ. Enter the result from line G of the worksheet on line 5.

**Tax withheld.** After you have figured your taxable income, enter the total of your federal income tax withheld on line 7. This amount is shown in box 2 of your Form(s) W-2. Copy B of Form(s) W-2 must be attached to the return.

See the instructions for Form 1040EZ if withholding tax is shown in box 4 of any

Form 1099-INT or Form 1099-OID you receive.

**Earned income credit (EIC).** If you can claim the EIC, enter your credit on line 8. You may be able to claim the credit on Form 1040EZ if your income is less than \$9,500 and you (or your spouse if filing jointly) were at least age 25 at the end of the year. See Chapter 35 for more information about the EIC.

**Total payments (line 9, Form 1040EZ).** This is the total of your federal income tax withheld (line 7) and any earned income credit (line 8) you can claim. If you paid any tax with a Form 4868, *Application for Automatic Extension of Time To File U.S. Individual Income Tax Return*, include the amount in the total on line 9. Also, print "Form 4868" and the amount paid to the left of line 9.

**Tax.** To find your tax, use the Tax Table in the instructions for Form 1040EZ or in the back of this publication. Find the income line that includes your taxable income shown on line 6 of your Form 1040EZ. Next, find the column heading for your filing status (single or married filing jointly) and read down the column. The amount shown where the income line and filing status column meet is your tax. Enter it on line 10.

**Refund or amount you owe.** If line 9 is larger than line 10, subtract line 10 from line 9 and enter the result on line 11a. This is the amount of your refund. If you want your refund sent to your bank or other financial institution, complete the boxes on lines 11b, c, and d.

If line 10 is larger than line 9, subtract line 9 from line 10 and enter the result on line 12. This is the amount you owe. For information on how to pay, see *Amount You Owe* in Chapter 1.

**Filled-in form.** A filled-in Form 1040EZ is shown in Chapter 37.

## Form 1040A

If you file Form 1040A, you must find your adjusted gross income and taxable income before you can figure your tax.

**Adjusted gross income (lines 16 and 17, Form 1040A).** This is your total income (line 14) minus your IRA deduction, and your spouse's IRA deduction if you file a joint return. You can figure your IRA deduction by completing one of the IRA worksheets in the instructions for Form 1040A. Also see Chapter 18.

**Taxable income (line 22, Form 1040A).** This is your adjusted gross income (line 17) minus your standard deduction (line 19) and the deduction for your exemptions (line 21).

**Standard deduction.** Your standard deduction is based on your filing status, whether you are 65 or older or blind, and whether you can be claimed as a dependent on another person's return. For information, see *Standard Deduction* under *Form 1040*, later, and Chapter 21.

**Exemptions.** To figure the deduction for your exemptions, multiply \$2,550 by the number of exemptions claimed on line 6d. If you can be claimed as a dependent on someone else's return, do not check the box on line 6a.

**Tax, credits, and payments.** Next, you must figure your tax, any credits you can claim, and the total payments made.

**Tax.** To find your tax, use the Tax Table in the instructions for Form 1040A or in the back of this publication. In the Tax Table, find the income line that includes your taxable income shown on line 22. Next, find the column heading that describes your filing status and read down the column. The amount shown where the income line and filing status column meet is your tax. Enter it on line 23.

**Note.** If this is the return of a child who was under age 14 on January 1, 1997, and who had more than \$1,300 of investment income, you generally cannot use the Tax Table. Use Form 8615, *Tax for Children Under Age 14 Who Have Investment Income of More Than \$1,300*, to compute the tax. Form 8615 is not used if neither parent is alive at the end of the year. For more information, see Chapter 32.

**Credits.** Credits, unlike deductions, are subtracted after you find your tax from the Tax Table, and they reduce your tax dollar for dollar. There are three credits that can be claimed on Form 1040A. They are:

- 1) Credit for child and dependent care expenses,
- 2) Credit for the elderly or the disabled, and
- 3) Earned income credit.

The earned income credit is explained later under *Payments*.

If you claim the **credit for child and dependent care expenses** (line 24a), you must complete all parts of Schedule 2 (Form 1040A) that apply and attach it to your return. For information on the credit for child and dependent care expenses, see Chapter 33.

If you claim the **credit for the elderly or the disabled** (line 24b), you must complete Schedule 3 (Form 1040A) and attach it to your return. For information on the credit for the elderly or the disabled, see Chapter 34.

Add lines 24a and 24b and enter the result on line 24c. Subtract your total credits (line 24c) from your tax (line 23) and enter the result on line 25.

**Total tax.** If you received **advance earned income credit** payments, the amount will be shown on your Form(s) W-2, box 9. Enter the amount of these payments on line 26. For more information, see *Advance Earned Income Credit Payments* in Chapter 35.

If you owe **employment taxes on cash wages paid to a household employee**, you must file Schedule H (Form 1040), *Household Employment Taxes*. On line 27 of Form 1040A, enter the amount of employment taxes you owe on such wages from line 27 of Schedule H. For details, see the instructions for Schedule H and Publication 926, *Household Employer's Tax Guide*.

Add the amounts on lines 25, 26, and 27. Enter the total on line 28. Also, if you owe the **alternative minimum tax**, discussed next, include that tax in the total on line 28. This sum is your total tax.

If the amount on line 17, plus any tax-exempt interest on line 8b, is more than:

- 1) \$45,000 if your filing status is married filing jointly or qualifying widow(er),
- 2) \$33,750 if your filing status is single or head of household, or
- 3) \$22,500 if your filing status is married filing separately,

and the amount on line 21 is \$10,200 or more, complete the *Alternative Minimum Tax Worksheet* in the Form 1040A instructions to see if you owe this tax and, if you do, the amount to include on line 28.

**Caution.** If filing for a child under age 14, add the amount on Form 1040A, line 17, to the child's tax-exempt interest from private activity bonds issued after August 7, 1986. If this amount is more than the total of \$1,300 plus the amount on Form 1040A, line 7, do not file Form 1040A. Instead, file Form 1040 for the child. Use Form 6251 to see if the child owes the alternative minimum tax.

**Payments.** On line 29a, enter the total **federal income tax withheld** from your pay. This amount is shown in box 2 of your Form(s) W-2. If you have more than one employer, add the amounts from these boxes and enter the total on line 29a.

If you received a Form 1099 showing income tax withheld on dividends, interest, IRA distributions, or pensions, include the

amount withheld in the total on line 29a. It is important to check all of your Form 1099 statements to see whether any income tax was withheld. A table showing the proper boxes that record withholding is included later. See *Payments* under *Form 1040*.

On line 29b, enter your 1996 **estimated tax payments** and any overpayment applied from your 1995 federal income tax return.

On line 29c, enter your **earned income credit** (EIC). You may be able to take this credit if lines 7 and 16 are less than \$25,078 and you had one qualifying child (less than \$28,495 if you had more than one qualifying child). A qualifying child is one that meets certain age and other requirements and lived with you. Also, you may be able to take this credit if lines 7 and 16 are less than \$9,500 and you do not have a qualifying child. You (or your spouse if filing jointly) must have been at least age 25 but under age 65 at the end of your tax year. To find out if you can take the EIC, follow the Form 1040A instructions for line 29c. More information on the earned income credit is in Chapter 35.

Add the amounts on lines 29a, 29b, and 29c and enter this total on line 29d. This sum is your total payments.

Include in the total on line 29d any **excess social security or railroad retirement tax withheld**. Write "Excess SST" and the amount in the space to the left of line 29d. See Chapter 36 for a discussion on this.

Also include in the total on line 29d any tax you paid if you filed Form 4868 to get an automatic **extension of time to file** your Form 1040A. Write "Form 4868" and the amount in the space to the left of line 29d. Also include any amount paid with Form 2688 if you filed for an additional extension.

**Refund or amount you owe.** After you have figured your total tax (line 28) and your total payments (line 29d), you can determine if you are due a tax refund or if you owe additional tax.

**Refund.** If line 29d is more than line 28, subtract line 28 from line 29d and enter the result on line 30. This is the amount of your overpayment. Enter on line 31a the exact amount you want refunded. If you want the entire amount on line 30 refunded, enter that amount on line 31a. If you want your refund sent to your bank or other financial institution, complete the boxes on lines 31b, c, and d.

If you want all or part of your overpayment applied to your 1997 estimated tax, you must enter the appropriate amount on line 32. The amount on line 32 will be credited to your 1997 estimated taxes unless you ask us to apply it to your spouse's account. This request should include your spouse's social security number. The amount on line 32 generally cannot be refunded to you until you file a tax return for 1997.

**Amount you owe.** If line 28 is more than line 29d, subtract line 29d from line 28 and enter the result on line 33. This is the amount you owe. For information on how to pay, see *Amount You Owe* in Chapter 1.

**Filled-in form.** A filled-in Form 1040A is shown in Chapter 38.

## Form 1040

If you file Form 1040, you must compute your adjusted gross income and taxable income before you can figure your tax.

### Adjusted Gross Income (lines 31 and 32, Form 1040)

Adjusted gross income (line 31, Form 1040) is your total income (line 22) minus any adjustments for the following:

- 1) IRA deduction for you (line 23a) and for your spouse (line 23b). See Chapter 18.
- 2) Deduction for moving expenses (line 24). See Chapter 19.
- 3) Deduction for one-half of your self-employment tax (line 25). See Publication 533, *Self-Employment Tax*.
- 4) Self-employed health insurance deduction (line 26). See Chapter 23.
- 5) Keogh retirement plan and self-employed SEP deduction (line 27). See Publication 560, *Retirement Plans for the Self-Employed*.
- 6) Penalty on early withdrawal of savings (line 28). See Chapter 8.
- 7) Alimony paid (line 29). You must enter the recipient's social security number in the space provided. See Chapter 20.
- 8) Other adjustments. Write in the following adjustments on the dotted line next to line 30 and include them in the total on line 30.
  - a) Certain expenses of qualified performing artists. See Chapter 28.
  - b) Jury duty pay given to your employer. See Chapter 13.
  - c) Amortization of the costs of forestation or reforestation if you do not have to file Schedule C, C–EZ, or F. See Chapter 12 of Publication 535, *Business Expenses*.
  - d) Certain required repayments of supplemental unemployment benefits. See Chapter 6.
  - e) Contributions to a Section 501(c)(18) pension plan.
  - f) Deduction for nonbusiness clean-fuel vehicle property. See Chapter 15 of Publication 535.
  - g) Expenses from the rental of personal property.

### Taxable Income (line 37, Form 1040)

There are two ways to figure the amount of your taxable income (line 37, Form 1040). You can choose to itemize your deductions

on Schedule A (Form 1040) or take the standard deduction.

### Itemizing Your Deductions

You can itemize your deductions (such as medical expenses, taxes, mortgage interest, and casualty losses) on Schedule A (Form 1040).

You may benefit from itemizing your deductions on Schedule A if you have total itemized deductions that are more than the highest standard deduction amount to which you otherwise are entitled. For example, you may have deductions for:

- 1) Large uninsured medical and dental expenses,
- 2) Interest and taxes on your home,
- 3) Contributions to qualified charities,
- 4) Casualty or theft losses not covered by insurance, or
- 5) Unreimbursed employee business expenses or other miscellaneous deductions.

If you decide to itemize your deductions, complete and attach Schedule A to your return. Enter the amount from line 28 of Schedule A on line 34 of Form 1040.

**Separate returns.** If you and your spouse file separate returns, you can use the method that gives you the lowest total tax, even though one of you may pay more than the other. However, if one of you itemizes deductions, the other should also itemize because the standard deduction of a married individual filing a separate return where either spouse itemizes deductions is zero.

**Changing your mind.** If you do not itemize your deductions and later find you should have itemized—or if you itemize and later find you should not have—you can change your return by filing Form 1040X, *Amended U.S. Individual Income Tax Return*. See *Amended Returns and Claims for Refund* in Chapter 1.

**Separate returns.** If you and your spouse filed separate returns, you can change methods of taking deductions only if you and your spouse make the same changes. Both of you must consent in writing to the assessment for any additional tax either one may owe as a result of the change.

**Taxable income.** If you itemize your deductions, your taxable income (line 37) is your adjusted gross income (line 32) minus your itemized deductions (line 34) and your exemptions (line 36).

### Standard Deduction

The standard deduction is based on your filing status and whether you are 65 or older or blind.

**65 or older or blind.** If you were 65 or older or blind in 1996, you are entitled to a higher standard deduction than taxpayers under 65 and not blind. For information on who qualifies for the higher standard deduction for

age and blindness, see Chapter 21. The standard deduction amounts are given in the standard deduction charts and worksheet in Chapter 21.

**Special rules.** Your standard deduction is **zero** if:

- 1) Your filing status is “married filing separate return” and your spouse itemizes deductions,
- 2) You are a dual-status or nonresident alien, or
- 3) You have a short tax year because of a change in your annual accounting period.

**Dependent.** If you can be claimed as a dependent on another person's return, your standard deduction may be limited. See *Standard Deduction for Dependents* in Chapter 21.

**Amount of the standard deduction.** If you decide to take the standard deduction, show the amount on line 34 of Form 1040.

The amount of the standard deduction for most people is shown on Form 1040 to the left of line 34. Others must use the standard deduction charts and worksheet in Chapter 21 or in the Form 1040 instructions to find their standard deduction.

**Taxable income.** If you take the standard deduction, your taxable income (line 37) is your adjusted gross income (line 32) minus your standard deduction (line 34) and your exemptions (line 36).

### Exemptions

Whether you itemize your deductions or use the standard deduction, you can generally deduct \$2,550 for each exemption you can claim. However, if your adjusted gross income (AGI) is more than the dollar amount for your filing status as shown in the following table, the amount of your deduction is less.

Filing Status	AGI more than:
Single .....	\$ 117,950
Married filing jointly .....	176,950
Married filing separately .....	88,475
Head of household .....	147,450
Qualifying widow(er) .....	176,950

Use the *Deduction for Exemptions Worksheet —Line 36* in the Form 1040 Instructions to figure the amount of your deduction.

Enter the amount you figure for your exemptions on line 36.

### Tax, Credits, and Payments

After finding your taxable income, the next step is to figure your income tax liability. This tax amount is then reduced by certain credits you may have and increased by any other taxes you may owe. Finally, you apply any

payments or other credits against your liability to determine whether you owe additional tax or are entitled to a refund.

## Tax

Most people use the Tax Table to figure their tax. However, you must use the Tax Rate Schedules to figure your tax if your taxable income is \$100,000 or more.

If you had a net capital gain or reported capital gain distributions on Form 1040, line 13, your tax may be less if you figure it using the *Capital Gain Tax Worksheet* in the Form 1040 instructions. Form 8615 may have to be used to figure the tax for a child under age 14 at the end of the year with more than \$1,300 of investment income.

**Tax Table.** The Tax Table is in the instructions for Form 1040 and in the back of this publication. To find your tax, read down the income column to the line that includes your taxable income as shown on line 37. Then read across the line to the column heading that describes your filing status. The amount shown where the income line and filing status column meet is your tax. Enter it on line 38.

**Tax Rate Schedules.** If your taxable income (line 37) is \$100,000 or more, you must figure your tax by using Tax Rate Schedule X, Y-1, Y-2, or Z unless you can use the *Capital Gain Tax Worksheet* or must use Form 8615.

The Tax Rate Schedules are in the Form 1040 instructions and in the back of this publication. Enter your tax on line 38.

**Maximum tax rate on capital gains (Schedule D).** The highest tax rate on taxable income is 39.6%. However, the highest tax rate on a net capital gain is 28%. A net capital gain is the amount of your net long-term capital gains that is more than your net short-term capital losses. The maximum 28% rate applies if you have a long-term capital gain shown on line 17, Schedule D (Form 1040), and a net gain shown on line 18, Schedule D (Form 1040). This maximum rate also applies if you received capital gain distributions and do not need Schedule D for other capital transactions. If this is the case, enter those distributions on line 13 of Form 1040. Write "CGD" on the dotted line next to line 13.

You should complete the *Capital Gain Tax Worksheet* in the Form 1040 instructions to figure your tax only if your taxable income (line 37, Form 1040) is more than the amount shown for your filing status in the following table.

Filing Status	Amount
Married filing jointly	\$ 96,900
Qualifying widow(er)	96,900
Head of household	83,050
Single	58,150
Married filing separately	48,450

If you use the *Capital Gain Tax Worksheet*, enter your tax from line 13 of the worksheet on line 38, Form 1040.

**Investment income of certain minor children.** If a child was under age 14 on January 1, 1997, and had more than \$1,300 of interest, dividends, and other investment income in 1996, part of that income may be taxed at the parent's rate. The tax is figured using Form 8615.

Form 8615 should not be filed if neither parent is alive at the end of the year or if a parent chooses to include the child's interest and dividend income on his or her return. For more information, see Chapter 32.

**Additional taxes.** Include any tax from Form 4972, *Tax on Lump-Sum Distributions*, or Form 8814, *Parents' Election To Report Child's Interest and Dividends*, in the total on line 38 and check the box that applies.

## Credits

After you have figured your tax, figure your credits and enter them on lines 39 through 42. Enter the total credits on line 43. Subtract line 43 from line 38. Enter the result on line 44. If line 43 is more than line 38, enter zero.

This chapter does not explain whether you are eligible for these credits. The following table is a list of credits and where to report them on Form 1040. Additional information is provided in the paragraphs that follow the table.

Credit	Line
Child and Dependent Care	39
Elderly or Disabled	40
Foreign Tax	41
General Business	42
Empowerment Zone Employment	42
Mortgage Interest	42
Prior Year Minimum Tax	42
Qualified Electric Vehicle	42
Nonconventional Fuel Source	43

**Credit for child and dependent care expenses.** Figure this credit on Form 2441, *Child and Dependent Care Expenses*. See Chapter 33 for information on this credit.

**Credit for the elderly or the disabled.** Figure this credit on Schedule R. See Chapter 34 for more information.

**Foreign tax credit.** Figure this credit on Form 1116. Foreign tax credit is discussed in Publication 514, *Foreign Tax Credit for Individuals*.

**Other credits.** Enter other credits on line 42 and check the appropriate box or enter the form number to identify which form you are attaching.

**General business credit.** The general business credit is made up of a number of separate business-related credits. If you have 2 or more of the separate credits, use Form 3800, *General Business Credit*, and

check box **a** on line 42. If you have only one of these credits, check box **d** and enter the form number for that credit in the space provided. See Form 3800 for more information.

**Empowerment zone employment credit.** Use Form 8844, *Empowerment Zone Employment Credit*, to figure the amount of this credit, check box **d** on line 42, and enter the form number in the space provided.

**Mortgage interest credit.** Use Form 8396, *Mortgage Interest Credit*, to figure the amount of this credit and check box **b** on line 42. See *Mortgage Interest Credit* in Chapter 36.

**Credit for prior year minimum tax.** Complete Form 8801, *Credit For Prior Year Minimum Tax—Individuals, Estates, and Trusts*, if you paid alternative minimum tax for 1995 on deferred preference items or have a carryforward of the minimum tax credit. Attach this form to your tax return and check box **c** on line 42.

**Qualified electric vehicle credit.** If you placed a qualified electric vehicle in service during the year, use Form 8834, *Qualified Electric Vehicle Credit*, to figure the amount of your credit. Check box **d** on line 42 and enter the form number in the space provided. See Chapter 36 for information on this credit.

**Credit for fuel from a nonconventional source.** If you sold fuel produced from a nonconventional source, include the amount of this credit in the total on line 43. Write "FNS" on the dotted line next to line 43. Also attach a separate schedule showing how you figured the credit. See Internal Revenue Code section 29 for further information.

**Total credits.** Add lines 39 through 42. Put the total on line 43.

## Other Taxes

If you owe any other taxes or if you received advance earned income credit payments, complete any of lines 45 through 50 that apply to you and enter your total tax on line 51.

This chapter does not explain these taxes. The following table is a list of the taxes and where to report them on Form 1040. The paragraphs that follow the table provide more information.

Other Taxes	Line
Self-Employment Tax	45
Alternative Minimum Tax	46
Social Security and Medicare Tax on Tips	47
IRA or Qualified Retirement Plan Penalty Tax	48
Advance Earned Income Credit Payments	49
Household Employment Taxes	50
Recapture Taxes	51
Section 72(m)(5) Excess Benefits Tax	51

Uncollected Tax on Tips or Life Insurance Premiums	51
Tax on Excess Golden Parachute Payments	51
Tax on Accumulation Distribution of Trusts	51

**Self-employment tax.** You must file Schedule SE (Form 1040) if either of the following applies to you (or your spouse if you file a joint return):

- 1) You were self-employed and your net earnings from self-employment were \$400 or more, or
- 2) You had church employee income of \$108.28 or more.

See Publication 533, *Self-Employment Tax*, for more information.

**Alternative minimum tax.** Use Form 6251 to see if you owe any alternative minimum tax. This tax is briefly discussed later in this chapter.

**Social security and Medicare tax on tip income not reported to employer.** Figure the tax on Form 4137, *Social Security and Medicare Tax on Unreported Tip Income*. See Chapter 7 for more information.

**IRA or qualified retirement plan penalty taxes.** You may owe additional taxes on your IRA or other qualified retirement plan if you:

- 1) Received any early distributions,
- 2) Received any excess distributions,
- 3) Had excess accumulations, or
- 4) Made excess contributions to your IRA.

If any of the above apply, get Form 5329, *Additional Taxes Attributable to Qualified Retirement Plans (Including IRAs), Annuities, and Modified Endowment Contracts*, to see if you owe this tax and if you must file this form. See Chapter 11 for more information on qualified retirement plans and Chapter 18 for more information on IRAs.

**Advance earned income credit payments.** Your W-2 form(s) will show these payments in box 9.

**Household employment taxes.** If you owe employment taxes on cash wages paid to a household employee, you must file Schedule H (Form 1040), *Household Employment Taxes*. For details, see the instructions for Schedule H and Publication 926.

**Recapture taxes.** If you must recapture an investment tax credit on Form 4255, a low-income housing credit on Form 8611, a federal mortgage subsidy on Form 8828, a qualified electric vehicle credit, or an Indian employment credit, include it in the total on line 51. On the dotted line next to line 51, identify it in the way explained in the Form 1040 instructions.

**Section 72(m)(5) excess benefits.** If you are or were a 5% owner of a business and you received a distribution of excess benefits from a qualified pension or annuity plan, you may have to pay a penalty tax of 10% of the distribution. Include the amount of the penalty in your total for line 51. Also write the amount and "Section 72(m)(5)" on the dotted line next to line 51. See Publication 560, *Retirement Plans for the Self-Employed*, for more information.

**Uncollected employee social security and Medicare or RRTA tax on tips (or group-term life insurance).** If you did not have enough wages to cover the social security tax and Medicare tax or railroad retirement (RRTA) tax due on tips you reported to your employer (or on group-term life insurance), include the tax due in the total for line 51. The amount of tax due will be shown in box 13 of your Form W-2. Also write the amount and "UT" on the dotted line next to line 51. See Chapter 7 for more information.

**Golden parachute payments.** If you received an excess parachute payment (EPP), you must pay a tax equal to 20% of this excess payment. Include the amount of this tax in your total for line 51. Also write the amount and "EPP" on the dotted line next to line 51. See the instructions for Form 1040, line 51, for more information.

**Total tax.** Add lines 45 through 50 and any amounts entered next to line 51. Put the total on line 51. This is your total tax.

## Payments

Once you have figured your total tax on line 51, figure your total payments. Enter the payments that apply to you on lines 52 through 57.

This chapter does not discuss all of these payments. The following table is a list of the payments (and credits that are considered payments) and where to report them on Form 1040. The paragraphs that follow the table provide more information.

Payments	Line
Federal Income Tax Withheld	52
Estimated Tax Paid	53
Earned Income Credit	54
Tax Paid with Extension	55
Excess Social Security and RRTA Tax Withheld	56
Regulated Investment Company Credit	57
Credit for Federal Tax Paid on Fuels	57

**Federal income tax withheld.** This includes amounts from Forms W-2, W-2G, 1099-R, and any other Form 1099. It is important to check all of your statements to see whether any tax was withheld and to carefully add the amounts before making an entry on line 52. The following table is a list

of the boxes that show income tax withholding.

FORM NUMBER	LOCATION
W-2	Box 2
W-2G	Box 2
1099-B	Box 4
1099-DIV	Box 2
1099-G	Box 4
1099-INT	Box 4
1099-MISC	Box 4
1099-OID	Box 4
1099-PATR	Box 4
1099-R	Box 4

**Estimated tax payments.** If you made estimated tax payments for 1996, enter the total of these payments on line 53. Also enter on line 53 any overpayment from your 1995 return that you applied to your 1996 estimated tax.

If you paid joint estimated tax but are now filing separate income tax returns or if you divorced in 1996, see *Estimated Tax* in Chapter 5 for further directions.

**Earned income credit (EIC).** You may be able to take this credit if lines 7 and 31 are each less than \$25,078 and you had one qualifying child (less than \$28,495 if you had more than one qualifying child). A qualifying child is one that meets certain age and other requirements and lived with you. Also, you may be able to take this credit if lines 7 and 31 are each less than \$9,500 and you do not have a qualifying child. You (or your spouse if filing jointly) must have been at least age 25 but under age 65 at the end of your tax year. To find out if you can take the EIC, follow the Form 1040 instructions for line 54. The earned income credit is also explained in Chapter 35.

**Tax paid with extension.** This is any amount you paid with Forms 4868, 2688, or 2350 (extensions of time to file).

**Excess social security and RRTA tax withheld.** If you worked for more than one employer and had too much social security or railroad retirement tax withheld, enter the excess amount on line 56. This is explained in Chapter 36.

**Regulated investment company credit.** If you can take a regulated investment company credit, attach Copy B of Form 2439, *Notice to Shareholder of Undistributed Long-Term Capital Gains*. Include the amount of the credit on line 57 and check box a.

**Fuel tax credit.** If you can take a credit for tax on gasoline, diesel fuel, and other fuels used in your business, or for certain diesel-powered cars, vans, and light trucks, attach Form 4136, *Credit for Federal Tax Paid on Fuels*. Include the amount of the credit on line 57 and check box b.

**Total payments.** Add lines 52 through 57 and enter this total on line 58. This sum is your total payments.

## Refund or Amount You Owe

After you have figured your total tax (line 51) and your total payments (line 58), you must determine if you are due a tax refund or if you owe additional tax.

### Refund

If the amount on line 58 is more than the amount on line 51, subtract line 51 from line 58 and enter the result on line 59. This is the amount of tax you have overpaid. If you want the entire amount refunded to you, enter the amount on line 60a. Instead of getting a check, you may be able to have your refund deposited directly into your account at a bank or other financial institution. Complete the boxes on lines 60b, c, and d.

If you want all of your overpayment applied to your 1997 estimated tax, enter the amount on line 61. If you want part of your overpayment applied to your 1997 estimated tax, you must complete both lines 60a and 61. The amount on line 61 will be credited to your 1997 estimated taxes unless you ask us to apply it to your spouse's account. This request should include your spouse's social security number.

### Amount You Owe

If the amount on line 51 is more than the amount on line 58, subtract line 58 from line 51 and enter the result on line 62. This is the amount you owe. For information on how to pay, see *Amount You Owe* in Chapter 1.

**Filled-in form.** A filled-in Form 1040 with certain forms and schedules is shown in Chapter 39.

## Alternative Minimum Tax

The tax law gives special treatment to some kinds of income and allows special deductions and credits for some kinds of expenses. Taxpayers who benefit from the law in these ways may have to pay at least a minimum amount of tax through an additional tax. This additional tax is called the **alternative minimum tax (AMT)**.

You may have to pay the alternative minimum tax if your taxable income for regular tax purposes, combined with certain adjustments and tax preference items, is more than:

- \$45,000 if your filing status is married filing a joint return (or a qualifying widow(er) with dependent child),
- \$33,750 if your filing status is single or head of household, or
- \$22,500 if your filing status is married filing a separate return.

**Adjustments and tax preference items.** The more common adjustments and tax preference items include:

- Addition of **personal exemptions**,
- Addition of the **standard deduction** (if claimed),
- Addition of **itemized deductions** claimed for state and local taxes, certain interest, most miscellaneous deductions, and part of medical expenses,
- Subtraction of any **refund of state and local taxes** included in gross income,
- Addition of accelerated **depreciation** that is more than straight line,
- Difference between **gain or loss** on the sale of property reported for regular tax purposes and AMT purposes,
- Addition of certain income from **incentive stock options**,
- Change in income from certain **installment sales**, because installment method cannot be used for AMT purposes,
- Change in certain **passive activity loss** deductions,
- Addition of certain **depletion** that is more than the adjusted basis of the property,
- Addition of part of the deduction for certain **intangible drilling costs**, and
- Addition of **tax-exempt interest** on certain private activity bonds.

**More information.** For more information about the alternative minimum tax, see the instructions for Form 1040, line 46, and **Form 6251, Alternative Minimum Tax—Individuals**.

## Tax Figured by IRS

If you want, the IRS will figure your tax for you on Form 1040EZ, Form 1040A, or Form 1040.

If the IRS figures your tax and you paid too much, you will receive a refund. If you did not pay enough, you will receive a bill for the balance. You may avoid interest or the penalty for late payment if you pay the bill within 30 days of the date of the bill or by the due date for your return, whichever is later.



The IRS cannot figure your tax for you if:

- 1) You must use Form 8615 to figure your tax (see Chapter 32),
- 2) You want your refund directly deposited, or
- 3) You want any of your refund applied to your 1997 estimated tax.

## Form 1040EZ

If you file Form 1040EZ by April 15, 1997, you can choose to have the IRS figure your tax. Put your peel-off label on your return. If you do not have a label, print (do not type) your name, address, and social security number in the spaces provided.

**What to complete.** Read lines 1 through 8 and fill in the lines that apply to you. If you are filing a joint return, use the space under the "Note" to the left of line 6 to separately show your taxable income and your spouse's taxable income.

**Earned income credit.** If you can take the earned income credit as discussed in Chapter 35, the IRS will figure it for you. Enter the amount and type of any nontaxable earned income in the boxes to the left of line 8. Print "EIC" in the space to the right of the words "earned income below" on line 8.

**Filing the return.** Sign and date your return. Also fill in your occupation. If you are filing a joint return, both you and your spouse must sign it. Show both of your occupations on a joint return.

Attach Copy B or the first copy of all your Form(s) W-2 to your return.

Mail the return to the Internal Revenue Service Center for the area where you live.

## Form 1040A

If you file Form 1040A by April 15, 1997, you can choose to have the IRS figure your tax. Place your peel-off label on your return. If you do not have a label, fill in (print or type) your name, address, and social security number. If you are married, give the social security numbers of both spouses even if you file separately.

**What to complete.** Read lines 1 through 22 and fill in the lines that apply to you. If you file a joint return, use the space to the left of line 22 to separately show your own and your spouse's taxable income. Complete lines 24a, 24b, 26, 27, and 29a through 29c if they apply to you. But do not fill in lines 24b and 29c if you want the IRS to figure the credits shown on those lines. Also, enter any write-in information that applies to you in the space to the left of line 29d.

**Credit for child and dependent care expenses.** If you can take this credit, complete Schedule 2 and attach it to your return. Enter the amount of the credit on line 24a (Form 1040A). The IRS will not figure this credit.

**Credit for the elderly or the disabled.** If you can take this credit, attach Schedule 3 to your return and write "CFE" in the space to the left of line 24b (Form 1040A). The IRS will figure this credit for you. Check the box on Schedule 3 for your filing status and age, and fill in lines 11 and 13 of Part III if they apply. Also, complete Part II of Schedule 3 if it applies. See Chapter 34 for more information about this credit.

**Earned income credit.** If you can take the earned income credit, as discussed in Chapter 35, the IRS will figure it for you. Write "EIC" next to line 29c. Enter the amount and type of any nontaxable earned income in the spaces provided below line 29c. If you have a qualifying child, you must fill in Schedule EIC and attach it to your return.

**Filing the return.** Sign and date your return. Also fill in your occupation. If you are filing a joint return, both you and your spouse must sign it. Show both of your occupations on a joint return.

Attach Copy B or the first copy of all your Form(s) W-2 to your return. Also attach any Form 1099-R you received that has withholding tax in box 4.

Mail the return to the Internal Revenue Service Center for the area where you live.

## Form 1040

If you file Form 1040 by April 15, 1997, you can choose to have the IRS figure your tax if you meet all of the conditions described below:

- 1) All of your income for the year was from wages, salaries, tips, interest, dividends, taxable social security benefits, unemployment compensation, IRA distributions, pensions, or annuities.
- 2) Your taxable income on line 37 is less than \$100,000.
- 3) You do not itemize deductions.
- 4) You do not file any of the following forms:
  - a) Form 2555, *Foreign Earned Income*.
  - b) Form 2555-EZ, *Foreign Earned Income Exclusion*.
  - c) Form 4137, *Social Security and Medicare Tax on Unreported Tip Income*.
  - d) Form 4970, *Tax on Accumulation Distribution of Trusts*.

- e) Form 4972, *Tax on Lump-Sum Distributions*.
- f) Form 6198, *At-Risk Limitations*.
- g) Form 6251, *Alternative Minimum Tax—Individuals*.
- h) Form 8615, *Tax for Children Under Age 14 Who Have Investment Income of More Than \$1,300*.
- i) Form 8814, *Parents' Election To Report Child's Interest and Dividends*.

**Name, address, and social security number.** Put your peel-off label on your return. If you do not have a label, fill in (print or type) your name, address, and social security number. If you are married, give the social security numbers of both spouses even if you file separately.

**What to complete.** Read lines 1 through 37 and fill in the lines that apply to you.

If you are filing a joint return, use the space above the words "Adjusted Gross Income" on the front of your return to separately show your taxable income and your spouse's taxable income.

Read lines 39 through 57. Fill in the lines that apply to you, but do not fill in the "Total" lines. Do not fill in lines 40 and 54 if you want the IRS to figure the credits shown on those lines. Please be sure to fill in line 52 for federal income tax withheld.

Fill in any forms or schedules asked for on the lines you completed, and attach them to your return when you file it.

### **Credit for the elderly or the disabled.**

If you can take the credit for the elderly or the disabled, as discussed in Chapter 34, attach Schedule R. Write "CFE" on the dotted line next to line 40 of Form 1040. The IRS will figure the credit for you. On Schedule R, check the box for your filing status and age, and fill in Part II and lines 11 and 13 of Part III if they apply.

**Earned income credit.** If you can take the earned income credit, as discussed in Chapter 35, the IRS will figure it for you. Write "EIC" in the space to the left of line 54 of Form 1040. Enter the amount and type of any nontaxable earned income in the spaces provided on line 54. If you have a qualifying child, you must fill in Schedule EIC and attach it to your return.

**Filing the return.** Sign and date your return. Also fill in your occupation. If you are filing a joint return, both you and your spouse must sign it. Show both of your occupations on a joint return.

Attach Copy B or the first copy of all your Form(s) W-2 to your return. Also attach any Form 1099-R you received that has withholding tax in box 4.

Mail the return to the Internal Revenue Service Center for the area where you live.

# Tax on Investment Income of Certain Minor Children

## Important Reminder

**Investment income of child under age 14.** The amount of investment income that may cause part of a child's investment income to be taxed at the parents' higher rate is \$1,300. See *Tax for Children Under Age 14 Who Have Investment Income of More Than \$1,300*, later.

## Introduction

This chapter discusses two special tax rules that apply to certain investment income of a child under age 14:

- 1) A child's parent may be able to choose to include the child's interest and dividend income on the parent's return so the child does not have to file a return. See *Parent's Election To Report Child's Interest and Dividends*, later.
- 2) If a child's interest, dividends, and other investment income total more than \$1,300, part of that income may be taxed at the parent's tax rate instead of the child's tax rate. See *Tax for Children Under Age 14 Who Have Investment Income of More Than \$1,300*, later.

For this purpose, the term "child" includes a legally adopted child and a stepchild. These rules apply whether or not the child is a dependent.

These rules do **not** apply if:

- The child is not required to file a tax return, or
- Neither of the child's parents were living at the end of the tax year.

## Useful Items

You may want to see:

### Publication

- **929** Tax Rules for Children and Dependents

### Form (and Instructions)

- **8615** Tax for Children Under Age 14 Who Have Investment Income of More Than \$1,300

- **8814** Parents' Election To Report Child's Interest and Dividends

## Which Parent's Return To Use

For parents who do not file a joint return, the following discussions explain which parent's tax return must be used when applying the special tax rules for the investment income of a child under 14. Only that parent can make the election described later under *Parent's Election To Report Child's Interest and Dividends*, and only that parent's tax rate and other return information is used in the computations explained later under *Tax for Children Under Age 14 Who Have Investment Income of More Than \$1,300*.

**Child's parents married.** If the child's parents are married to each other and file a joint return, use the joint return. If they file separate returns, use the return of the parent with the greater taxable income.

**Parents treated as not married.** If a child's parents are married to each other but not living together, and the parent with whom the child lives (the custodial parent) is considered unmarried, use the return of the custodial parent. If the custodial parent is not considered unmarried, use the return of the parent with the greater taxable income.

For an explanation of when a married person living apart from his or her spouse is considered unmarried, see *Head of Household* in Chapter 2.

**Child's parents divorced.** If a child's parents are divorced or legally separated, and the parent who had custody of the child for the greater part of the year (the custodial parent) has not remarried, use the return of the custodial parent.

**Custodial parent remarried.** If the custodial parent has remarried, the stepparent (rather than the noncustodial parent) is treated as the child's other parent. Therefore, if the custodial parent and the stepparent file a joint return, use that joint return. Do not use the return of the noncustodial parent.

If the custodial parent and the stepparent are married, but file separate returns, use the return of the one with the greater taxable income. If the custodial parent and the stepparent are married but not living together, the earlier discussion under *Parents treated as not married* applies.

**Child's parents never married.** If a child's parents did not marry each other, but lived together all year, use the return of the parent with the greater taxable income. If the parents did not live together all year, the rules explained earlier under *Child's parents divorced* apply.

**Widows and widowers.** If a widow or widower remarries, the new spouse is treated as the child's other parent. The rules explained

earlier under *Custodial parent remarried* apply.

## Parent's Election To Report Child's Interest and Dividends

You may be able to elect to include your child's interest and dividend income on your tax return, so your child will not have to file a return.

You can make this election for 1996 only if **all** the following conditions are met.

- 1) Your child was under age 14 on January 1, 1997.
- 2) Your child is required to file a return for 1996 unless you make this election.
- 3) Your child had income only from interest and dividends (including Alaska Permanent Fund dividends).
- 4) The dividend and interest income was less than \$6,500.
- 5) No estimated tax payment was made for 1996 and no 1995 overpayment was applied to 1996 under your child's name and social security number.
- 6) No federal income tax was taken out of your child's income under the backup withholding rules.
- 7) You are the parent whose return must be used when applying the special tax rules for children under 14. (See *Which Parent's Return To Use*, earlier.)

These conditions are also shown in *Figure 32-A*.

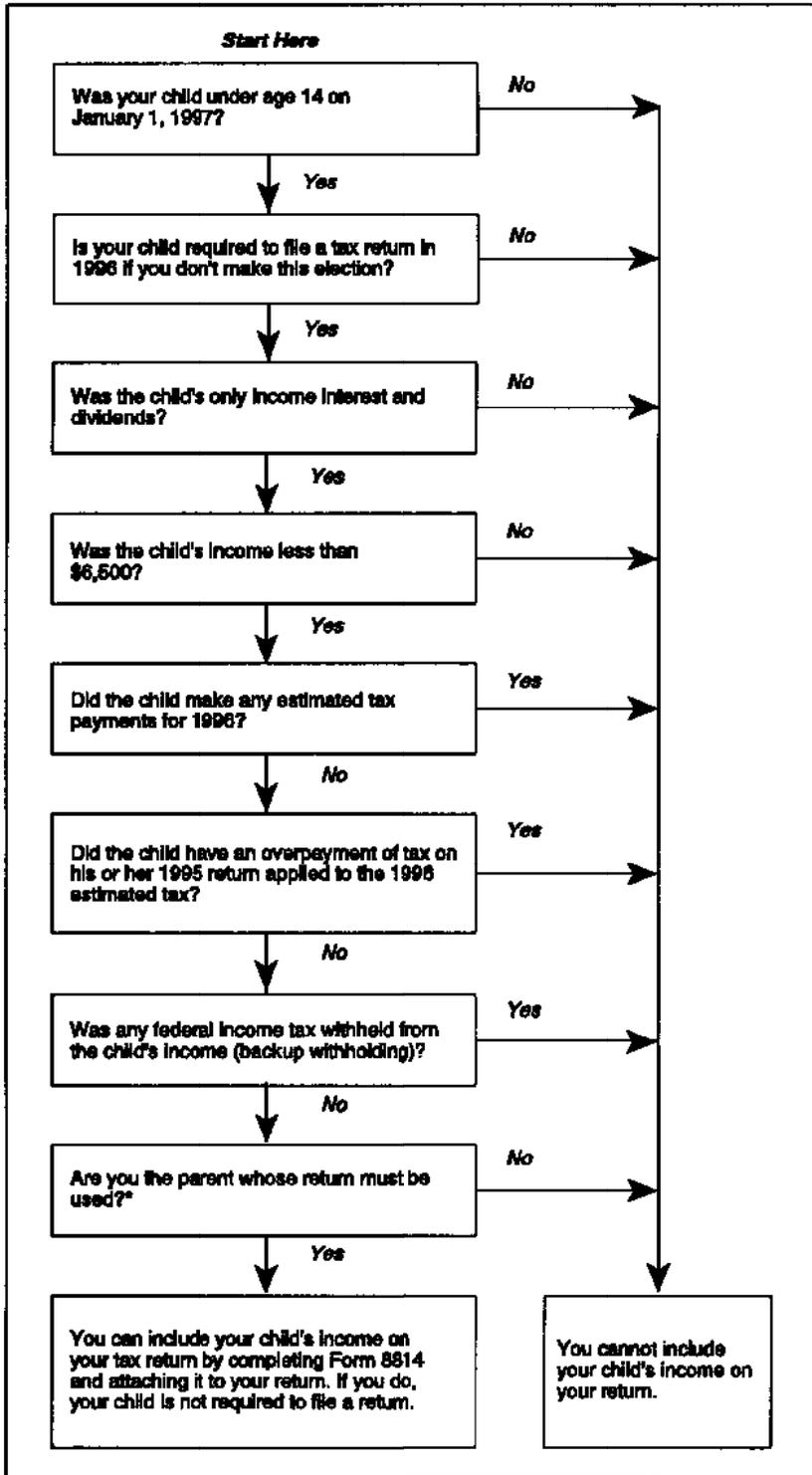
**How to elect.** Make the election by attaching **Form 8814** to your Form 1040 or Form 1040NR. Attach a separate Form 8814 for each child for whom you make the election. If you file Form 8814, you cannot file Form 1040A or Form 1040EZ.

**Tax effect of election.** The federal income tax on your child's income may be more if you make the Form 8814 election rather than file a return for the child. This is because the income may be taxed at a higher tax rate on your return. Also, by making the Form 8814 election, you cannot take certain deductions the child would be entitled to on his or her return, as explained next.

**Deductions you cannot take.** If you use Form 8814, you cannot take any of the following deductions that could have been taken on your child's return:

- 1) Standard deduction of \$650 (\$1,650 if your child was blind),
- 2) Deduction for penalty on early withdrawal of your child's savings, and
- 3) Itemized deductions (such as your child's investment expenses or charitable contributions).

**Figure 32-A. Can You Include Your Child's Income On Your Tax Return?**



\* See Which Parent's Return To Use

**Increased adjusted gross income.** If you use Form 8814 to add your child's income to yours, your increased adjusted gross income may reduce certain items on your return, such as any itemized deductions for medical expenses, casualty and theft losses, and certain miscellaneous expenses.

**Penalty for underpayment of estimated tax.** If you make this election for 1996 and did not have enough tax withheld or pay enough estimated tax to cover the tax you owe, you may be subject to a penalty. If you plan to make this election for 1997, you may need to increase your federal income tax withholding or your estimated tax payments to avoid the penalty. See Chapter 5 for information on increasing your withholding and estimated taxes.

## Figuring Amount of Child's Income To Report

Step 1 of Form 8814 is used to figure the amount of your child's interest and dividend income to report on your return. Only the amount over \$1,300 is added to your income. This amount is shown on line 5 of Form 8814. Include the amount from line 5 of all your Forms 8814 in the total on line 21, Form 1040 or Form 1040NR. In the space next to line 21, write "Form 8814" and the total from line 5 of all your Forms 8814.

**Alternative minimum tax.** If your child received any tax-exempt interest from a private activity bond, you must determine if that interest is a tax preference item for alternative minimum tax (AMT) purposes. If it is, you must include this amount with your own tax preference items when figuring your AMT. Get the instructions for Form 6251, *Alternative Minimum Tax—Individuals*, for information.

**Capital gain distributions.** If your child's dividend income included any capital gain distributions, get Publication 929 and see the discussion under *Capital gain distributions* in Part 2.

## Figuring Additional Tax

Step 2 of Form 8814 is used to figure the tax on the amount of your child's interest and dividends that you do not include in your income. This tax is added to the tax figured on your taxable income.

This additional tax is the **smaller** of:

- 1)  $15\% \times$  (your child's gross income minus \$650), or
- 2) \$97.50.

Include the amount from line 8 of all your Forms 8814 in the total on line 38, Form 1040, or line 37, Form 1040NR. Check box a on Form 1040, line 38, or Form 1040NR, line 37.

## Illustrated Example

This example shows how to fill in Form 8814.

David and Linda Parks are married and will file separate tax returns for 1996. Their only child, Philip, is 8. For 1996, Philip received a Form 1099-INT showing \$3,200 taxable interest income and a Form 1099-DIV showing \$300 ordinary dividends. His parents decide to include that income on one of their returns so that they will not have to file a return for Philip.

First, David and Linda each figure their taxable income (Form 1040, line 37) without regard to Philip's income. David's taxable income is \$41,700 and Linda's is \$59,300. Because her taxable income is greater, Linda can elect to include Philip's income on her return.

On Form 8814, Linda enters her name and social security number, then Philip's name and social security number. She enters Philip's taxable interest income, \$3,200, on line 1a. Philip had no tax-exempt interest income, so she leaves line 1b blank. Linda enters Philip's ordinary dividends, \$300, on line 2a. Philip did not have any nontaxable distributions, so she leaves line 2b blank and enters \$300 on line 2c.

Linda adds the amounts on lines 1a and 2c and enters the result, \$3,500, on line 3. From that amount she subtracts the \$1,300 base amount shown on line 4 and enters the result, \$2,200, on line 5. This is the portion of Philip's income that Linda must add to her income.

Linda includes the \$2,200 in the total on line 21 of her Form 1040 and in the space next to that line writes "Form 8814—\$2,200." Adding that amount to her income increases each of the amounts on lines 22, 31, 32, 35, and 37 of her Form 1040 by \$2,200. Linda is not claiming any deductions or credits that are affected by the increase to her income. Therefore, her revised taxable income on line 37 is \$61,500 (\$59,300 + \$2,200).

On Form 8814, Linda subtracts the \$650 shown on line 6 from the \$3,500 on line 3 and enters the result, \$2,850, on line 7. Because that amount is \$650 or more, she enters \$97.50 on line 8. This is the tax on the \$1,300 of Philip's income that Linda did not add to her income. She must add this additional tax to the tax figured on her revised taxable income.

She figures the tax on her \$61,500 revised taxable income to be \$15,013, then adds \$97.50, and enters the \$15,110.50 total on line 38. She checks box a on her Form 1040, line 38.

Linda attaches Form 8814 to her Form 1040.

## Tax for Children Under Age 14 Who Have Investment Income of More Than \$1,300

Part of a child's 1996 investment income may be subject to tax at the parent's tax rate if:

- 1) The child was under age 14 on January 1, 1997,
- 2) The child's investment income was more than \$1,300, and
- 3) The child is required to file a return for 1996.

Figure 32—Illustrates this.

If the child's parent does not or cannot choose to include the child's income on his or her return, figure the child's tax on Form 8615. Attach the form to the child's Form 1040, Form 1040A, or Form 1040NR.

On Form 8615, enter the names and social security numbers of the child and the parent in the spaces provided. (If the parents filed a joint return, enter the name and social security number of the parent who is listed first on the joint return.) Check the box for the parent's filing status. Then figure the child's tax on Form 8615 in these three steps:

**Step 1.** Figure the child's net investment income.

**Step 2.** Figure a tentative tax on the net investment income based on the parent's tax rate.

**Step 3.** Figure the child's tax.

**Alternative minimum tax.** A child may be subject to alternative minimum tax (AMT) if he or she has certain items given preferential treatment under the tax laws or certain adjustments to taxable income that total more than an exemption amount. See *Alternative Minimum Tax* in Chapter 31.

AMT is figured on Form 6251. For information on special limits that apply to a child who files Form 6251, see *Limit on AMT* under *Alternative Minimum Tax* in Publication 929.

**Parent's return information.** See *Which Parent's Return To Use*, at the beginning of this chapter, for information on which parent's return information must be used on Form 8615.

**Different tax years.** If the parent and the child do not have the same tax year, complete Form 8615 using the information on the parent's return for the tax year that ends in the child's tax year.

**Using estimates.** If the information needed from the parent's return is not known by the time the child's return is due (usually April 15), you can file the return using estimates.

**Parents' Election To Report  
Child's Interest and Dividends**

▶ See instructions below and on back.  
▶ Attach to parents' Form 1040 or Form 1040NR.

Name(s) shown on your return: **Linda Parks**  
 Your social security number: **III 00 III**  
 A Child's name (first, initial, and last): **Philip Parks**  
 B Child's social security number: **000 00 0000**  
 C If more than one Form 8814 is attached, check here

**Step 1 Figure amount of child's interest and dividend income to report on your return**

1a	Enter your child's <b>taxable</b> interest income. If this amount is different from the amounts shown on the child's Forms 1099-INT and 1099-OID, see the instructions	1a	<b>3,200</b>	
b	Enter your child's <b>tax-exempt</b> interest income. <b>DO NOT</b> include this amount on line 1a	1b		
2a	Enter your child's gross dividends, including any Alaska Permanent Fund dividends. If none, enter -0- on line 2c and go to line 3. If your child received any capital gain distributions or dividends as a nominee, see the instructions	2a	<b>300</b>	
b	Enter your child's nontaxable distributions that are included on line 2a. These should be shown in box 1d of Form 1099-DIV	2b		
c	Subtract line 2b from line 2a	2c	<b>300</b>	
3	Add lines 1a and 2c. If the total is \$1,300 or less, skip lines 4 and 5 and go to line 6. If the total is \$6,500 or more, do not file this form. Your child must file his or her own return to report the income	3	<b>3,500</b>	
4	Base amount	4	<b>1,300</b>	<b>00</b>
5	Subtract line 4 from line 3. If you checked the box on line C above or if line 2a includes any capital gain distributions, see the instructions. Also, include this amount in the total on Form 1040, line 21, or Form 1040NR, line 21. In the space next to line 21, enter "Form 8814" and show the amount. Go to line 6 below	5	<b>2,200</b>	

**Step 2 Figure your tax on the first \$1,300 of child's interest and dividend income**

6	Amount not taxed	6	<b>650</b>	<b>00</b>
7	Subtract line 6 from line 3. If the result is zero or less, enter -0-	7	<b>2,850</b>	
8	Tax. Is the amount on line 7 less than \$650? NO. Enter \$97.50 here and see the Note below. YES. Multiply line 7 by 15% (.15). Enter the result here and see the Note below.	8	<b>97</b>	<b>50</b>

**Note:** If you checked the box on line C above, see the instructions. Otherwise, include the amount from line 8 in the tax you enter on Form 1040, line 38, or Form 1040NR, line 37. Be sure to check box a on Form 1040, line 38, or Form 1040NR, line 37.

**General Instructions**

**Purpose of Form.**—Use this form if you elect to report your child's income on your return. If you do, your child will not have to file a return. You can make this election if your child meets all of the following conditions:

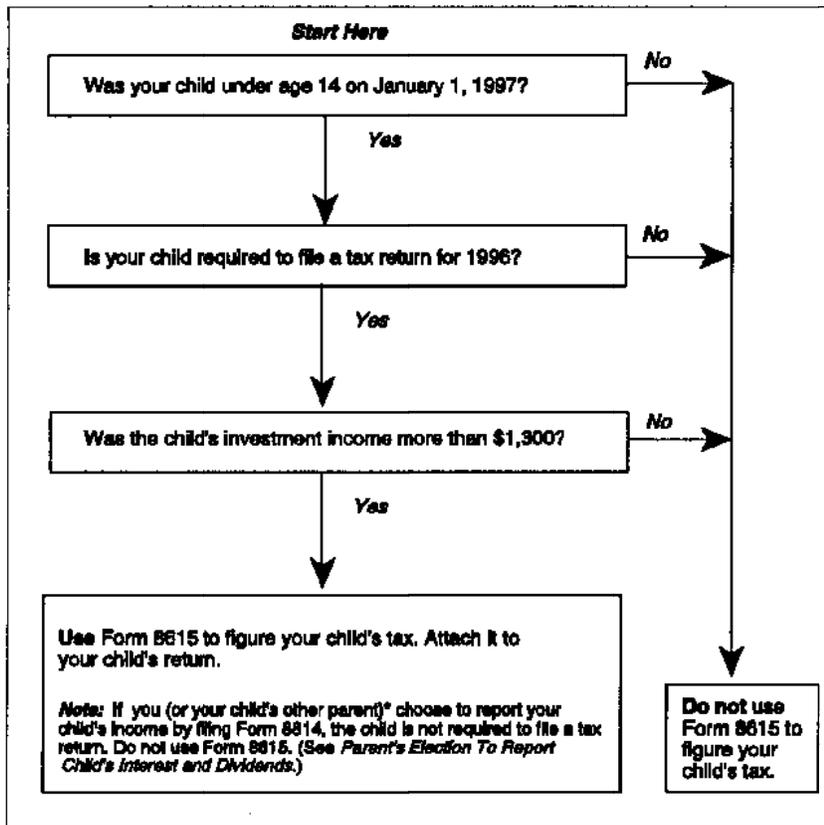
- Was under age 14 on January 1, 1997.
- Is required to file a 1996 return.
- Had income only from interest and dividends, including Alaska Permanent Fund dividends.
- Had gross income for 1996 that was less than \$6,500.

- Had no estimated tax payments for 1996.
  - Did not have any overpayment of tax shown on his or her 1995 return applied to the 1996 return.
  - Had no Federal income tax withheld from his or her income.
- You must also qualify as explained on page 2 of these instructions.
- Step 1 of the form is used to figure the amount of your child's income to report on your return. Step 2 is used to figure an additional tax that must be added to your tax.

**How To Make the Election.**—To make the election, complete and attach Form 8814 to your tax return and file your return by the due date (including extensions). A separate Form 8814 must be filed for each child whose income you choose to report.

**TIP:** The Federal income tax on your child's income may be less if you file a tax return for the child instead of making this election. This is because you cannot take certain deductions that your child would be entitled to on his or her own return. For details, see *Deductions You May Not Take* on page 2.

**Figure 32-B. Do You Have To Use Form 8615 To Figure Your Child's Tax?**



\*See Which Parent's Return To Use

You can use any reasonable estimate. This includes using information from last year's return. If you use an estimated amount on Form 8615, write "Estimated" on the line next to the amount.

When you get the correct information, file an amended return on Form 1040X, *Amended U.S. Individual Income Tax Return*. See *Parent's return information not available under Tax for Children Under Age 14 Who Have Investment Income of More Than \$1,300* in Publication 929 for more information.

## Step 1. Figuring Net Investment Income

The first step in figuring a child's tax using Form 8615 is to figure the child's net investment income. To do that, use Step 1 of Form 8615.

**Line 1 (investment income).** If the child had **investment income only**, enter the adjusted gross income shown on the child's return. Adjusted gross income is shown on line 32 of Form 1040; line 17 of Form 1040A; or line 32 of Form 1040NR. Form 1040EZ cannot be used if Form 8615 must be filed.

If the child had **earned income**, figure the amount to enter on line 1 of Form 8615 by using the worksheet in the instructions for the form.

However, if the child has excluded any foreign earned income or deducted either a loss from self-employment or a net operating loss from another year, use the worksheet in Publication 929 to figure the amount to enter on line 1.

**Investment income.** Investment income generally is all income other than salaries, wages, and other amounts received as pay for work actually done. It includes taxable interest, dividends, capital gains, the taxable part of social security payments and pension payments, and certain distributions from trusts.

**Nontaxable income.** For this purpose, investment income includes only amounts that the child must include in total income. Nontaxable investment income, such as tax-exempt interest and the nontaxable part of social security and pension payments, is not included.

**Sources of income.** A child's investment income includes all income produced by property belonging to the child, regardless of whether the property was transferred to the child or purchased by the child, and regardless of when the property was transferred or purchased or who transferred it. Investment income includes amounts produced by assets the child obtained with earned income (such as interest on a savings account into which the child deposited wages).

A child's investment income includes income produced by property given as a gift to the child under the Uniform Gift to Minors Act.

**Example.** Amanda Black, 13, received the following income:

- Dividends — \$600
- Wages — \$2,100
- Taxable interest — \$1,200
- Tax-exempt interest — \$100
- Net capital gains — \$100.

The dividends were on stock given to her by her grandparents. Amanda's investment income is \$1,900. This is the total of the dividends (\$600), taxable interest (\$1,200), and net capital gains (\$100). Her wages are earned (not investment) income because they are pay received for work actually done. Her tax-exempt interest is not included because it is nontaxable.

**Trust income.** If a child is the beneficiary of a trust, distributions of taxable interest, dividends, capital gains, and other investment income from the trust are investment income to the child.

**Line 2 (deductions).** If the child does not itemize deductions on Schedule A (Form 1040 or Form 1040NR), enter \$1,300 on line 2.

If the child does itemize deductions, the amount to enter on line 2 is the larger of:

- 1) \$650, plus the child's itemized deductions on Schedule A (Form 1040) or Schedule A (Form 1040NR) that are directly connected with the production of his or her investment income, or
- 2) \$1,300.

If the child's directly-connected itemized deductions are not more than \$650, enter \$1,300 on line 2.

**Directly connected itemized deductions.** Itemized deductions are directly connected with the production of investment income if they are for expenses paid to produce or collect taxable income or to manage, conserve, or maintain property held for producing income. These expenses include custodian fees and service charges, service fees to collect taxable interest and dividends, and certain investment counsel fees. They are deducted on Schedule A (Form 1040) to the extent that they, plus certain other miscellaneous itemized deductions, are more than 2% of adjusted gross income. See Chapter 30 for more information about the 2% of adjusted gross income limit on miscellaneous itemized deductions.

**Example 1.** Roger, 12, has investment income of \$8,000, no other income, no adjustments to income, and itemized deductions of \$300 that are directly connected with his investment income. His adjusted gross income is \$8,000, which is entered on line 1. The amount on line 2 is \$1,300 because \$1,300 is more than the sum of \$650 plus his directly connected itemized deductions of

\$300. His net investment income, on line 3, is \$6,700 (\$8,000 – \$1,300).

**Example 2.** Eleanor, 8, has investment income of \$16,000 and an early withdrawal penalty of \$100. She has no other income. She has itemized deductions of \$1,100 that are directly connected with the production of her investment income. Her adjusted gross income, entered on line 1, is \$15,900 (\$16,000 – \$100). The amount entered on line 2 is \$1,750. This is the larger of:

- 1) \$650 plus the \$1,100 of directly connected itemized deductions, or
- 2) \$1,300.

Eleanor's net investment income is \$14,150 (\$15,900 – \$1,750).

## Step 2. Figuring Tentative Tax at Parent's Tax Rate

The tentative tax is the difference in the tax on the parent's taxable income figured with and without the child's net investment income. Figure it on lines 6 through 13 of Form 8615.

**Caution.** When figuring the tentative tax, do not refigure any of the exclusions, deductions, or credits on the parent's return because of the inclusion of a child's net investment income on the parent's return. For example, do not refigure the medical expense deduction.

**Special rule.** See *Trusts* under *Step 2. Figuring Tentative Tax At Parent's Tax Rate* in Publication 929 for information about a special rule that may apply if the parent is the grantor of a trust.

## More Than One Child

The tax return information of the child's parent may be used on Forms 8615 for other children (including adopted children and stepchildren).

**Line 7 (net investment income of other children).** If the tax return information of the parent is also used on any other child's Form 8615, enter on line 7 the total of the amounts from line 5 of all the other children's Forms 8615. Do not include the amount from line 5 of the Form 8615 being completed.

**Example.** Paul and Jane Persimmon have three children, Sharon, Jerry, and Mike, who must attach Form 8615 to their tax returns. The children's net investment income amounts on line 5 of their Forms 8615 are:

- Sharon — \$800
- Jerry — \$600
- Mike — \$1,000

Line 7 of Sharon's Form 8615 would show \$1,600, the total of the amounts on line 5 of Jerry's and Mike's Forms 8615.

Line 7 of Jerry's Form 8615 would show \$1,800 (\$800 + \$1,000).

Line 7 of Mike's Form 8615 would show \$1,400 (\$800 + \$600).

**Other children's information not available.** If the net investment income of the other children is not available when the return is due, either file the return using estimates or use an extension of time to file. Extensions are discussed under *Extensions of Time To File* in Chapter 1.

**Lines 12a and 12b (dividing the tentative tax).** If an amount is entered on line 7, divide the tentative tax shown on line 11 among the children according to each child's share of the total net investment income. This is done on lines 12a, 12b, and 13. Add the amount on line 7 to the amount on line 5 and enter the total on line 12a. Divide the amount on line 5 by the amount on line 12a and enter the result, as a decimal, on line 12b.

**Example.** In the earlier example under *Line 7 (net investment income of other children)*, Sharon's Form 8615 shows \$1,600 on line 7. The amount entered on line 12a is \$2,400, the total of the amounts on lines 5 and 7 (\$800 + \$1,600). The decimal on line 12b is .33, figured as follows and rounded to two places.

$$\frac{\$800}{\$2,400} = .33$$

## Step 3. Figuring the Child's Tax

The final step in figuring a child's tax using Form 8615 is to determine the **larger** of:

- 1) The total of:
  - a) The child's share of the tentative tax based on the parent's tax rate, plus
  - b) The tax on the child's taxable income in excess of net investment income, figured at the child's tax rate, or
- 2) The tax on the child's taxable income, figured at the child's tax rate.

This is the child's tax. It is figured on lines 14 through 18 of Form 8615.

## Illustrated Example

The following example includes a completed Form 8615.

John and Laura Brown have one child, Sara. She is 13 and has \$2,500 taxable interest and dividend income and \$1,500 earned income. She does not itemize deductions. John and Laura file a joint return with John's name and social security number listed first. They claim three exemptions, including an exemption for Sara, on their return.

Because Sara has both earned and unearned income and her gross income is more than \$650, she must file a tax return. Because she is under age 14 and has more than \$1,300 investment income, part of her income may be subject to tax at her parents' rate. A completed Form 8615 must be attached to her return.

Sara's father, John, fills out Sara's return for her.

John enters his name and social security number on Sara's Form 8615 because his name and number are listed first on the joint return he and Laura are filing. He checks the box for married filing jointly.

He enters Sara's investment income, \$2,500, on line 1. Sara does not itemize deductions, so John enters \$1,300 on line 2. He enters \$1,200 on line 3 (\$2,500 – \$1,300).

Sara's taxable income, as shown on line 22 of her Form 1040A, is \$2,500. This is her total income (\$4,000) minus her standard deduction (\$1,500). Her standard deduction is limited to the amount of her earned income. John enters \$2,500 on line 4.

John compares the amounts on lines 3 and 4 and enters the smaller amount, \$1,200, on line 5.

John enters \$48,000 on line 6. This is the taxable income from line 37 of John and Laura's joint Form 1040 return. Sara is an only child, so line 7 is blank. He adds the amounts on line 5 (\$1,200), line 6 (\$48,000), and line 7 and enters the \$49,200 total on line 8.

Using the column for married filing jointly in the Tax Table, John finds the tax on \$49,200. He enters the tax, \$8,570, on line 9. He enters \$8,234 on line 10. This is the tax from line 38 of John and Laura's Form 1040. He enters \$336 on line 11 (\$8,570 – \$8,234).

Because line 7 is blank, John skips lines 12a and 12b and enters \$336 on line 13.

John subtracts the amount on line 5 (\$1,200) from the amount on line 4 (\$2,500) and enters the result, \$1,300, on line 14. Using the column for single filing status in the Tax Table, John finds the tax on \$1,300. He enters this tax, \$197, on line 15. He adds the amounts on lines 13 (\$336) and 15 (\$197) and enters the total, \$533, on line 16.

Using the column for single filing status in the Tax Table, John finds the tax on \$2,500 (the amount on line 4). He enters this tax, \$377, on line 17.

John compares the amounts on lines 16 and 17 and enters the larger amount, \$533, on line 18 of Sara's Form 8615. He also enters that amount on line 23 of Sara's Form 1040A. John also completes Schedule 1 (Form 1040A) for Sara.

**Tax for Children Under Age 14  
Who Have Investment Income of More Than \$1,300**

Department of the Treasury  
Internal Revenue Service

▶ Attach ONLY to the child's Form 1040, Form 1040A, or Form 1040NR.

Attachment  
Sequence No. **33**

Child's name shown on return

*Sara L. Brown*

Child's social security number

*111 : 00 : 1111*

**A** Parent's name (first, initial, and last). Caution: See instructions on back before completing.

*John J. Brown*

**B** Parent's social security number

*000 : 00 : 0001*

**C** Parent's filing status (check one):

- Single     Married filing jointly     Married filing separately     Head of household     Qualifying widow(er)

**Step 1 Figure child's net investment income**

<b>1</b> Enter child's investment income, such as taxable interest and dividend income. See instructions. If this amount is \$1,300 or less, stop; do not file this form . . . . .	<b>1</b>	<i>2,500</i>	
<b>2</b> If the child DID NOT itemize deductions on Schedule A (Form 1040 or Form 1040NR), enter \$1,300. If the child ITEMIZED deductions, see instructions . . . . .	<b>2</b>	<i>1,300</i>	
<b>3</b> Subtract line 2 from line 1. If the result is zero or less, stop; do not complete the rest of this form but ATTACH it to the child's return . . . . .	<b>3</b>	<i>1,200</i>	
<b>4</b> Enter child's taxable income from Form 1040, line 37; Form 1040A, line 22; or Form 1040NR, line 36 . . . . . ▶	<b>4</b>	<i>2,500</i>	
<b>5</b> Enter the smaller of line 3 or line 4. . . . . ▶	<b>5</b>	<i>1,200</i>	

**Step 2 Figure tentative tax based on the tax rate of the parent listed on line A**

<b>6</b> Enter parent's taxable income from Form 1040, line 37; Form 1040A, line 22; Form 1040EZ, line 6; TeleFile Tax Record, line J; Form 1040NR, line 36; or Form 1040NR-EZ, line 13. If the parent transferred property to a trust, see instructions . . . . .	<b>6</b>	<i>48,000</i>	
<b>7</b> Enter the total net investment income, if any, from Forms 8615, line 5, of ALL OTHER children of the parent identified above. Do not include the amount from line 5 above . . . . .	<b>7</b>		
<b>8</b> Add lines 5, 6, and 7 . . . . .	<b>8</b>	<i>49,200</i>	
<b>9</b> Tax on line 8 based on the parent's filing status. See instructions. If from Capital Gain Tax Worksheet, enter amount from line 4 of that worksheet here ▶ . . . . .	<b>9</b>	<i>8,570</i>	
<b>10</b> Enter parent's tax from Form 1040, line 38; Form 1040A, line 23; Form 1040EZ, line 10; TeleFile Tax Record, line J; Form 1040NR, line 37; or Form 1040NR-EZ, line 14. If from Capital Gain Tax Worksheet, enter amount from line 4 of that worksheet here ▶ . . . . .	<b>10</b>	<i>8,234</i>	
<b>11</b> Subtract line 10 from line 9. If line 7 is blank, enter on line 13 the amount from line 11; skip lines 12a and 12b . . . . .	<b>11</b>	<i>336</i>	
<b>12a</b> Add lines 5 and 7 . . . . . <b>12a</b>			
<b>b</b> Divide line 5 by line 12a. Enter the result as a decimal (rounded to two places) . . . . .	<b>12b</b>	<i>x</i>	
<b>13</b> Multiply line 11 by line 12b . . . . . ▶	<b>13</b>	<i>336</i>	

**Step 3 Figure child's tax—if lines 4 and 5 above are the same, enter -0- on line 15 and go to line 16.**

<b>14</b> Subtract line 5 from line 4 . . . . . <b>14</b>	<i>1,300</i>		
<b>15</b> Tax on line 14 based on the child's filing status. See instructions. If from Capital Gain Tax Worksheet, enter amount from line 4 of that worksheet here ▶ . . . . .	<b>15</b>	<i>197</i>	
<b>16</b> Add lines 13 and 15 . . . . .	<b>16</b>	<i>533</i>	
<b>17</b> Tax on line 4 based on the child's filing status. See instructions. If from Capital Gain Tax Worksheet, check here . . . . . ▶ <input type="checkbox"/>	<b>17</b>	<i>377</i>	
<b>18</b> Enter the larger of line 16 or line 17 here and on Form 1040, line 38; Form 1040A, line 23; or Form 1040NR, line 37. . . . . ▶	<b>18</b>	<i>533</i>	

**General Instructions**

**Purpose of Form.**—For children under age 14, investment income over \$1,300 is taxed at the parent's rate if the parent's rate is higher than the child's rate. If the child's investment income is more than \$1,300, use this form to figure the child's tax.

**Investment income.**—As used on this form, "investment income" includes all taxable income other than earned income as defined on page 2. It includes taxable interest, dividends, capital gains, rents,

royalties, etc. It also includes pension and annuity income and income (other than earned income) received as the beneficiary of a trust.

**Who Must File.**—Generally, Form 8615 must be filed for any child who was under age 14 on January 1, 1997, had more than \$1,300 of investment income, and is required to file a tax return. If neither parent was alive on December 31, 1996, do not use Form 8615. Instead, figure the child's tax in the normal manner.

**Note:** The parent may be able to elect to report the child's interest and dividends on his or her return. If the parent makes this election, the child will not have to file a return or Form 8615. For more details, get Form 8814, Parents' Election To Report Child's Interest and Dividends.

**Additional information.**—For more details, get Pub. 929, Tax Rules for Children and Dependents.

**Incomplete information for parent.**—If the parent's taxable income or filing status or the net investment income of the parent's other children is not known by the

# Child and Dependent Care Credit

## Important Changes for 1996

**Taxpayer identifying number needed for the qualifying dependent.** You must include on your 1996 return the taxpayer identification number (generally the social security number) of the qualifying person. If the correct number is not shown, the credit may not be allowed. This does not apply if the child was born in December 1996.

**Individual taxpayer identification number (ITIN) for aliens.** The IRS will issue an ITIN to a nonresident or resident alien who does not have — and is not eligible to get — a social security number (SSN). To apply for an ITIN, Form W-7 must be filed with the IRS. It usually takes about 30 days to get an ITIN. The ITIN is entered wherever an SSN is requested on a tax return. If you are required to include another person's SSN on your return and that person does not have — and cannot get — an SSN, enter that person's ITIN.

An ITIN is for tax use only. It does not entitle the holder to social security benefits or change the holder's employment or immigration status under U.S. law.

## Important Reminders

**Provider identification.** You must provide certain information on all persons or organizations that care for your child or dependent. For information on this identification, see *Provider Identification Test*.

**You may have to pay employment taxes.** If you pay someone to come to your home and care for your dependent or spouse, you may be a household employer who has to pay employment taxes. Usually, you are **not** a household employer if the person who cares for your child or dependent does so at his or her home or place of business. See *Employment Taxes for Household Employers*.

## Introduction

This chapter discusses the credit for child and dependent care expenses and covers the following topics:

- Tests you must meet to claim the credit
- How to figure the credit

- How to claim the credit
- Employment taxes you may have to pay as a household employer

If you pay someone to care for your dependent under age 13 or for your spouse or dependent who is not able to care for himself or herself, you may be able to get a credit of up to 30% of your expenses. To qualify, you must pay these expenses so you can work or look for work.

**Dependent care benefits.** If you received any dependent care benefits from your employer in 1996, you may be able to exclude from your income all or part of them. See *Employer's Dependent Care Benefits* under *How To Figure the Credit*.

### Useful Items

You may want to see:

#### Publication

- 503** Child and Dependent Care Expenses
- 926** Household Employer's Tax Guide

#### Form (and Instructions)

- 2441** Child and Dependent Care Expenses
- 6251** Alternative Minimum Tax—Individuals
- Schedule 2 (Form 1040A)** Child and Dependent Care Expenses for Form 1040A Filers
- Schedule H (Form 1040)** Household Employment Taxes
- W-10** Dependent Care Provider's Identification and Certification

## Tests To Claim the Credit

To be able to claim the credit for child and dependent care expenses, you must meet **all** the following tests. These tests are presented in *Figure 33-A* and are also explained in detail in this chapter. To claim the credit, you must file Form 1040 or Form 1040A, not Form 1040EZ.

- 1) The care must be for one or more qualifying persons. (See *Qualifying Person Test*.)
- 2) You (and your spouse if you are married) must keep up a home that you live in with the qualifying person or persons. (See *Keeping Up a Home Test*.)
- 3) You (and your spouse if you are married) must have earned income during the year. (However, see *Rule for student-spouse or spouse not able to care for self* under *Earned Income Test*.)
- 4) You must pay child and dependent care expenses so you (and your spouse if you are married) can work or look for

work. (See *Work-Related Expense Test*.)

- 5) You must make payments for child and dependent care to someone you (or your spouse) cannot claim as a dependent. If you make payments to your child, he or she cannot be your dependent and must be age 19 or older by the end of the year. (See *Payments to Relatives* under *Work-Related Expense Test*.)
- 6) Your filing status must be Single, Head of household, Qualifying widow(er) with dependent child, or Married filing jointly. You must file a joint return if you are married, unless an exception discussed later under *Joint Return Test* applies to you.
- 7) You must identify the care provider on your tax return. (See *Provider Identification Test*.)
- 8) You must exclude less than \$2,400 (less than \$4,800 if two or more qualifying persons were cared for) of dependent care assistance benefits. (See *Reduced Dollar Limit*.)

## Qualifying Person Test

Your child and dependent care expenses must be for the care of one or more members of your home who are qualifying persons. A qualifying person is:

- 1) Your dependent who was under age 13 when the care was provided and for whom you can claim an exemption,
- 2) Your spouse who was physically or mentally not able to care for himself or herself, or
- 3) Your dependent who was physically or mentally not able to care for himself or herself and for whom you can claim an exemption (or could claim an exemption except the person had \$2,550 or more of gross income).

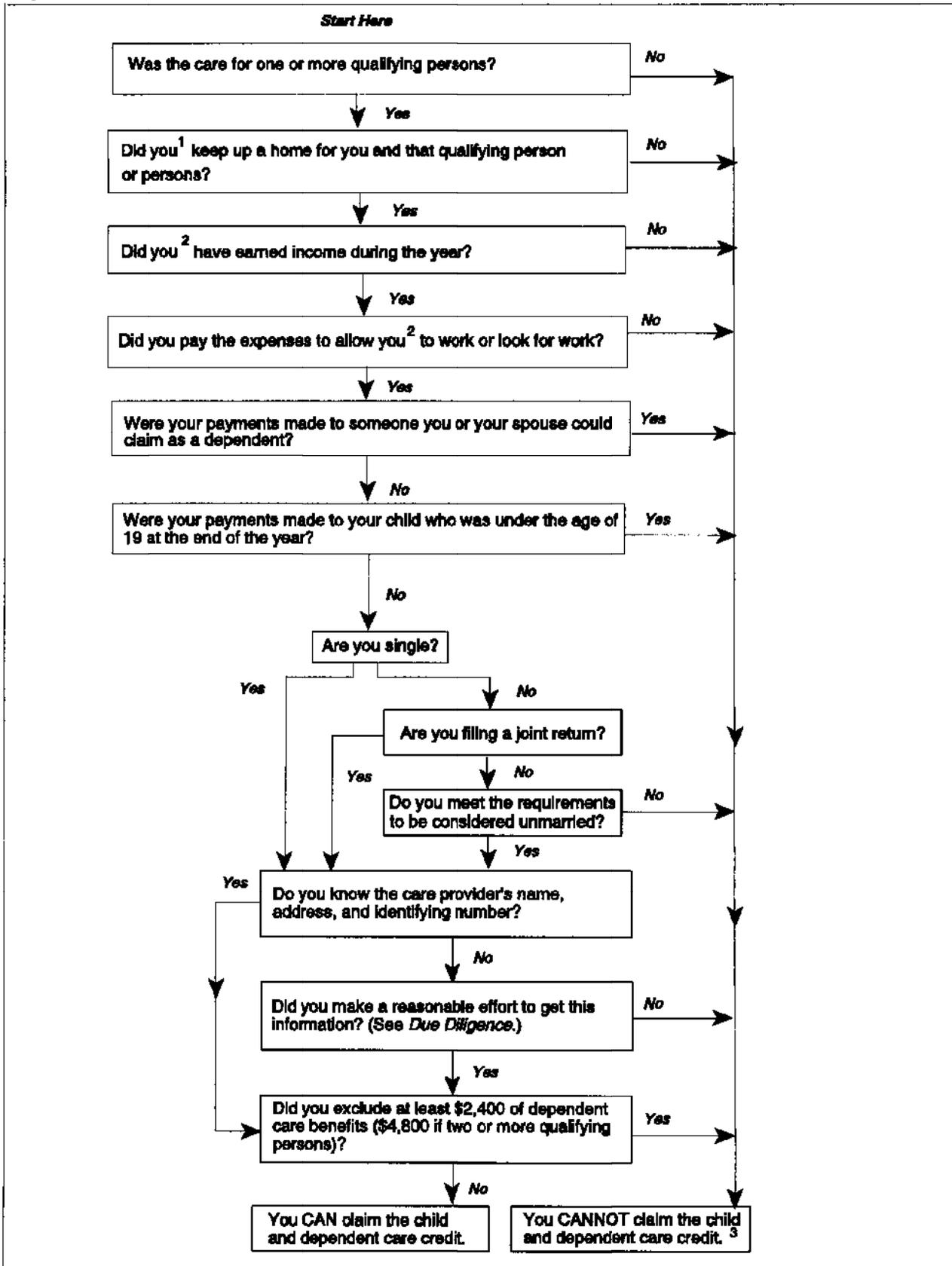


**CAUTION** You must include on your return the taxpayer identification number (generally the social security number) of the qualifying person. If the correct number is not shown, the credit may not be allowed. This does not apply if the child was born in December 1996.

If you are divorced or separated, see *Child of Divorced or Separated Parents* to determine which parent may treat the child as a qualifying person.

**Physically or mentally not able to care for oneself.** Persons who cannot dress, clean, or feed themselves because of physical or mental problems are considered not able to care for themselves. Also, persons who must have constant attention to prevent them from injuring themselves or others are considered not able to care for themselves.

**Figure 33-A. Can You Claim the Credit?**



1. You and your spouse if you were married.  
 2. This also applies to your spouse, unless your spouse was disabled or a full-time student.  
 3. If you had expenses that met the requirements for 1995, except that you did not pay them until 1996, you may be able to claim those expenses in 1996. See *Expenses not paid until the following year under How To Figure the Credit.*

**Person qualifying for part of year.** You determine a person's qualifying status each day. For example, if the person you pay child and dependent care expenses for no longer qualifies on September 16, count only those expenses through September 15. Also see *Dollar Limit*, later.

### Child of Divorced or Separated Parents

To be a qualifying person, your child usually must be your dependent for whom you can claim an exemption. But an exception may apply if you are divorced or separated. Under the exception, if you are the custodial parent, you can treat your child as a qualifying person even if you cannot claim the child's exemption. If you are the noncustodial parent, you cannot treat your child as a qualifying person even if you can claim the child's exemption.

This exception applies if:

- 1) One or both parents had custody of the child for more than half of the year,
- 2) One or both parents provided more than half of the child's support for the year, and
- 3) Either—
  - a) The custodial parent signed Form 8332, *Release of Claim to Exemption for Child of Divorced or Separated Parents*, or a similar statement, agreeing not to claim the child's exemption for the year, or
  - b) The noncustodial parent provided at least \$600 for the child's support and can claim the child's exemption under a pre-1985 decree of divorce or separate maintenance, or written agreement.

A similar statement includes a divorce decree or separation agreement that went into effect after 1984 that allows the noncustodial parent to claim the child's exemption without any conditions, such as payment of support.

You can use *Figure 33–B* to see whether this exception applies to you. If it applies, only the custodial parent can treat the child as a qualifying person. If the exception does not apply, follow the regular rules for a qualifying person under *Qualifying Person Test*, earlier.

If you can take the credit because of this exception, write your child's first and last name and taxpayer identification number (TIN) in the space to the left of line 3, Form 2441 or Schedule 2 (Form 1040A). If the child was born in December 1996 and does not have a TIN, enter "12/96" next to the child's name.

**Example.** You are divorced and have custody of your 8-year-old child. You sign Form 8332 to allow your ex-spouse to take the exemption. You pay child care expenses so you can work. Your child is a qualifying person and you, the custodial parent, can claim the credit for those expenses, even

though your ex-spouse claims an exemption for the child.

**Custodial parent.** You are the custodial parent if, during the year, you have custody of your child longer than your child's other parent has custody.

**Divorced or separated.** For purposes of determining whether your child is a qualifying person, you are considered divorced or separated if either of the following applies.

- 1) You are divorced or separated under a decree of divorce or separate maintenance or a written separation agreement, or
- 2) You lived apart from your spouse for all of the last 6 months of the year.

### Keeping Up a Home Test

To claim the credit, you (and your spouse if you are married) must keep up a home that you live in with one or more qualifying persons. You are keeping up a home if you pay more than half the cost of running it for the year.

**Home.** The term "home" means the main home for both you and the qualifying person. Your home can be the main home even if the qualifying person does not live there all year because of his or her:

- 1) Birth,
- 2) Death, or
- 3) Temporary absence due to:
  - a) Sickness,
  - b) School,
  - c) Business,
  - d) Vacation,
  - e) Military service, or
  - f) Custody agreement.

**Costs of keeping up home.** The costs of keeping up a home normally include property taxes, mortgage interest, rent, utility charges, home repairs, insurance on the home, and food eaten at home.

The costs of keeping up a home do not include payments for clothing, education, medical treatment, vacations, life insurance, transportation, or mortgage principal. They also do not include the purchase, permanent improvement, or replacement of property. For example, you cannot include the cost of replacing a water heater. However, you can include the cost of repairing a water heater.

### Earned Income Test

To claim the credit, you (and your spouse if you are married) must have earned income during the year.

**Earned income includes** wages, salaries, tips, other employee compensation, and net earnings from self-employment. A net loss

from self-employment reduces earned income. Earned income also includes strike benefits and any disability pay you report as wages. It also includes nontaxable earned income such as parsonage allowances, meals and lodging furnished for the convenience of the employer, voluntary salary deferrals, military basic quarters and subsistence allowances and in-kind quarters and subsistence, and military pay earned in a combat zone.

**Members of the clergy and religious workers.** Certain income earned by ministers, members of religious orders, and Christian Science practitioners may not be considered earned income for this purpose. See *Earned Income Test* in Publication 503.

**Earned income does not include** pensions or annuities, social security payments, workers' compensation, interest, dividends, or unemployment compensation. It also does not include scholarship or fellowship grants, except for amounts paid to you (and reported on Form W-2) for teaching, research, or other services.

**Rule for student-spouse or spouse not able to care for self.** Your spouse is treated as having earned income for any month that he or she is:

- 1) A full-time student, or
- 2) Physically or mentally not able to care for himself or herself.

Figure the earned income of the nonworking spouse as shown under *Earned Income Limit*, under *How To Figure the Credit*, later.

This rule applies to only one spouse for any one month. If, in the same month, both you and your spouse do not work and are either full-time students or physically or mentally not able to care for yourselves, only one of you can be treated as having earned income in that month.

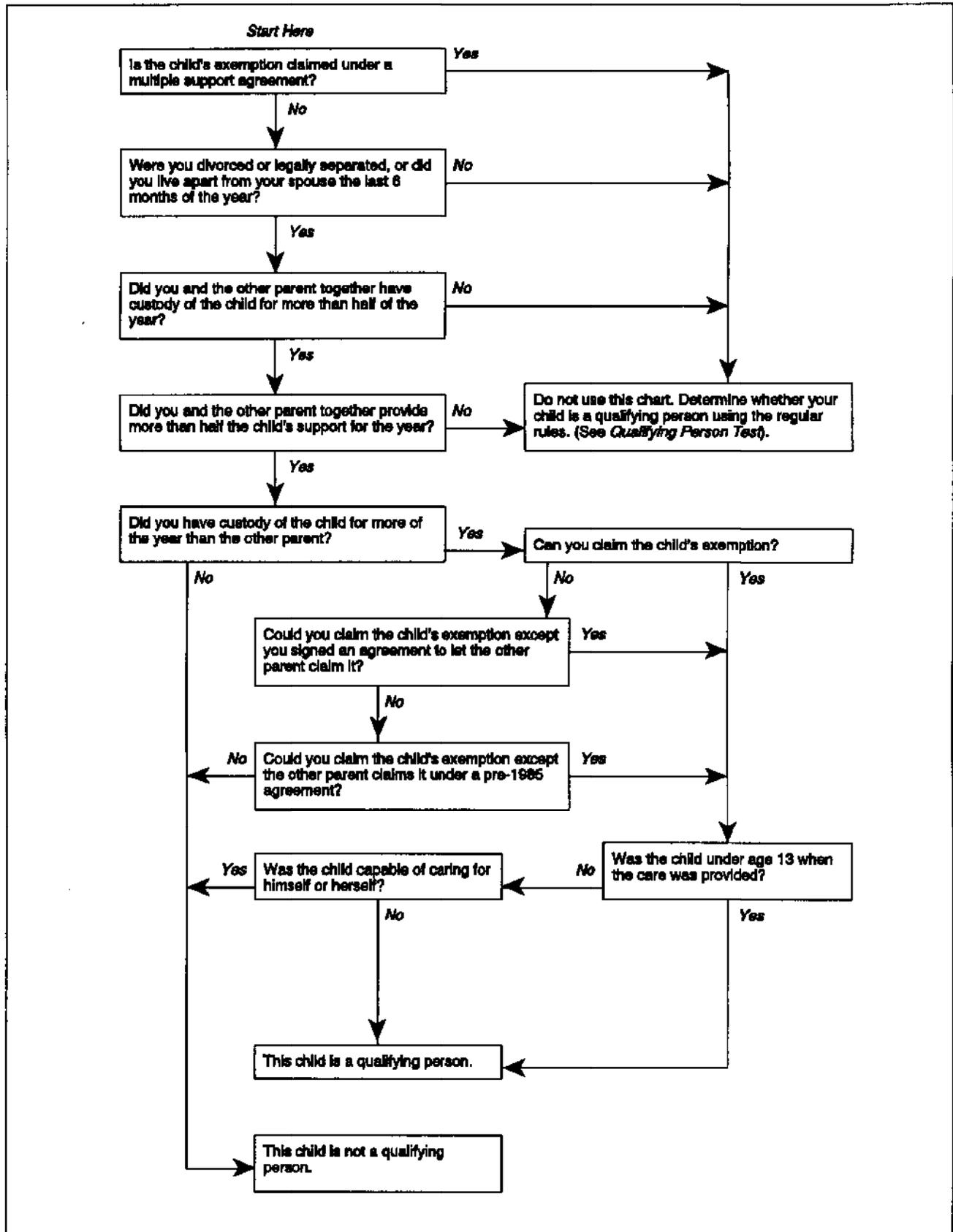
**Full-time student.** You are a full-time student if you are enrolled at and attend a school for the number of hours or classes that the school considers full time. You must have been a student for some part of each of 5 calendar months during the year. (The months need not be consecutive.) If you attend school only at night, you are not a full-time student. However, as part of your full-time course of study, you may attend some night classes.

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

### Work-Related Expense Test

Child and dependent care expenses must be work related to qualify for the credit. Expenses are considered work related only if:

Figure 33-B. Is a Child of Divorced or Separated Parents a Qualifying Person?



- They allow you (and your spouse if you are married) to work or look for work, and
- They are for a qualifying person's care.

## Working or Looking for Work

To be work related, your expenses must allow you to work or look for work. If you are married, generally both you and your spouse must work or look for work. Your spouse is treated as working during any month he or she is a full-time student or is physically or mentally not able to care for himself or herself.

Your work can be for others or in your own business or partnership. It can be either full time or part time. Work also includes actively looking for work. However, if you do not find a job and have no earned income for the year, you cannot take this credit. See *Earned Income Test*, earlier.

Whether your expenses allow you to work or look for work depends on the facts. For example, the cost of a sitter while you and your spouse go out to eat is not normally a work-related expense. Expenses are not considered work related merely because you had them while you were working. They must enable you to be gainfully employed. For example, you are not gainfully employed if you do unpaid volunteer work or volunteer work for a nominal salary.

**Work for part of year.** If you work or actively look for work during only part of the period covered by the expenses, then you must figure your expenses for each day. For example, if you work all year and pay care expenses of \$120 a month (\$1,440 for the year), all the expenses are work related. However, if you work or look for work for only 2 months and 15 days during the year and pay expenses of \$120 a month, your work-related expenses are limited to \$300 ( $2\frac{1}{2}$  months  $\times$  \$120).

**Payments while you are out sick.** Do not count as work-related expenses amounts you pay for child and dependent care while you are off work because of illness. These amounts are not paid to allow you to work. This applies even if you get sick pay and are still considered an employee.

## Care of a Qualifying Person

To be work related, your expenses must be to provide care for a qualifying person. You do not have to choose the least expensive way of providing the care.

Expenses for household services qualify if part of the services is for the care of qualifying persons. See *Household services*, later.

Expenses are for the care of a qualifying person only if their main purpose is the person's well-being and protection. Expenses for care do not include amounts you pay for food, clothing, and entertainment. However, if these amounts are incident to and cannot be separated from the cost of caring for the

qualifying person, you can count the total cost.

**Schooling.** You can count the total cost of sending your child to school if:

- 1) Your child is in a grade level below the first grade, **and**
- 2) The amount you pay for schooling is incident to and cannot be separated from the cost of care.

If your child is in the first grade or higher, or if the cost of schooling can be separated, you must divide the total cost between the cost of care and the cost of schooling. You can count only the cost of care in figuring your credit.

**Example 1.** You take your 3-year-old child to a nursery school that provides lunch and educational activities as a part of its pre-school child-care service. You can count the total cost in figuring the credit.

**Example 2.** Your 5-year-old child goes to kindergarten in the morning. In the afternoon, she attends an after-school day care program at the same school. Your total cost for sending her to the school is \$3,000, of which \$1,800 is for the after-school program. Only the \$1,800 qualifies for figuring the credit.

**Example 3.** You place your 10-year-old child in a boarding school so you can work full time. Only the part of the boarding school expense that is for the care of your child is a work-related expense. You cannot count any part of the amount you pay the school for your child's education.

**Care outside your home.** You can count the cost of care provided outside your home if the care is for your dependent under age 13, or any other qualifying person who regularly spends at least 8 hours each day in your household.

**Dependent care center.** You can count care provided outside your home by a dependent care center if the center complies with all state and local regulations that apply to these centers. A dependent care center is a place that provides care for more than six persons (other than persons who live there) and receives a fee, payment, or grant for providing services for any of those persons, even if the center is not run for profit.

**Camp.** The cost of sending your child to an overnight camp is **not** considered a work-related expense.

**Transportation.** The cost of getting a qualifying person from your home to the care location and back, or from the care location to school and back, is **not** considered a work-related expense. This includes the costs of bus, subway, taxi, or private car. Also, if you pay the transportation cost for the care provider to come to your home, you cannot count this cost as a work-related expense.

**Household services.** Expenses you pay for household services meet the work-related expense test if they are at least partly for the

well-being and protection of a qualifying person.

Household services are ordinary and usual services done in and around your home that are necessary to run your home. They include the services of a housekeeper, maid, or cook. However, they do not include the services of a chauffeur, bartender, or gardener. See *Household Services* in Publication 503 for more information.

In this chapter, the term "housekeeper" refers to any household employee whose services include the care of a qualifying person.

**Taxes paid on wages.** The taxes you pay on wages for qualifying child and dependent care services are work-related expenses. See *Employment Taxes for Household Employers*, later.

## Payments to Relatives

You can count work-related payments you pay to relatives who are not your dependents, even if they live in your home. However, do not count any amounts you pay to:

- 1) A dependent for whom you (or your spouse if you are married) can claim an exemption, or
- 2) Your child who was under age 19 at the end of the year, even if he or she is not your dependent.

## Joint Return Test

Generally, married couples must file a joint return to take the credit. However, if you are legally separated or living apart from your spouse, you may be able to file a separate return and still take the credit.

**Legally separated.** You are not considered married if you are legally separated from your spouse under a decree of divorce or separate maintenance. You are eligible to take the credit on a separate return.

**Married and living apart.** You are not considered married and are eligible to take the credit if **all** the following apply:

- 1) You file a separate return.
- 2) Your home is the home of a qualifying person for more than half the year.
- 3) You pay more than half the cost of keeping up your home for the year.
- 4) Your spouse does not live in your home for the last 6 months of the year.

**Death of spouse.** If your spouse died during the year and you do not remarry before the end of the year, you generally must file a joint return to take the credit. If you do remarry before the end of the year, the credit can be claimed on your deceased spouse's separate return.

## Provider Identification Test

You must identify all persons or organizations that provide care for your child or dependent. Do this on the same form you use to claim the credit. If you file Form 1040, use Part I of Form 2441 to show the information. If you file Form 1040A, use Part I of Schedule 2.

**Information needed.** To identify the care provider, you must give the provider's:

- 1) Name,
- 2) Address, and
- 3) Taxpayer identification number.

If the care provider is an individual, the taxpayer identification number is his or her social security number or individual taxpayer identification number. If the care provider is an organization, then it is the employer identification number (EIN).

You do not have to show the taxpayer identification number if the care provider is one of certain tax-exempt organizations (such as a church or school). In this case, write "Tax-Exempt" in the space where the tax form calls for the number.

If you cannot provide all of the information, or the information is incorrect, you must be able to show that you used due diligence (discussed later) in trying to furnish the necessary information.

**Getting the information.** You can use **Form W-10** to request the required information from the care provider. If you do not use Form W-10, you can get the required information from:

- 1) A copy of the provider's social security card,
- 2) A copy of the provider's driver's license (in a state where the license includes the social security number),
- 3) A copy of the provider's completed Form W-4 if he or she is your household employee,
- 4) A copy of the statement furnished by your employer if the provider is your employer's dependent care plan, or
- 5) A letter or invoice from the provider if it shows the information.



You should keep this information with your tax records. Do not send Form W-10 (or other document containing this information) to the Internal Revenue Service.

**Due diligence.** If the care provider information you give is incorrect or incomplete, your credit may not be allowed. However, if you can show that you used due diligence in trying to supply the information, you can still claim the credit.

You can show due diligence by getting and keeping the provider's completed Form

W-10 or one of the other sources of information listed earlier. Care providers can be penalized if they do not provide this information to you or if they provide incorrect information.

**Provider refusal.** If the provider refuses to give you their identifying information, you should report whatever information you have (such as the name and address) on the form you use to claim the credit. Write "See page 2" in the columns calling for the information you do not have. On the bottom of page 2, explain that you requested the information from the care provider, but the provider did not give you the information. This statement will show that you used due diligence in trying to furnish the necessary information.

## How To Figure the Credit

Your credit is a percentage of your work-related expenses. Your expenses are subject to the earned income limit and the dollar limit. The percentage is based on your adjusted gross income.

### Figuring Total Work-Related Expenses

To figure the credit for 1996 work-related expenses, count only those you paid by December 31, 1996.

**Expenses prepaid in an earlier year.** If you pay for services before they are provided, you can count the prepaid expenses only in the year the care is received. Claim the expenses for the later year as if they were actually paid in that later year.

**Expenses not paid until the following year.** Do **not** count 1995 expenses that you paid in 1996 as work-related expenses for 1996. You may be able to claim an additional credit for them on your 1996 return, but you must figure it separately. See *Payments for previous year's expenses* under *Amount of Credit* in Publication 503.



**TIP** If you had expenses in 1996 that you did not pay until 1997, you cannot count them when figuring your 1996 credit. You may be able to claim a credit for them on your 1997 return.

**Expenses reimbursed.** If a state social services agency pays you a nontaxable amount to reimburse you for some of your child and dependent care expenses, you cannot count the expenses that are reimbursed as work-related expenses.

**Example.** You paid work-related expenses of \$3,000. You are reimbursed \$2,000 by a state social services agency. You can use only \$1,000 to figure your credit.

**Medical expenses.** Some expenses for the care of qualifying persons who are not able

to care for themselves may qualify as work-related expenses and also as medical expenses. You can use them either way, but you cannot use the same expenses to claim both a credit and a medical expense deduction.

If you use these expenses to figure the credit and they are more than the earned income limit or the dollar limit, discussed later, you can add the excess to your medical expenses. However, if you use your total expenses to figure your medical expense deduction, you cannot use any part of them to figure your credit.



**CAUTION** Amounts excluded from your income under your employer's dependent care benefits plan **cannot** be used to claim a medical expense deduction.

### Employer's Dependent Care Benefits

Dependent care benefits include:

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

Your salary may have been reduced to pay for these benefits.

**Exclusion.** If your employer provides dependent care benefits under a qualified plan, you may be able to exclude these benefits from your income. Your employer can tell you whether your benefit plan qualifies. If it does, you must complete Part III of either Form 2441 or Schedule 2 (Form 1040A) to claim the exclusion even if you cannot take the credit. You cannot use Form 1040EZ.

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

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

**Statement for employee.** Your employer must give you a Form W-2, *Wage and Tax Statement* (or similar statement), showing in box 10 the total amount of dependent care benefits provided to you during the year under a qualified plan. Your employer will also include any dependent care benefits over \$5,000 in your wages on Form W-2.

**Forfeitures.** Forfeitures are amounts credited to your dependent care benefit account and included in the amount shown in box 10 of your Form W-2, but not received because you did not incur the expense.

When figuring your exclusion, subtract any forfeitures from the total dependent care benefits reported by your employer. To do this, enter the forfeited amount on line 12 of Form 2441 or Schedule 2 (Form 1040A).



*Forfeitures do not include amounts that you expect to receive in the future.*

**Claiming the credit.** In figuring your credit, do not include the amount of any dependent care benefits that you exclude from your income in your work-related expenses. The excluded amount also reduces the dollar limit as discussed later.

## Earned Income Limit

The amount of work-related expenses you use to figure your credit cannot be more than:

- 1) Your earned income for the year, if you are **single** at the end of the year, or
- 2) The smaller of your earned income or your spouse's earned income for the year, if you are **married** at the end of the year.

Earned income is defined under *Earned Income Test*, earlier.



*For purposes of item (2), use your spouse's earned income for the entire year, even if you were married for only part of the year.*

**Separated spouse.** If you are legally separated or married and living apart from your spouse (as described under *Joint Return Test*, earlier), you are not considered married for purposes of the earned income limit. Use only your income in figuring the earned income limit.

**Surviving spouse.** If your spouse died during the year and you file a joint return as a surviving spouse, you are not considered married for purposes of the earned income limit. Use only your income in figuring the earned income limit.

**Community property laws.** You should disregard community property laws when you figure earned income for this credit.

**Student-spouse or spouse not able to care for oneself.** Your spouse who is either a full-time student or not able to care for himself or herself is treated as having earned income. His or her earned income for each month is considered to be at least \$200 if there is one qualifying person in your home, or at least \$400 if there are two or more. If your spouse works during that month, use the higher of \$200 (or \$400) or his or her actual earned income for that month. If your spouse is a full-time student or not able to care for himself or herself for only part of a month, the full \$200 (or \$400) still applies for that month.

If, in the same month, both you and your spouse are either full-time students or not able to care for yourselves, only one spouse can be considered to have this earned income of \$200 (or \$400) for that month.

## Dollar Limit

There is a dollar limit on the amount of your work-related expenses you can use to figure the credit. This limit is \$2,400 for one qualifying person, or \$4,800 for two or more qualifying persons.

**Yearly limit.** The dollar limit is a yearly limit. The amount of the limit remains the same no matter how long you have a qualifying person in your household. Use the \$2,400 limit if you paid work-related expenses for the care of one qualifying person at any time during the year. Use \$4,800 if you paid work-related expenses for the care of more than one qualifying person at any time during the year.

## Reduced Dollar Limit

If you received dependent care benefits from your employer that you exclude from your income, you must subtract that amount from the dollar limit that applies to you. Your reduced dollar limit is figured on lines 21 through 25 of Form 2441 or Schedule 2 (Form 1040A). See *Employer's Dependent Care Benefits*, earlier, for information on excluding these benefits.

**Example.** You are a widower with one child and earn \$20,000 a year. You pay work-related expenses of \$1,600 for your 4-year-old child and qualify to claim the credit for child and dependent care expenses. Your employer pays an additional \$1,000 under a dependent care benefits plan. This \$1,000 is excluded from your income. The dollar limit for your work-related expenses is \$2,400 (one qualifying person). However, your credit is figured on only \$1,400 of the \$1,600 work-related expenses you paid because your dollar limit is reduced as follows:

Dollar limit: Maximum allowable expenses for one qualifying person	\$ 2,400
Minus: Dependent care benefits you can exclude from income	- 1,000
Reduced dollar limit on expenses you can use for the credit	<u>\$ 1,400</u>

## Amount of Credit

To determine the amount of your credit, multiply your work-related expenses (after applying the earned income and dollar limits) by a percentage. This percentage depends on your adjusted gross income shown on line 32 of Form 1040 or line 17 of Form 1040A. The following table shows the percentage to use based on adjusted gross income.

Adjusted Gross Income		Percentage
Over	But not over	
\$ 0 —	\$10,000	30%
10,000 —	12,000	29%
12,000 —	14,000	28%

14,000 —	16,000	27%
16,000 —	18,000	26%
18,000 —	20,000	25%
20,000 —	22,000	24%
22,000 —	24,000	23%
24,000 —	26,000	22%
26,000 —	28,000	21%
28,000 —	No limit	20%



*Your credit may be limited because of the alternative minimum tax. See your form instructions.*

## How To Claim the Credit

To claim the credit, you can file Form 1040 or Form 1040A. You cannot claim the credit on Form 1040EZ.

**Form 1040.** You must complete **Form 2441** and attach it to your Form 1040. Enter the credit on line 39 of your Form 1040. An example of a filled-in Form 2441 is at the end of this chapter.

**Form 1040A.** You must complete **Schedule 2 (Form 1040A)** and attach it to your Form 1040A. Enter the credit on line 24a of your Form 1040A. See Chapter 38 for an example of a filled-in Schedule 2.

**Tax credit not refundable.** Your credit for child and dependent care expenses cannot be more than the amount of your tax liability. This means that you cannot get a refund for any part of the credit that is more than your tax.



**Records.** You should keep records of your work-related expenses. Also, if your dependent or spouse is not able to care for himself or herself, your records should show both the nature and the length of the disability. Other records you should keep to support your claim for the credit are described earlier under *Provider Identification Test*.

## Employment Taxes for Household Employers

If you pay someone to come to your home and care for your dependent or spouse, you may be a household employer who has to have an employer identification number (EIN) and pay employment taxes. If the individuals who work in your home are self-employed, you are not liable for any of the taxes discussed in this section. Self-employed persons who are in business for themselves are not household employees. Usually, you are **not** a household employer if the person who cares for your dependent or spouse does so at his or her home or place of business.

If you use a placement agency that exercises control over what work is done and how it will be done by a babysitter or companion who works in your home, that person is not your employee. This control could include providing rules of conduct and appearance and requiring regular reports. In this case, you do not have to pay employment taxes. But, if an agency merely gives you a list of sitters and you hire one from that list, the sitter may be your employee.

If you have a household employee you may be subject to:

- 1) Social security and Medicare taxes,
- 2) Federal unemployment tax, and
- 3) Federal income tax withholding.

Social security and Medicare taxes are withheld from the employee's pay and matched by the employer. Federal unemployment (FUTA) tax is paid by the employer only and is for the employee's unemployment insurance. Federal income tax is withheld from the employee's total pay if the employee asks you to do so and you agree.

For more information on a household employer's tax responsibilities, see Publication 926 and Schedule H (Form 1040).

You may also be subject to state income tax withholding and state unemployment tax. You should contact your state unemployment tax office for information on how to file the state tax returns and for a state reporting number.

## Examples

The following examples show how to figure the credit for child and dependent care expenses. Example 2 is illustrated by the filled-in Form 2441 at the end of this chapter.

### Example 1: Child Care—Two Children.

Ann and Jerry Jones are married and keep up a home for their two preschool children, ages 2 and 4. They claim their children as dependents and file a joint return using Form 1040A. Their adjusted gross income (AGI) is \$27,500. Ann earned \$15,000 and Jerry earned \$12,500.

During the year, they pay work-related expenses of \$3,000 for child care at a neighbor's home and \$2,200 for child care at Pine Street Nursery School.

They figure the credit on Schedule 2 as follows:

Child care by neighbor .....	\$ 3,000
Child care by nursery school .....	+2,200
Total work-related expenses .....	<u>\$ 5,200</u>
Dollar limit .....	<u>\$ 4,800</u>
Percentage for AGI of \$27,500 .....	21%
<b>Amount of credit (21% of \$4,800)</b>	<u><u>\$ 1,008</u></u>

### Example 2: Dependent Care Benefits.

Joan Thomas is divorced and has two children, ages 3 and 9. She works at ACME Computers. Her adjusted gross income (AGI) is \$29,000, and the entire amount is earned income.

Joan's younger child stays at her employer's on-site child-care center while she works. The benefits from this child-care center qualify to be excluded from her income. Her employer reports the value of this service as \$3,000 for the year. This \$3,000 is shown in box 10 of her Form W-2, but is not included in taxable wages in box 1.

A neighbor cares for Joan's older child after school, on holidays, and during the summer. She pays her neighbor \$2,400 for this care.

Joan figures her credit on Form 2441 as follows:

Work-related expenses Joan paid .....	<u>\$ 2,400</u>
Dollar limit .....	\$ 4,800
Minus: Dependent care benefits excluded from income .....	- 3,000
Reduced dollar limit .....	<u>\$ 1,800</u>
Percentage for AGI of \$29,000 .....	20%
<b>Amount of credit (20% of \$1,800)</b>	<u><u>\$ 360</u></u>

Department of the Treasury  
Internal Revenue Service (99)

▶ Attach to Form 1040.

▶ See separate instructions.

Name(s) shown on Form 1040

Joan Thomas

Your social security number  
559 00 3436

You need to understand the following terms to complete this form:  
**Qualifying Person(s), Dependent Care Benefits, Qualified Expenses, and Earned Income.** See Important Terms on page 1 of the Form 2441 instructions.

**Part I** Persons or Organizations Who Provided the Care—You must complete this part.  
(If you need more space, use the bottom of page 2.)

1 (a) Care provider's name	(b) Address (number, street, apt. no., city, state, and ZIP code)	(c) Identifying number (SSN or EIN)	(d) Amount paid (see instructions)
<u>Pat Green</u>	<u>12 Ash Avenue Hometown, TX 75240</u>	<u>240-00-3811</u>	<u>2,400</u>
<u>ACME Computers</u>	<u>(See W-2)</u>		

2 Add the amounts in column (d) of line 1 . . . . .

2 2,400

3 Enter the number of **qualifying persons** cared for in 1996 . . . . .

2

Did you receive dependent care benefits? — NO —> Complete only Part II below.  
— YES —> Complete Part III on the back now.

**Caution:** If the care was provided in your home, you may owe employment taxes. See the instructions for Form 1040, line 50.

**Part II** Credit for Child and Dependent Care Expenses

4 Enter the amount of <b>qualified expenses</b> you incurred and paid in 1996. DO NOT enter more than \$2,400 for one qualifying person or \$4,800 for two or more persons. If you completed Part III, enter the amount from line 25 . . . . .	<u>4</u>	<u>1,800</u>	
5 Enter <b>YOUR earned income</b> . . . . .	<u>5</u>	<u>29,000</u>	
6 If married filing a joint return, enter <b>YOUR SPOUSE'S</b> earned income (if student or disabled, see the instructions); <b>all others</b> , enter the amount from line 5 . . . . .	<u>6</u>	<u>29,000</u>	
7 Enter the <b>smallest</b> of line 4, 5, or 6 . . . . .	<u>7</u>		<u>1,800</u>
8 Enter the amount from Form 1040, line 32 . . . . .	<u>8</u>	<u>29,000</u>	
9 Enter on line 9 the decimal amount shown below that applies to the amount on line 8	<u>9</u>		<u>x .20</u>
10 Multiply line 7 by the decimal amount on line 9. Enter the result. Then, see the instructions for the amount of credit to enter on Form 1040, line 39 . . . . .	<u>10</u>		<u>360</u>

If line 8 is—		Decimal amount is	If line 8 is—		Decimal amount is
Over	But not over		Over	But not over	
\$0—10,000		.30	\$20,000—22,000		.24
10,000—12,000		.29	22,000—24,000		.23
12,000—14,000		.28	24,000—26,000		.22
14,000—16,000		.27	26,000—28,000		.21
16,000—18,000		.26	28,000—No limit		.20
18,000—20,000		.25			

For Paperwork Reduction Act Notice, see separate instructions.

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Form **2441** (1996)

**Part III Dependent Care Benefits**—Complete this part only if you received these benefits.

11	Enter the total amount of <b>dependent care benefits</b> you received for 1996. This amount should be shown in box 10 of your W-2 form(s). DO NOT include amounts that were reported to you as wages in box 1 of Form(s) W-2 . . . . .	11	3,000
12	Enter the amount forfeited, if any. See the instructions . . . . .	12	
13	Subtract line 12 from line 11 . . . . .	13	3,000
14	Enter the total amount of <b>qualified expenses</b> incurred in 1996 for the care of the qualifying person(s) . . . . .	14	5,400
15	Enter the <b>smaller</b> of line 13 or 14 . . . . .	15	3,000
16	Enter <b>YOUR earned income</b> . . . . .	16	29,000
17	If married filing a joint return, enter <b>YOUR SPOUSE'S</b> earned income (if student or disabled, see the line 6 instructions); if married filing a <b>separate</b> return, see the instructions for the amount to enter; <b>all others</b> , enter the amount from line 16 . . . . .	17	29,000
18	Enter the <b>smallest</b> of line 15, 16, or 17. . . . .	18	3,000
19	<b>Excluded benefits.</b> Enter here the <b>smaller</b> of the following: <ul style="list-style-type: none"> <li>• The amount from line 18, or</li> <li>• \$5,000 (\$2,500 if married filing a separate return and you were required to enter your spouse's earned income on line 17).</li> </ul>	19	3,000
20	<b>Taxable benefits.</b> Subtract line 19 from line 13. Also, include this amount on Form 1040, line 7. On the dotted line next to line 7, write "DCB" . . . . .	20	-0-

To claim the child and dependent care credit, complete lines 21-25 below, and lines 4-10 on the front of this form.

21	Enter the amount of qualified expenses you incurred and paid in 1996. DO NOT include on this line any excluded benefits shown on line 19 . . . . .	21	2,400
22	Enter \$2,400 (\$4,800 if two or more qualifying persons) . . . . .	22	4,800
23	Enter the amount from line 19 . . . . .	23	3,000
24	Subtract line 23 from line 22. If zero or less, <b>STOP</b> . You cannot take the credit. <b>Exception.</b> If you paid 1995 expenses in 1996, see the line 10 instructions . . . . .	24	1,800
25	Enter the <b>smaller</b> of line 21 or 24 here and on line 4 on the front of this form . . . . .	25	1,800



# 34.

## Credit for the Elderly or the Disabled

### Introduction

This chapter discusses:

- Who qualifies for the credit for the elderly or the disabled, and
- How to figure this credit.

The maximum credit available is \$1,125. You may be able to take this credit if you are:

- 65 or older, or
- Retired on permanent and total disability.

**The Internal Revenue Service (IRS) will figure your credit.** If you choose to have the IRS figure your tax on Form 1040 or Form 1040A, and you qualify for the credit for the elderly or the disabled, the IRS will also figure the credit for you. See *Credit Figured for You*, later.

### Useful Items

You may want to see:

#### Publication

- 524** Credit for the Elderly or the Disabled
- 554** Tax Information for Older Americans

#### Forms (and Instructions)

- Schedule 3 (Form 1040A)** Credit for the Elderly or the Disabled for Form 1040A Filers
- Schedule R (Form 1040)** Credit for the Elderly or the Disabled

## Can You Take the Credit?

You can take the credit for the elderly or the disabled if:

- 1) You are a **qualified individual** and
- 2) Your income is not more than certain limits.

*Figure 34–A* and *Figure 34–B* can be used as guides to see if you qualify.

Use *Figure 34–A* first to see if you are a qualified individual. If you are, go to *Figure 34–B* to make sure your income is not too high to take the credit.

You can take the credit only if you file Form 1040 or Form 1040A. You cannot take the credit if you file Form 1040–EZ.

**Figuring the credit.** You figure the credit on Schedule R (Form 1040), *Credit for the Elderly or the Disabled*, or on Schedule 3 (Form 1040A), *Credit for the Elderly or the Disabled for Form 1040A Filers*.

If you want, the IRS will figure the credit for you. See *Credit Figured for You*, later.

### Qualified Individual

You are a qualified individual for this credit if you are a U.S. citizen or resident and:

- 1) You are age 65 or older by the end of the tax year, or
- 2) You are under age 65 at the end of the tax year, and
  - a) You are retired on permanent and total disability,
  - b) You did not reach mandatory retirement age before 1996, and
  - c) You received taxable disability income in 1996.

**Age 65.** You are considered 65 on the day before your 65th birthday. Therefore, you are 65 by the end of the year if your 65th birthday is on January 1 of the following year.

### U.S. Citizen or Resident

You must be a U.S. citizen or resident (or be treated as a resident) to take the credit. Generally, you cannot take the credit if you were a nonresident alien at any time during the tax year.

**Exception.** If you are a nonresident alien who is married to a U.S. citizen or resident at the end of the tax year and you both choose to be treated as U.S. residents and be taxed on your worldwide income, you may be able to take the credit.

If you were a nonresident alien at the beginning of the year and a resident at the end of the year, and you were married to a U.S. citizen or resident at the end of the year, you may both choose to be treated as U.S. residents for the entire year and you may be allowed to take the credit. For information on these choices, see Chapter 1 of Publication 519, *U.S. Tax Guide for Aliens*.

### Married Persons

Generally, if you are married at the end of the tax year, you and your spouse must file a joint return to take the credit. If you and your spouse did not live in the same household at any time during the tax year, you can file either joint or separate returns and still take the credit.

If you meet all the tests, you can file as head of household and qualify to take the credit even if your spouse lived with you during the first 6 months of the year. See *Head of Household* in Chapter 2 for the tests you must meet.

### Under Age 65

If you are under age 65, you can qualify for the credit only if you are retired on permanent and total disability.

You are retired on permanent and total disability if:

- 1) You were permanently and totally disabled when you retired, and
- 2) You retired on disability before the close of the tax year.

If you retired on disability before 1977 and were not permanently and totally disabled at that time, you can qualify for the credit if you were permanently and totally disabled on January 1, 1976, or January 1, 1977.

You are considered retired on disability, even if you do not retire formally, when you have stopped working because of your disability.

**Permanent and total disability.** You are permanently and totally disabled if you cannot engage in any substantial gainful activity because of your physical or mental condition. A physician must certify that the condition has lasted or can be expected to last continuously for 12 months or more, or that the condition can be expected to result in death. See *Physician's statement*, later.

**Substantial gainful activity.** Substantial gainful activity is the performance of significant duties over a reasonable period of time while working for pay or profit, or in work generally done for pay or profit.

Full-time work (or part-time work done at your employer's convenience) in a competitive work situation for at least the minimum wage conclusively shows that you are able to engage in substantial gainful activity. The minimum wage was \$4.25 an hour from January 1, 1996, through September 30, 1996. It is \$4.75 an hour for the year beginning October 1, 1996. It will be \$5.15 an hour beginning September 1, 1997.

Substantial gainful activity is not work you do to take care of yourself or your home. It is not unpaid work on hobbies, institutional therapy or training, school attendance, clubs, social programs, and similar activities. However, doing this kind of work may show that you are able to engage in substantial gainful activity.

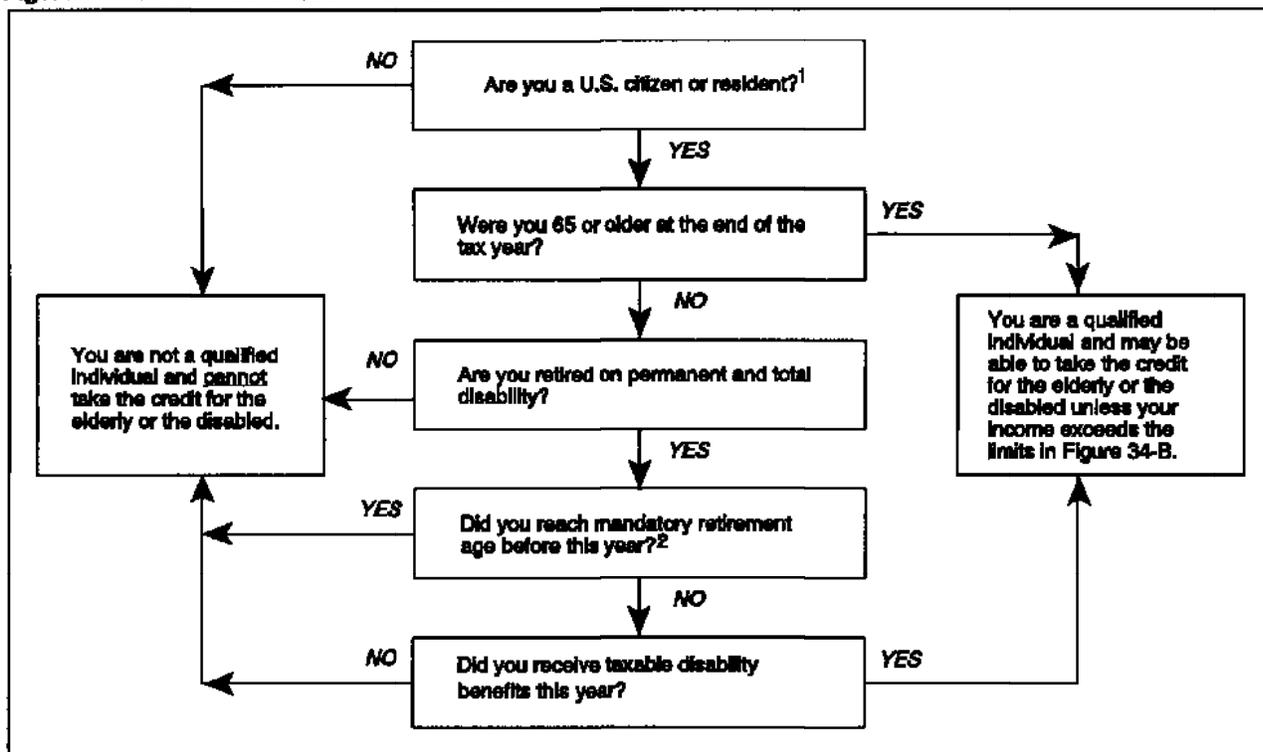
The fact that you have not worked for some time is not, of itself, conclusive evidence that you cannot engage in substantial gainful activity.

The following examples illustrate the tests of substantial gainful activity.

**Example 1.** Trisha, a sales clerk, retired on disability. She is 53 years old and now works as a full-time babysitter for the minimum wage. Even though Trisha is doing different work, she is able to do the duties of her new job in a full-time competitive work situation for the minimum wage. She cannot take the credit because she is able to engage in substantial gainful activity.

**Example 2.** Tom, a bookkeeper, retired on disability. He is 59 years old and now

**Figure 34-A. Are You a Qualified Individual?**



<sup>1</sup> If you were a nonresident alien at any time during the tax year and were married to a U.S. citizen or resident at the end of the tax year, see U.S. citizen or resident under *Qualified Individual*. If you and your spouse both choose to be treated as U.S. residents, answer yes to this question.

<sup>2</sup> Mandatory retirement is the age set by your employer at which you would have been required to retire, had you not become disabled.

**Figure 34-B. Income Limits**

If your income is more than the limits in this Figure, you cannot claim the credit.

If you are:	You cannot take the credit if the amount from Form 1040A, line 17 or Form 1040, line 32 is:
Single, Head of household, or Qualifying widow(er) with dependent child	\$17,500 or more, or you received \$5,000 or more of nontaxable social security or other nontaxable pensions
Married filing a joint return and only one spouse qualifies in Figure 34-A	\$20,000 or more, or you received \$5,000 or more of nontaxable social security or other nontaxable pensions
Married filing a joint return and both spouses qualify in Figure 34-A	\$25,000 or more, or you received \$7,500 or more of nontaxable social security or other nontaxable pensions
Married filing a separate return and you did not live with your spouse at any time during the year	\$12,500 or more, or you received \$3,750 or more of nontaxable social security or other nontaxable pensions

drives a truck for a charitable organization. He sets his own hours and is not paid. Duties of this nature generally are performed for pay or profit. Some weeks he works 10 hours, and some weeks he works 40 hours. Over the year he averages 20 hours a week. The kind of work and his average hours a week conclusively show that Tom is able to engage in substantial gainful activity. This is true even though Tom is not paid and he sets his own hours. He cannot take the credit.

**Example 3.** John, who retired on disability, took a job with a former employer on a trial basis. The purpose of the job was to see if John could do the work. The trial period lasted for 6 months during which John was paid the minimum wage. Because of John's disability, he was assigned only light duties of a nonproductive "make-work" nature. The activity was gainful because John was paid at least the minimum wage. But the activity was not substantial because his duties were nonproductive. These facts do not, by themselves, show that John is able to engage in substantial gainful activity.

**Example 4.** Joan, who retired on disability from employment as a bookkeeper, lives with her sister who manages several motel units. Joan assists her sister for one or two hours a day by performing duties such as washing dishes, answering phones, registering guests, and bookkeeping. Joan can select the time of day when she feels most fit to perform the tasks undertaken. Work of this nature, performed off and on during the day at Joan's convenience, is not activity of a "substantial and gainful" nature even if she is paid for the work. The performance of these duties does not, of itself, show that Joan is able to engage in substantial gainful activity.

**Sheltered employment.** Certain work offered at qualified locations to physically or mentally impaired persons is considered sheltered employment. These locations are in sheltered workshops, hospitals and similar institutions, homebound programs, and Department of Veterans Affairs (VA) sponsored homes. Compared to commercial employment, pay is lower for sheltered employment. Therefore, one usually does not look for sheltered employment if he or she can get other employment. The fact that one has accepted sheltered employment is not proof of that person's ability to engage in substantial gainful activity.

**Physician's statement.** If you are under 65, you must have your physician complete a statement certifying that you are permanently and totally disabled. Attach the statement to your return. You can use the physician's statement in Part II of either Schedule R (Form 1040) or Schedule 3 (Form 1040A). However, check the box on line 2 and do not attach a physician's statement if:

- 1) You filed a physician's statement for this disability for 1983 or an earlier year, or you filed a statement for tax years after 1983 and your physician signed line B on the statement, and

- 2) Due to your continued disabled condition, you were unable to engage in any substantial gainful activity during the tax year.

If you checked box 4, 5, or 6 in Part I, print in the space above the box on line 2 in Part II, the name(s) of the spouse(s) for whom the box is checked.

If you have not filed a physician's statement in a previous year, or if the statement you filed did not meet these conditions, your physician must complete the statement.

If you file a joint return and you checked box 5 in Part I of either Schedule R or Schedule 3, you and your spouse must each file a physician's statement. Attach a separate Schedule R or Schedule 3 for your spouse with only Part II filled out.

**Veterans.** If the Department of Veterans Affairs (VA) certifies that you are permanently and totally disabled, you can file VA Form 21-0172, *Certification of Permanent Total Disability*, instead of the physician's statement. VA Form 21-0172 must be signed by a person authorized by the VA to do so. You can get this form from your local VA regional office.

**Disability income.** If you are under age 65, you can qualify for the credit only if you have taxable disability income.

Disability income must meet the following two requirements:

- 1) The income must be paid under your employer's accident or health plan or pension plan.
- 2) The income must be wages or payments in lieu of wages for the time you are absent from work because of permanent and total disability.

Any payment you receive from a plan that does not provide for disability retirement is not disability income. Any lump-sum payment for accrued annual leave that you receive when you retire on disability is a salary payment and is not disability income.

For purposes of the credit for the elderly or the disabled, disability income does **not** include amounts you receive after you reach mandatory retirement age. Mandatory retirement age is the age set by your employer at which you would have had to retire, had you not become disabled.

## Figuring the Credit

You can figure the credit yourself (see the explanation that follows), or the IRS will figure it for you. See *Credit Figured for You*, later.

**Figuring the credit yourself.** If you figure the credit yourself, fill out the front of either Schedule R (if you are filing Form 1040) or Schedule 3 (if you are filing Form 1040A). Next, fill out Part III of either Schedule R or Schedule 3. There are three steps to follow

in Part III to determine the amount on which you figure your credit:

- 1) Determine your **overall income limit** (lines 10–12, of either Schedule R or Schedule 3).
- 2) Total any **nontaxable social security or railroad retirement benefits** and other nontaxable pensions and disability benefits you received (lines 13a, 13b, and 13c of either Schedule R or Schedule 3).
- 3) Determine your **excess adjusted gross income** (lines 14–17, of either Schedule R or Schedule 3).

These three steps are discussed later.

**Amount of credit.** If (1) is more than the total of (2) and (3), multiply the difference by 15% to get the amount of your credit. If the total of (2) and (3) is more than (1), you cannot take the credit. This computation is found in Part III, lines 18–20, of either Schedule R or Schedule 3. In certain cases the amount of your credit may be limited. See *Limits on Credit*, later.

## Step 1. Determine Overall Income Limit

To figure the credit, you must first determine your overall income limit. See *Table 34-1. Overall Income Limits for Schedule R and Schedule 3*.

**Overall income limit for persons under age 65.** If you are a qualified individual under age 65, your overall income limit cannot be more than your taxable disability income. This limit affects you **only if one of the following applies**:

- 1) Your filing status is single, head of household, or qualifying widow(er) with dependent child and your taxable disability income is less than \$5,000,
- 2) Your filing status is married filing a joint return and:
  - a) Your spouse is also a qualified individual under 65 and your combined taxable disability income is less than \$7,500,
  - b) Your spouse is under 65 and **not** a qualified individual and your taxable disability income is less than \$5,000, or
  - c) Your spouse is 65 or older and your taxable disability income is less than \$2,500, or
- 3) Your filing status is married filing separately and your taxable disability income is less than \$3,750.

## Step 2. Total Certain Nontaxable Income

Once you have determined your overall income limit, you must reduce it by the total amount of nontaxable social security and

Table 34-1. Overall Income Limits for Schedule R and Schedule 3

If your filing status is:	Amount to enter on line 10 of Schedule R or Schedule 3 is:
<b>Single</b> , an unmarried head of household, or a qualifying widow or widower and	
• 65 or older .....	\$5,000
• under 65 and retired on permanent and total disability <sup>1</sup> .....	\$5,000
<b>Married filing a joint return</b> and	
• both of you are 65 or older .....	\$7,500
• both of you are under 65 and one of you retired on permanent and total disability <sup>1</sup> .....	\$5,000
• both of you are under 65 and both of you retired on permanent and total disability <sup>2</sup> .....	\$7,500
• one of you is 65 or older, and the other is under 65 and retired on permanent and total disability <sup>3</sup> .....	\$7,500
• one of you is 65 or older, and the other is under 65 and <b>not</b> retired on permanent and total disability .....	\$5,000
<b>Married filing a separate return</b> and did not live with your spouse at any time during the year and	
• 65 or older .....	\$3,750
• under 65 and retired on permanent and total disability <sup>1</sup> .....	\$3,750

<sup>1</sup> Amount cannot be more than the taxable disability income.

<sup>2</sup> Amount cannot be more than your combined taxable disability income.

<sup>3</sup> Amount is \$5,000 plus the taxable disability income of the spouse under age 65, but not more than \$7,500.

certain other nontaxable payments (covered later) you receive during the year.

Enter these nontaxable payments on line 13a or 13b of either Schedule R or Schedule 3, and total them on line 13c. If you are married filing a joint return, you must enter the combined amount of nontaxable payments both you and your spouse receive.

Worksheets are provided in the Form 1040 or Form 1040A instructions to help you determine if any part of your social security benefits (or equivalent railroad retirement benefits) is taxable. The nontaxable portions are used to reduce your base amount.

The following payments reduce your overall income limit.

- Nontaxable social security payments. This is the nontaxable part of the amount of benefits shown in box 5 of Form SSA-1099, which includes disability benefits, before deducting any amounts withheld to pay premiums on supplementary Medicare insurance, and before any reduction because of receipt of a benefit under worker's compensation.

Do not include a lump-sum death benefit payment you may receive as a surviving spouse, or a surviving child's insurance benefit payments you may receive as a guardian.

- Social security equivalent part of tier 1 railroad retirement pension payments that are not taxed. This is the nontaxable part of the amount of benefits shown in box 5 of Form RRB-1099.
- Nontaxable pension or annuity payments or disability benefits that are paid under a law administered by the Department of Veterans Affairs (VA). Do not include amounts received as a pension, annuity, or similar allowance for personal injuries or sickness resulting from active service in the armed forces of any country or in the Coast and Geodetic Survey or the Public Health Service, or as a disability annuity under section 808 of the Foreign Service Act of 1980.
- Pension or annuity payments or disability benefits that are excluded from income under any provision of federal law other than the Internal Revenue Code. Amounts

that are a return of your cost of a pension or annuity do not reduce your overall income limit.

You should be sure to take into account all of the nontaxable amounts you receive. These amounts are verified by the IRS through information supplied by other government agencies.

### Step 3. Determine Excess Adjusted Gross Income

You also have to subtract the amount of your excess adjusted gross income from the overall income limit used to figure your credit.

You figure your excess adjusted gross income as follows:

- 1) Subtract from your adjusted gross income the amount shown for your filing status in the following list:
  - a) **\$7,500** if you are single, a head of household, or a qualifying widow(er) with a dependent child,
  - b) **\$10,000** if you are married filing a joint return, or
  - c) **\$5,000** if you are married filing a separate return and you and your spouse did not live in the same household at any time during the tax year.
- 2) Divide the result of (1) by 2.

Figure your excess adjusted gross income on lines 14 through 17 of either Schedule R or Schedule 3.

If the total of your nontaxable social security or other nontaxable pensions or disability benefits (line 13c of either Schedule R or Schedule 3) plus your excess adjusted gross income (line 17 of either Schedule R or Schedule 3) equals or is more than your overall income limit, you will not be able to take the credit.

**Example.** You are 66 years old and your spouse is 64. Your spouse is not disabled. You file a joint return on Form 1040. Your adjusted gross income is \$14,630. Together you received \$3,200 from social security, which was nontaxable. You figure the credit as follows:

1) overall income limit .....	\$5,000
2) Subtract the total of:	
a) Social security and other nontaxable pensions .....	\$3,200
b) Excess adjusted gross income [(\$14,630 - \$10,000) ÷ 2] .....	2,315
3) Balance (Not less than -0-) .....	-0-
<b>4) Credit</b> .....	<b>-0-</b>

You cannot take the credit since your nontaxable social security (line 2a) plus your excess adjusted gross income (line 2b) is more than your amount on line 1.

## Limits on Credit

Your credit may be limited because of the alternative minimum tax.

The amount of your credit may be limited if:

- 1) You file Schedule C, C-EZ, D, E, or F (Form 1040), and
- 2) The amount on Form 1040, line 22, is more than:

**\$33,750** if single or head of household,

**\$45,000** if married filing jointly or qualifying widow(er) with a dependent child, or

**\$22,500** if married filing separately.

For purposes of (2), include any tax-exempt interest from private activity bonds issued after August 7, 1986, and any net operating loss deduction.

If both (1) and (2) do not apply, your credit is not subject to this limit. Enter the amount of the credit from Schedule R, line 20, on Form 1040, line 40.

If you meet both (1) and (2), get Form 6251, *Alternative Minimum Tax—Individuals*, and complete it through line 24. The limit on your credit will be the smaller of:

- 1) Your credit as computed, or
- 2) Your regular tax (line 38 of Form 1040) minus—
  - a) Any credit for child and dependent care expenses, and
  - b) Any amount shown on line 24, Form 6251.

Enter the smaller of (1) or (2) on Form 1040, line 40. If (2) is the smaller amount, also write "AMT" on the dotted line next to line 40, Form 1040, and replace the amount on Schedule R, line 20, with that amount.

**Tax credit not refundable.** Your credit for the elderly or the disabled cannot be more than the amount of your tax liability. Therefore, you cannot get a refund for any part of the credit that is more than your tax.

## Credit Figured for You

If you file Form 1040 and you want the IRS to figure your credit, see *Form 1040* under *Tax Figured by IRS* in Chapter 31.

If you file Form 1040A and you want the IRS to figure your credit, see *Form 1040A* under *Tax Figured by IRS* in Chapter 31.

## Examples

The following examples illustrate the credit for the elderly or the disabled. Assume that none of the taxpayers in these examples had to file a Form 6251. The overall income limits are taken from *Table 34–1*, shown earlier.

**Example 1.** Jerry Ash is 68 years old and single, and files Form 1040A. He received the following income for the year:

Nontaxable social security .....	\$3,120
Interest (taxable) .....	215
Pension (all taxable) .....	3,600
Wages from a part-time job .....	4,245

Jerry's adjusted gross income is \$8,060 (\$4,245 + \$3,600 + \$215). Jerry figures the credit on Schedule 3 (Form 1040A) as follows:

1) Overall income limit .....	\$5,000
2) Subtract the total of:	
a) Social security and other nontaxable pensions .....	\$3,120
b) Excess adjusted gross income [(\$8,060 – \$7,500) + 2] .....	280
	<u>3,400</u>
3) Balance .....	<u>\$1,600</u>
<b>4) Credit</b> (15% of \$1,600) .....	<u>\$ 240</u>

Jerry's credit is \$240. He files Schedule 3 (Form 1040A) and shows this amount on line 24b of Form 1040A.

**Example 2.** James Davis is 58 years old and single, and files Form 1040. Two years ago he retired on permanent and total disability, and he is still permanently and totally disabled. He filed the required physician's statement with his return for the year he retired on disability, so this year he checks the box in Part II of Schedule R.

He received the following income for the year:

Nontaxable social security .....	\$3,000
Interest (taxable) .....	100
Taxable disability pension .....	8,400

James' adjusted gross income is \$8,500 (\$8,400 + \$100). He figures the credit on Schedule R as follows:

1) Overall income limit .....	<u>\$5,000</u>
2) Taxable disability pension .....	<u>\$8,400</u>
3) Smaller of (1) or (2) .....	\$5,000
4) Subtract the total of:	
a) Nontaxable disability benefits (social security) ...	\$3,000
b) Excess adjusted gross income [(8,500 – \$7,500) ÷ 2] .....	500
	<u>3,500</u>
5) Balance (Not less than 0) .....	<u>\$1,500</u>
<b>6) Credit</b> (15% of \$1,500) .....	<u>\$ 225</u>

His credit is \$225. He enters \$225 on line 40 of Form 1040.

**Example 3.** William White is 53. His wife Helen is 49. William had a stroke 10 years ago and retired on permanent and total disability. He is still permanently and totally disabled because of the stroke. In November of last year, Helen was injured in an accident at work and retired on permanent and total disability.

William received nontaxable social security disability benefits of \$3,000 during the year and a taxable disability pension of \$6,000. Helen earned \$9,200 from her job and received a taxable disability pension of \$1,000. Their joint return on Form 1040 shows adjusted gross income of \$16,200 (\$6,000 + \$9,200 + \$1,000).

Helen got her doctor to complete Part II of Schedule R. William had filed a physician's statement with their return for the year he had the stroke. His doctor had signed on line B to certify that William was permanently and totally disabled. William does not have to file another physician's statement this year. He must fill out Part II of a separate Schedule R (not shown) and attach it to the joint return. He checks the box in Part II and writes his first name in the space above line 2.

William and Helen use Schedule R to figure their \$135 credit for the elderly or the disabled. They enter this amount on line 40 of Form 1040. See their filled-in Schedule R on the next two pages.

**Schedule R  
(Form 1040)**

Department of the Treasury  
Internal Revenue Service

**Credit for the Elderly or the Disabled**

▶ Attach to Form 1040. ▶ See separate instructions for Schedule R.

OMB No. 1545-0074

**1996**

Attachment  
Sequence No. 16

Name(s) shown on Form 1040

William M. White and Helen A. White

Your social security number

220:00:3333

You may be able to take this credit and reduce your tax if by the end of 1996:

- You were age 65 or older, OR
- You were under age 65, you retired on permanent and total disability, and you received taxable disability income.

But you must also meet other tests. See the separate instructions for Schedule R.

Note: In most cases, the IRS can figure the credit for you. See the instructions.

**Part I Check the Box for Your Filing Status and Age**

If your filing status is:	And by the end of 1996:	Check only one box:
Single, Head of household, or Qualifying widow(er) with dependent child	1 You were 65 or older . . . . .	1 <input type="checkbox"/>
	2 You were under 65 and you retired on permanent and total disability . . . . .	2 <input type="checkbox"/>
	3 Both spouses were 65 or older . . . . .	3 <input type="checkbox"/>
	4 Both spouses were under 65, but only one spouse retired on permanent and total disability . . . . .	4 <input type="checkbox"/>
	5 Both spouses were under 65, and both retired on permanent and total disability . . . . .	5 <input checked="" type="checkbox"/>
	6 One spouse was 65 or older, and the other spouse was under 65 and retired on permanent and total disability . . . . .	6 <input type="checkbox"/>
	7 One spouse was 65 or older, and the other spouse was under 65 and NOT retired on permanent and total disability . . . . .	7 <input type="checkbox"/>
Married filing a joint return	8 You were 65 or older and you lived apart from your spouse for all of 1996 . . . . .	8 <input type="checkbox"/>
	9 You were under 65, you retired on permanent and total disability, and you lived apart from your spouse for all of 1996 . . . . .	9 <input type="checkbox"/>
Married filing a separate return	8 You were 65 or older and you lived apart from your spouse for all of 1996 . . . . .	8 <input type="checkbox"/>
	9 You were under 65, you retired on permanent and total disability, and you lived apart from your spouse for all of 1996 . . . . .	9 <input type="checkbox"/>

Did you check box 1, 3, 7, or 8?  Yes  No

Skip Part II and complete Part III on back.  
 Complete Parts II and III.

**Part II Statement of Permanent and Total Disability (Complete only if you checked box 2, 4, 5, 6, or 9 above.)**

- IF: 1 You filed a physician's statement for this disability for 1983 or an earlier year, or you filed a statement for tax years after 1983 and your physician signed line B on the statement, AND
- 2 Due to your continued disabled condition, you were unable to engage in any substantial gainful activity in 1996, check this box
- If you checked this box, you do not have to file another statement for 1996.
  - If you did not check this box, have your physician complete the statement below.

**Physician's Statement (See instructions at bottom of page 2.)**

I certify that Helen A. White Name of disabled person

was permanently and totally disabled on January 1, 1976, or January 1, 1977, OR was permanently and totally disabled on the date he or she retired. If retired after 1976, enter the date retired. ▶ November 30, 1996

Physician: Sign your name on either line A or B below.

- A The disability has lasted or can be expected to last continuously for at least a year . . . . .
- B There is no reasonable probability that the disabled condition will ever improve . . . . .
- Physician's signature: Juanita D. Deeter Date: 2/7/97

Physician's name: Juanita D. Deeter Physician's address: 1900 Green St, Hometown, MD 20000

**Part III Figure Your Credit**

<b>10 If you checked (in Part I):</b>		<b>Enter:</b> Box 1, 2, 4, or 7 . . . . . \$5,000 Box 3, 5, or 6 . . . . . \$7,500 Box 8 or 9 . . . . . \$3,750	10	7,500
Did you check box 2, 4, 5, 6, or 9 in Part I?		Yes → You must complete line 11. No → Enter the amount from line 10 on line 12 and go to line 13.		
<b>11 If you checked:</b>		• Box 6 in Part I, add \$5,000 to the taxable disability income of the spouse who was under age 65. Enter the total. • Box 2, 4, or 9 in Part I, enter your taxable disability income. • Box 5 in Part I, add your taxable disability income to your spouse's taxable disability income. Enter the total.	11	7,000
TIP: For more details on what to include on line 11, see the instructions.				
<b>12 If you completed line 11, enter the smaller of line 10 or line 11; all others, enter the amount from line 10</b>			12	7,000
<b>13 Enter the following pensions, annuities, or disability income that you (and your spouse if filing a joint return) received in 1996:</b>				
a Nontaxable part of social security benefits, and Nontaxable part of railroad retirement benefits treated as social security. See instructions.		13a	3,000	
b Nontaxable veterans' pensions, and Any other pension, annuity, or disability benefit that is excluded from income under any other provision of law. See instructions.		13b		
c Add lines 13a and 13b. (Even though these income items are not taxable, they must be included here to figure your credit.) If you did not receive any of the types of nontaxable income listed on line 13a or 13b, enter -0- on line 13c.		13c	3,000	
<b>14 Enter the amount from Form 1040, line 32</b>		14	16,200	
<b>15 If you checked (in Part I):</b>		<b>Enter:</b> Box 1 or 2 . . . . . \$7,500 Box 3, 4, 5, 6, or 7 . . . . . \$10,000 Box 8 or 9 . . . . . \$5,000	15	10,000
<b>16 Subtract line 15 from line 14. If zero or less, enter -0-</b>		16	6,200	
<b>17 Enter one-half of line 16</b>		17	3,100	
<b>18 Add lines 13c and 17</b>		18	6,100	
<b>19 Subtract line 18 from line 12. If zero or less, stop; you cannot take the credit. Otherwise, go to line 20</b>		19	900	
<b>20 Multiply line 19 by 15% (.15). Enter the result here and on Form 1040, line 40. Caution: If you file Schedule C, C-EZ, D, E, or F (Form 1040), your credit may be limited. See the Instructions for line 20 for the amount of credit you can claim</b>		20	135	

**Instructions for Physician's Statement**

**Taxpayer**

If you retired after 1976, enter the date you retired in the space provided in Part II.

**Physician**

A person is permanently and totally disabled if both of the following apply:  
 1. He or she cannot engage in any substantial gainful activity because of a physical or mental condition, and

2. A physician determines that the disability has lasted or can be expected to last continuously for at least a year or can lead to death.

# Earned Income Credit

## Important Changes for 1996

**Earned income amount is more.** The amount you can earn in 1996 and still get the credit is more than in 1995. The amount you can earn in 1996 must be less than:

- \$25,078 with one qualifying child,
- \$28,495 with more than one qualifying child, or
- \$9,500 without a qualifying child.

**Earned income credit is more.** The amount of the credit for 1996 is more than in 1995. The most credit you can receive in 1996 is:

- \$2,152 with one qualifying child,
- \$3,556 with more than one qualifying child, or
- \$323 without a qualifying child.

**Social security numbers.** You must provide a correct and valid social security number for each person listed on your tax return who was born **before December 1, 1996**. For purposes of the earned income credit, this includes yourself, your spouse, and any qualifying children. If a social security number is missing or incorrect, you may not get the credit. See *Social security number*, later.

**Investment income more than \$2,200.** You cannot claim the earned income credit if your investment income is more than \$2,200. For most people, investment income is taxable interest and dividends, tax-exempt interest, and capital gain net income. To get more detailed information, see *Investment Income* later.

**Modified AGI (adjusted gross income).** Generally, you must know your earned income and modified AGI to figure the amount of your earned income credit. See *Modified AGI (adjusted gross income)*, later. Modified AGI will also affect persons who have the same qualifying child. See *Qualifying Child for More Than One Person*, later.



**CAUTION** If you had a 1996 Form W-5 in effect before June 27, 1996, get Publication 596, Earned Income Credit, and go to Part IV, Form W-5 Before June 27, 1996.

**Self-employed persons.** If you are self-employed and your net earnings are \$400 or more, be sure to correctly fill out Schedule SE (Form 1040), *Self-Employment Tax*, and pay the proper amount of self-employment tax. If you do not, you may not get all the credit you are entitled to.

## Important Reminders

**Advance payment of the earned income credit in your paycheck.** If you qualify for the earned income credit, you can receive part of it in each paycheck throughout the year. See *Advance Earned Income Credit Payments*, later, for more information.

**Certain nonresident aliens cannot claim the earned income credit.** If you are a nonresident alien for any part of the year, you cannot claim the earned income credit unless you are married to a U.S. citizen or resident and choose to be treated as a resident alien for the entire year. See *Nonresident alien* for more information.

**Military personnel.** For purposes of the earned income credit, if you are in the U.S. military on extended active duty outside the United States, you are considered to live in the United States during that duty period. Therefore, you may be able to claim the earned income credit if you meet all the other rules. See *Military personnel*, later, for a definition of “extended active duty.”

**Income earned by an inmate at a penal institution.** Amounts prisoners receive for their work while inmates at a penal institution do not qualify for the earned income credit.

**Credit has no effect on certain welfare benefits.** The earned income credit and the advance earned income credit payments you receive will not be used to determine whether you are eligible for the following benefit programs or how much you can receive from the programs:

- Aid to Families With Dependent Children (AFDC),
- Medicaid,
- Supplemental Security Income (SSI),
- Food Stamps, and
- Low-income housing.

## Introduction

The earned income credit is a special credit for certain persons who work. The credit reduces the amount of tax you owe (if any) and is intended to offset some of the increases in living expenses and social security taxes.

To get the credit you must:

- 1) File a tax return—even if:
  - You do not owe any tax, or

- You did not earn enough money to file a return.
- 2) Meet certain rules. These rules are explained in *Who Can Claim the Credit?*
  - 3) Fill out the EIC Worksheet to figure the amount of credit and where to enter it on Form 1040, 1040A, or 1040EZ. Fill out Schedule EIC and attach it to Form 1040 or 1040A only if you have one or more qualifying children.
  - 4) **An easier way**—Let the Internal Revenue Service figure the credit for you. See *IRS will figure your credit for you*, later.

This chapter will explain the following:

- Who can claim the credit,
- What is earned income,
- How to figure the credit, and
- What form you will need to claim the credit.

## Useful Items

You may want to see:

### Publication

- 504** Divorced or Separated Individuals
- 533** Self-Employment Tax
- 596** Earned Income Credit

### Form (and Instructions)

- Schedule EIC** Earned Income Credit
- Schedule SE (Form 1040)** Self-Employment Tax
- W-5** Earned Income Credit Advance Payment Certificate

## Who Can Claim the Credit?

The earned income credit is available to persons with a qualifying child and to persons without a qualifying child. This section will list separately the rules that persons with a qualifying child must meet to get the credit and the rules that persons without a qualifying child must meet to get the credit. Some of the rules are the same, but some of the rules only apply to persons with a qualifying child or to persons without a qualifying child. Use the discussion that applies to you. A “qualifying child” is explained later, under *Who Is a Qualifying Child*.

**Military personnel.** U.S. military personnel stationed outside the United States on extended active duty are considered to live in the U.S. during that duty period for purposes of the earned income credit.

**Extended active duty.** Extended active duty means you are called or ordered to duty for an indefinite period or for a period of more than 90 days. Once you begin serving

your extended active duty, you are still considered to have been on extended active duty even if you serve less than 90 days.



See *Publication 3, Armed Forces Tax Guide*, for more information and examples on claiming the earned income credit.

**Social security number.** You must provide a correct and valid social security number (SSN) for each person listed on your tax return who was born before December 1, 1996. Enter the SSN for your qualifying child on Schedule EIC, line 4. If your qualifying child is also your dependent, enter the SSN on Schedule EIC, line 4, and also on line 6c of Form 1040 or 1040A.

If you, your spouse, or your child does not have an SSN, apply for one by filing **Form SS-5** with your local Social Security Administration.

If either you, your spouse, or your child is a **resident or nonresident alien** who does not have (and is not eligible to get) an SSN, file Form W-7, *Application for IRS Individual Taxpayer Identification Number*. This is known as an ITIN. Enter this ITIN wherever the SSN is requested. Use it for tax purposes only.



Earned income credit denied. You cannot claim the credit using an ITIN.

For purposes of claiming the earned income credit, you **must** have an SSN for you, your spouse, and your qualifying child. The SSN must be issued by the Social Security Administration to a U. S. citizen or to a person who has permission from the Immigration and Naturalization Service to work in the United States. For 1996, if your child was born in December 1996, an SSN is not needed. For 1997, an SSN will be needed no matter when during the year the child is born.

**If the filing deadline is approaching.** If the filing deadline is approaching and you still do not have an SSN, you have two choices.

- 1) Request an automatic extension (Form 4868) to August 15. This extension does not give you extra time to pay any amount you expect to owe. You should pay any amount you expect to owe to avoid interest or penalty charges (see the instructions for Form 4868, *Application for Automatic Extension of Time to File U.S. Individual Income Tax Return*).
- 2) File the return on time, without claiming the earned income credit and do not attach Schedule EIC (if you have a qualifying child). After receiving the SSN, file an amended return (Form 1040X) claiming the credit and attach a filled-in Schedule EIC (if you have a qualifying child).

**Nonresident alien.** If you are a nonresident alien for any part of the year, you **cannot** claim the credit unless:

- 1) You are married to a U.S. citizen or a resident alien, **and**
- 2) You choose to be treated as a resident for all of 1996.

If you make this choice, you and your spouse are taxed on your worldwide income. You cannot claim any tax treaty benefits as a resident of a foreign country during the tax year in which the choice is in effect.

**How to make the choice.** To make the choice, file a joint return for the first tax year for which the choice applies and attach a statement. The statement should contain the following:

- 1) A declaration that one spouse was a nonresident alien and the other spouse was a U.S. citizen or resident alien on the last day of your tax year and that you choose to be treated as U.S. residents for all of 1996, and
- 2) The name, address, and social security number of each spouse.

For more detailed information, get Publication 519, *U.S. Tax Guide for Aliens*.



If you make the choice and qualify for the earned income credit, you will need social security numbers on your income tax return for you, your spouse, and any qualifying children. See *Social security number*, earlier for more information.

**Unmarried couples living together.** Generally, only one person can claim the credit when unmarried couples live together and have a child living with them. If the child is a qualifying child for both persons, only the person with the higher modified adjusted gross income can be eligible to claim the credit. The person with the lower modified adjusted gross income cannot claim the credit under the rules for *Persons Who Work and Have One or More Qualifying Children* or *Persons Who Work and Do Not Have a Qualifying Child*. See *Modified AGI (adjusted gross income)*, later.



If you had a 1996 Form W-5 in effect before June 27, 1996, go to Part IV, Form W-5 Before June 27, 1996, in Publication 596.

## Persons Who Work and Have One or More Qualifying Children

Generally, if you are a nonresident alien for any part of the year, you cannot claim the credit. See *Nonresident alien*, earlier. To claim the earned income credit, you must meet **all** the following rules.

- 1) You must have a qualifying child who lived with you in the United States for more than half the year (the whole year

for an eligible foster child). See *Birth or death of a child*, later and *Military personnel*, earlier, for more information. You, your spouse, and your qualifying child must have a social security number issued by the Social Security Administration. See *Social security number* earlier.

- 2) You must have earned income during the year.
- 3) Your earned income and modified AGI must each be less than:
  - \$25,078 if you have one qualifying child, or
  - \$28,495 if you have more than one qualifying child.See *Modified AGI (adjusted gross income)*, later.
- 4) Your investment income cannot be more than \$2,200. *Investment income* is defined later.
- 5) Your filing status can be any filing status **except** married filing a separate return. See *Married persons living apart*, later.
- 6) You cannot be a qualifying child of another person. If you are filing a joint return, neither you nor your spouse can be a qualifying child of another person.
- 7) Your qualifying child cannot be the qualifying child of another person whose modified AGI is more than yours.
- 8) You usually must claim as a dependent a qualifying child who is married. See *Qualifying child who is married under Relationship Test*, for an exception.
- 9) You are not filing Form 2555, *Foreign Earned Income* (or Form 2555-EZ, *Foreign Earned Income Exclusion*).



If you meet all these rules, fill out Schedule EIC and attach it to either Form 1040 or Form 1040A. Also complete the EIC Worksheet to figure the amount of your credit. If you have a qualifying child, you cannot file Form 1040EZ.

Enter "No" next to line 54 (Form 1040) or line 29c (Form 1040A) if you **cannot** claim the credit because:

- 1) Your total taxable and nontaxable income was \$25,078, or more if you have one qualifying child (or \$28,495 or more if you have more than one qualifying child),
- 2) You (or your spouse if filing a joint return) were a qualifying child of another person in 1996,
- 3) Your qualifying child is also the qualifying child of another person whose modified AGI is more than yours, or
- 4) You, your spouse, or qualifying child does not have an SSN. See *Social security number*, earlier.

**Investment income.** You cannot claim the earned income credit if your investment income is more than \$2,200. For most people, investment income is the total of the following amounts.

- Taxable interest (line 8a of Form 1040 or 1040A).
- Tax-exempt interest (line 8b of Form 1040 or 1040A).
- Dividend income (line 9 of Form 1040 or 1040A).
- Capital gain net income (line 13 of Form 1040, if more than zero).

However, if you are reporting income from the rental of personal property on Form 1040, line 21, investment income also includes that income in excess of the total deductible related expenses. If you are filing Schedule E (Form 1040), *Supplemental Income and Loss*, investment income may also include additional amounts. See Publication 596 for details.



*If you had a 1996 Form W-5 in effect before June 27, 1996, go to Part IV, Form W-5 Before June 27, 1996, in Publication 596.*

**Married persons living apart.** Married persons living apart usually must file a joint return to claim the earned income credit. Even though you are married, you may file as head of household if:

- 1) Your spouse did not live in your home at any time during the last 6 months of the year,
- 2) You paid more than half the cost to keep up your home for the entire year, and
- 3) Your home was, for more than half the year, the main home of your child, stepchild, adopted child, or foster child. You also must be entitled to claim an exemption for your child.

You will meet (3) even if you cannot claim your child as an exemption because:

- 1) You released your claim in writing to the other parent by filling out **Form 8332**, or a similar written statement, or
- 2) There is a pre-1985 agreement (decree of divorce or separate maintenance or written agreement) granting the exemption to your child's other parent.

## Persons Who Work and Do Not Have a Qualifying Child

Generally, if you are a nonresident alien for any part of the year, you cannot claim the earned income credit. If you do not have a qualifying child, then you must meet **all** the following rules to claim the credit:

- 1) You must have earned income during 1996.

- 2) Your earned income and modified adjusted gross income must each be less than \$9,500. See *Modified AGI (adjusted gross income)*, later.
- 3) Your investment income cannot be more than \$2,200. See *Investment income* earlier.
- 4) Your filing status can be any filing status **EXCEPT** married filing a separate return. See *Married Persons Exception*, later.
- 5) You cannot be a qualifying child of another person. If you are filing a joint return, neither you nor your spouse can be a qualifying child of another person. See *Qualifying Child of Another Person* under *Explanation of Rules for Persons Without a Qualifying Child*, later.
- 6) You (or your spouse, if filing a joint return) must be at least age 25 but under age 65 at the end of your tax year (usually December 31). See *Age Rule*, later.
- 7) You are not eligible to be claimed as a dependent on anyone else's return. If you file a joint return, neither you nor your spouse can be eligible to be claimed as a dependent on anyone else's return. See *Dependent Rule*, later.
- 8) Your main home (and your spouse's if filing a joint return) must be in the United States for more than half the year. See *Main Home Rule*, later.
- 9) You are not filing Form 2555, *Foreign Earned Income*, or Form 2555-EZ, *Foreign Earned Income Exclusion*.



*To get the credit, you must have social security numbers for you and your spouse. See Social security number, earlier.*



*If you meet all these rules, fill out the EIC Worksheet to figure the amount of your credit.*

Enter "No" next to line 54 (Form 1040), line 29c (Form 1040A), or line 8 (Form 1040EZ) if you **cannot** claim the credit because:

- 1) Your total taxable and nontaxable earned income was \$9,500 or more,
- 2) You (and your spouse if filing a joint return) were under age 25 or over age 64,
- 3) Your home (and your spouse's if filing a joint return) was not in the United States for more than half the year, or
- 4) You (or your spouse if filing a joint return) were a qualifying child for another person in 1996.
- 5) You (or your spouse if filing a joint return) do not have a social security number.

## Explanation of Rules For Persons With a Qualifying Child

In this section you will find explanations and examples for some of the rules listed under *Who Can Claim the Credit* for persons who have a qualifying child.

### Who Is a Qualifying Child?

You have a qualifying child if your child meets three tests and has a social security number (see *Social security number*, earlier). The three tests are:

- 1) Relationship,
- 2) Residency, and
- 3) Age.



*Your qualifying child does not necessarily have to be your dependent. See Qualifying child who is married.*

If your child does not meet all three tests then the child is not a qualifying child. However, you might qualify for the credit if you do not have a qualifying child and your earned income is under \$9,500. See *Persons Who Work and Do Not Have a Qualifying Child* for more information.



*Make sure the social security numbers for you, your spouse, and your qualifying child are correct. If they are missing or incorrect, you may not get the credit. See Social security number, earlier.*

### Relationship Test

To meet the relationship test, the child must be your:

- Son, daughter, or adopted child (or a descendant of your son, daughter, or adopted child—for example, your grandchild)
- Stepson or stepdaughter, or
- Eligible foster child (this could include a niece, nephew, brother, sister, cousin, etc.).

**Adopted child.** Your adopted child includes a child placed with you for adoption by an authorized placement agency, even if the adoption is not final.

**Eligible foster child.** For purposes of the earned income credit, a person is your eligible foster child if:

- 1) The child lived with you and was a member of your household for the whole year, **and**
- 2) You cared for that child as you would your own child.

As long as both (1) and (2) are met, any person can be your "eligible foster child."

The eligible foster child does not have to be related to you.

**Qualifying child who is married.** You generally **must** claim an exemption for your married qualifying child. If you cannot claim an exemption for your married qualifying child, you may still get the earned income credit if you meet either of the following:

- 1) You cannot claim your child's exemption because you gave that right to your child's other parent by filling out **Form 8332** or a similar written statement, **or**
- 2) You cannot claim your child's exemption because you gave that right to your child's other parent in a pre-1985 agreement (such as a separation agreement or divorce decree).

If you need more information about either of these exceptions or when you can claim an exemption for your child, see Chapter 3.

## Residency Test

To meet the residency test:

- 1) You must have a child who lived with you for more than half the year (the whole year if your child is an eligible foster child), and
- 2) The home must be in the United States (one of the 50 states or the District of Columbia).

To meet the residency test, you do not need a traditional home. For example, if your child lived with you for more than half the year in a homeless shelter, the residency test is met.

**Birth or death of a child.** You will meet the rule for a child living with you for more than half the year if:

- The child was alive for half the year or less during the year, **and**
- The child lived with you for the part of the year he or she was alive.

If your qualifying child is an eligible foster child, you will meet the rule for a child living with you for the whole year if:

- The child was born or died during the year, **and**
- The child lived with you for the part of 1996 he or she was alive.

**Temporary absences.** You will meet the residency test if you or the child is away from home on a temporary absence due to a special circumstance. Examples of a temporary absence include:

- Illness,
- Attending school,
- Business,
- Vacation, or
- Military service.

## Age Test

To meet the age test, your child must meet one of three rules.

- 1) The child must be under age 19 at the end of the year,
- 2) The child must be a full-time student under age 24 at the end of the year, or
- 3) The child must be permanently and totally disabled at any time during the tax year, regardless of age.

**Full-time student.** Your child is a full-time student if he or she:

- Was enrolled as a student at a school during any 5 months of 1996 for the number of hours or classes that the school considers to be full time, or
- Took a full-time, on-farm training course during any 5 months of 1996. The course had to be given by a school or a state, county, or local government agency.



*A school includes technical, trade, and mechanical schools. It does not include on-the-job training courses or correspondence schools.*

**Permanently and totally disabled.** Your child is permanently and totally disabled if both the following apply:

- 1) He or she cannot engage in any substantial gainful activity because of a physical or mental condition, **and**
- 2) A doctor determines the condition has lasted or can be expected to last continuously for at least a year or can lead to death.

## Other Rules for a Qualifying Child

The next two items explain what happens if:

- 1) You (or your spouse if filing a joint return) are a qualifying child of another person, or
- 2) You and someone else have the same qualifying child.

## Qualifying Child of Another Person

If you (or your spouse if filing a joint return) are a qualifying child of another person, then you cannot claim the earned income credit—no matter how many qualifying children you have.

**Example.** You and your daughter lived with your mother all year. You are 22 years old and attended a trade school full time. You had a part-time job and earned \$5,700. You had no other income. Your mother worked and earned \$16,000.

Your daughter is your qualifying child.

Your mother meets all the rules for the earned income credit. Both you and your

daughter are qualifying children of your mother.

You cannot claim the earned income credit because you are your mother's qualifying child.

## Qualifying Child for More Than One Person

If you and someone else have the same qualifying child, only the person with the higher modified AGI may be able to claim the credit. This is true even if the person with the higher modified AGI does not meet all the rules to claim the credit. See *Modified AGI (adjusted gross income)* under *How To Figure the Credit*.

**Example 1.** You and your son lived with your mother all year. You are 25 years old. Your only income was \$9,300 from a part-time job. Your mother's only income was \$15,000 from her job.

Your son is a qualifying child of both you and your mother. However, because you both have the same qualifying child, only one of you can claim the credit. Because your mother's modified AGI (\$15,000) is more than your modified AGI (\$9,300), only your mother can claim the earned income credit. You cannot claim the credit under the rules for persons with one or more qualifying children or persons without a qualifying child.

**Example 2.** Use the same facts from Example 1, except that your mother's modified AGI is \$40,000.

Your mother cannot claim the earned income credit because her modified AGI is more than \$25,078. Even though your mother cannot claim the earned income credit, you cannot claim the credit either, because your mother's modified AGI is more than yours.

**Example 3.** You and your sister shared a house for the entire year. You have 3 young children who lived in the household. Your sister does not have any children. However, she cares for your children as if they were her own. You earn \$12,000 and your sister earns \$13,000.

The children meet the age and residency test for both you and your sister. They meet the relationship test for you because they are your children. They also meet the relationship test for your sister because they lived with her in the same household for the whole year. She cared for them as if they were her own. Therefore, they qualify as her eligible foster children.

Your children are qualifying children for both you and your sister. However, because your sister's modified AGI is higher than yours, she is the only one who can claim the credit.

Schedule EIC has spaces to enter the names of only 2 children. In this example there are 3 children. You cannot split the qualifying children. Your sister's higher modified AGI entitles her to the credit for all 3 qualifying children whether or not their names appear on Schedule EIC.



If the other person is your spouse and you file a joint return, this rule does not apply.

## Explanation of Rules for Persons Without a Qualifying Child

In this section you will find explanations and examples for some of the rules listed under *Who Can Claim the Credit* for persons who do not have a qualifying child. The following rules are discussed:

- Married Persons Exception
- Qualifying Child of Another Person
- Age Rule
- Dependent Rule
- Main Home Rule

### Married Persons Exception

Married persons living apart usually must file a joint return to claim the earned income credit. Even though you are married, you may file as head of household if:

- 1) Your spouse did not live in your home at any time during the last 6 months of the year,
- 2) You paid more than half the cost to keep up your home for the entire year, and
- 3) Your home was, for more than half of the year, the main home of your child, adopted child, stepchild, or foster child. You also must be entitled to claim an exemption for your child.

You will meet (3) even if you cannot claim an exemption for your child because:

- You released your claim in writing to the other parent by filling out Form 8332 or a similar written statement, or
- There is a pre-1985 agreement (decree of divorce or separate maintenance or written agreement) granting the exemption to your child's other parent.

If the child who qualifies you for head of household status also meets the requirements of your qualifying child, you cannot claim the credit under *Persons Who Work and Do Not Have a Qualifying Child*.

**Example 1.** You are married and lived apart from your spouse all year. You earned \$8,000 and your 19-year-old son lived with you all year. You provided more than half the cost of maintaining your home. Your son had a part-time job and earned \$2,000. He was not a full-time student or permanently and totally disabled. You qualify for the "head of household" filing status and claim your son as a dependent. You can get the earned income credit under the rules for *Persons Who Work and Do Not Have a Qualifying Child*. Your son does not meet the age test for a

qualifying child. Your son is 19, not a full-time student, and is not permanently and totally disabled. Even though your son is your dependent, he is not your qualifying child when figuring the earned income credit.

**Example 2.** The facts are the same as Example 1, except your son is 18. In that case, your son is your dependent and a qualifying child. You would qualify for the credit under the rules for *Persons Who Work and Have One or More Qualifying Children*, and not under the rules for *Persons Who Work and Do Not Have a Qualifying Child* because your son is your qualifying child.

### Qualifying Child of Another Person

If you (or your spouse if filing a joint return) are a qualifying child of another person, then you cannot claim the earned income credit.

**Example.** You lived with your mother during the year. You are age 26 and permanently and totally disabled. Your only income was from a community center where you went twice a week to answer telephones. You were paid a small fee of \$1,500 for the year. Your mother worked and earned \$16,000.

You are a qualifying child of your mother. She can claim the earned income credit if she meets all the other rules. Because you are a qualifying child of your mother, you cannot claim the earned income credit.

### Age Rule

You must be at least age 25 but under age 65 at the end of your tax year. If you are married filing a joint return, either you or your spouse must be at least age 25 but under age 65 at the end of your tax year. It does not matter which spouse meets the age rule, as long as one of the spouses does. The end of the tax year for most people is December 31.

**Example 1.** You are single, age 28, and do not have any children. You meet the "Age Rule" for claiming the earned income credit.

**Example 2.** You are married and will file a joint return. You are age 23 and your spouse is age 27. You meet the "Age Rule" for claiming the earned income credit because your spouse is at least age 25 but under age 65.

**Example 3.** You are married and will file a joint return. You are age 62 and your spouse is 66. You meet the "Age Rule" for claiming the earned income credit because you are at least age 25 but under age 65.

**Example 4.** You are married and file a joint return. You worked and your spouse was a full-time student. You are age 29 and your spouse is age 24. You meet the age test because you are at least 25 but under 65. It does not matter if only one of you has earned income. As long as you meet all the other rules, you can still get the credit.

### Dependent Rule

You (or your spouse if filing a joint return) must be able to claim an exemption for yourself on your tax return. If someone else can claim you as a dependent on their return, you cannot claim the earned income credit. If someone else can claim you as a dependent on their return but does not, you still cannot claim the credit.

**Example 1.** You are age 25, single, and living at home with your parents. You work and are not a student. You earned \$7,500. Your parents cannot claim you as a dependent. When you file your return, you claim an exemption for yourself. Therefore, you meet the "Dependent Rule."

**Example 2.** You are age 25, single, and living at home with your parents. You work and earned \$2,000. Your parents can claim you as a dependent but decide not to. You cannot claim the credit because your parents could have claimed you as a dependent.

**Example 3.** You file as head of household. Your mother is your dependent. You maintain your own home. You worked and earned \$8,500. No one can claim you as a dependent. You claim an exemption for yourself when you file your return. You meet the "Dependent Rule."

### Main Home Rule

Your main home (and your spouse's if filing a joint return) must be in the United States for more than half the year. Your main home can be **any location** where you regularly live. For example, some homeless individuals live in shelters. Such individuals are entitled to claim the credit if they also meet all the other rules for eligibility.

U.S. military stationed outside the United States on extended active duty are considered to live in the U.S. during that duty period. See *Military personnel* under *Who Can Claim the Credit* for a definition of extended active duty.

## What Is Earned Income?

You have just learned about some of the rules you must meet if you want to claim the earned income credit. Another rule everyone must meet to get the credit is to have earned income. There are two ways to get earned income.

- 1) You work for someone who pays you, or
- 2) You work in a business you own.

That is why this credit is called the earned income credit. What is "earned income?" This section will explain what counts as earned income in order to get the earned income credit. For examples of what is or is not earned income see *Table 35-1*. The paragraphs which follow will explain some areas that are considered earned income when figuring the credit.

**Table 35-1. Examples of Earned Income When Figuring the Earned Income Credit**

<b>Earned Income</b>	
<b>Includes:</b>	<b>Does not include:</b>
<b>TAXABLE EARNED INCOME</b> (Enter on EIC Worksheet, line 1)*	
Wages, salaries, and tips  Union strike benefits  Long-term disability benefits received prior to minimum retirement age  Net earnings from self-employment (enter on line 5 of the Form 1040 EIC Worksheet)	Interest and dividends  Social security and railroad retirement benefits  Welfare benefits  Pensions or annuities  Veterans' benefits (including VA rehabilitation payments)
<b>NONTAXABLE EARNED INCOME</b> (Enter on EIC Worksheet, line 4)*	Workers' compensation benefits  Alimony  Child support  Unemployment compensation (insurance)  Taxable scholarship or fellowship grants that were not reported on Form W-2  Variable housing allowance for the military  Earnings for work performed while an inmate at a penal institution
* Voluntary salary deferrals (for example: 401(k) plans or the Federal Thrift Savings Plan)  * Pay earned in a combat zone (box 13, Code Q, of your W-2)  * Basic quarter and subsistence allowances and in-kind quarters and subsistence from the U.S. military (box 13, Code Q, of your W-2)  * The value of meals or lodging provided by an employer for the convenience of the employer  * Housing allowance or rental value of a parsonage for the clergy (see "Ministers and members of religious orders")  * Excludable dependent care benefits (line 19 of either Form 2441 or Schedule 2)  * Voluntary salary reductions such as under a cafeteria plan	

\* If you want IRS to figure your credit for you, enter the amount and type of your nontaxable earned income on line 8 (Form 1040EZ), line 29c (Form 1040A), or line 54 (Form 1040). For more information see, "IRS will figure your credit for you" in this chapter.

**Earned income that is not taxed.** As you can see, *Table 35-1* includes some examples of earned income that is not taxed. Earned income that is not taxed still counts as earned income when figuring the amount of your earned income credit.

To figure the earned income credit, you add the amounts of earned income that were not taxed to any amounts of taxable earned income you received during the year. You do this by putting the amount of the earned income that is not taxed on line 4 of the EIC Worksheet. Also, enter the type and amount of earned income that is not taxed in the spaces next to line 54 (Form 1040), line 29c

(Form 1040A), or line 8 (Form 1040EZ). More information on how to do this is in the section called *How To Figure the Credit*. However, if you are a minister, see *Ministers and members of religious orders*, later, under *If You Own Your Business*.

**Special note for military personnel.** Pay earned in a combat zone, basic quarters and subsistence allowances, and the value of in-kind quarters and subsistence are all earned income that is not taxed but must be used when you figure the earned income credit. These amounts will be on your W-2 in box 13

under code "Q." See Publication 3 for more detailed information.

**Disability payments.** If you retired on disability, payments you receive are considered earned income until you reach minimum retirement age. Minimum retirement age generally is the earliest age at which you can receive a pension or annuity if you are not disabled. You must report your taxable disability payments on line 7 of either Form 1040 or Form 1040A, until you reach minimum retirement age.

Beginning on the day after you reach minimum retirement age, payments you receive are taxable as a pension and are not considered earned income. Report the pension payments on Form 1040, lines 16a and 16b (or Form 1040A, lines 11a and 11b).

**Cafeteria plans.** If your employer offers a benefit plan that allows you to "pick and choose" among two or more benefits consisting of cash and certain employee benefits that are not taxed, you are probably participating in a cafeteria plan. Some of the benefits that may be offered include:

- Accident or health insurance, and
- Dependent care assistance.

If you choose a benefit that is not taxed (such as accident and health insurance) and agree to a voluntary salary reduction for the benefit, the amount of the salary reduction is earned income for purposes of this credit.

**Community property laws.** If you live in a state that has community property laws for married persons, do not follow those community property laws when using your earned income to figure your earned income credit.

**Earnings while an inmate at a penal institution.** Amounts paid to inmates in penal institutions for their work are not earned income when figuring the earned income credit. If the total on line 7 (Form 1040 or 1040A) or line 1 (Form 1040EZ), includes such income, subtract that income from the total on line 7 (or line 1). Enter the result on line 1 of the EIC Worksheet in your tax package. Also, enter "PRI" and the amount subtracted next to line 7 (Form 1040 or 1040A) or in the space to the right of the words "W-2 form(s)" of line 1 (Form 1040EZ).

**Household employees.** If you were a household employee who did not receive a Form W-2 because your employer paid you less than \$1,000 in 1996, be sure to include the amount you were paid on line 7 (Form 1040 or 1040A) or line 1 (Form 1040EZ). Enter "HSH" and the amount not reported on Form W-2 next to line 7 (Form 1040 or 1040A) or in the space to the right of the words "W-2 form(s)" of line 1 (Form 1040EZ).

**Note.** If you are not self-employed, a statutory employee (explained later), or a

minister or member of a religious order, skip *If You Own Your Business* and begin reading the section called *How To Figure the Credit*.

## If You Own Your Business

If you own your business, you are self-employed. You must include your net earnings from self-employment in earned income, even if the amount is less than \$400. Net earnings is the amount you get after you subtract your business expenses and half of your self-employment taxes from your business gross (total) income. If this figure is a net loss, you must subtract the loss from your total earned income.



*If you are self-employed and your net earnings are \$400 or more, be sure to correctly fill out Schedule SE (Form 1040) and pay the proper amount of self-employment tax. If you do not, you may not get all the credit you are entitled to.*

You may figure the amount of your net earnings by using either the regular or optional methods shown on Schedule SE (Form 1040). Publication 533 and the instructions for Schedule SE explain these methods. If you are eligible to choose the optional method, you may use up to \$1,600 as the amount of earned income.

**Example.** You had \$20,000 in gross farm income and a net farm **loss** of \$5,000 for the year. You had no other income. Since your gross farm income was more than \$2,400 and your net earnings (a loss of \$5,000) from farming were less than \$1,733, you can choose the farm optional method of figuring self-employment tax.

Even though you had a net loss for the year, you can enter \$1,600 as net earnings from self-employment on Schedule SE. The \$1,600 is earned income for purposes of figuring the earned income credit.

**Net earnings from self-employment.** Your net earnings from self-employment are earned income. Net earnings can be found on Schedule SE (Form 1040), Section A, line 3, or Section B, lines 3 and 4b. From this amount you must subtract the amount you claimed (or should have claimed) on Form 1040, line 25. This net amount is your earned income to use in figuring the earned income credit. If you do not have to file Schedule SE (because your net earnings from self-employment minus half of your self-employment tax is under \$400), include the net amount in earned income on line 5 of the EIC Worksheet in the Form 1040 instructions. However, see *Table 35-2* for instructions about figuring the amount to enter on line 5 of the EIC Worksheet.

**Table 35-2.** If you were self-employed or you reported your income and expenses on Schedule C (or Schedule C-EZ) as a statutory employee, use *Table 35-2* to figure the amount to enter on the EIC Worksheet, line 5, in the Form 1040 instructions.

**Ministers and members of religious orders.** If you can claim the earned income credit and file Schedule SE and the amount on line 2 of that schedule includes an amount that was also reported on Form 1040, line 7, follow these special rules.

- 1) Print "Clergy" to the right of line 54, Form 1040.
- 2) Determine how much of the income reported on Form 1040, line 7, was also reported on Schedule SE, line 2.
- 3) Subtract that income from the amount on Form 1040, line 7. Enter only the difference on the EIC Worksheet, line 1.
- 4) Complete Table 35-2 to determine the amount to enter on the EIC Worksheet, line 5 in the Form 1040 instructions.

If you received a housing allowance or were provided housing, **do not** include the allowance or rental value of the parsonage as nontaxable earned income on the EIC Worksheet, line 4, in the Form 1040 instructions (or in the space provided on line 54 of Form 1040). This income should already be included on Schedule SE, line 2.

**Statutory employee.** Statutory employees are generally considered self-employed.

However, the amounts received by statutory employees have social security and Medicare taxes withheld. For purposes of the earned income credit, statutory employees are treated as employees. Therefore, the gross (total) amount received from employment is included in earned income. The four types of statutory employees are:

- 1) An agent (or commission) driver who delivers food or beverages (other than milk) or laundry or dry cleaning for someone else.
- 2) A full-time life insurance salesperson.
- 3) A homemaker who works by the guidelines of the person for whom the work is done, with materials furnished by and returned to that person or to someone that person designates.
- 4) A traveling or city salesperson (other than an agent-driver or commission-driver) who works full time (except for sideline sales activities) for one firm or person getting orders from customers. The order must be for items for resale or use as supplies in the customer's business. The customers must be retailers, wholesalers, contractors, or operators of hotels, restaurants, or other businesses dealing with food or lodging.

**Table 35-2. How To Figure Line 5 of the Form 1040 EIC Worksheet**  
(Keep for your records)

*If filing a joint return and your spouse was also self-employed or reported income and expenses on Schedule C or C-EZ as a statutory employee, add your spouse's amounts to yours to figure the amounts to enter below.*

- 1. If You Are Filing Schedule SE:**
  - a. Enter the amount from Schedule SE, Section A, line 3, or Section B, line 3, whichever applies ..... **1a.** \_\_\_\_\_
  - b. Enter the amount, if any, from Schedule SE, Section B, line 4b..... **1b.** \_\_\_\_\_
  - c. Add lines 1a and 1b..... **1c.** \_\_\_\_\_
  - d. Enter the amount from Form 1040, line 25..... **1d.** \_\_\_\_\_
  - e. Subtract line 1d from line 1c ..... **1e.** \_\_\_\_\_
- 2. If you are not required to file Schedule SE (for example, because your net earnings from self-employment were less than \$400) complete lines 2a through 2c. But do not include on these lines any statutory employee income or any amount exempt from self-employment tax as the result of the filing and approval of Form 4029 or 4361.**
  - a. Enter any net farm profit or (loss) from Schedule F, line 36, and farm partnerships, Schedule K-1 (Form 1065), line 15a ..... **2a.** \_\_\_\_\_
  - b. Enter any net profit or (loss) from Schedule C, line 31, Schedule C-EZ, line 3, and Schedule K-1 (Form 1065), line 15a (other than farming) ..... **2b.** \_\_\_\_\_
  - c. Add lines 2a and 2b. Enter the total even if a loss ..... **2c.** \_\_\_\_\_
- 3. If you are filing Schedule C or C-EZ as a statutory employee, enter the amount from line 1 of that Schedule C or C-EZ..... **3.** \_\_\_\_\_**
- 4. Add lines 1e, 2c, and 3. Enter the total here and on line 5 of the EIC Worksheet, even if a loss. If the result is a loss, enter it in parentheses and read the **Caution** below ..... **4.** \_\_\_\_\_**

**Caution:** *If line 5 of the Earned Income Credit Worksheet is a loss, subtract it from the total of lines 3 and 4 of that Worksheet and enter the result on line 6 of that worksheet. If the result is zero or less, you can't take the earned income credit.*

If you were a statutory employee and you reported your income and expenses on Schedule C (Form 1040) (or Schedule C–EZ), your earned income includes the amount on line 1 of Schedule C (or Schedule C–EZ).

If you need further information about statutory employees, see Publication 15–A, *Employer's Supplemental Tax Guide*.

**Approved Form 4361 and Form 4029.** This section is for persons who have an approved:

- Form 4361, *Application for Exemption from Self-Employment Tax for Use by Ministers, Members of Religious Orders and Christian Science Practitioners*, or
- Form 4029, *Application for Exemption from Social Security and Medicare Taxes and Waiver of Benefits*.

Each approved form exempts certain income from the self-employment tax. Each form is discussed in this section in terms of what is or is not earned income for purposes of the earned income credit.

**Form 4361.** If you have an approved Form 4361, amounts you received for performing ministerial duties as an employee are earned income. This includes wages, salaries, tips, and other employee compensation. Other employee compensation includes nontaxable compensation such as housing allowances or the rental value of a parsonage that you receive as part of your pay for services as an employee.

Amounts you received in the exercise of ministerial duties, but not as an employee, are not earned income. Examples include fees for performing marriages and honoraria for delivering speeches.

Any compensation you received from an undertaking unrelated to the ministry is earned income. This is so, whether you received the amounts as an employee or as a self-employed individual.

**Form 4029.** If you have an approved Form 4029, all wages, salaries, tips, and other employee compensation are earned income. Amounts you received as a self-employed individual are not earned income. Also, losses from Schedule C, C–EZ, or F cannot be subtracted from wages on line 7 of Form 1040.

## How To Figure the Credit

Once you know that you qualify for the earned income credit, you need to know how to figure the amount of the credit. You have two choices of how to figure the credit.

- 1) Have the IRS figure the credit for you. If you would like to do this, see *IRS Will Figure Your Credit For You*, or
- 2) If you want to figure the credit yourself, do the following:

- a) Complete the EIC Worksheet and enter the amount of the credit on line 54 (Form 1040), line 29c (Form 1040A), or on line 8 (Form 1040EZ).
- b) Complete Schedule EIC and attach it to your Form 1040 or Form 1040A, if you have a qualifying child.

**Earned income credit table.** You use this table to find the amount of your credit. The table is located at the end of this chapter.

**Modified AGI (adjusted gross income).** You need to know your earned income and modified AGI when figuring your credit amount. Your credit amount depends on how many qualifying children you have, how much you earn, and your modified AGI. In many cases your modified AGI will be the same figure as your AGI. AGI includes items such as taxable social security benefits and unemployment benefits.

Modified AGI for most people filing Form 1040, 1040A, or 1040EZ is the same as AGI. AGI is the amount on line 31 (Form 1040), line 16 (Form 1040A), and line 4 (Form 1040EZ).

Modified AGI is the amount on Form 1040, line 31, increased by the amount of (1) any loss claimed on Form 1040, line 13 and (2) one-half of any losses on Form 1040, lines 12 and 18. But see Publication 596 to figure your modified AGI if you are filing Schedule E or you are claiming a loss from the rental of personal property not used in a trade or business.



*If you had a 1996 Form W-5 in effect before June 27, 1996, go to Part IV, Form W-5 Before June 27, 1996, in Publication 596.*

**Alternative minimum tax (AMT).** The tax laws give special treatment to some kinds of income and expenses. This special treatment could substantially reduce or eliminate an individual's income tax. So that taxpayers who benefit from these laws will pay at least a minimum amount of tax, there is a special tax called the AMT.

You may have to pay the AMT if your taxable income for regular tax purposes, combined with any of the adjustments and preference items that apply to you, totals more than:

- **\$45,000** if you are married filing a joint return (or a qualifying widow(er) with dependent child)
- **\$33,750** if your filing status is head of household or single

You **must** reduce your earned income credit by the amount of any AMT you have for the tax year.

**Form 1040 and the AMT.** If you file Form 1040 and included AMT on line 46, subtract it from the amount on line 10 of the Form 1040 EIC Worksheet. Enter the result (if more than zero) on Form 1040, line 54.

Also, replace the amount on the EIC Worksheet, line 10, with the amount entered on Form 1040, line 54.

**Form 1040A and the AMT.** If you file Form 1040A and included AMT on line 28, subtract it from the amount on line 9 of the Form 1040A EIC Worksheet. Enter the result (if more than zero) on Form 1040A, line 29c. Also, replace the amount on the Form 1040A EIC Worksheet, line 9, with the amount entered on Form 1040A, line 29c.

See Form 6251, *Alternative Minimum Tax—Individuals*.

## IRS Will Figure Your Credit For You

There are certain instructions you must follow before IRS can figure the credit for you.

### Form 1040

If you are filing Form 1040 and you want the IRS to figure the credit for you, you must fill out parts of Form 1040 and:

- 1) Enter any advance earned income credit payments received in 1996 on line 49,
- 2) Complete Schedule EIC if you have a qualifying child, and
- 3) Print "EIC" next to line 54. Also, if you have any earned income that is not taxed, enter the amount and type of income in the spaces provided on line 54. See Table 35–1 for examples of earned income that is not taxed.
- 4) If line 7 includes an amount for work performed while an inmate in a penal institution, print "PRI" and the amount received (if any) next to line 7.
- 5) If you were a household employee and did not receive a Form W–2 because your employer paid you less than \$1,000 in 1996, print "HSH" and the amount not reported on a Form W–2 next to line 7. Also include the amount you were paid in the total for line 7.

To see which lines on Form 1040 you must fill out, get Publication 967, *The IRS Will Figure Your Tax*.

### Form 1040A

If you are filing Form 1040A and you want the IRS to figure the credit for you, you must:

- 1) Fill in the parts of Form 1040A through line 22 that apply to you.
- 2) If you file a joint return, use the space to the left of line 22 to separately show your own taxable income and your spouse's taxable income.
- 3) Complete lines 24a, 24b, 26, 27, 29a, 29b, and any write-ins on line 29d, if they apply to you. If you received any advance earned income credit payments, show the amount of the payment on line 26.
- 4) Attach the first copy or Copy B of all your W–2 and 1099–R forms that show federal income tax withheld.

- 5) Fill in and attach any schedules or forms asked for on the lines you completed.
- 6) Complete Schedule EIC if you have a qualifying child.
- 7) Print "EIC" next to line 29c. Also, if you have earned income that is not taxed, enter the amount and type of income in the spaces provided. See Table 35-1, earlier, for examples of earned income that is not taxed.
- 8) If line 7 includes an amount for work performed while an inmate in a penal institution, print "PRI" and the amount received (if any) next to line 7.
- 9) If you were a household employee and did not receive a Form W-2 because your employer paid you less than \$1,000 in 1996, print "HSH" and the amount not reported on Form W-2 next to line 7. Also include the amount you were paid in the total for line 7.
- 10) Sign and date your return (both spouses must sign a joint return), enter your occupations, and file your return by April 15, 1997.

### Form 1040EZ

If you are filing Form 1040EZ and you want the IRS to figure the credit for you, you must:

- 1) Fill in lines 1-7.
- 2) If you file a joint return, use the space under the "Note" to the left of line 6 to separately show your own and your spouse's taxable income.
- 3) Fill in the amount and type of any earned income that is not taxed in the spaces marked "Type" and "\$" to the left of line 8.
- 4) If you can claim the credit, enter "EIC" on line 8 in the space to the right of the words "earned income below."
- 5) If line 1 includes an amount for work performed while an inmate in a penal institution, print "PRI" and the amount received (if any) to the right of the words "W-2 form(s)" of line 1.
- 6) If you were a household employee and did not receive a Form W-2 because your employer paid you less than \$1,000 in 1996, print "HSH" and the amount not reported on a Form W-2 to the right of the words "W-2 form(s)" of line 1. Also include the amount you were paid in the total for line 1.
- 7) Attach the first copy or Copy B of all your W-2 forms.
- 8) Sign and date your return (both spouses must sign a joint return), enter your occupation, and file your return by April 15, 1997.

## How To Figure the Credit Yourself

There are certain instructions you must follow if you want to figure the credit yourself.

### Form 1040A, EIC Worksheet, and Schedule EIC

Figure the amount of your credit on the EIC Worksheet if you meet the rules under *Who Can Claim the Credit* and your total earned income (line 7, Form 1040A) and your modified AGI (same as AGI) are each less than:

- \$9,500 if you do not have a qualifying child,
- \$25,078 if you have one qualifying child, or
- \$28,495 if you have more than one qualifying child.

If you **do not** meet all the rules, then you do not qualify for the earned income credit. If you qualify for the credit and have a qualifying child, you must also fill out Schedule EIC and attach it to your Form 1040A. Do not attach the EIC Worksheet to your return.

If line 7 includes any amount paid to an inmate in a penal institution for work, see *Earnings while an inmate at a penal institution* earlier for a special instruction.

If you were a household employee who did not receive a Form W-2 because your employer paid you less than \$1,000 in 1996, see *Household employees under What Is Earned Income?* for a special instruction.



If Form 1040A, line 7, includes an amount for a taxable scholarship or fellowship grant that was not reported on your W-2, enter the total line 7 amount on line 1 of the EIC Worksheet. Next, enter the amount of the taxable scholarship or fellowship grant (that was not reported on your W-2) in the box for line 2 of the Form 1040A EIC Worksheet. Then subtract line 2 from line 1 of the EIC Worksheet and enter the result on line 3.

### Form 1040, EIC Worksheet, and Schedule EIC

Figure the amount of your credit on the EIC Worksheet if you meet the rules under *Who Can Claim the Credit* and your total earned income (line 7, Form 1040) and your modified AGI are each less than:

- \$9,500 if you do not have a qualifying child,
- \$25,078 if you have one qualifying child, or
- \$28,495 if you have more than one qualifying child.

If you qualify for the credit and have a qualifying child, you must also fill out Schedule EIC and attach it to your Form 1040. Do not attach the EIC Worksheet to your return.

If line 7 includes any amount paid to an inmate in a penal institution for work, see *Earnings while an inmate at a penal institution* earlier for a special instruction.

If you were a household employee who did not receive a Form W-2 because your employer paid you less than \$1,000 in 1996,

see *Household employees* earlier for a special instruction.



If Form 1040, line 7, includes an amount for a taxable scholarship or fellowship grant that was not reported on your Form W-2, enter the total line 7 amount on line 1 of the EIC Worksheet. Next, enter the amount of the taxable scholarship or fellowship grant (that was not reported on your W-2) on line 2 of the Form 1040 EIC Worksheet. Then subtract line 2 from line 1 and enter the result on line 3.

### Form 1040EZ and EIC Worksheet

Figure the amount of your credit on the EIC Worksheet if you meet the rules under *Who Can Claim the Credit* and your total earned income (line 1, Form 1040EZ) and your modified AGI (same as AGI) are each less than \$9,500. Do not attach the EIC Worksheet to your Form 1040EZ return.

If line 1 includes any amount paid to an inmate in a penal institution for work, see *Earnings while an inmate at a penal institution* earlier for a special instruction.

If you were a household employee who did not receive a Form W-2 because your employer paid you less than \$1,000 in 1996, see *Household employees* earlier for a special instruction.



If Form 1040EZ, line 1, includes an amount for a taxable scholarship or fellowship grant that was not reported on your W-2, enter the Form 1040EZ, line 1, amount on line 1 of the EIC Worksheet. Next, enter the amount of the taxable scholarship or fellowship grant (that was not on your W-2) on line 2 of the EIC Worksheet. Then subtract line 2 from line 1 and enter the result on line 3.

## Examples

This part of the chapter contains two comprehensive examples that illustrate how to claim the credit. The first example is about David and Judy Brown who have 3 children. The second example is about Kelly Green who does not have a qualifying child.

### Example 1

David and Judy Brown have three children—Karl, age 3, and twins Trisha and Mary, age 1. The children lived with David and Judy for all of 1996. David worked and earned \$16,000. He also received \$1,500 in unemployment compensation. Judy made crafts and sold them at a flea market. Her net earnings from self-employment were \$350. In addition, they earned \$50 interest from a savings account.

Their total earned income is \$16,350 (\$16,000 + \$350). Their modified AGI is \$17,900 (\$16,000 + \$350 + \$1,500 + \$50). David and Judy will file a joint return using Form 1040. They qualify for the earned

income credit and complete Schedule EIC and the EIC Worksheet.

They take the following steps to complete the forms. Their completed Schedule EIC and the EIC Worksheet are at the end of the chapter. The Browns will attach Schedule EIC to Form 1040 when they send their completed return to IRS.



**TIP** If you have more than two qualifying children, list only two of the children on Schedule EIC.

## Step 1 — Schedule EIC

The Browns complete Schedule EIC because they have qualifying children. They enter “David and Judy Brown” and David’s social security number on the line provided at the top of Schedule EIC. They enter the social security number that appears first on Form 1040. The Browns fill out *Information About Your Qualifying Child or Children* (lines 1–6).

**Line 1.** The Browns enter only Karl’s and Trisha’s names. They do not enter Mary’s name. However, Mary is still a qualifying child even though her name is not on Schedule EIC.

**Line 2.** The Browns enter the year of birth for Karl (1993) in the column “(a) Child 1” and for Trisha (1995) in the column “(b) Child 2.”

**Lines 3(a) and 3(b).** The Browns skip these lines because the children were born after 1977.

**Line 4.** The Browns enter Karl’s and Trisha’s SSN. See *Social security number*, earlier, for more information.



**TIP** If your child was born in December 1996, you do not have to enter his or her SSN on line 4. Instead enter “12/96” on line 4.

**Line 5.** The Browns enter “son” for Karl and “daughter” for Trisha. This line shows the children’s relationship to the Browns.

**Line 6.** The Browns enter “12” for Karl and “12” for Trisha. This line shows how many months in 1996 the children lived with David and Judy.



**TIP** Do not enter more than 12 on line 6. Count temporary absences, such as for school, vacation, or medical care, as time lived in your home. If the child lived with you for more than half of 1996 but less than 7 months, enter “7” on line 6.

## Step 2 — EIC Worksheet

In Step 1 the Browns completed the information about their qualifying children. Next, they complete the EIC Worksheet to figure their earned income credit amount.

**Line 1.** The Browns enter David’s earned income (\$16,000) from Form 1040, line 7.

**Line 2.** The Browns leave this line blank because they did not have any taxable scholarship or fellowship grant income.

**Line 3.** They subtract line 2 from line 1 and enter \$16,000.

**Line 4.** Because all of David’s and Judy’s earned income is taxable, they leave this line blank.

**Line 5.** Because Judy was self-employed, she completed *Table 35–2* and entered the result – \$350 – here. *Table 35–2* can be found earlier in this chapter. A filled-in *Table 35–2* is not shown in this example.

**Line 6.** They add lines 3, 4, and 5 and enter \$16,350. This is their total earned income.

**Line 7.** To find the amount of their credit, the Browns go to the **Earned Income Credit Table** at the end of the chapter. They have two qualifying children listed on Schedule EIC—Karl and Trisha. They find their earned income of \$16,350 (from EIC Worksheet, line 6) in the range of \$16,350 to \$16,400. They follow this line across to the column “Two children” and find \$2,552. They enter \$2,552 on line 7.

**Line 8.** The Browns enter their modified AGI \$17,900. This amount is the same as their AGI because the Browns did not have any of the types of income shown under *Modified AGI (adjusted gross income)*, earlier.

**Line 9.** The Browns check the box for **No** and follow the instruction because their modified AGI of \$17,900 is more than \$11,650. They again go to the **Earned Income Credit Table** to find the amount of their credit based on their modified AGI (EIC Worksheet, line 8). They find the \$17,900 in the range of \$17,900 to \$17,950. They follow this line across to the column “Two children” and find \$2,226. They enter \$2,226 on line 9.

**Line 10.** Because they checked **No** on line 9, they compare the amounts on line 7 (\$2,552) and line 9 (\$2,226). They enter the smaller amount on line 10 and also on Form 1040, line 54. The \$2,226 is the Browns’ earned income credit.

## Example 2—Form 1040EZ

Kelly Green is age 30 and a full-time student. She lived with her parents in the United States for all of 1996. She had a part-time job and earned \$6,040. She earned \$20 interest on a savings account. She is not a dependent on her parents’ return because she does not meet the gross income test. She does not have any children. Kelly qualifies for the earned income credit. Kelly will file Form 1040EZ and complete the EIC Worksheet. The steps she uses follow. Her completed EIC Worksheet is at the end of the chapter.

### Completing the EIC Worksheet

Kelly figures the amount of her earned income credit on the *Earned Income Credit Worksheet* as follows:

**Line 1.** She enters \$6,040 from Form 1040EZ, line 1.

**Line 2.** Kelly leaves this line blank because she did not receive any taxable scholarships or fellowship grants.

**Line 3.** She subtracts line 2 from line 1 and enters \$6,040.

**Line 4.** Kelly leaves this line blank because all her income is taxable.

**Line 5.** She adds lines 3 and 4 and enters \$6,040. This is her total earned income.

**Line 6.** To find her credit, Kelly goes to the *Earned Income Credit Table* at the end of the chapter. She finds her earned income of \$6,040 (from line 5 above) in the range of \$6,000 to \$6,050. Kelly follows this line across to the column “No children” and finds \$266.

**Line 7.** She enters \$6,060 from Form 1040EZ, line 4. Modified AGI on Form 1040EZ is the same as AGI.

**Line 8.** Kelly checks the box for **Yes** and follows the instruction, because her modified AGI of \$6,060 is more than \$5,300. Kelly again goes to the *Earned Income Credit Table* to find the amount of the credit based on her modified AGI. She finds \$6,060 in the range of \$6,050 to \$6,100. Kelly follows this line across to the column “No children” and finds \$262. Kelly enters \$262.

**Line 9.** Because Kelly checked the **Yes** box for line 8, she enters the smaller of \$266 (line 6) or \$262 (line 8). She enters \$262 here and on Form 1040EZ, line 8. The \$262 is Kelly’s earned income credit.

## Advance Earned Income Credit Payments

Would you like to get part of your earned income credit now instead of waiting until after the end of the year? If you work for someone and expect to qualify for the earned income credit in 1997, you can choose to get part of the credit in advance. Give your employer a 1997 Form W-5 and he or she will include part of the credit regularly in your pay.



**CAUTION** If you had a 1996 Form W-5 in effect before June 27, 1996, get *Publication 596*, Earned Income Credit, and go to *Part IV*, Form W-5 Before June 27, 1996.

**Who can get the advance payment of the earned income credit?** There are certain basic rules you must meet to see if you can get part of the earned income credit paid to you throughout the year in your paycheck. You must:

- 1) Work and earn less than a certain amount. The amount in 1996 was \$25,078. The amount for 1997 will be higher (see Form W-5 for the 1997 amount),
- 2) Have a qualifying child, and
- 3) Meet all the rules under *Persons Who Work and Have One or More Qualifying Children*, earlier, or in the instructions for the W-5.

**Persons who are not entitled to receive the advance payments.** Under certain circumstances, even if you meet the rules for receiving part of the earned income credit in advance, you may not be entitled to get it. If your wages are not subject to federal income tax, social security tax, or Medicare tax withholding, you cannot get the advance payment of the earned income credit. If you are a farm worker and are paid on a daily basis, your employer is not required to pay you the advance amount of the credit.

## How To Get Advance Payments for 1997

To get part of the credit in advance, you must fill out a 1997 Form W-5.

After you have read the instructions and answered the questions on Form W-5, give the lower part of the form to your employer. Keep the top part for your records.

If you have more than one employer, give a certificate to only one of them. If you are married and both you and your spouse are employed and expect to qualify for the credit, you may give a Form W-5 to your employer and your spouse may give one to his or her employer.



*If you receive advance earned income credit payments in 1997, you must file Form 1040 or Form 1040A for 1997. You must file a return to report what you already received and to take advantage of any additional earned income credit that you may qualify for.*

**If you receive advance payments of the earned income credit** and later find out that you do not qualify for the credit, you will have to pay back any advance payment you are not entitled to when you file your Form 1040 or Form 1040A.

The 1997 Form W-5 you give to your employer is valid until December 31, 1997. If you expect to qualify for the earned income credit in 1998 and you want to receive advance payments, you must give your employer a **new** Form W-5 in 1998. Do this each year you think you are eligible for the credit.

**When to give your employer a new Form W-5.** If you no longer want to get advance payments or if your situation changes and you no longer qualify for the earned income credit, you must give your employer a new Form W-5. Check the **NO** box in question 1 on the new form.

If your spouse files a Form W-5 with his or her employer, you must file a new Form W-5 with your employer. Check the **Yes** box in question 4 that your spouse has filed a Form W-5.

## Advance Earned Income Credit Payments Received in 1996

If you received advance payments of the earned income credit in 1996, you must file a

tax return to report the payments. Report the amount on line 49, Form 1040 (or line 26, Form 1040A). Your Form W-2, box 9, will show the amount you received. You cannot use Form 1040EZ to report your advance payments.

**Did you have a Form W-5 in effect before June 27, 1996?** If you had a 1996 Form W-5 in effect before June 27, 1996, go to Part IV of Publication 596. You must do this to see if you can claim the credit on your 1996 tax return. Part IV contains a list of rules to see if you qualify for the credit and a worksheet to fill out if you do qualify.

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## Checklist and Table for Figuring the Credit

The pages that follow the filled-in form and worksheets have some helpful information you may need. They are:

- Eligibility Checklist. This is your final check to see if you really do qualify for the earned income credit.
- The Earned Income Credit Table immediately follows the *Eligibility Checklist*.

**SCHEDULE EIC**  
(Form 1040A or 1040)

Department of the Treasury  
Internal Revenue Service

**Earned Income Credit**  
**(Qualifying Child Information)**

▶ Attach to Form 1040A or 1040.  
▶ See instructions on back.

OMB No. 1545-0074

**1996**

Attachment  
Sequence No. 43

Name(s) shown on return: First and initial(s)	Last	Your social security number
David and Judy	Brown	333003333

**Before You Begin . . .**

- See the instructions for Form 1040A, line 29c, or Form 1040, line 54, to find out if you can take this credit.
- If you can take the credit, fill in the Earned Income Credit Worksheet in the Form 1040A or Form 1040 instructions to figure your credit. But if you want the IRS to figure it for you, see instructions on back.

Then, you must complete and attach Schedule EIC only if you have a qualifying child (see boxes on back).

**Information About Your Qualifying Child or Children**

If you have more than two qualifying children, you only have to list two to get the maximum credit.

*Caution: If you do not attach Schedule EIC and fill in all the lines that apply, it will take us longer to process your return and issue your refund.*

	(a) Child 1		(b) Child 2	
	First name	Last name	First name	Last name
1 Child's name: . . . . .	Karl	Brown	Trisha	Brown
2 Child's year of birth . . . . .	19	93	19	95
3 If the child was born before 1978 AND—				
a was under age 24 at the end of 1995 and a student, check the "Yes" box, OR . . .	<input type="checkbox"/> Yes		<input type="checkbox"/> Yes	
b was permanently and totally disabled (see back), check the "Yes" box . . . . .	<input type="checkbox"/> Yes		<input type="checkbox"/> Yes	
4 Enter the child's social security number. If born in December 1995; see instructions on back . . . . .	000001234		000004321	
5 Child's relationship to you (for example, son, grandchild, etc.) . . .	Son		Daughter	
6 Number of months child lived with you in the United States in 1995 . . .	12 months		12 months	

**TIP:** Do you want the earned income credit added to your take-home pay in 1997? To see if you qualify, get Form W-5 from your employer or by calling the IRS at 1-800-TAX-FORM (1-800-829-3876).

For Paperwork Reduction Act Notice, see Form 1040A or 1040 Instructions.

Cat. No. 13339M

Schedule EIC (Form 1040A or 1040) 1996

**Filled-in Worksheet — David and Judy Brown**  
 (Page references are to the Form 1040 instructions)



**Earned Income Credit Worksheet—Line 54**  
 (keep for your records)

**Caution:** If you were a household employee who did not receive a Form W-2 because your employer paid you less than \$1,000 in 1996 or you were a minister or member of a religious order, see **Special Rules** on page 27 before completing this worksheet. Also, see **Special Rules** if Form 1040, line 7, includes any amount paid to an inmate in a penal institution.

1. Enter the amount from Form 1040, line 7 . . . . . 1. 16,000
2. If you received a taxable scholarship or fellowship grant that was not reported on a W-2 form, enter that amount here . . . . . 2. \_\_\_\_\_
3. Subtract line 2 from line 1 . . . . . 3. 16,000
4. Enter any nontaxable earned income (see the next page). Types of nontaxable earned income include contributions to a 401(k) plan, and military housing and subsistence. These should be shown in box 13 of your W-2 form . . . . . 4. \_\_\_\_\_
5. If you were self-employed or used Schedule C or C-EZ as a statutory employee, enter the amount from the worksheet on page 27 . . . . . 5. 350
6. Add lines 3, 4, and 5 . . . . . 6. 16,350
7. Look up the amount on line 6 above in the EIC Table on pages 28-29 to find your credit. Enter the credit here . . . . . 7. 2,552  
 If line 7 is zero, stop. You cannot take the credit. Enter "No" next to Form 1040, line 54.
8. Enter your modified AGI (see page 27) . . . . . 8. 17,900
9. Is line 8 less than—  
 • \$5,300 if you do not have a qualifying child?  
 • \$11,650 if you have at least one qualifying child?  
 Yes. Go to line 10 now.  
 No. Look up the amount on line 8 above in the EIC Table on pages 28-29 to find your credit. Enter the credit here . . . . . 9. 2,226
10. Earned income credit.  
 • If you checked "Yes" on line 9, enter the amount from line 7.  
 • If you checked "No" on line 9, enter the smaller of line 7 or line 9 . . . . . 10. 2,226  
 Next: Take the amount from line 10 above and enter it on Form 1040, line 54.

**AND**

If you had any nontaxable earned income (see line 4 above), enter the amount and type of that income in the spaces provided on line 54.

**AND**

Complete Schedule EIC and attach it to your return ONLY if you have a qualifying child.

**Note:** If you owe the alternative minimum tax (Form 1040, line 46), subtract it from the amount on line 10 above. Then, enter the result (if more than zero) on Form 1040, line 54. Also, replace the amount on line 10 above with the amount entered on Form 1040, line 54.

**Filled-in Worksheet — Kelly Green**  
(Page references are to the Form 1040EZ instructions)

**Earned Income Credit Worksheet—Line 8** (keep for your records)



**Caution:** If you were a household employee who did not receive a Form W-2 because your employer paid you less than \$1,000 in 1996, see **Special Rules** on page 10 before completing this worksheet. Also, see **Special Rules** if Form 1040EZ, line 1, includes any amount paid to an inmate in a penal institution.

- 1. Enter the amount from Form 1040EZ, line 1 . . . . . 1. 6,040
- 2. If you received a taxable scholarship or fellowship grant that was not reported on a W-2 form, enter that amount here . . . . . 2. \_\_\_\_\_
- 3. Subtract line 2 from line 1 . . . . . 3. 6,040
- 4. Enter any nontaxable earned income (see page 9). Types of nontaxable earned income include contributions to a 401(k) plan, and military housing and subsistence. These should be shown in box 13 of your W-2 form . . . . . 4. \_\_\_\_\_
- 5. Add lines 3 and 4 . . . . . 5. 6,040

**Caution:** If line 5 is \$9,500 or more, you cannot take the credit. Print "No" to the right of the word "below" on line 8 of Form 1040EZ.

- 6. Look up the amount on line 5 above in the EIC Table on page 12 to find your credit. Enter the credit here . . . . . 6. 266
- 7. Enter the amount from Form 1040EZ, line 4 . . . . . 7. 6,060

8. Is line 7 \$5,300 or more?

**Yes.** Look up the amount on line 7 above in the EIC Table on page 12 to find your credit. Enter the credit here . . . . . 8. 262

**No.** Go to line 9.

9. **Earned income credit.**

- If you checked "Yes" on line 8, enter the smaller of line 6 or line 8.
- If you checked "No" on line 8, enter the amount from line 6 . . . . . 9. 262

**Next:** Take the amount from line 9 above and enter it on Form 1040EZ, line 8.

**AND**

If you had any nontaxable earned income (see line 4 above), enter the type and amount of that income in the spaces marked "Type" and "\$" to the left of line 8.

Table 35-3. Earned Income Credit (EIC) Eligibility Checklist

**CAN YOU REALLY CLAIM THE EARNED INCOME CREDIT?  
(For use in preparing 1996 tax returns)**

*You may claim the earned income credit if you answer YES to all the following questions.\**



You, your spouse, and your qualifying child must each have a social security number to claim the credit. (See **social security number** earlier.) DO NOT use this checklist if, in 1996, you had a Form W-5 in effect with your employer before June 27, 1996. Instead, go to Part IV in Publication 596.

	YES	NO
1. Is the total of your taxable and nontaxable earned income at least \$1 but less than: <ul style="list-style-type: none"> <li>• \$ 9,500 if you do not have a qualifying child</li> <li>• \$25,078 if you have one qualifying child</li> <li>• \$28,495 if you have more than one qualifying child</li> </ul>	<input type="checkbox"/>	<input type="checkbox"/>
2. Is your modified adjusted gross income less than: <ul style="list-style-type: none"> <li>• \$ 9,500 if you do not have a qualifying child</li> <li>• \$25,078 if you have one qualifying child</li> <li>• \$28,495 if you have more than one qualifying child</li> </ul>	<input type="checkbox"/>	<input type="checkbox"/>
3. Is your investment income \$2,200 or less?	<input type="checkbox"/>	<input type="checkbox"/>
4. Is your filing status married filing jointly, head of household, qualifying widow(er), or single?	<input type="checkbox"/>	<input type="checkbox"/>
5. Answer <b>YES</b> if you (and your spouse if filing a joint return) are not a qualifying child of another person?	<input type="checkbox"/>	<input type="checkbox"/>
6. Answer <b>YES</b> if you did not file Form 2555 or Form 2555-EZ to exclude from your gross income any income earned in foreign countries or to deduct or exclude a foreign housing amount?	<input type="checkbox"/>	<input type="checkbox"/>
<b>STOP: If you have a qualifying child, answer question 7 and skip 8. If you do not have a qualifying child skip 7 and answer 8.*</b>		
7. • Did your qualifying child live with you in the United States for more than half the year (the whole year if an eligible foster child)? Includes military personnel on extended active duty outside the U.S.	<input type="checkbox"/>	<input type="checkbox"/>
• Answer <b>YES</b> if your qualifying child is also a qualifying child for another person and your modified AGI is higher than the other persons. Answer <b>YES</b> if your child is only a qualifying child for you.	<input type="checkbox"/>	<input type="checkbox"/>
• If your qualifying child is married, did you claim the child as a dependent? If your qualifying child is not married, check <b>YES</b> (See <b>Qualifying child who is married</b> in this chapter for an exception.)	<input type="checkbox"/>	<input type="checkbox"/>
<b>OR</b>		
8. • Was your main home (and your spouse's if filing a joint return) in the United States for more than half the year? Includes military personnel on extended active duty outside the U.S.	<input type="checkbox"/>	<input type="checkbox"/>
• Were you (or your spouse, if filing a joint return) at least age 25 but less than 65 at the end of your tax year?	<input type="checkbox"/>	<input type="checkbox"/>
• No one can claim you (or your spouse if filing a joint return) as a dependent on their return. If you (and your spouse if filing a joint return) are not eligible to be a dependent on anyone else's return, check <b>YES</b> . If you (or your spouse if filing a joint return) are eligible to be claimed as a dependent on someone else's return, check <b>NO</b> .	<input type="checkbox"/>	<input type="checkbox"/>

\* **PERSONS WITH A QUALIFYING CHILD:** If you answered **YES** to questions 1 through 7, you can claim the credit. Remember to fill out Schedule EIC and attach it to your return. Also, use the EIC Worksheet to figure your credit.

**PERSONS WITHOUT A QUALIFYING CHILD:** If you answered **YES** to questions 1 through 6 and 8, you can claim the credit. Use the EIC Worksheet to figure your credit. Remember, you can now use Form 1040EZ.

**IF YOU ANSWERED NO TO ANY QUESTION:** You are not eligible for the credit.

# 1996 Earned Income Credit (EIC) Table

Caution: This is not a tax table.

To find your credit: Read down the "At least — But less than" columns under the Earned Income Credit Worksheet column below and find the line that includes the amount entered on line 5 or 7, Form 1040EZ or Form 1040A EIC Worksheet, or line 6 or 8, Form 1040 EIC Worksheet. Then read across to the column that fits your circumstance and enter the credit from the column on line 6 or line 8, Form 1040EZ or 1040A EIC Worksheet, or line 7 or 9, Form 1040 EIC Worksheet.

INCOME FROM EIC WORKSHEET— SEE "To find your credit" above		And you have—			INCOME FROM EIC WORKSHEET— SEE "To find your credit" above		And you have—			INCOME FROM EIC WORKSHEET— SEE "To find your credit" above		And you have—			INCOME FROM EIC WORKSHEET— SEE "To find your credit" above		And you have—		
At least	But less than	No children	One child	Two children	At least	But less than	No children	One child	Two children	At least	But less than	No children	One child	Two children	At least	But less than	No children	One child	Two children
		Your credit is—					Your credit is—					Your credit is—					Your credit is—		
\$1	\$50	\$2	\$9	\$10	3,200	3,250	247	1,097	1,290	6,400	6,450	235	2,152	2,570	11,700	11,750	0	2,134	3,532
50	100	6	26	30	3,250	3,300	251	1,114	1,310	6,450	6,500	231	2,152	2,590	11,750	11,800	0	2,126	3,521
100	150	10	43	50	3,300	3,350	254	1,131	1,330	6,500	6,550	228	2,152	2,610	11,800	11,850	0	2,118	3,511
150	200	13	60	70	3,350	3,400	258	1,148	1,350	6,550	6,600	224	2,152	2,630	11,850	11,900	0	2,110	3,500
200	250	17	77	90	3,400	3,450	262	1,165	1,370	6,600	6,650	220	2,152	2,650	11,900	11,950	0	2,102	3,490
250	300	21	94	110	3,450	3,500	266	1,182	1,390	6,650	6,700	216	2,152	2,670	11,950	12,000	0	2,094	3,479
300	350	25	111	130	3,500	3,550	270	1,199	1,410	6,700	6,750	212	2,152	2,690	12,000	12,050	0	2,086	3,469
350	400	29	128	150	3,550	3,600	273	1,216	1,430	6,750	6,800	208	2,152	2,710	12,050	12,100	0	2,078	3,458
400	450	33	145	170	3,600	3,650	277	1,233	1,450	6,800	6,850	205	2,152	2,730	12,100	12,150	0	2,070	3,448
450	500	36	162	190	3,650	3,700	281	1,250	1,470	6,850	6,900	201	2,152	2,750	12,150	12,200	0	2,062	3,437
500	550	40	179	210	3,700	3,750	285	1,267	1,490	6,900	6,950	197	2,152	2,770	12,200	12,250	0	2,054	3,426
550	600	44	196	230	3,750	3,800	289	1,284	1,510	6,950	7,000	193	2,152	2,790	12,250	12,300	0	2,046	3,416
600	650	48	213	250	3,800	3,850	293	1,301	1,530	7,000	7,050	189	2,152	2,810	12,300	12,350	0	2,038	3,405
650	700	52	230	270	3,850	3,900	296	1,318	1,550	7,050	7,100	186	2,152	2,830	12,350	12,400	0	2,030	3,395
700	750	55	247	290	3,900	3,950	300	1,335	1,570	7,100	7,150	182	2,152	2,850	12,400	12,450	0	2,022	3,384
750	800	59	264	310	3,950	4,000	304	1,352	1,590	7,150	7,200	178	2,152	2,870	12,450	12,500	0	2,014	3,374
800	850	63	281	330	4,000	4,050	308	1,369	1,610	7,200	7,250	174	2,152	2,890	12,500	12,550	0	2,006	3,363
850	900	67	298	350	4,050	4,100	312	1,386	1,630	7,250	7,300	170	2,152	2,910	12,550	12,600	0	1,998	3,353
900	950	71	315	370	4,100	4,150	316	1,403	1,650	7,300	7,350	166	2,152	2,930	12,600	12,650	0	1,990	3,342
950	1,000	75	332	390	4,150	4,200	319	1,420	1,670	7,350	7,400	163	2,152	2,950	12,650	12,700	0	1,982	3,332
1,000	1,050	78	349	410	4,200	4,250	323	1,437	1,690	7,400	7,450	159	2,152	2,970	12,700	12,750	0	1,974	3,321
1,050	1,100	82	366	430	4,250	4,300	323	1,454	1,710	7,450	7,500	155	2,152	2,990	12,750	12,800	0	1,966	3,311
1,100	1,150	86	383	450	4,300	4,350	323	1,471	1,730	7,500	7,550	151	2,152	3,010	12,800	12,850	0	1,958	3,300
1,150	1,200	90	400	470	4,350	4,400	323	1,488	1,750	7,550	7,600	147	2,152	3,030	12,850	12,900	0	1,950	3,290
1,200	1,250	94	417	490	4,400	4,450	323	1,505	1,770	7,600	7,650	143	2,152	3,050	12,900	12,950	0	1,942	3,279
1,250	1,300	98	434	510	4,450	4,500	323	1,522	1,790	7,650	7,700	140	2,152	3,070	12,950	13,000	0	1,934	3,269
1,300	1,350	101	451	530	4,500	4,550	323	1,539	1,810	7,700	7,750	136	2,152	3,090	13,000	13,050	0	1,926	3,258
1,350	1,400	105	468	550	4,550	4,600	323	1,556	1,830	7,750	7,800	132	2,152	3,110	13,050	13,100	0	1,918	3,247
1,400	1,450	109	485	570	4,600	4,650	323	1,573	1,850	7,800	7,850	128	2,152	3,130	13,100	13,150	0	1,910	3,237
1,450	1,500	113	502	590	4,650	4,700	323	1,590	1,870	7,850	7,900	124	2,152	3,150	13,150	13,200	0	1,902	3,226
1,500	1,550	117	519	610	4,700	4,750	323	1,607	1,890	7,900	7,950	120	2,152	3,170	13,200	13,250	0	1,894	3,216
1,550	1,600	120	536	630	4,750	4,800	323	1,624	1,910	7,950	8,000	117	2,152	3,190	13,250	13,300	0	1,886	3,205
1,600	1,650	124	553	650	4,800	4,850	323	1,641	1,930	8,000	8,050	113	2,152	3,210	13,300	13,350	0	1,878	3,195
1,650	1,700	128	570	670	4,850	4,900	323	1,658	1,950	8,050	8,100	109	2,152	3,230	13,350	13,400	0	1,870	3,184
1,700	1,750	132	587	690	4,900	4,950	323	1,675	1,970	8,100	8,150	105	2,152	3,250	13,400	13,450	0	1,862	3,174
1,750	1,800	136	604	710	4,950	5,000	323	1,692	1,990	8,150	8,200	101	2,152	3,270	13,450	13,500	0	1,854	3,163
1,800	1,850	140	621	730	5,000	5,050	323	1,709	2,010	8,200	8,250	98	2,152	3,290	13,500	13,550	0	1,846	3,153
1,850	1,900	143	638	750	5,050	5,100	323	1,726	2,030	8,250	8,300	94	2,152	3,310	13,550	13,600	0	1,838	3,142
1,900	1,950	147	655	770	5,100	5,150	323	1,743	2,050	8,300	8,350	90	2,152	3,330	13,600	13,650	0	1,830	3,132
1,950	2,000	151	672	790	5,150	5,200	323	1,760	2,070	8,350	8,400	86	2,152	3,350	13,650	13,700	0	1,822	3,121
2,000	2,050	155	689	810	5,200	5,250	323	1,777	2,090	8,400	8,450	82	2,152	3,370	13,700	13,750	0	1,814	3,111
2,050	2,100	159	706	830	5,250	5,300	323	1,794	2,110	8,450	8,500	78	2,152	3,390	13,750	13,800	0	1,806	3,100
2,100	2,150	163	723	850	5,300	5,350	319	1,811	2,130	8,500	8,550	75	2,152	3,410	13,800	13,850	0	1,798	3,090
2,150	2,200	166	740	870	5,350	5,400	316	1,828	2,150	8,550	8,600	71	2,152	3,430	13,850	13,900	0	1,790	3,079
2,200	2,250	170	757	890	5,400	5,450	312	1,845	2,170	8,600	8,650	67	2,152	3,450	13,900	13,950	0	1,782	3,068
2,250	2,300	174	774	910	5,450	5,500	308	1,862	2,190	8,650	8,700	63	2,152	3,470	13,950	14,000	0	1,774	3,058
2,300	2,350	178	791	930	5,500	5,550	304	1,879	2,210	8,700	8,750	59	2,152	3,490	14,000	14,050	0	1,766	3,047
2,350	2,400	182	808	950	5,550	5,600	300	1,896	2,230	8,750	8,800	55	2,152	3,510	14,050	14,100	0	1,758	3,037
2,400	2,450	186	825	970	5,600	5,650	296	1,913	2,250	8,800	8,850	52	2,152	3,530	14,100	14,150	0	1,750	3,026
2,450	2,500	189	842	990	5,650	5,700	293	1,930	2,270	8,850	8,900	48	2,152	3,556	14,150	14,200	0	1,742	3,016
2,500	2,550	193	859	1,010	5,700	5,750	289	1,947	2,290	8,900	8,950	44	2,152	3,556	14,200	14,250	0	1,734	3,005
2,550	2,600	197	876	1,030	5,750	5,800	285	1,964	2,310	8,950	9,000	40	2,152	3,556	14,250	14,300	0	1,726	2,995
2,600	2,650	201	893	1,050	5,800	5,850	281	1,981	2,330	9,000	9,050	36	2,152	3,556	14,300	14,350	0	1,718	2,984
2,650	2,700	205	910	1,070	5,850	5,900	277	1,998	2,350	9,050	9,100	33	2,152	3,556	14,350	14,400	0	1,710	2,974
2,700	2,750	208	927	1,090	5,900	5,950	273	2,015	2,370	9,100	9,150	29	2,152	3,556	14,400	14,450	0	1,702	2,963
2,750	2,800	212	944	1,110	5,950	6,000	270	2,032	2,390	9,150	9,200	25	2,152	3,556	14,450	14,500	0	1,694	2,953
2,800	2,850	216	961	1,130	6,000	6,050	266	2,049	2,410	9,200	9,250	21	2,152	3,556	14,500	14,550	0	1,686	2,942
2,850	2,900	220	978	1,150	6,050	6,100	262	2,066	2,430	9,250	9,300	17	2,152	3,556	14,550	14,600	0	1,678	2,932
2,900	2,950	224	995	1,170	6,100	6,150	258	2,083	2,450	9,300	9,350	13	2,152	3,556	14,600	14,650	0	1,670	2,921
2,950	3,000	228																	

1996 Earned Income Credit (EIC) Table Continued (Not a tax table.)

INCOME FROM EIC WORKSHEET—SEE "To find your credit" above		And you have—			INCOME FROM EIC WORKSHEET—SEE "To find your credit" above		And you have—			INCOME FROM EIC WORKSHEET—SEE "To find your credit" above		And you have—			INCOME FROM EIC WORKSHEET—SEE "To find your credit" above		And you have—		
At least	But less than	No children	One child	Two children	At least	But less than	No children	One child	Two children	At least	But less than	No children	One child	Two children	At least	But less than	No children	One child	Two children
		Your credit is—					Your credit is—					Your credit is—					Your credit is—		
14,700	14,750	0	1,654	2,900	18,300	18,350	0	1,079	2,142	21,900	21,950	0	504	1,384	25,500	25,550	0	0	626
14,750	14,800	0	1,646	2,889	18,350	18,400	0	1,071	2,131	21,950	22,000	0	496	1,373	25,550	25,600	0	0	615
14,800	14,850	0	1,638	2,879	18,400	18,450	0	1,063	2,121	22,000	22,050	0	488	1,363	25,600	25,650	0	0	604
14,850	14,900	0	1,630	2,868	18,450	18,500	0	1,055	2,110	22,050	22,100	0	480	1,352	25,650	25,700	0	0	594
14,900	14,950	0	1,622	2,858	18,500	18,550	0	1,047	2,100	22,100	22,150	0	472	1,342	25,700	25,750	0	0	583
14,950	15,000	0	1,614	2,847	18,550	18,600	0	1,039	2,089	22,150	22,200	0	464	1,331	25,750	25,800	0	0	573
15,000	15,050	0	1,606	2,837	18,600	18,650	0	1,031	2,079	22,200	22,250	0	456	1,320	25,800	25,850	0	0	562
15,050	15,100	0	1,598	2,826	18,650	18,700	0	1,023	2,068	22,250	22,300	0	448	1,310	25,850	25,900	0	0	552
15,100	15,150	0	1,591	2,816	18,700	18,750	0	1,015	2,058	22,300	22,350	0	440	1,299	25,900	25,950	0	0	541
15,150	15,200	0	1,583	2,805	18,750	18,800	0	1,007	2,047	22,350	22,400	0	432	1,289	25,950	26,000	0	0	531
15,200	15,250	0	1,575	2,795	18,800	18,850	0	999	2,037	22,400	22,450	0	424	1,278	26,000	26,050	0	0	520
15,250	15,300	0	1,567	2,784	18,850	18,900	0	991	2,026	22,450	22,500	0	416	1,268	26,050	26,100	0	0	510
15,300	15,350	0	1,559	2,774	18,900	18,950	0	983	2,015	22,500	22,550	0	408	1,257	26,100	26,150	0	0	499
15,350	15,400	0	1,551	2,763	18,950	19,000	0	975	2,005	22,550	22,600	0	400	1,247	26,150	26,200	0	0	489
15,400	15,450	0	1,543	2,753	19,000	19,050	0	967	1,994	22,600	22,650	0	392	1,236	26,200	26,250	0	0	478
15,450	15,500	0	1,535	2,742	19,050	19,100	0	959	1,984	22,650	22,700	0	384	1,226	26,250	26,300	0	0	468
15,500	15,550	0	1,527	2,732	19,100	19,150	0	951	1,973	22,700	22,750	0	376	1,215	26,300	26,350	0	0	457
15,550	15,600	0	1,519	2,721	19,150	19,200	0	943	1,963	22,750	22,800	0	368	1,205	26,350	26,400	0	0	446
15,600	15,650	0	1,511	2,710	19,200	19,250	0	935	1,952	22,800	22,850	0	360	1,194	26,400	26,450	0	0	436
15,650	15,700	0	1,503	2,700	19,250	19,300	0	927	1,942	22,850	22,900	0	352	1,184	26,450	26,500	0	0	425
15,700	15,750	0	1,495	2,689	19,300	19,350	0	919	1,931	22,900	22,950	0	344	1,173	26,500	26,550	0	0	415
15,750	15,800	0	1,487	2,679	19,350	19,400	0	911	1,921	22,950	23,000	0	336	1,163	26,550	26,600	0	0	404
15,800	15,850	0	1,479	2,668	19,400	19,450	0	903	1,910	23,000	23,050	0	328	1,152	26,600	26,650	0	0	394
15,850	15,900	0	1,471	2,658	19,450	19,500	0	895	1,900	23,050	23,100	0	320	1,141	26,650	26,700	0	0	383
15,900	15,950	0	1,463	2,647	19,500	19,550	0	887	1,889	23,100	23,150	0	312	1,131	26,700	26,750	0	0	373
15,950	16,000	0	1,455	2,637	19,550	19,600	0	879	1,879	23,150	23,200	0	304	1,120	26,750	26,800	0	0	362
16,000	16,050	0	1,447	2,626	19,600	19,650	0	871	1,868	23,200	23,250	0	296	1,110	26,800	26,850	0	0	352
16,050	16,100	0	1,439	2,616	19,650	19,700	0	863	1,858	23,250	23,300	0	288	1,099	26,850	26,900	0	0	341
16,100	16,150	0	1,431	2,605	19,700	19,750	0	855	1,847	23,300	23,350	0	280	1,089	26,900	26,950	0	0	331
16,150	16,200	0	1,423	2,595	19,750	19,800	0	847	1,836	23,350	23,400	0	272	1,078	26,950	27,000	0	0	320
16,200	16,250	0	1,415	2,584	19,800	19,850	0	839	1,826	23,400	23,450	0	264	1,068	27,000	27,050	0	0	310
16,250	16,300	0	1,407	2,574	19,850	19,900	0	831	1,815	23,450	23,500	0	256	1,057	27,050	27,100	0	0	299
16,300	16,350	0	1,399	2,563	19,900	19,950	0	823	1,805	23,500	23,550	0	248	1,047	27,100	27,150	0	0	289
16,350	16,400	0	1,391	2,552	19,950	20,000	0	815	1,794	23,550	23,600	0	240	1,036	27,150	27,200	0	0	278
16,400	16,450	0	1,383	2,542	20,000	20,050	0	807	1,784	23,600	23,650	0	232	1,026	27,200	27,250	0	0	267
16,450	16,500	0	1,375	2,531	20,050	20,100	0	799	1,773	23,650	23,700	0	224	1,015	27,250	27,300	0	0	257
16,500	16,550	0	1,367	2,521	20,100	20,150	0	792	1,763	23,700	23,750	0	216	1,005	27,300	27,350	0	0	246
16,550	16,600	0	1,359	2,510	20,150	20,200	0	784	1,752	23,750	23,800	0	208	994	27,350	27,400	0	0	236
16,600	16,650	0	1,351	2,500	20,200	20,250	0	776	1,742	23,800	23,850	0	200	984	27,400	27,450	0	0	225
16,650	16,700	0	1,343	2,489	20,250	20,300	0	768	1,731	23,850	23,900	0	192	973	27,450	27,500	0	0	215
16,700	16,750	0	1,335	2,479	20,300	20,350	0	760	1,721	23,900	23,950	0	184	962	27,500	27,550	0	0	204
16,750	16,800	0	1,327	2,468	20,350	20,400	0	752	1,710	23,950	24,000	0	176	952	27,550	27,600	0	0	194
16,800	16,850	0	1,319	2,458	20,400	20,450	0	744	1,700	24,000	24,050	0	168	941	27,600	27,650	0	0	183
16,850	16,900	0	1,311	2,447	20,450	20,500	0	736	1,689	24,050	24,100	0	160	931	27,650	27,700	0	0	173
16,900	16,950	0	1,303	2,437	20,500	20,550	0	728	1,679	24,100	24,150	0	152	920	27,700	27,750	0	0	162
16,950	17,000	0	1,295	2,426	20,550	20,600	0	720	1,668	24,150	24,200	0	144	910	27,750	27,800	0	0	152
17,000	17,050	0	1,287	2,416	20,600	20,650	0	712	1,657	24,200	24,250	0	136	899	27,800	27,850	0	0	141
17,050	17,100	0	1,279	2,405	20,650	20,700	0	704	1,647	24,250	24,300	0	128	889	27,850	27,900	0	0	131
17,100	17,150	0	1,271	2,395	20,700	20,750	0	696	1,636	24,300	24,350	0	120	878	27,900	27,950	0	0	120
17,150	17,200	0	1,263	2,384	20,750	20,800	0	688	1,626	24,350	24,400	0	112	868	27,950	28,000	0	0	110
17,200	17,250	0	1,255	2,373	20,800	20,850	0	680	1,615	24,400	24,450	0	104	857	28,000	28,050	0	0	99
17,250	17,300	0	1,247	2,363	20,850	20,900	0	672	1,605	24,450	24,500	0	96	847	28,050	28,100	0	0	88
17,300	17,350	0	1,239	2,352	20,900	20,950	0	664	1,594	24,500	24,550	0	88	836	28,100	28,150	0	0	78
17,350	17,400	0	1,231	2,342	20,950	21,000	0	656	1,584	24,550	24,600	0	80	826	28,150	28,200	0	0	67
17,400	17,450	0	1,223	2,331	21,000	21,050	0	648	1,573	24,600	24,650	0	72	815	28,200	28,250	0	0	57
17,450	17,500	0	1,215	2,321	21,050	21,100	0	640	1,563	24,650	24,700	0	64	805	28,250	28,300	0	0	46
17,500	17,550	0	1,207	2,310	21,100	21,150	0	632	1,552	24,700	24,750	0	56	794	28,300	28,350	0	0	36
17,550	17,600	0	1,199	2,300	21,150	21,200	0	624	1,542	24,750	24,800	0	48	783	28,350	28,400	0	0	25
17,600	17,650	0	1,191	2,289	21,200	21,250	0	616	1,531	24,800	24,850	0	40	773	28,400	28,450	0	0	15
17,650	17,700	0	1,183	2,279	21,250	21,300	0	608	1,521	24,850	24,900	0	32	762	28,450	28,495	0	0	5
17,700	17,750	0	1,175	2,268	21,300	21,350	0	600	1,510	24,900	24,950	0	24	752	28,495 or more	0	0	0	
17,750	17,800	0	1,167	2,258	21,350	21,400	0	592	1,499	24,950	25,000	0	16	741					
17,800	17,850	0	1,159	2,247	21,400	21,450	0	584	1,489	25,000	25,050	0	8	731					
17,850	17,900	0	1,151	2,237	21,450	21,500	0	576	1,478	25,050	25,100	0	*	720					
17,900	17,950	0																	

## Other Credits

### Important Changes for 1996

**Excess withholding of social security tax and tier 1 railroad retirement tax.** Social security and railroad retirement tax (RRTA) were both withheld at a rate of 6.2% on the first \$62,700 of wages in 1996. If you had two or more employers and they withheld too much social security or RRTA tax during 1996, you may be entitled to a credit of the excess withholding. For more information about the credit and how to get it, see *Credit for Excess Social Security Tax or Railroad Retirement Tax Withheld*.

**Credit on Diesel-Powered Highway Vehicles.** The credit allowed to purchasers of diesel-powered highway vehicles has been repealed. If you purchased a diesel-powered highway vehicle after August 20, 1996, you are not entitled to the credit.

### Important Change for 1997

**Adoption Credit.** Beginning in 1997 you may be able to claim a nonrefundable credit of up to \$5,000 (\$6,000 for certain special needs children) for expenses paid for adopting a child. For more information about this credit, get Publication 553, *Highlights of 1996 Tax Changes*.



You cannot take this credit on your 1996 tax return.

## Introduction

In addition to the child and dependent care credit (Chapter 33), the credit for the elderly or the disabled (Chapter 34), and the earned income credit (Chapter 35) you may be able to claim other tax credits. This chapter is divided into two parts and discusses seven credits in the following order.

- 1) Part 1, Nonrefundable Credits:
  - Credit for prior year minimum tax,
  - Mortgage interest credit,
  - Credit for electric vehicles, and
  - Foreign tax credit.
- 2) Part 2, Refundable Credits:
  - Credit for excess social security tax or railroad retirement tax withheld,

- Credit from a regulated investment company, and
- Credit on diesel-powered highway vehicles.

**Nonrefundable credits.** The first part of the chapter, *Nonrefundable Credits*, covers four credits that you subtract directly from your tax. These credits may reduce your tax to zero. If these credits are more than your tax, the excess is not refunded to you.

**Refundable credits.** The second part of this chapter, *Refundable Credits*, covers three credits that are refundable to you and treated as payments. These credits are added to the federal income tax withheld and any estimated tax payments you made. If this total is more than your total tax, the excess will be refunded to you.

### Useful Items

You may want to see:

#### Publication

- 378** Fuel Tax Credits and Refunds
- 514** Foreign Tax Credit for Individuals
- 564** Mutual Fund Distributions
- 936** Home Mortgage Interest Deduction

#### Form (and Instructions)

- 1040** U.S. Individual Income Tax Return
- 1116** Foreign Tax Credit (Individual, Estate, Trust, or Nonresident Alien Individual)
- 2439** Notice to Shareholder of Undistributed Long-Term Capital Gains
- 4136** Credit for Federal Tax Paid on Fuels
- 8396** Mortgage Interest Credit
- 8801** Credit For Prior Year Minimum Tax—Individuals, Estates, and Trusts
- 8828** Recapture of Federal Mortgage Subsidy
- 8834** Qualified Electric Vehicle Credit

## Nonrefundable Credits

The following credits are discussed in this part:

- Credit for prior year minimum tax
- Mortgage interest credit
- Credit for electric vehicles
- Foreign tax credit.

## Credit for Prior Year Minimum Tax

The tax laws give special treatment to some kinds of income and allow special deductions and credits for some kinds of expenses. If you benefit from these laws, you may have to pay at least a minimum amount of tax. This is called the alternative minimum tax.

The special treatment of some items of income and expenses only allows you to postpone paying tax until a later year. It does not allow you to completely avoid the tax. In these situations, you may be able to claim a credit for prior year minimum tax against your current year's tax. The amount of the credit cannot reduce your current year's tax below your current year's tentative alternative minimum tax.

You may be able to take a credit against your regular tax if you:

- 1) Paid alternative minimum tax in 1995,
- 2) Had an unused minimum tax credit that you are carrying forward from 1995 to 1996, or
- 3) Had certain unallowed nonconventional-source fuel, orphan drug, or qualified electric vehicle credits in 1995.

**Credit amount.** The credit is generally the amount of alternative minimum tax you actually paid in 1995 reduced by the part of it generated by exclusion items. Add to this any:

- 1) Credit carried forward,
- 2) Unallowed nonconventional-source fuel credit,
- 3) Unallowed orphan drug credit, and
- 4) Unallowed electric vehicle credit.

**Exclusion items.** These are adjustments and preference items that result in the permanent exclusion of income for regular tax purposes. The exclusion items are:

- The standard deduction,
- Medical and dental expenses,
- Miscellaneous itemized deductions,
- Taxes,
- Interest expense,
- Exclusion for gains on sale of certain small business stock,
- Tax-exempt interest from certain private activity bonds, and
- Depletion.

**Reduction for canceled debt.** You may have to reduce the credit if you exclude from income a debt canceled after 1993:

- In a bankruptcy case,
- When you are insolvent,
- That was a qualified farm debt, or
- That was a qualified real property business debt.

If you have to reduce the credit, you must reduce the amount available at the beginning of the year after the debt was canceled. For more information, see Publication 908, *Bankruptcy Tax Guide*.

**How to claim the credit.** Figure your 1996 credit and any carryforward to 1997 on **Form 8801**, and attach it to your Form 1040. Include the credit in your total for line 43, Form 1040, and check box c. You can carry forward any unused credit for prior year minimum tax to later years until it is completely used.

For additional information about the credit, see the instructions for Form 8801.

## Mortgage Interest Credit

Mortgage credit certificates issued by state and local governments may entitle a certificate holder to a mortgage interest credit. The certificate must be used in connection with the purchase, qualified rehabilitation, or qualified home improvement of the certificate holder's main home.

**Who qualifies.** You may be able to claim a mortgage interest credit if you were issued a mortgage credit certificate (MCC) under a qualified MCC program. The MCC must relate to your main home.

**Amount of credit.** You figure the credit by multiplying the certificate credit rate by the lesser of the interest you paid during the year on your actual loan amount (mortgage) or the interest you paid on the loan amount shown on your MCC. The certificate credit rate and the maximum loan amount are shown on the MCC.

**Limit.** If the certificate credit rate is more than 20%, the credit cannot be more than \$2,000.

**Dividing the credit.** If two or more persons (other than a married couple filing a joint return) hold an interest in the home to which the MCC relates, the credit must be divided based on the interest held by each person.

**Example.** John and his brother, George, were issued an MCC. They used the certificate to obtain a mortgage on a home that is their main home. John has a 60% interest and George has a 40% interest. John paid \$5,400 mortgage interest and George paid \$3,600.

The MCC shows a credit rate of 25% and a maximum loan amount of \$65,000. Their actual mortgage loan is \$60,000, which is less than the \$65,000 maximum. However, their combined credit is limited to \$2,000 because the credit rate is more than 20%.

John's credit is limited to \$1,200 ( $\$2,000 \times 60\%$ ). He figures the credit by multiplying the interest he paid (\$5,400) by the certificate credit rate (25%) for a total of \$1,350. However, his credit is limited to the \$1,200 above.

George's credit is limited to \$800 ( $\$2,000 \times 40\%$ ). He figures the credit by multiplying

the interest he paid (\$3,600) by the certificate credit rate (25%) for a total of \$900. His credit is limited to the \$800 above.

**Carryforward.** If your allowable credit is more than your tax liability reduced by certain credits, you can carry forward the unused portion of the credit to your next 3 tax years or until used, whichever comes first.

If you are subject to the \$2,000 limit because your certificate credit rate is more than 20%, no amount over the \$2,000 (or your prorated share of the \$2,000 if you must allocate the credit) may be carried forward.

**How to claim the credit.** Figure the credit and any carryforward to next year on **Form 8396**, and attach it to your Form 1040. Be sure to include any carryforward from 1993, 1994, and 1995. You cannot use a carryforward from 1993 on your tax return for any year after 1996.

Include the credit in your total for line 43 (Form 1040), and check box b.

**Reduced home mortgage interest deduction.** If you itemize your deductions on Schedule A (Form 1040), reduce your home mortgage interest deduction by the amount on line 3 of Form 8396, even if part of that amount is to be carried forward to 1997. For more information about the home mortgage interest deduction, see Chapter 25.

**Recapture of Federal mortgage subsidy.** If you closed on a mortgage from a qualified mortgage bond program and received a mortgage credit certificate after December 31, 1990, you may be subject to a recapture rule. The recapture would generally occur if you sold or disposed of your home during the first 9 years following the date of closing. See Publication 523, *Selling Your Home*, for more information.

## Credit for Electric Vehicles

You may be allowed a 10% tax credit if you placed a qualified electric vehicle in service during the year.

**Qualified electric vehicle.** This is a motor vehicle that:

- 1) Has at least four wheels and is manufactured for use on public streets, roads, and highways.
- 2) Is powered *primarily* by an electric motor that draws its power from rechargeable batteries, fuel cells, or other portable sources of electrical current.
- 3) Is originally used by you.
- 4) Is acquired for your own use, not for resale.

**Amount of credit.** The credit is equal to 10% of the cost of the vehicle. However, if the vehicle is a depreciable business asset, you must reduce the cost by any section 179

deduction before figuring the credit. Get Publication 463, *Travel, Entertainment, Gift, and Car Expenses* for information on the section 179 deduction.

The credit is limited to \$4,000 for each vehicle.

**Special rules.** You cannot take the credit if you use the vehicle predominately outside the United States.

The credit will be subject to recapture if, within 3 years after the date you place the vehicle in service, the vehicle is used predominately outside the United States or is modified so that it is no longer eligible for the credit.

**How to claim the credit.** To claim the credit, complete **Form 8834**, and attach it to your Form 1040. Include the credit in your total for line 43, check box d, and write "8834" on the line next to box d.

## Foreign Tax Credit

You generally can choose to claim income taxes you paid or accrued during the year to a foreign country or U.S. possession as a credit against your U.S. income tax. Or, you can deduct them as an itemized deduction.

To take the foreign tax credit, complete **Form 1116** and attach it to your Form 1040. Enter the credit on line 41, Form 1040. For more information, get Publication 514.

## Refundable Credits

The following credits are refundable and are treated as payments of tax:

- Credit for excess social security tax or railroad retirement tax withheld,
- Credit from a regulated investment company, and
- Credit on diesel-powered highway vehicles.

## Credit for Excess Social Security Tax or Railroad Retirement Tax Withheld

Most employers must withhold social security tax from your wages. Certain government employers (some federal, state, and local governments) do not have to withhold social security tax.

If you work for a railroad employer, that employer must withhold tier 1 railroad retirement (RRTA) tax and tier 2 RRTA tax.

If you worked for two or more employers in 1996, too much social security tax or RRTA may have been withheld from your pay. You can claim the excess as a credit against your income tax. The following table shows the maximum amount of wages subject to tax and the maximum amount of tax that should have been withheld in 1996.

Type of Tax	Maximum wages subject to tax	Maximum tax that should have been withheld
Social Security		
RRTA tier 1	\$62,700.00	\$3,887.40
RRTA tier 2	\$46,500.00	\$2,278.50

**Note.** All wages are subject to Medicare tax withholding.

**One employer.** If any one employer withheld social security or RRTA tax that exceeded the amounts in the preceding table, you cannot claim the extra amount withheld by that employer as a credit against your income tax. Your employer must adjust this for you.

**Joint return.** If you are filing a joint return, you cannot add the social security or RRTA tax withheld from your spouse's wages to the amount withheld from your wages. Figure the credit separately for both you and your spouse to determine if either of you has excess withholding.

**How to claim the credit.** If you file Form 1040, enter the credit on line 56. If you file Form 1040A, include the credit in the total on line 29d. Write "Excess SST" and show the amount of the credit in the space to the left of the line.

**Note.** You cannot claim the credit for excess social security or railroad retirement tax on Form 1040EZ.

**How to figure the credit if you did not work for a railroad.** If you did not work for a railroad during 1996, figure the credit as follows:

1. Add all social security tax withheld (but not more than \$3,887.40 for each employer). Enter the total here .....
2. Enter any uncollected social security tax on tips or group-term life insurance included in the total on Form 1040, line 51 .....
3. Add lines 1 and 2. If \$3,887.40 or less, stop here. You cannot claim the credit .....
4. Social security tax limit ..... 3,887.40
5. Credit. Subtract line 4 from line 3. Enter the result here and on Form 1040, line 56 (or Form 1040A, line 29d) .....

**Example.** You are married and file a joint return with your spouse who had no gross income in 1996. During 1996 you worked for the Brown Shoe Company and earned \$45,000 in wages. Social security tax of \$2,790 was withheld. You also worked for another employer in 1996 and earned \$35,000 in wages. \$2,170 of social security tax was withheld from these wages. Because you worked for more than one employer and your total wages were more than \$62,700, you can claim a credit of \$1,072.60 for the excess social security tax withheld.

1. Add all social security tax withheld (but not more than \$3,887.40 for each employer). Enter the total here ..... \$ 4,960.00
2. Enter any uncollected social security tax on tips or group-term life insurance included in the total on Form 1040, line 51 ..... -0-
3. Add lines 1 and 2. If \$3,887.40 or less, stop here. You cannot claim the credit ..... 4,960.00
4. Social security tax limit ..... 3,887.40
5. Credit. Subtract line 4 from line 3. Enter the result here and on Form 1040, line 56 (or Form 1040A, line 29d) ..... \$ 1,072.60

**How to figure the credit if you worked for a railroad.** If you were a railroad employee during 1996, figure the credit as follows:

1. Add all social security and tier 1 RRTA tax withheld (but not more than \$3,887.40 for each employer). Enter the total here .....
2. Enter any uncollected social security and tier 1 RRTA tax on tips or group-term life insurance included in the total on Form 1040, line 51 .....
3. Add lines 1 and 2. If \$3,887.40 or less, enter -0- on line 5 and go to line 6 .....
4. Social security and tier 1 RRTA tax limit ..... 3,887.40
5. Subtract line 4 from line 3 .....
6. Add all tier 2 RRTA tax withheld (but not more than \$2,278.50 for each employer). Enter the total here .....
7. Enter any uncollected tier 2 railroad retirement tax on tips or group-term life insurance included in the total on Form 1040, line 51 .....

8. Add lines 6 and 7. If \$2,278.50 or less, enter -0- on line 10 and go to line 11 .....
9. RRTA tier 2 limit ..... 2,278.50
10. Subtract line 9 from line 8 .....
11. Credit. Add lines 5 and 10. Enter the result here and on Form 1040, line 56 (or Form 1040A, line 29d) .....

## Credit from a Regulated Investment Company

You must include in your income any amounts that an investment company (for example, a mutual fund) allocated to you as capital gain distributions, even if you did not actually receive them. If the investment company paid a tax on the capital gain, you are allowed a credit for the tax since it is considered paid by you. The company will send you **Form 2439** showing the undistributed capital gains amount and the tax paid, if any. Claim the credit by entering the amount on line 57, Form 1040, and checking box a. Also attach Copy B of Form 2439 to your return. See *Capital Gain Distributions* in Chapter 9 for more information on undistributed capital gains.

## Credit on Diesel-Powered Highway Vehicles

If you purchased a diesel-powered highway vehicle before August 21, 1996, you may be entitled to a **one-time** credit if:

- 1) You are the first owner of the vehicle, and
- 2) You did not purchase the vehicle for the purpose of reselling it.

**Amount of credit.** The credit is \$102 if you purchased a diesel-powered automobile or \$198 if you purchased a diesel-powered light van or truck.

**How to claim the credit.** To claim the credit, complete **Form 4136** and attach it to Form 1040. Enter the credit on line 57, Form 1040, and check box b.

For more information, see the discussion of *Diesel-Powered Highway Vehicles* in Publication 378.

# Part Seven.

## Sample Returns

*The three chapters in this part give examples of filled-in tax returns. Chapter 37 illustrates Form 1040EZ. Chapter 38 illustrates Form 1040A with some of the schedules that may need to be filled out and filed with it. Chapter 39 illustrates Form 1040 with many of the schedules and forms that may need to be filled out and filed with it.*

### 37.

## Form 1040EZ

### Introduction

This chapter gives an example of how to fill out Form 1040EZ. The example uses the situation of Pat Brown who is single and a student. Her completed return is at the end of the chapter.

Pat Brown is single and does not have any children or dependents. She is 26 years old and has been a full-time student at State University since January 1996. She is trying to earn a teaching degree and has a scholarship that covers her tuition and \$1,000 of her room and board. Her parents cannot claim her as a dependent; nor can anyone else do so. In January of this year, she received a Form W-2 that shows she earned \$5,500 in wages and had \$150 in federal income tax withheld. She also received a 1996 Form 1099-INT showing she had \$270 in interest income.

Pat filed Form 1040EZ for 1995, so the IRS sent her the TeleFile package this year. Because she has taxable income not reported on Form W-2, Pat cannot use TeleFile. She decides to use Form 1040EZ again for 1996.

To make processing her return quicker and to speed her refund, Pat prints (does not type) her numbers and keeps them inside the boxes on her Form 1040EZ. She does not use dollar signs.

### Use the IRS Label (Name, Address, and Social Security Number)

Pat uses the mailing label that came with her forms package. The label has her name, address, and social security number. She does not put the label on her tax return until the return is completed and she is sure the return and label are accurate.

Pat could use the label even if some of the information on it was incorrect. She would make the necessary changes directly

on the label and then place it on her completed return.

**Presidential Election Campaign Fund.** Pat wants \$3 of her taxes to go to this fund, so she checks the "Yes" box. Checking "Yes" will not change her tax or reduce her refund.

### Income

Pat has two items of income which must be combined and entered on line 1 of Form 1040EZ. The part of her scholarship that is for room and board (\$1,000) is taxable. She adds this amount to her wages (\$5,500), which are shown in box 1 of her Form W-2. Pat enters the total (6,500) on line 1. She prints "SCH" in the space to the right of the words "W-2 form(s) on line 1." After "SCH" she shows the taxable amount (\$1,000) of her scholarship.

On line 2, she enters her interest income of 270. She adds her wages, taxable scholarship, and interest together to figure her adjusted gross income of \$6,770. She enters 6,770 on line 4.

**Standard deduction and personal exemption.** Because Pat cannot be claimed as a dependent by her parents or anyone else, she checks the "No" box and enters 6,550 on line 5. This is the total of her standard deduction (\$4,000) and her personal exemption (\$2,550).

If Pat could have been claimed as a dependent by her parents or anyone else (even if they chose not to claim her as a dependent), she would check the "Yes" box on line 5. She would use the worksheet on the back of Form 1040EZ to figure her standard deduction. She could not claim an exemption for herself.

Pat subtracts line 5 (6,550) from line 4 (6,770) and enters the result of 220 on line 6. This amount is Pat's taxable income which is used to figure her income tax.

### Payments and Tax (Figure Your Tax and Credit)

Pat had \$150 of federal income tax withheld from her wages by her employer. She found this amount in box 2 of her 1996 Form W-2. She enters 150 on line 7 of Form 1040EZ.

Pat reads the instructions for line 8 to see if she can take the earned income credit, and finds that she can. Because she does not have any nontaxable earned income to enter in the spaces marked **Type** and **\$** on line 8, she leaves those spaces blank.

**Note.** If Pat wanted the IRS to compute her tax and credit for her, she would stop at this point. She would make sure lines 1 through 7 were accurately completed. Then she would print "EIC" in the space to the right of the words "earned income below," skip lines 9 through 12, sign and date the return, and enter her occupation. Finally, she would attach the first copy or Copy B of her W-2 form to her return and mail it by April 15, 1997.

Pat decides to figure the tax and credit herself. After completing line 7 and leaving the **Type** and **\$** spaces blank on line 8, she figures the amount of her credit by completing the *Earned income credit worksheet* that is in the Form 1040EZ instructions under *Line 8 Earned income credit (EIC)*. A copy of her completed worksheet is shown at the end of this chapter. The amount of her credit is \$208. She enters 208 on line 8, Form 1040EZ. Next, she adds line 7 (federal income tax withheld) to line 8 (earned income credit) and enters the total (358) on line 9.

To complete line 10, she takes the amount on line 6, her taxable income of 220, and goes to the Tax Table. She reads down the income column of the Tax Table until she finds the line that includes her taxable income shown on line 6 of her Form 1040EZ.

She reads across the line to find the Single column. The amount shown at the point where the income line and the filing status column meet is her tax (32).

She enters this amount on line 10 of her Form 1040EZ.

### Refund or Amount You Owe

Pat compares line 9 and line 10. Because line 9 is larger, she subtracts line 10 (32) from line 9 (358) to arrive at her refund of 326. She enters this amount on line 11a. Pat will receive a tax refund of \$326.

**Direct deposit.** Instead of getting a paper check, Pat wants to have her refund deposited directly into her bank account. She

reads the section on direct deposit of refunds in the Form 1040EZ instructions and completes lines 11b through 11d.

**If tax is owed.** If Pat did not qualify for the earned income credit and her employer had not withheld any federal income tax from her wages, Pat would have owed \$32 in income tax. She would have been instructed to enter that amount on line 12. She would then include a check or money order for the full amount of \$32, payable to “Internal Revenue Service.” She would write on the front of her check or money order:

Her name,

Her address,

Her social security number,

Her daytime telephone number, and

“1996 Form 1040EZ.”

---

## Sign Your Return

Pat goes back over her return to make sure that she entered the numbers clearly and correctly and that the math is accurate.

Pat signs and dates her return and enters her occupation in the spaces provided at the bottom of the form. Now that she has filled in her Form 1040EZ, she takes her peel-off address label from inside her forms package and, after checking it for accuracy (and making any corrections), places it in the address

portion at the top of her return. She attaches Copy B of her Form W-2 to the location indicated on the front of Form 1040EZ.

She makes a copy of her filled-in tax return for her records. Then she uses the envelope that came with her forms package to mail her return to the service center.

A filled-in copy of Pat's earned income credit worksheet and tax return follows.



**Filled-In Form 1040EZ - EIC Worksheet**

If you need more information, turn to the page shown in the circle.

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**Earned Income Credit Worksheet—Line 8 (keep for your records)**



**Caution:** If you were a household employee who did not receive a Form W-2 because your employer paid you less than \$1,000 in 1996, see **Special Rules** on page 10 before completing this worksheet. Also, see **Special Rules** if Form 1040EZ, line 1, includes any amount paid to an inmate in a penal institution.

- 1. Enter the amount from Form 1040EZ, line 1 . . . . . 1. 6,500
- 2. If you received a taxable scholarship or fellowship grant that was not reported on a W-2 form, enter that amount here . . . . . 2. 1,000
- 3. Subtract line 2 from line 1 <sup>(265)</sup> . . . . . 3. 5,500
- 4. Enter any nontaxable earned income (see page 9). Types of nontaxable earned income include contributions to a 401(k) plan, and military housing and subsistence. These should be shown in box 13 of your W-2 form . . . . . 4. \_\_\_\_\_
- 5. Add lines 3 and 4 . . . . . 5. 5,500

**Caution:** If line 5 is \$9,500 or more, you cannot take the credit. Print "No" to the right of the word "below" on line 8 of Form 1040EZ.

- 6. Look up the amount on line 5 above in the EIC Table on page 12 to find your credit. Enter the credit here . . . . . 6. 304
- 7. Enter the amount from Form 1040EZ, line 4 . . . . . 7. 6,770

- 8. Is line 7 \$5,300 or more? <sup>(275)</sup>
  - Yes. Look up the amount on line 7 above in the EIC Table on page 12 to find your credit. Enter the credit here . . . . . 8. 208
  - No. Go to line 9.

- 9. **Earned income credit.**
  - If you checked "Yes" on line 8, enter the smaller of line 6 or line 8.
  - If you checked "No" on line 8, enter the amount from line 6 . . . . . 9. 208

**Next:** Take the amount from line 9 above and enter it on Form 1040EZ, line 8.

**AND**

If you had any nontaxable earned income (see line 4 above), enter the type and amount of that income in the spaces marked "Type" and "\$" to the left of line 8.

# Form 1040A

## Introduction

This chapter gives an example of how to fill out Form 1040A. The example uses the situation of Don and Jean Smith, a married couple with two young children. Their completed return is at the end of the chapter.

## Name, Address, and Social Security Number

The Smiths filed Form 1040A for 1995 so the IRS sent them the Form 1040A tax package this year. Since they meet all the requirements for using Form 1040A (see *Which Form Should I Use?* in Chapter 1), they decide to use it again for 1996.

Don and Jean use the label that came with their forms package. The label has their names, address, and social security numbers. They check the label to make sure it is correct, but they do not put it on the return until they have completed and checked the return to make sure it is accurate. Because they use the label, their tax return can be processed faster.

The Smiths should use the label even if some of the information on it is incorrect. They would make any necessary changes directly on the label.

**Presidential Election Campaign Fund.** Don and Jean each want \$3 of their tax to go to this fund. They check both *Yes* boxes. Checking *Yes* does not increase their tax or reduce their refund.

## Filing Status

Don and Jean must choose their filing status before they figure their tax liability.

**Filing status (lines 1–5).** Don and Jean check the box on line 2 to file a joint return.

## Exemptions

Don and Jean must indicate the number of exemptions they can claim.

**Exemptions (lines 6a–d).** Don and Jean can take two personal exemptions, one for each of them. They claim these exemptions by checking the boxes on lines 6a and 6b and enter the total, “2,” in the box at the

right. On line 6c, column 1, they write their children’s names and enter “02” in the box for “lived with you” at the right.

Because both of their children were born before December 1996, they write Lynn’s and Todd’s social security numbers in column 2. They write their children’s relationship to them (daughter and son) in column 3. They enter “12” in column 4 for each child since their daughter lived with them all year and their son was born during the year. They do not have any other dependents, so in the box on line 6d they enter “04” as the total number of exemptions.

## Total Income

Don worked full time as a carpenter during 1996. Jean worked full time as a secretary until September when she was laid off. She received a distribution from her company’s profit-sharing plan and also received unemployment compensation. Don and Jean report their income on **lines 7–13b** and total it on **line 14**.

**Wages (line 7).** Don’s Form W–2, *Wage and Tax Statement*, shows he earned \$22,250 in 1996. Jean’s Form W–2 shows she earned \$12,155. They find these amounts in box 1 of their Forms W–2. They add the amounts and put the total, \$34,405, on line 7.

**Interest income (lines 8a–b and Part I of Schedule 1).** Don and Jean received a statement (Form 1099–INT) from Hometown Savings Bank showing they earned \$410 of taxable interest income last year. Because their interest income is over \$400, they must list the name of the bank and the amount received in Part I of Schedule 1. They also enter this amount on line 8a of Form 1040A. Don and Jean also received \$35 of tax-exempt interest from a municipal bond. They enter \$35 on line 8b. This amount does not increase their taxable income.

**Dividends (line 9).** Don and Jean opened an account in a mutual fund last year. They received a statement (Form 1099–DIV) from the fund showing they earned dividends of \$20. They also received a Form 1099–DIV from the XYZ Corporation showing they earned dividends of \$80 last year. Because the total amount of their dividends is not over \$400, they do not have to list them in Part II of Schedule 1. They enter the total amount of their dividends, \$100, on line 9 of Form 1040A.

**Pensions (lines 11a–b).** Jean received Form 1099–R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.* from her employer’s profit-sharing plan showing a distribution of \$2,250 in box 1. Box 2a shows -0- and box 7 shows Code **G**.

Before the distribution was made, Jean received an explanation from the plan administrator that advised her that the distribution would be tax free with no withholding if she elected a direct rollover into an eligible retirement plan, including an IRA. Jean, age 40, made the election to transfer the distribution directly to her IRA. The plan administrator made the transfer directly into her IRA account. This transfer qualifies as a tax-free rollover under the rules described in Chapter 11.

Jean reports \$2,250 on line 11a and \$0 on line 11b. Because she rolled over the entire distribution into her IRA, Jean does not file Form 5329 or pay the 10% tax on early distributions.

**Unemployment compensation (line 12).** Jean received Form 1099–G, *Certain Government Payments*, from her state, showing \$1,010 in unemployment compensation. She enters this amount on line 12.

**Nontaxable income.** Don and Jean also received a Form 1099–G showing a \$100 1995 state tax refund they received in 1996. Because they did not itemize deductions on their 1995 federal return, they do not report the refund as income in 1996. If they had itemized, part or all of the refund may have had to be included in income.

**Total (line 14).** Their total income is the sum of the amounts shown on lines 7, 8a, 9, and 12. Don and Jean add these amounts and enter the total, \$35,925, on line 14.

## Adjusted Gross Income

Don and Jean figure their **adjusted gross income** on **lines 15 and 16**.

**IRA deduction (lines 15a–c).** In 1996, Don contributed \$750 to his IRA and Jean contributed \$650 to hers. Jean also contributed an additional \$100 to her IRA in January 1997 and asked that it be counted for 1996. They complete lines 1–3 of *IRA Worksheet 1* (as shown later) in their forms instruction package to figure how much of their contributions they can deduct. The entire amount of their contributions to both IRAs is deductible. They enter \$750 for Don on line 15a and \$750 for Jean on line 15b. The sum of their IRA contributions to both IRAs, \$1,500, is entered on line 15c.

**Adjusted gross income (line 16).** Don and Jean subtract their total IRA deduction on line 15c from their total income on line 14. They enter the result, \$34,425, on line 16 and on line 17. This amount is their adjusted gross income. Since it is not less than \$28,495, they do not qualify for the earned income credit.

**IRA Worksheet 1—Lines 15a and 15b** (keep for your records)

	(a) Your IRA	(b) Your working spouse's IRA
1. Enter IRA contributions you made, or will make by April 15, 1997, for 1996. But do not enter more than \$2,000 in either column . . . . .	1. <u>750</u>	<u>750</u>
2. Enter wages, salaries, and tips for each person from Form 1040A, line 7 . . . . .	2. <u>22,250</u>	<u>0,155</u>
3. Enter the smaller of line 1 or line 2. Enter on Form 1040A, line 15a, the part of line 3, column (a), you choose to deduct. Enter on Form 1040A, line 15b, the part, if any, of line 3, column (b), you choose to deduct. If filing a joint return and contributions were made to your nonworking spouse's IRA, go to line 4 . . . . .	3. <u>750</u>	<u>750</u>
<b>Nonworking spouse's IRA</b>		
4. Enter the smaller of line 2, column (a), or \$2,250 . . . . .	4. _____	_____
5. Enter the amount from line 3, column (a) . . . . .	5. _____	_____
6. Subtract line 5 from line 4 . . . . .	6. _____	_____
7. Enter IRA contributions made, or that will be made by April 15, 1997, for 1996 for your nonworking spouse. But do not enter more than \$2,000 . . . . .	7. _____	_____
8. Enter the smaller of line 6 or line 7. Enter on Form 1040A, line 15a, the part of line 8 you choose to deduct . . . . .	8. _____	_____

## Taxable Income

Don and Jean figure their **taxable income** on lines 17–22.

**Standard deduction (lines 18a–b and 19).** Lines 18a–b do not apply to either Don or Jean. They enter their standard deduction amount of \$6,700 (see Chapter 21) on line 19. They subtract their standard deduction on line 19 from their adjusted gross income on line 17 and enter the result, \$27,725, on line 20.

**Exemptions (line 21).** Don and Jean deduct \$2,550 for each exemption shown on line 6d. They multiply \$2,550 by 4 (the number of exemptions shown on line 6d) and enter the result, \$10,200, on line 21. They subtract that amount from the amount on line 20 (\$27,725) and put the difference, \$17,525, on line 22. This amount is their taxable income.

## Tax, Credits, and Payments

Next, Don and Jean figure their tax liability.

**Tax (line 23).** Don and Jean use the Tax Table in the 1040A instructions to find their tax. The Smiths' taxable income from line 22 is \$17,525. Don and Jean first look for the large print "17,000" in the table. Under this, they look down to the line for taxable income of at least 17,500 but less than 17,550. Their taxable income is between these two amounts. They then find their tax, \$2,629, in the column for married filing jointly. They put this amount on line 23.

**Credit for child and dependent care expenses (line 24a and Schedule 2).** While both of them were working, their 10-month-old son, Todd, went to a day-care center and their 7-year-old daughter, Lynn, stayed with a neighbor before and after school. The neighbor also cared for the children when school and the day-care center were not in session.

Don and Jean paid \$3,325 of qualified child-care expenses for the time both of

them worked in 1996. The cost for the day-care center was \$2,325. They paid the neighbor \$1,000. Their employers did not provide any dependent care benefits.

Don and Jean prepare Parts I and II of Schedule 2. They enter the names, addresses, and taxpayer identification numbers (employer identification number and social security number) of the day-care center and the neighbor who provided the care on line 1, columns a, b, and c.

The Smiths enter the amounts they paid to the child-care providers on line 1, column d, and enter the total of these amounts, \$3,325, on line 2. Because they had qualified expenses for two children, they enter "2" in the box for line 3. (Their names and social security numbers are included on line 6c of their return.)

On line 4, they enter the amount of qualified expenses, \$3,325, they paid when both parents were working. On line 5, Don enters his earned income; on line 6, Jean enters her earned income. Because their child-care expenses were less than Jean's earned income and less than Don's earned income, all the expenses can be used to figure the credit. So they enter \$3,325 on line 7. They enter their adjusted gross income from Form 1040A, line 17 (\$34,425) on line 8. Then they check the table for line 9 to see what percentage of their child-care expenses they can take as a credit.

Since the amount on line 8 of Schedule 2 is \$34,425, they can take 20% of \$3,325, or \$665, as their credit. They put .20 on line 9 and \$665 on line 10. They are not subject to the alternative minimum tax (discussed in Chapter 31), so their credit is not limited and they do not complete the credit limit worksheet. They enter \$665 on line 24a of Form 1040A. Because their credit is less than their tax, they can use all of it to reduce their income tax liability.

**Total tax (line 28).** Don and Jean leave line 24b blank because they do not claim a credit for the elderly or the disabled. They subtract their total credits on line 24c (\$665) from the tax on line 23 (\$2,629) and enter the difference, \$1,964, on line 25. They leave line 26 blank because they did not receive any advance earned income credit payments. They

also leave line 27 blank because they are not household employers. The amount from line 25 (\$1,964) is carried to line 28. This is their total tax liability.

The Smiths do not complete the alternative minimum tax worksheet because their adjusted gross income plus their tax-exempt interest income is not more than \$45,000.

**Total payments (lines 29a–d).** Don and Jean then check box 2 of their Forms W–2 and box 4 of Form 1099–R for the amount of federal income tax withheld from their income. Don's Form W–2 shows \$1,612 tax withheld and Jean's Form W–2 shows \$659 tax withheld. Jean's Form 1099–R shows no withholding since she elected a direct rollover into her IRA. Tax was not withheld from Jean's unemployment compensation. The Smiths did not make any estimated tax payments for 1996. They are not entitled to the earned income credit on line 29c. Their total payments are \$2,271. They enter this amount on lines 29a and 29d.

## Refund or Amount You Owe

The tax withheld from the Smiths' wages is more than their total tax. They subtract their tax on line 28, \$1,964, from their total payments shown on line 29d, \$2,271, and enter the difference, \$307, on lines 30 and 31a. This is the amount that will be refunded to them.

Instead of getting a paper check, Don and Jean may be able to have their refund deposited directly into their account at a bank or other financial institution. They can request direct deposit by completing lines 31b, c, and d.

If Don and Jean had not had at least \$1,964 withheld for federal income tax, they would have owed tax. They would have entered the difference between their tax (line 28) and their payments (line 29d) on line 33. They would then enclose a check or money order for the full amount owed (line 33), payable to "Internal Revenue Service." See *Amount You Owe* in Chapter 1.

## Sign Your Return

Don and Jean sign and date their return and list their occupations. Then they check their return to make sure it is accurate and complete. They remove the peel-off label from the forms package and put it in the address portion on the top of the form. Then they attach Copy B of their Forms W–2 to the location indicated on the front of their return.

They use the envelope that came with their forms package to mail their return to the service center. Don and Jean save a copy of the return for their records.

**Filed-in Form 1040A**

**If you need more information, turn to the page shown in the circle.**

**Label** (See page 15.) Use the IRS label. Otherwise, please print in ALL CAPITAL LETTERS.

Your first name: DON J & JEAN F SMITH  
 Last name: SMITH  
 Social security number: 48001-30-1111  
 Address: 90 BEAVER CT, HOMETOWN MI 48001  
 ZIP code: 48001

**14** Your social security number  
**15** Spouse's social security number

**17** LABEL HERE

**14** For Privacy Act and Paperwork Reduction Act Notice, see page 9.

**Presidential Election Campaign Fund** (See page 15.)

Do you want \$3 to go to this fund?  Yes  No

If a joint return, does your spouse want \$3 to go to this fund?  Yes  No

Note: Checking "Yes" will not change your tax or reduce your refund.

**23**

Single

**2** Married filing joint return (even if only one had income)

Married filing separate return. Enter spouse's social security number above and full name here. ▶

Head of household (with qualifying person). (See page 16.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶

**5** Qualifying widow(er) with dependent child (year spouse died ▶ 19 ). (See page 16.)

**6a**  Yourself. If your parent (or someone else) can claim you as a dependent on his or her tax return, do not check box 6a.

**27** **b**  Spouse

**c** Dependents. If more than six dependents, see page 17.

(1) First name	Last name	(2) Dependent's social security number. If born in Dec. 1996, see page 18.	(3) Dependent's relationship to you	(4) No. of months lived in your home in 1996
LYNN	SMITH	410007070	DAUGHTER	12
TODD	SMITH	410009090	SON	12

No. of boxes checked on lines 6a and 6b: **2**

No. of your children on line 6c who lived with you: **02**

• did not live with you due to divorce or separation (see page 18):

Dependents on 6c not entered above:

Add numbers entered in boxes above: **04**

**56** **d** Total number of exemptions claimed: **4**

**7** Wages, salaries, tips, etc. This should be shown in box 1 of your W-2 form(s). Attach Form(s) W-2. **7** \$ **34405**

**67** **8a** Taxable interest income. If over \$400, attach Schedule 1. **8a** \$ **410**

**76** **b** Tax-exempt interest. DO NOT include on line 8a. **8b** \$ **35**

**78** **c** Dividends. If over \$400, attach Schedule 1. **9** \$ **100**

**148** **10a** Total IRA distributions. **10a** \$ **10b** Taxable amount (see page 20). **10b** \$

**93** **11a** Total pensions and annuities. **11a** \$ **2250** **11b** Taxable amount (see page 20). **11b** \$ **0**

**57** **12** Unemployment compensation. **12** \$ **1010**

**100** **13a** Social security benefits. **13a** \$ **13b** Taxable amount (see page 22). **13b** \$

**14** Add lines 7 through 13b (far right column). This is your total income. **14** \$ **35925**

**141** **15a** Your IRA deduction (see page 22). **15a** \$ **750**

**b** Spouse's IRA deduction (see page 22). **15b** \$ **750**

**230** **c** Add lines 15a and 15b. These are your total adjustments. **15c** \$ **1500**

**16** Subtract line 15c from line 14. This is your adjusted gross income. If under \$28,495 (under \$9,500 if a child did not live with you), see the instructions for line 29c on page 29. **16** \$ **34425**

**Filled-in Form 1040A**

**If you need more information, turn to the page shown in the circle.**

1996 Form 1040A page 2

	17 Enter the amount from line 16.	17 \$	34425
	18a Check if: <input type="checkbox"/> You were 65 or older <input type="checkbox"/> Blind <input type="checkbox"/> Spouse was 65 or older <input type="checkbox"/> Blind	Enter number of boxes checked ▶ 18a	<input type="checkbox"/>
163	b If you are married filing separately and your spouse itemizes deductions, see page 26 and check here ▶ 18b		<input type="checkbox"/>
185	19 Enter the standard deduction for your filing status. But see page 26 if you checked any box on line 18a or b OR someone can claim you as a dependent. • Single—4,000 • Married filing jointly or Qualifying widow(er)—6,700 • Head of household—5,900 • Married filing separately—3,350	19 \$	6700
	20 Subtract line 19 from line 17. If line 19 is more than line 17, enter 0.	20 \$	27725
	21 Multiply \$2,550 by the total number of exemptions claimed on line 6d.	21 \$	10200
234	22 Subtract line 21 from line 20. If line 21 is more than line 20, enter 0. This is your taxable income. If you want the IRS to figure your tax, see page 26. ▶ 22	22 \$	17525
243	23 Find the tax on the amount on line 22 (see page 26).	23 \$	2629
	24a Credit for child and dependent care expenses. Attach Schedule 2.	24a \$	665
253	b Credit for the elderly or the disabled. Attach Schedule 3.	24b \$	
	c Add lines 24a and 24b. These are your total credits.	24c \$	665
289	25 Subtract line 24c from line 23. If line 24c is more than line 23, enter 0.	25 \$	1964
249	26 Advance earned income credit payments from Form(s) W-2.	26 \$	
	27 Household employment taxes. Attach Schedule H.	27 \$	
42	28 Add lines 25, 26, and 27. This is your total tax. ▶ 28	28 \$	1964
	29a Total Federal income tax withheld from Forms W-2 and 1099.	29a \$	2271
48	b 1996 estimated tax payments and amount applied from 1995 return.	29b \$	
260	c Earned income credit. Attach Schedule EIC if you have a qualifying child.	29c \$	
285	d Nontaxable earned income: amount ▶ \$ and type ▶		
	29d Add lines 29a, 29b, and 29c (do not include nontaxable earned income). These are your total payments. ▶ 29d	29d \$	2271
	30 If line 29d is more than line 28, subtract line 28 from line 29d. This is the amount you overpaid.	30 \$	307
16	31a Amount of line 30 you want refunded to you. If you want it sent directly to your bank account, see page 35 and fill in 31b, c, and d.	31a \$	307
	b Routing number	c Type: <input type="checkbox"/> Checking <input type="checkbox"/> Savings	
	d Account number		51
	32 Amount of line 30 you want applied to your 1997 estimated tax.	32 \$	
53	33 If line 28 is more than line 29d, subtract line 29d from line 28. This is the amount you owe. For details on how to pay, including what to write on your payment, see page 36.	33 \$	
	34 Estimated tax penalty (see page 36).	34 \$	
16	<b>Sign here</b> Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and accurately list all amounts and sources of income I received during the tax year. Declaration of preparer (other than the taxpayer) is based on all information of which the preparer has any knowledge.		
	Your signature <i>Don J Smith</i>	Date 4-8-97	Your occupation Carpenter
	Spouse's signature. If joint return, BOTH must sign. <i>Jean B Smith</i>	Date 4-8-97	Spouse's occupation SECRETARY
	Preparer's signature	Date	Check if self-employed <input type="checkbox"/>
	Firm's name (or yours if self-employed) and address	EIN	Preparer's SSN
		ZIP code	

1996 Form 1040A page 2



**Filled-in Schedule 2**

If you need more information, turn to the page shown in the circle.

**Schedule 2**  
(Form 1040A)

Department of the Treasury—Internal Revenue Service

**Child and Dependent Care Expenses for Form 1040A Filers**

243

**1996**

OMB No. 1545-0085

Name(s) shown on Form 1040A: First and initial(s)	Last	Your social security number
Don J + JEAN P	SMITH	329001000

You need to understand the following terms to complete this schedule: **Qualifying Person(s), Dependent Care Benefits, Qualified Expenses, and Earned Income.** See Important Terms on page 51.

**Part I Persons or Organizations Who Provided the Care—You MUST complete this part.**

1	(a) Care provider's name	(b) Address (number, street, apt. no., city, state, and ZIP code)	(c) Identifying number (SSN or EIN)	(d) Amount paid (see page 52)
	ANYTIME CHILDCARE CENTER	612 CASTLE STREET HOMETOWN MI 48001	1100077000	\$ 2325
	MARIE THOMAS	38 MINTON LANE HOMETOWN MI 48001	326004000	\$ 1000
(If you need more space, use the bottom of page 2.)				2 \$ 3325
2 Add the amounts in column (d) of line 1.				
3 Enter the number of qualifying persons cared for in 1996 . . . . .				2

Did you receive dependent care benefits?  No  Yes

No —————> Complete only Part II below.  
Yes —————> Complete Part III on the back now.

**Caution:** If the care was provided in your home, you may owe employment taxes. See the instructions for Form 1040A, line 27, on page 27.

**Part II Credit for Child and Dependent Care Expenses**

4 Enter the amount of qualified expenses you incurred and paid in 1996. DO NOT enter more than 2,400 for one qualifying person or 4,800 for two or more persons. If you completed Part III, enter the amount from line 25. **4 \$ 3325**

5 Enter YOUR earned income. **5 \$ 22250**

6 If married filing a joint return, enter YOUR SPOUSE'S earned income (if student or disabled, see page 52); all others, enter the amount from line 5. **6 \$ 12155**

7 Enter the smallest of line 4, 5, or 6. **7 \$ 3325**

8 Enter the amount from Form 1040A, line 17. **8 \$ 34425**

9 Enter on line 9 the decimal amount shown below that applies to the amount on line 8.

If line 8 is—		Decimal amount is	If line 8 is—		Decimal amount is
Over	But not over		Over	But not over	
\$0—10,000		.30	\$20,000—22,000		.24
10,000—12,000		.29	22,000—24,000		.23
12,000—14,000		.28	24,000—26,000		.22
14,000—16,000		.27	26,000—28,000		.21
16,000—18,000		.26	28,000—No limit		.20
18,000—20,000		.25			

**9** × **20**

10 Multiply line 7 by the decimal amount on line 9. Enter the result. Then, see page 53 for the amount of credit to enter on Form 1040A, line 24a. **10 \$ 665**

## Form 1040

## Introduction

This chapter gives an example of how to fill out Form 1040. The example uses the situation of Frank and Evelyn Jones, a married couple with two children. Their completed return is at the end of the chapter.

## Name, Address, and Social Security Number

In May 1996, Frank and Evelyn sold their home and moved to a new home in a nearby city. Soon after their move, they called the IRS and asked for Form 8822, *Change of Address*. They completed the form and mailed it to the Internal Revenue Service Center where they filed their last return.

Because the IRS received Frank and Evelyn's Form 8822 before the peel-off labels for the 1996 tax forms packages were prepared, their new address appears on the peel-off label that came in their Form 1040 package for 1996. The label also has their social security numbers. They do not put the label on their return until they have completed and checked the return to make sure it is accurate.

The forms they received in their Form 1040 package were based on the return and schedules they filed for 1995. They used the order blank in their Form 1040 package to order any other forms they needed.

**Presidential Election Campaign Fund.** Frank and Evelyn each want \$3 of their tax to go to the Presidential Election Campaign Fund. They check both *Yes* boxes. Checking "Yes" will not increase their tax or reduce their refund.

## Filing Status and Exemptions

Frank and Evelyn show their filing status and personal exemptions on lines 1–6d.

**Filing status (lines 1–5).** Because Frank and Evelyn decide to file a joint return, they check the filing status box on line 2, *Married filing joint return*.

**Exemptions (lines 6a–6d).** Frank and Evelyn show the exemption for Frank on line 6a and the exemption for Evelyn on line 6b. They enter "2" on the line to the right of lines 6a and b.

Their daughter, Marie, who is 18, earned \$2,700 last year. Frank and Evelyn provided more than half her support. The gross income test does not apply because she is under 19, and the other dependency tests were met. (See *Exemptions for Dependents* in Chapter 3.) They claim Marie as a dependent on line 6c.

Their son, James, who is 22, goes to a local college full time. During the summer, James earned \$2,600, which he spent for his support. The gross income test does not apply because he is a full-time student under age 24. Frank and Evelyn provided more than \$2,600 toward their son's support, and the other dependency tests were met. On line 6c of the return, they claim James as a dependent.

Frank and Evelyn write the information asked about Marie and James on line 6c, columns (1), (2), (3), and (4). They enter "2" on the first line to the right of line 6c because both Marie and James lived at home.

Grace Smith, Evelyn's mother, lives with Frank and Evelyn and their two children. Grace got a pension of \$2,100 and social security of \$2,900 during the year. She spent this money for clothing and other personal things. Only \$1,500 of her pension is gross income for her and taxable. The rest of the pension is not taxable because it is a return of her cost.

Frank and Evelyn must figure Grace's total support to know if they can claim her exemption. Because five persons live in the household, Grace's total support includes one-fifth of the family's food costs and one-fifth of the rental value of the house. Frank and Evelyn paid a total of \$8,000 for food for the family. The fair rental value of their house was \$13,000 for the year. They also bought Grace a \$200 television set for her bedroom, paid \$700 for a trip she took, and paid her unreimbursed medical and drug expenses of \$300. Grace's total support is:

Expenses paid by Grace .....	\$ 5,000
Expenses paid by Frank and Evelyn:	
TV set .....	\$ 200
Trip .....	700
Medical .....	300
Food—Grace's share ( $\frac{1}{5}$ of \$8,000) .....	1,600
Lodging—Grace's share ( $\frac{1}{5}$ of \$13,000) .....	2,600
Total .....	\$ 5,400
<b>Total support</b> .....	<u>\$10,400</u>

The support Frank and Evelyn provided is more than half of Grace's total support, so they meet the support test to claim her as a dependent. Since Grace had less than \$2,550 gross income, Frank and Evelyn also meet the gross income test to claim her as a dependent. The other dependency tests are also met, so Frank and Evelyn can claim Grace as a dependent. They write the information asked about Grace on line 6c of their return.

Frank and his two brothers provided \$3,500 for the total support of their sister,

Clara Jones. Frank provided 35%, one brother provided 35%, and the other brother provided the remaining 30%. Any one of them may claim the exemption for Clara if a written statement from each of the others is attached to the income tax return of the brother claiming the exemption. The brothers agree to let Frank claim Clara as his dependent this year. They each give Frank a signed Form 2120, *Multiple Support Declaration*, for Frank to attach to his return. (Forms 2120 are not shown.) Frank and Evelyn write the information asked about Clara on line 6c. They enter "2" on the third line to the right of line 6c for Grace and Clara.

They then enter "6" in the box to the right of line 6d to show the total exemptions they claim.

## Income

Frank works full time as an electrician. Evelyn, a retired state government employee, is a partner in the Gateway Travel Agency. Frank and Evelyn own stocks and a bond, and Frank owns rental property.

Frank and Evelyn report the income they received for the year on lines 7–21.

**Wages (line 7).** Frank's Form W–2, *Wage and Tax Statement*, shows he earned \$29,680. (Form W–2 is not shown here.) Frank and Evelyn enter \$29,680 on line 7.

**Interest income (lines 8a and 8b and Part I of Schedule B).** Frank and Evelyn have a statement savings account, a certificate of deposit (CD) in which Frank's brother, Chuck Jones, also has a one-third investment, and a tax-exempt municipal bond. The Forms 1099–INT that they received show that they had interest income of \$330 on their statement savings account with National Bank and \$150 on their CD with First Savings and Loan. They must report their interest income on Schedule B because they received part of the interest as nominees for Chuck. (Even if they did not receive interest as nominees, they would still have to report their interest on Schedule B because it is more than \$400.) In addition, they received \$500 interest from the municipal bond. They did not receive a Form 1099–INT for this tax-exempt interest and do not report it on Schedule B.

On line 1, Part 1 of Schedule B, they enter the names of the financial institutions and the interest received from each, including the interest they received as nominees for Chuck. They show Chuck's share of the interest, \$50 ( $\$150 \times$  one-third), separately below a \$480 subtotal of all interest income listed. They identify the \$50 as "Nominee Distribution" and subtract it from the \$480 subtotal. They report the remainder, \$430, on line 2. They file a Form 1099–INT and Form 1096, *Annual Summary and Transmittal of U.S. Information Returns*, with their Internal Revenue Service Center showing the \$50 distribution to Chuck. They give Chuck Copy B of the Form 1099–INT. (Form 1099–INT and Form 1096 are not shown here.)

They did not have excludable savings bond interest (explained in *Education Savings Bond Program* in Chapter 8), so they leave line 3 blank and enter \$430 on line 4, Schedule B, and on line 8a, Form 1040. They show the \$500 tax-exempt interest on line 8b, Form 1040. They will not include the tax-exempt interest in their total income on line 22.

**Dividends (line 9 and Part II of Schedule B).** During the year, Frank and Evelyn received or had credited to their accounts the following dividends and other corporate distributions:

**Forms 1099-DIV**

Acme Publishing Company		
Gross dividends, etc. (Box 1a)	.....	\$210
Ordinary dividends (Box 1b)	.....	210
Zepco, Inc.		
Gross dividends, etc. (Box 1a)	.....	\$310
Ordinary dividends (Box 1b)	.....	300
Nontaxable distributions (Box 1d)	.....	10
Equity Mutual Fund		
Gross dividends, etc. (Box 1a)	.....	\$ 50
Ordinary dividends (Box 1b)	.....	50
Tiger Mutual Fund		
Gross dividends, etc. (Box 1a)	.....	\$ 60
Ordinary dividends (Box 1b)	.....	60
Equity Brokers		
Gross dividends, etc. (Box 1a)	.....	\$ 40
Ordinary dividends (Box 1b)	.....	40

**Schedule K-1 (Form 1065)**

Evelyn's share of dividends on stock owned by her partnership	.....	\$ 80
---	-------	-------

Frank and Evelyn received more than \$400 in dividends, so they must report them on Schedule B.

They list all payers and the total amount received from each payer on line 5, Part II of Schedule B. This includes the nontaxable distributions. They show the total on line 6. Frank and Evelyn did not receive any capital gain distributions, so they leave line 7 blank. They put their \$10 nontaxable distribution from Zepco, Inc., on line 8. They reduce their basis in the stock by this amount.

Since line 7 is blank, Frank and Evelyn enter \$10 on line 9. They subtract this amount from the \$750 on line 6 and enter the result, \$740, on line 10, Part II of Schedule B, and on line 9, Form 1040.

**Foreign accounts and foreign trusts (Part III of Schedule B).** Evelyn has a foreign checking account that she uses for her travel agency. Because she had no more than \$10,000 in the account at any time during the year, she answers *No* to the question on line 11a in Part III of Schedule B. Neither Frank nor Evelyn received a distribution from a foreign trust during the year, and neither of them was a grantor of, or transferor to, a foreign trust, so they answer *No* to the question on line 12 in Part III of Schedule B.

**State and local income tax refunds (line 10).** Frank and Evelyn received a 1995 state tax refund of \$110 in 1996. This amount is shown on the Form 1099-G, *Certain Government Payments*, sent to them by their state. Because they itemized their deductions on Schedule A for 1995, they use the worksheet in their Form 1040 instructions package to figure the taxable part of their refund. They use their copy of their 1995 tax return to fill out lines 2, 3, and 4 of the worksheet. Their filled-in worksheet is shown here.

**State and Local Income Tax Refund Worksheet**  
—Line 10

1. Enter the income tax refund from Form(s) 1099-G (or similar statement)	.....	\$ 110
2. Enter the amount from your 1995 Schedule A, line 28	.....	\$6,842
3. Enter on line 3 the amount shown below for the filing status claimed on your 1995 Form 1040:		
Single, enter \$3,900		
Married filing jointly or Qualifying widow(er), enter \$6,550		
Married filing separately, enter \$3,275		
Head of household, enter \$5,750	.....	\$6,550
4. Did you fill in line 33a on your 1995 Form 1040? <b>No.</b> Enter -0-	.....	-0-
5. Add lines 3 and 4	.....	\$6,550
6. Subtract line 5 from line 2. If zero or less, enter -0-	.....	\$ 292
7. Taxable part of your refund. Enter the smaller of line 1 or line 6 here and on Form 1040, line 10	.....	\$ 110

They report \$110 as income on line 10 of their Form 1040.

**Pensions (lines 16a and 16b).** Evelyn retired in 1995 on her 63rd birthday. She received pension income of \$850 in 1995 and \$2,550 in 1996. \$150 of her \$9,000 pension cost was recovered tax free in 1995. Evelyn uses the worksheet in her Form 1040 instructions package to figure the taxable part of her pension for 1996. Her filled-in worksheet is shown here.

**Worksheet for Simplified General Rule**

1. Enter the total pension or annuity payments received this year. Also enter this amount on Form 1040, line 16a	.....	\$2,550
2. Enter your cost in the plan at the annuity starting date plus any death benefit exclusion	.....	\$9,000
3. <u>Age at annuity starting date:</u> <u>Enter:</u>		
55 and under	300	
56 - 60	260	
61 - 65	240	
66 - 70	170	
71 and older	120	240
4. Divide line 2 by the number on line 3.	.....	\$37.50

5. Multiply line 4 by the number of months for which this year's payments were made. If your annuity starting date was <b>before</b> 1987, skip lines 6 and 7 and enter this amount on line 8. Otherwise, go to line 6.	.....	\$ 450
6. Enter the amount, if any, recovered tax free in years after 1986	.....	\$ 150
7. Subtract line 6 from line 2.	.....	\$8,850
8. Enter the smaller of line 5 or line 7	.....	\$ 450
9. <b>Taxable amount.</b> Subtract line 8 from line 1. Enter the result, but not less than zero. Also enter this amount on Form 1040, line 16b. If your Form 1099-R shows a larger amount, use the amount on this line instead of the amount from Form 1099-R	.....	\$2,100

Evelyn shows the total pension, \$2,550, on line 16a, Form 1040. She shows the taxable amount, \$2,100, on line 16b.

**Rental and partnership income (line 17 and Schedule E).** Frank and Evelyn show their total income from these sources on Schedule E and on line 17, Form 1040.

**Rental income (Part I of Schedule E).** Frank received rental income from two properties he owns, a store building and an unimproved piece of land. On line 1, Schedule E, he lists the building and its location in the space marked "A," and the land and its location in the space marked "B." On line 2, he checks the *No* box for both properties because neither was used for personal purposes.

On line 3, Frank enters his \$8,400 rental income from the building in column A, his \$720 rental income from the land in column B, and the total, \$9,120, in the "Totals" column. Then he lists expenses, such as insurance, interest, general repairs, and real estate taxes, on the appropriate lines in each column. On line 6, column A, he shows his auto expenses connected with the rental of the building, figured at 31 cents a mile. Because he is claiming auto expenses, he completes Part V of Form 4562, *Depreciation and Amortization*.

In Part I of Schedule E, he adds the expenses for each property and on line 19 enters \$5,420 in column A, \$100 in column B, and the total, \$5,520, in the "Totals" column.

Frank's records show that he purchased the store building in 1980. His basis for the building is \$40,000, and he is using the straight line method of depreciation with a 40-year life. Frank shows depreciation of \$1,000 for 1996 on line 20 in column A and the "Totals" column. Because the building was placed in service before 1996, he can figure the depreciation on the building on a separate worksheet and does not need to enter it on Form 4562 or attach his worksheet.

Frank enters the total expenses for each property on line 21, columns A and B. In each column he subtracts the amount on line 21 from the amount on line 3 and enters the result on line 22. He adds the amounts

on line 22 and enters his total rental income, \$2,600, on lines 24 and 26.

**Partnership income (Part II of Schedule E).** Evelyn is an active partner in the Gateway Travel Agency. The following amounts are shown as her share of income and deductions on the Schedule K-1 (Form 1065) given to her by the partnership.

Ordinary income from trade or business	\$1,900
Dividends	80
Charitable contributions	50
Net earnings from self-employment	1,900

Evelyn puts the name of her partnership in column (a) of line 27, in the space marked "A" and completes columns (b) and (d). Because she is at risk for the amounts invested in the partnership, she checks column (e) and does not complete Form 6198, *At-Risk Limitations*.

Because Evelyn actively participates in her partnership's business activities, she reports the ordinary business income from the partnership as nonpassive income in column (k), line 27. She enters that amount on line 28a in column (k), and also on lines 29 and 31.

Evelyn reports her other partnership items as follows:

Dividends—line 5 of Schedule B. Also, see *Dividends (line 9 and Part II of Schedule B)*, earlier.

Contributions—line 15 of Schedule A. Also, see *Itemized Deductions (Schedule A)*, later.

Net earnings from self-employment—line 2, Section A of Schedule SE. Also, see *Other Taxes*, later.

**Summary (Part V of Schedule E).** In Part V of Schedule E, Frank and Evelyn combine the amounts on lines 26 and 31. They enter the total, \$4,500, on line 40, Schedule E, and on line 17, Form 1040.

**Other income (line 21).** Frank won a \$50 prize in a photography contest. Frank and Evelyn show this income on line 21, Form 1040.

**Total income (line 22).** Frank and Evelyn add the amounts on lines 7 through 21 to figure their total income, \$37,610. They enter this amount on line 22.

## Sale of Home (Form 2119)

Frank and Evelyn bought and moved into their new home May 5, 1996, and sold their old home May 6, 1996.

They do not have a taxable gain on the sale of their home. However, they must report it on Form 2119, *Sale of Your Home*.

They received a Form 1099-S, *Proceeds From Real Estate Transactions*, showing gross proceeds of \$165,000 from the sale. Their records also show the following items:

<b>Old home</b>	
Original basis (purchased 1970)	\$ 18,000

Improvements	7,000
Adjusted basis	\$ 25,000
Fixing-up expenses for sale	\$ 1,000
Selling price	\$ 165,000

### Settlement charges at closing (old home):

Realtor's commission	\$ 8,250
Balance of mortgage	4,500
Penalty for prepayment of mortgage	50
Mortgage interest (4/1/96-5/5/96)	20
Points—paid by seller for buyer	750
Real estate taxes (1/1/96-5/5/96)	630
	14,200
<b>Net received</b>	<b>\$ 150,800</b>

### New home

Purchase price	\$ 90,000
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### Settlement charges, payments, and adjustments (new home):

Title search, attorney fees, other settlement fees	\$ 1,300
Points charged to buyer (1% of loan amount)	400
Mortgage taken out	(40,000)
Down payment	(5,000)
Real estate taxes (1/1/96-5/4/96—for period seller owned the home; credit from seller to buyer)	(300)
	(43,600)
<b>Balance due at settlement</b>	<b>\$ 46,400</b>

They deduct certain of the amounts paid at settlement when they sold their old home and purchased their new home as itemized deductions on Schedule A. Their itemized deduction for home mortgage interest includes the \$50 penalty for prepayment of the mortgage on their old home, the \$20 interest on the old house from April 1 through May 5, and the \$400 points paid for the mortgage on their new home. The points qualify to be deducted in full in the year paid. See *Interest paid (lines 10-14, Schedule A)* under *Itemized Deductions*, later.

Frank and Evelyn figure the amount realized and the gain on the sale of their old home as follows:

Selling price	\$165,000
Less selling expenses:	
Commission	\$8,250
Points	\$ 750
	\$ 9,000
Amount realized	\$156,000
Less: Adjusted basis of home sold	25,000
<b>Gain on sale</b>	<b>\$131,000</b>

They use these figures to fill out Part I of Form 2119.

They are over 55 and meet all the tests for the once-in-a-lifetime exclusion of up to \$125,000. They choose to take the exclusion. To do this, they fill out Part II of Form 2119. On line 14, they enter the amount they can exclude, \$125,000.

They then complete Part III of Form 2119. On line 15, they enter \$6,000 (\$131,000 gain - \$125,000 exclusion). This is the part of their gain they cannot exclude. On line 19b, they enter the cost of their new home, \$91,300 (\$90,000 purchase price + \$1,300 settlement fees). By filling in the rest of Part III, they find their taxable gain is zero and the adjusted basis of their new home is \$85,300.

## Adjustments to Income

Frank and Evelyn report their adjustments to income on lines 23a-30.

**IRA deduction (lines 23a and 23b).** Frank and Evelyn each made contributions to an individual retirement arrangement (IRA). Frank contributed \$2,000 to his IRA in 1996. In February 1997, Evelyn contributed \$900 to her IRA for 1996.

Because neither Frank nor Evelyn was covered by an employer retirement plan during 1996, they each figure their deduction using lines 1 through 3 of *IRA Worksheet 1* in their Form 1040 instructions package. Before they can complete their worksheets, they must each figure their earned income. Frank's earned income is \$29,680, the amount of his wages.

Since earned income includes income from self-employment and is reduced by the deduction for one-half of self-employment tax (explained later), Evelyn must first fill out a Schedule SE (see *Other Taxes*, later). She finds that her earned income is \$1,765. This is \$1,900 (the amount on her Schedule SE, Section A, line 3) minus \$135 (the deduction for one-half of her self-employment tax shown on Schedule SE, Section A, line 6, and carried to line 25, Form 1040).

Only Frank's column of the worksheet is shown here.

### IRA Worksheet 1

- Enter IRA contributions you made, or will make by April 15, 1997, for 1996. But **do not** enter more than \$2,000 **\$ 2,000**
- Enter wages and other earned income from Form 1040, minus any deductions on Form 1040, lines 25 and 27. Do not reduce wages by any loss from self-employment **29,680**
- Enter the **smaller** of line 1 or line 2. Enter on Form 1040, line 23a the part of line 3 you choose to deduct **\$ 2,000**

Both Frank and Evelyn can deduct their total contribution. They show Frank's \$2,000 contribution on line 23a and Evelyn's \$900 contribution on line 23b.

**Moving expenses (line 24 and Form 3903).** Frank was transferred by his employer to a new job in another city. Frank and Evelyn decided to sell their home and buy a townhouse closer to Frank's new job. Evelyn

kept her partnership interest at the old location because she can still carry out her duties by mail and telephone from the new home and does not have to commute.

Frank and Evelyn make sure that the move meets the distance and time tests explained under *Requirements* in Chapter 19. The distance from their old home to Frank's new job is 91 miles farther than the distance from their old home to Frank's old job. Therefore, they meet the 50-mile distance test. Also, Frank expects to meet the 39-week full-time work test.

Their records show the following expenses for the move.

Paid to van company for moving furniture and household goods .....	\$ 530
Car mileage to drive from old to new home—100 miles at 10 cents a mile ...	10
Motel room rent for one night on the day of arrival .....	60
Meals on the day of arrival .....	50
Pre-move mileage and motel expenses while looking for new home .....	500
Pre-move meals while looking for new home .....	200

They figure their moving expense deduction on Form 3903, *Moving Expenses*, which they attach to their return.

They show the cost to move furniture and other household goods, \$530, on line 4, Form 3903.

They show \$70 on line 5. This is the cost of travel from their old home to their new home (\$10 car mileage plus \$60 motel room rent).

They cannot deduct the amounts they spent for meals on the day of arrival or for pre-move househunting expenses.

Frank and Evelyn add lines 4 and 5 and enter the result, \$600, on line 6. Frank's employer did not reimburse him for his moving expenses, so they enter -0- on line 7. They then enter \$600 on line 8 of Form 3903 and on line 24 of Form 1040.

**Deduction for self-employment tax (line 25).** Evelyn owes self-employment tax for 1996. To figure the amount she can deduct, she completes a Schedule SE. (See *Other Taxes*, later.) She enters the amount from line 6, Section A, of Schedule SE on line 25 of Form 1040.

**Self-employed health insurance deduction (line 26).** Frank and Evelyn cannot claim the 30% deduction for health insurance of a self-employed person, because they participated all year in a health plan subsidized by Frank's employer. They can deduct health insurance premiums that they paid as itemized deductions on Schedule A.

**Adjusted gross income (line 31).** Frank and Evelyn add the amounts from lines 23a, 23b, 24, and 25, and enter \$3,635 on line 30. Then they subtract line 30 from line 22. This amount, \$33,975, is their adjusted gross income. They enter it on lines 31 and 32. This is the amount they use to figure the limit on their medical deduction and the limit on their

miscellaneous deductions. They will also use this amount to figure whether certain of their itemized deductions and their deduction for exemptions are limited.

## Standard Deduction

Frank and Evelyn must decide whether to take the standard deduction or itemize their actual deductions. They find the standard deduction for their filing status next to line 34. Their standard deduction is \$6,700. They will use this amount to compare with their itemized deductions when they complete Schedule A.

## Itemized Deductions (Schedule A)

Frank and Evelyn figure their total itemized deductions by completing Schedule A.

**Medical and dental expenses (lines 1–4, Schedule A).** Frank and Evelyn paid \$2,611 for medical and dental expenses that were not reimbursed by insurance. This includes \$300 for Grace Smith (Evelyn's dependent mother) and \$700 for Clara Jones (Frank's dependent sister). It also includes \$800 for health insurance premiums.

They enter \$2,611 on line 1 and their adjusted gross income, \$33,975, on line 2. On line 3, they enter \$2,548, which is 7.5% of their adjusted gross income. They subtract line 3 from line 1 and enter the result, \$63, on line 4.

**Taxes paid (lines 5–9, Schedule A).** Frank and Evelyn next itemize the deductible taxes they paid during the year.

Frank had \$851 state income tax withheld from his salary. He and Evelyn also made estimated state income tax payments of \$550. They enter the total, \$1,401, on line 5.

Frank and Evelyn's tax year for real estate taxes on both their old and new homes is the calendar year, with payment due August 1. Their share of the tax on their old home, sold on May 6, was \$630. Frank and Evelyn are considered to have paid their share of the real estate taxes on their old home even though they did not actually pay them to the tax authority.

The real estate tax on their new home was \$910 for the year. The tax for the period the seller owned the home was \$300. Frank and Evelyn can deduct their share, \$610.

Frank and Evelyn also paid \$300 real estate taxes on a lakeside cottage they own and use only for personal purposes.

Frank and Evelyn's real estate tax deduction is \$1,540 (\$630 + \$610 + \$300). They write this amount on line 6.

Frank and Evelyn show their total taxes paid, \$2,941, on line 9.

**Interest paid (lines 10–14, Schedule A).** Frank and Evelyn made mortgage interest

payments on both their old and new homes during the year.

They received a Form 1098, *Mortgage Interest Statement*, from the financial institution that holds the mortgage on their new home. Box 1 shows they paid \$2,400 mortgage interest. Box 2 shows they paid \$400 deductible points at closing. They add these amounts and enter the total, \$2,800, on line 10 of Schedule A.

They did not receive a Form 1098 from the financial institution that held the mortgage on their old home. From January to April they paid \$140 interest on that mortgage. The settlement sheet for the sale of their old home showed a \$50 penalty for prepayment of the mortgage and \$20 interest for the period April 1 through May 5. They enter the total of these amounts, \$210, on line 11.

They add the amounts on lines 10 and 11 and show their total deductible interest, \$3,010, on line 14. Frank and Evelyn also paid \$260 interest on their credit card and revolving charge accounts. They cannot deduct this personal interest.

**Gifts to charity (lines 15–18, Schedule A).** Frank and Evelyn made cash charitable contributions of \$778. They made no one gift of \$250 or more. They have receipts for all their contributions. Evelyn's share of the charitable contributions made by the Gateway Travel Agency, as shown on her Schedule K-1 (Form 1065), is \$50. Frank and Evelyn enter the total, \$828, on line 15. They also enter this amount on line 18.

**Casualty and theft losses (line 19, Schedule A).** Frank and Evelyn did not have any casualty or theft losses, so they enter -0- on line 19.

**Job expenses and miscellaneous deductions (lines 20–26, Schedule A).** Frank and Evelyn list union dues of \$350, subscriptions to trade magazines of \$75, and small tools needed for Frank's job costing \$348, and enter the total of these deductions, \$773, on line 20. They do not have any expenses on lines 21 or 22, so they also enter \$773 on line 23.

They enter their adjusted gross income, \$33,975, on line 24 and \$680 ( $\$33,975 \times .02$ ) on line 25. They subtract line 25 from line 23 and enter the result, \$93, on line 26.

**Other miscellaneous deductions (line 27).** Frank and Evelyn do not have any miscellaneous deductions not subject to the 2% of adjusted gross income limit, so they enter -0- on line 27.

**Total itemized deductions (line 28, Schedule A).** Because the amount Frank and Evelyn entered on line 32 was not more than \$117,950, they now add lines 4, 9, 14, 18, and 26, and write the total of their itemized deductions, \$6,935, on line 28. Since this total is larger than their standard deduction (\$6,700), they enter \$6,935 on line 34, Form 1040.

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## Tax Computation

Frank and Evelyn are now ready to figure their tax on lines 32–38. The situations described on lines 33a and 33b do not apply to them, so they leave the boxes on those lines blank. They subtract their itemized deductions on line 34 from their adjusted gross income on line 32 and enter \$27,040 on line 35. They multiply \$2,550 by the six exemptions they claimed on line 6d, and they enter the result, \$15,300, on line 36. They subtract this from line 35. The result, \$11,740, is their taxable income. They enter it on line 37.

Frank and Evelyn must use the Tax Table to figure their tax because their taxable income is less than \$100,000. They read down the income column until they find the line that includes their \$11,740 taxable income. Next, they find the column heading that describes their filing status—married filing jointly—and read down the column. The amount shown where the income line and filing status column meet, \$1,759, is their tax. They write it on line 38.

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## Credits

Because Frank and Evelyn do not have any credits, they leave lines 39–43 blank and enter \$1,759 on line 44.

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## Other Taxes

Evelyn has self-employment income over \$400. Her self-employment tax is the only “Other” tax Frank and Evelyn show on lines 45–50.

**Self-employment tax (line 45 and Schedule SE).** Evelyn can figure her self-employment tax on the short Schedule SE (Section A).

She enters her self-employment income of \$1,900 on line 2 of Section A. She also enters \$1,900 on line 3 and multiplies that amount by .9235. She enters the result, \$1,755, on line 4. She multiplies the amount on line 4 by .153 to figure her self-employment tax of \$269, which she enters on line 5. She enters one-half of this amount (\$135) on line 6.

Frank and Evelyn enter Evelyn’s self-employment tax on line 45, Form 1040. They enter the amount from line 6 of her Schedule SE on line 25, Form 1040. (See *Deduction for self-employment tax*, under *Adjustments to Income*, earlier.) They attach Evelyn’s Schedule SE to their Form 1040.

Because they are not liable for any other taxes, they add the amount on line 45 to the amount on line 44. This total, \$2,028, is Frank and Evelyn’s total tax. They enter it on line 51.

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## Payments

Frank and Evelyn enter \$1,248 on line 52. This is the amount of federal income tax withheld from Frank’s salary, as shown on his Form W–2. On line 53, they write \$800, the amount of estimated federal income tax payments they made for the year.

Frank and Evelyn enter on line 58, Form 1040, the total of these payments, \$2,048.

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## Refund or Amount Owed

Because line 58 is more than line 51, Frank and Evelyn have overpaid their taxes. They write the amount of the overpayment, \$20, on line 59. They do not want the overpayment credited to their 1997 estimated tax, so they also enter \$20 on line 60a. This is the amount of their refund.

Frank and Evelyn want their refund deposited directly to their bank account, so they fill in lines 60b–d.

They check their return to make sure they have completed all the items and the schedules called for and that they have attached the schedules and forms in attachment sequence number order. The attachment sequence number is just below the year in the upper right corner of each schedule or form. They remove the peel-off label from their Form 1040 package and put it in the address portion on the top of Form 1040. Both Frank and Evelyn sign the return and date it, because it is a joint return. Also, they enter their occupations in the space provided next to the signature lines.

Frank and Evelyn make a copy of the return to keep for their records. Then they use the envelope that came with their Form 1040 package to mail the return to the Service Center for their area.

**Filed-in Form 1040**

**If you need more information, turn to the page shown in the circle.**

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

For the year Jan. 1—Dec. 31, 1996, or other tax year beginning 1996, ending 19 OMB No. 1545-0074

**Label**

(See page 11.)

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

Presidential Election Campaign (See page 11.)

**Filing Status**

Check only one box.

**Exemptions**

If more than six dependents, see the instructions for line 6c.

Your first name and initial: **JT** 516-00-1492  
 Last name: **FRANK R & EVELYN D JONES**  
 3807 MILLWAY LAKECITY NY 14010  
 Social Security Number: **575-00-1776 829 30**  
 Spouse's Social Security Number: **203**  
 Apt. no. **11**

Your social security number

Spouse's social security number

For help finding line instructions, see pages 2 and 3 in the booklet.

Yes	No	Note: Checking "Yes" will not change your tax or reduce your refund.
<input checked="" type="checkbox"/>	<input type="checkbox"/>	
<input checked="" type="checkbox"/>	<input type="checkbox"/>	

Do you want \$3 to go to this fund? If a joint return, does your spouse want \$3 to go to this fund?

- 1  Single
- 2  Married filing joint return (even if only one had income)
- 3  Married filing separate return. Enter spouse's social security no. above and full name here. ▶
- 4  Head of household (with qualifying person). (See instructions.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶
- 5  Qualifying widow(er) with dependent child (year spouse died ▶ 19 ). (See instructions.)

6a  Yourself. If your parent (or someone else) can claim you as a dependent on his or her tax return, do not check box 6a.

6b  Spouse

(1) First name	Last name	(2) Dependent's social security number. If born in Dec. 1996, see inst.	(3) Dependent's relationship to you	(4) No. of months lived in your home in 1996	No. of boxes checked on lines 6a and 6b	No. of your children on line 6c who:
Marie	Jones	123 00 4567	Daughter	12	2	2
James	Jones	224 00 5678	Son	12		
Grace	Smith	345 00 6789	Mother	12		
Clara	Jones	456 00 7890	Sister	0*		

6c Total number of exemptions claimed: **6**

**Income**

Attach Copy B of your Forms W-2, W-2G, and 1099-R here.

If you did not get a W-2, see the instructions for line 7.

Enclose, but do not attach any payment. Also, please enclose Form 1040-V (see the instructions for line 62).

7	Wages, salaries, tips, etc. Attach Form(s) W-2	7	29,690
8a	Taxable interest. Attach Schedule B if over \$400.	8a	430
8b	Tax-exempt interest. DO NOT include on line 8a.	8b	500
9	Dividend income. Attach Schedule B if over \$400.	9	740
10	Taxable refunds, credits, or offsets of state and local income taxes (see instructions).	10	110
11	Alimony received	11	
12	Business income or (loss). Attach Schedule C or C-EZ	12	
13	Capital gain or (loss). If required, attach Schedule D	13	
14	Other gains or (losses). Attach Form 4797	14	
15a	Total IRA distributions	15a	2,550
15b	Total pensions and annuities	15b	2,100
16	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E	16	4,500
17	Farm income or (loss). Attach Schedule F	17	
18	Unemployment compensation	18	
19	Social security benefits	19	
20a	Other income. List type and amount—see instructions	20a	50
20b	Other income. List type and amount—see instructions	20b	
21	Other income. List type and amount—see instructions	21	50
22	Add the amounts in the far right column for lines 7 through 21. This is your total income ▶	22	37,610

**Adjusted Gross Income**

If line 31 is under \$28,495 (under \$9,500 if a child did not live with you), see the instructions for line 54.

23a	Your IRA deduction (see instructions)	23a	2,000
23b	Spouse's IRA deduction (see instructions)	23b	900
24	Moving expenses. Attach Form 3903 or 3903-F	24	600
25	One-half of self-employment tax. Attach Schedule SE	25	135
26	Self-employed health insurance deduction (see inst.)	26	
27	Keogh & self-employed SEP plans. If SEP, check <input type="checkbox"/>	27	
28	Penalty on early withdrawal of savings	28	
29	Alimony paid. Recipient's SSN ▶	29	
30	Add lines 23a through 29	30	3,635
31	Subtract line 30 from line 22. This is your adjusted gross income ▶	31	33,975

For Privacy Act and Paperwork Reduction Act Notice, see page 7. \* Forms 2120 attached (not shown)

Cat. No. 11320B

Form 1040 (1996)

**Filed-in Form 1040**

**If you need more information, turn to the page shown in the circle.**

Form 1040 (1996)

Page 2

<b>Tax Computation</b>	32	Amount from line 31 (adjusted gross income)	32	33,975
	33a	Check if: <input type="checkbox"/> You were 65 or older, <input type="checkbox"/> Blind; <input type="checkbox"/> Spouse was 65 or older, <input type="checkbox"/> Blind. Add the number of boxes checked above and enter the total here		
	b	If you are married filing separately and your spouse itemizes deductions or you were a dual-status alien, see instructions and check here		
	34	Enter the larger of: Itemized deductions from Schedule A, line 28, OR Standard deduction shown below for your filing status. But see the instructions if you checked any box on line 33a or b or someone can claim you as a dependent. • Single—\$4,000 • Married filing jointly or Qualifying widow(er)—\$6,700 • Head of household—\$5,900 • Married filing separately—\$3,350	34	6,935
	35	Subtract line 34 from line 32	35	27,040
	36	If line 32 is \$88,475 or less, multiply \$2,550 by the total number of exemptions claimed on line 6d. If line 32 is over \$88,475, see the worksheet in the inst. for the amount to enter	36	15,300
	37	<b>Taxable income.</b> Subtract line 36 from line 35. If line 36 is more than line 35, enter -0-	37	11,740
	38	<b>Tax.</b> See instructions. Check if total includes any tax from: a <input type="checkbox"/> Form(s) 8814 b <input type="checkbox"/> Form 4972	38	1,759
<b>Credits</b>	39	Credit for child and dependent care expenses. Attach Form 2441	39	
	40	Credit for the elderly or the disabled. Attach Schedule R	40	
	41	Foreign tax credit. Attach Form 1116	41	
	42	Other. Check if from a <input type="checkbox"/> Form 3800 b <input type="checkbox"/> Form 8396 c <input type="checkbox"/> Form 8801 d <input type="checkbox"/> Form (specify)	42	
	43	Add lines 39 through 42	43	
	44	Subtract line 43 from line 38. If line 43 is more than line 38, enter -0-	44	1,759
<b>Other Taxes</b>	45	Self-employment tax. Attach Schedule SE	45	269
	46	Alternative minimum tax. Attach Form 6251	46	
	47	Social security and Medicare tax on tip income not reported to employer. Attach Form 4137	47	
	48	Tax on qualified retirement plans, including IRAs. If required, attach Form 5329	48	
	49	Advance earned income credit payments from Form(s) W-2	49	
	50	Household employment taxes. Attach Schedule H.	50	
	51	Add lines 44 through 50. This is your total tax	51	2,028
<b>Payments</b>	52	Federal income tax withheld from Forms W-2 and 1099	52	1,248
	53	1996 estimated tax payments and amount applied from 1995 return	53	900
	54	Earned income credit. Attach Schedule EIC if you have a qualifying child. Nontaxable earned income: amount and type	54	
	55	Amount paid with Form 4868 (request for extension)	55	
	56	Excess social security and RRTA tax withheld (see inst.)	56	
	57	Other payments. Check if from a <input type="checkbox"/> Form 2439 b <input type="checkbox"/> Form 4136	57	
	58	Add lines 52 through 57. These are your total payments	58	2,048
<b>Refund</b>	59	If line 58 is more than line 51, subtract line 51 from line 58. This is the amount you OVERPAID	59	20
	60a	Amount of line 59 you want REFUNDED TO YOU	60a	20
	b	Routing number 0100000000 c Type: <input checked="" type="checkbox"/> Checking <input type="checkbox"/> Savings		
	d	Account number 23456789000000000001		
	61	Amount of line 59 you want APPLIED TO YOUR 1997 ESTIMATED TAX	61	
<b>Amount You Owe</b>	62	If line 51 is more than line 58, subtract line 58 from line 51. This is the AMOUNT YOU OWE. For details on how to pay and use Form 1040-V, see instructions	62	
	63	Estimated tax penalty. Also include on line 62	63	
<b>Sign Here</b>	Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.			
	Your signature	Date	Your occupation	
	Frank R. Jones	3-20-97	Electrician	
	Spouse's signature. If a joint return, BOTH must sign.	Date	Spouse's occupation	
	Evelyn D. Jones	3-20-97	Travel Agent	
<b>Paid Preparer's Use Only</b>	Preparer's signature	Date	Check if self-employed <input type="checkbox"/>	Preparer's social security no.
	Firm's name (or yours if self-employed) and address	EIN	ZIP code	

Printed on recycled paper

**Filled-In Schedule A**

If you need more information, turn to the page shown in the circle.

**SCHEDULES A&B**  
(Form 1040)

**Schedule A—Itemized Deductions**

OMB No. 1545-0074

(Schedule B is on back)

**1996**

Department of the Treasury  
Internal Revenue Service

▶ Attach to Form 1040. ▶ See instructions for Schedules A and B (Form 1040).

Attachment  
Sequence No. 07

Name(s) shown on Form 1040

**Frank R. and Evelyn D. Jones**

Your social security number  
**516 00 1492**

<b>Medical and Dental Expenses</b> (167)	1	Caution: Do not include expenses reimbursed or paid by others. Medical and dental expenses (see page A-1)	1	2,611	
	2	Enter amount from Form 1040, line 32, [2] 33,975			
	3	Multiply line 2 above by 7.5% (.075)	3	2,549	
	4	Subtract line 3 from line 1. If line 3 is more than line 1, enter -0-	4		63
<b>Taxes You Paid</b> (172)	5	State and local income taxes	5	1,401	
	6	Real estate taxes (see page A-2)	6	1,540	
	7	Personal property taxes	7		
	8	Other taxes. List type and amount ▶	8		
	9	Add lines 5 through 8	9		2,941
<b>Interest You Paid</b> (177)	10	Home mortgage interest and points reported to you on Form 1098	10	2,800	
	11	Home mortgage interest not reported to you on Form 1098. If paid to the person from whom you bought the home, see page A-2 and show that person's name, identifying no., and address ▶	11	210	
	12	Points not reported to you on Form 1098. See page A-3 for special rules	12		
	13	Investment interest. If required, attach Form 4952. (See page A-3.)	13		
14	Add lines 10 through 13	14		3,010	
<b>Gifts to Charity</b>	15	Gifts by cash or check. If you made any gift of \$250 or more, see page A-3	15	828	
	16	Other than by cash or check. If any gift of \$250 or more, see page A-3. If over \$500, you MUST attach Form 8283	16		
	17	Carryover from prior year	17		
	18	Add lines 15 through 17	18		828
<b>Casualty and Theft Losses</b> (191)	19	Casualty or theft loss(es). Attach Form 4684. (See page A-4.)	19		-0-
<b>Job Expenses and Most Other Miscellaneous Deductions</b> (217)	20	Unreimbursed employee expenses—job travel, union dues, job education, etc. If required, you MUST attach Form 2106 or 2106-EZ. (See page A-4.) ▶ Union dues - \$250; subscriptions to trade magazines - \$75; tools for job - \$248	20	773	
	21	Tax preparation fees	21		
	22	Other expenses—investment, safe deposit box, etc. List type and amount ▶	22		
	23	Add lines 20 through 22	23	773	
	24	Enter amount from Form 1040, line 32, [24] 33,975	24		
	25	Multiply line 24 above by 2% (.02)	25	680	
26	Subtract line 25 from line 23. If line 25 is more than line 23, enter -0-	26		93	
<b>Other Miscellaneous Deductions</b>	27	Other—from list on page A-4. List type and amount ▶	27		-0-
<b>Total Itemized Deductions</b> (231)	28	Is Form 1040, line 32, over \$117,950 (over \$58,975 if married filing separately)? NO. Your deduction is not limited. Add the amounts in the far right column for lines 4 through 27. Also, enter on Form 1040, line 34, the larger of this amount or your standard deduction. YES. Your deduction may be limited. See page A-5 for the amount to enter.	28		6,935

For Paperwork Reduction Act Notice, see Form 1040 instructions.

Cat. No. 11330X

Schedule A (Form 1040) 1996

**Filled-In Schedule B**

If you need more information, turn to the page shown in the circle.

Name(s) shown on Form 1040. Do not enter name and social security number if shown on other side.

Your social security number

**Schedule B—Interest and Dividend Income**

Attachment Sequence No. 08

**Part I 67**  
**Interest Income**

(See page B-1.)

Note: If you received a Form 1099-INT, Form 1099-OID, or substitute statement from a brokerage firm, list the firm's name as the payer and enter the total interest shown on that form.

Note: If you had over \$400 in taxable interest income, you must also complete Part III.

1 List name of payer. If any interest is from a seller-financed mortgage and the buyer used the property as a personal residence, see page B-1 and list this interest first. Also, show that buyer's social security number and address ▶

National Bank  
First Savings and Loan  
Subtotal  
Nominee Distribution

Amount

	330	
	150	
	480	
1	( 50 )	
2	430	
3		
4	430	

71

2 Add the amounts on line 1  
3 Excludable interest on series EE U.S. savings bonds issued after 1989 from Form 8815, line 14. You MUST attach Form 8815 to Form 1040

78

**Part II 78**  
**Dividend Income**

(See page B-1.)

Note: If you received a Form 1099-DIV or substitute statement from a brokerage firm, list the firm's name as the payer and enter the total dividends shown on that form.

Note: If you had over \$400 in gross dividends and/or other distributions on stock, you must also complete Part III.

5 List name of payer. Include gross dividends and/or other distributions on stock here. Any capital gain distributions and nontaxable distributions will be deducted on lines 7 and 8 ▶

Asma Publishing Co.  
Zepco, Inc.  
Equity Mutual Fund  
Tiger Mutual Fund  
Equity Brokers  
Gateway Travel Agency

Amount

	210	
	310	
	50	
	60	
	40	
5	80	
6	750	
7		
8	10	
9	10	
10	740	

6 Add the amounts on line 5  
7 Capital gain distributions. Enter here and on Schedule D  
8 Nontaxable distributions. (See the inst. for Form 1040, line 9.)  
9 Add lines 7 and 8  
10 Subtract line 9 from line 6. Enter the result here and on Form 1040, line 9 ▶  
\*If you do not need Schedule D to report any other gains or losses, see the instructions for Form 1040, line 13.

**Part III 15**  
**Foreign Accounts and Trusts**

(See page B-1.)

You must complete this part if you (a) had over \$400 of interest or dividends; (b) had a foreign account; or (c) received a distribution from, or were a grantor of, or a transferor to, a foreign trust.

11a At any time during 1996, did you have an interest in or a signature or other authority over a financial account in a foreign country, such as a bank account, securities account, or other financial account? See page B-1 for exceptions and filing requirements for Form TD F 90-22.1  
b If "Yes," enter the name of the foreign country ▶  
12 During 1996, did you receive a distribution from, or were you the grantor of, or transferor to, a foreign trust? If "Yes," see page B-2 for other forms you may have to file

Yes	No
	<input checked="" type="checkbox"/>
	<input checked="" type="checkbox"/>

**Filed-in Schedule E**

**If you need more information, turn to the page shown in the circle.**

**SCHEDULE E  
(Form 1040)**

Department of the Treasury  
Internal Revenue Service

**Supplemental Income and Loss**

(From rental real estate, royalties, partnerships,  
S corporations, estates, trusts, REMICs, etc.)

OMB No. 1545-0074

**1996**

Attachment  
Sequence No. 13

▶ Attach to Form 1040 or Form 1041. ▶ See instructions for Schedule E (Form 1040).

Name(s) shown on return

**Frank R. and Evelyn D. Jones**

Your social security number  
**516 00 1492**

**Part I** **Income or Loss From Rental Real Estate and Royalties** *Note: Report income and expenses from your business of renting personal property on Schedule C or C-EZ (see page E-1). Report farm rental income or loss from Form 4835 on page 2, line 39.*

1	Show the kind and location of each rental real estate property:	2	For each rental real estate property listed on line 1, did you or your family use it for personal purposes for more than the greater of 14 days or 10% of the total days rented at fair rental value during the tax year? (See page E-1.)	Yes	No
A	Store building 410 Main St., Hometown, NY	85		A	✓
B	Unimproved lot Hometown, NY			B	✓
C				C	

Income:	Properties			Totals (Add columns A, B, and C.)
	A	B	C	
3 Rents received . . . . .	3 8,400	720		3 9,120
4 Royalties received . . . . .	4			4
<b>Expenses:</b>				
5 Advertising . . . . .	5			
6 Auto and travel (see page E-2) . . . . .	6 78			
7 Cleaning and maintenance . . . . .	7			
8 Commissions . . . . .	8			
9 Insurance . . . . .	9 300			
10 Legal and other professional fees . . . . .	10			
11 Management fees . . . . .	11			
12 Mortgage interest paid to banks, etc. (see page E-2) . . . . .	12 3,100			12 3,100
13 Other interest . . . . .	13			
14 Repairs . . . . .	14 742			
15 Supplies . . . . .	15			
16 Taxes . . . . .	16 1,200	100		
17 Utilities . . . . .	17			
18 Other (list) ▶ . . . . .	18			
19 Add lines 5 through 18 . . . . .	19 5,420	100		19 5,520
20 Depreciation expense or depletion (see page E-2) . . . . .	20 1,000			20 1,000
21 Total expenses. Add lines 19 and 20 . . . . .	21 6,420	100		
22 Income or (loss) from rental real estate or royalty properties. Subtract line 21 from line 3 (rents) or line 4 (royalties). If the result is a (loss), see page E-2 to find out if you must file Form 6198 . . . . .	22 1,980	620		
23 Deductible rental real estate loss. <b>Caution:</b> Your rental real estate loss on line 22 may be limited. See page E-3 to find out if you must file Form 8582. Real estate professionals must complete line 42 on page 2 . . . . .	23 ( )	( )	( )	
24 Income. Add positive amounts shown on line 22. Do not include any losses . . . . .	24			24 2,600
25 Losses. Add royalty losses from line 22 and rental real estate losses from line 23. Enter the total losses here . . . . .	25 ( )			
26 Total rental real estate and royalty income or (loss). Combine lines 24 and 25. Enter the result here. If Parts II, III, IV, and line 39 on page 2 do not apply to you, also enter this amount on Form 1040, line 17. Otherwise, include this amount in the total on line 40 on page 2 . . . . .	26			26 2,600

For Paperwork Reduction Act Notice, see Form 1040 instructions.

Cat. No. 11344L

Schedule E (Form 1040) 1996

**Filed-in Schedule E**

**If you need more information, turn to the page shown in the circle.**

Name(s) shown on return. Do not enter name and social security number if shown on other side.

**108**

Your social security number

**Note:** If you report amounts from farming or fishing on Schedule E, you must enter your gross income from those activities on line 41 below. Real estate professionals must complete line 42 below.

**Part II Income or Loss From Partnerships and S Corporations** *Note: If you report a loss from an at-risk activity, you MUST check either column (e) or (f) of line 27 to describe your investment in the activity. See page E-4. If you check column (f), you must attach Form 6199.*

27	(a) Name	(b) Enter P for partnership; S for S corporation	(c) Check if foreign partnership	(d) Employer identification number	Investment At Risk? (e) All is at risk (f) Some is not at risk
A	Gateway Travel Agency	P		10-1234567	✓
B					
C					
D					
E					

Passive Income and Loss			Nonpassive Income and Loss		
(g) Passive loss allowed (attach Form 8582 if required)	(h) Passive income from Schedule K-1	(i) Nonpassive loss from Schedule K-1	(j) Section 179 expense deduction from Form 4562	(k) Nonpassive income from Schedule K-1	
A				1,900	
B					
C					
D					
E					
28a Totals				1,900	
b Totals					
29	Add columns (h) and (k) of line 28a . . . . .				29 1,900
30	Add columns (g), (i), and (j) of line 28b . . . . .				30 ( )
31	Total partnership and S corporation income or (loss). Combine lines 29 and 30. Enter the result here and include in the total on line 40 below . . . . .				31 1,900

**Part III Income or Loss From Estates and Trusts**

32	(a) Name	(b) Employer identification number
A		
B		

Passive Income and Loss		Nonpassive Income and Loss	
(c) Passive deduction or loss allowed (attach Form 8582 if required)	(d) Passive income from Schedule K-1	(e) Deduction or loss from Schedule K-1	(f) Other income from Schedule K-1
A			
B			
33a Totals			
b Totals			
34	Add columns (d) and (f) of line 33a . . . . .		34
35	Add columns (c) and (e) of line 33b . . . . .		35 ( )
36	Total estate and trust income or (loss). Combine lines 34 and 35. Enter the result here and include in the total on line 40 below . . . . .		36

**Part IV Income or Loss From Real Estate Mortgage Investment Conduits (REMICs) — Residual Holder**

37	(a) Name	(b) Employer identification number	(c) Excess inclusion from Schedules O, line 2c (see page E-4)	(d) Taxable income (net loss) from Schedules O, line 1b	(e) Income from Schedules O, line 3b
38	Combine columns (d) and (e) only. Enter the result here and include in the total on line 40 below . . . . .				38

**Part V Summary**

39	Net farm rental income or (loss) from Form 4835. Also, complete line 41 below . . . . .	39	
40	TOTAL income or (loss). Combine lines 26, 31, 36, 38, and 39. Enter the result here and on Form 1040, line 17 ▶	40	4,500
41	<b>Reconciliation of Farming and Fishing Income.</b> Enter your gross farming and fishing income reported on Form 4835, line 7; Schedule K-1 (Form 1065), line 15b; Schedule K-1 (Form 1120S), line 23; and Schedule K-1 (Form 1041), line 13 (see page E-4) . . . . .	41	
42	<b>Reconciliation for Real Estate Professionals.</b> If you were a real estate professional (see page E-3), enter the net income or (loss) you reported anywhere on Form 1040 from all rental real estate activities in which you materially participated under the passive activity loss rules . . . . .	42	

**Filled-In Schedule SE**

If you need more information, turn to the page shown in the circle.

**SCHEDULE SE**  
**(Form 1040)**

9

**Self-Employment Tax**

OMB No. 1545-0074

**1996**

Attachment  
Sequence No. 17

Department of the Treasury  
Internal Revenue Service (99)

▶ See Instructions for Schedule SE (Form 1040).

▶ Attach to Form 1040.

Name of person with self-employment income (as shown on Form 1040)

Evelyn D. Jones

Social security number of person  
with self-employment income ▶

575:00:1776

**Who Must File Schedule SE**

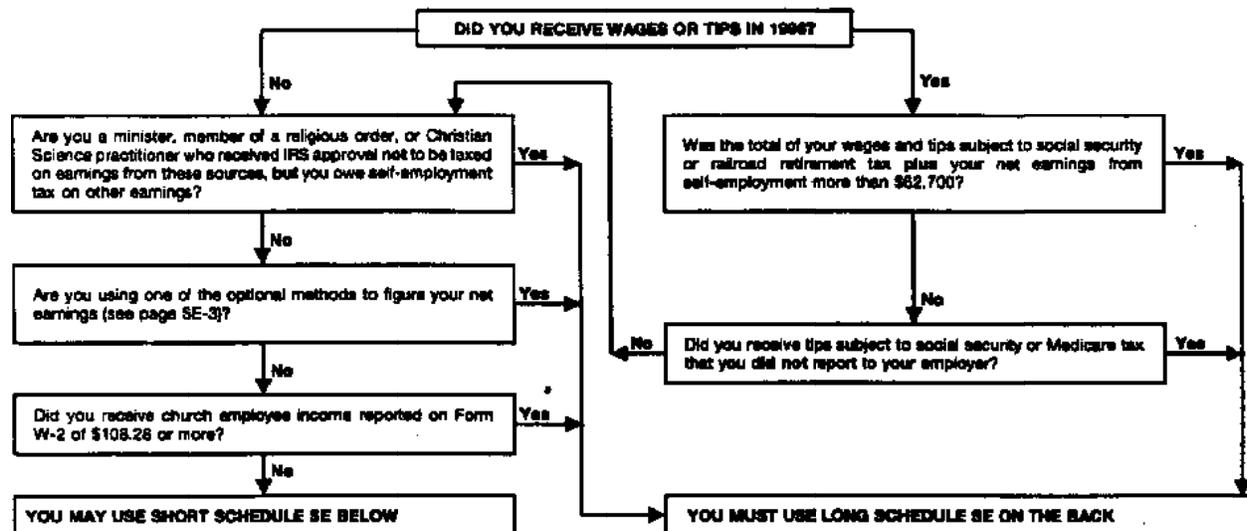
You must file Schedule SE if:

- You had net earnings from self-employment from other than church employee income (line 4 of Short Schedule SE or line 4c of Long Schedule SE) of \$400 or more, OR
- You had church employee income of \$108.28 or more. Income from services you performed as a minister or a member of a religious order is not church employee income. See page SE-1.

**Note:** Even if you had a loss or a small amount of income from self-employment, it may be to your benefit to file Schedule SE and use either "optional method" in Part II of Long Schedule SE. See page SE-3.

**Exception:** If your only self-employment income was from earnings as a minister, member of a religious order, or Christian Science practitioner and you filed Form 4361 and received IRS approval not to be taxed on those earnings, do not file Schedule SE. Instead, write "Exempt-Form 4361" on Form 1040, line 45.

**May I Use Short Schedule SE or MUST I Use Long Schedule SE?**



**Section A—Short Schedule SE. Caution: Read above to see if you can use Short Schedule SE.**

1	Net farm profit or (loss) from Schedule F, line 36, and farm partnerships, Schedule K-1 (Form 1065), line 15a	1	
2	Net profit or (loss) from Schedule C, line 31; Schedule C-EZ, line 3; and Schedule K-1 (Form 1065), line 15a (other than farming). Ministers and members of religious orders see page SE-1 for amounts to report on this line. See page SE-2 for other income to report.	2	1,900
3	Combine lines 1 and 2	3	1,900
4	Net earnings from self-employment. Multiply line 3 by 92.35% (.9235). If less than \$400, do not file this schedule; you do not owe self-employment tax ▶	4	1,755
5	Self-employment tax. If the amount on line 4 is: • \$62,700 or less, multiply line 4 by 15.3% (.153). Enter the result here and on Form 1040, line 46. • More than \$62,700, multiply line 4 by 2.9% (.029). Then, add \$7,774.80 to the result. Enter the total here and on Form 1040, line 45.	5	269
6	Deduction for one-half of self-employment tax. Multiply line 5 by 50% (.5). Enter the result here and on Form 1040, line 25	6	135

175

For Paperwork Reduction Act Notice, see Form 1040 Instructions.

Cat. No. 113582

Schedule SE (Form 1040) 1996

**Filled-in Form 2119**

**If you need more information, turn to the page shown in the circle.**

Form **2119**

**(127) Sale of Your Home**

OMB No. 1545-0072

**1996**

Attachment Sequence No. 20

Department of the Treasury  
Internal Revenue Service

▶ Attach to Form 1040 for year of sale.

▶ See separate instructions. ▶ Please print or type.

Your first name and initial. If a joint return, also give spouse's name and initial  
**Frank R. and Evelyn D. Jones**

Last name  
**Jones**

Your social security number  
**516 001492**

Spouse's social security number

Present address (no., street, and apt. no., rural route, or P.O. box no. if mail is not delivered to street address)

City, town or post office, state, and ZIP code

**Fill in Your Address Only if You Are Filing This Form by Itself and Not With Your Tax Return**

**Part I Gain on Sale**

1	Date your former main home was sold (month, day, year)	▶	1	5	/	6	/	96
2	Have you bought or built a new main home?		<input checked="" type="checkbox"/> Yes <input type="checkbox"/> No					
3	If any part of either main home was ever rented out or used for business, check here ▶ <input type="checkbox"/> and see page 3.							
4	Selling price of home. Do not include personal property items you sold with your home		4	165,000				
5	Expense of sale (see page 3)		5	9,000				
6	Subtract line 5 from line 4		6	156,000				
7	Adjusted basis of home sold (see page 3)		7	25,000				
8	Gain on sale. Subtract line 7 from line 6		8	131,000				

**Is line 8 more than zero?**

Yes → If line 2 is "Yes," you must go to Part II or Part III, whichever applies. If line 2 is "No," go to line 9.

No → Stop and attach this form to your return.

9 If you haven't replaced your home, do you plan to do so within the replacement period (see page 1)?  Yes  No

- If line 9 is "Yes," stop here. Attach this form to your return, and see **Additional Filing Requirements** on page 1.
- If line 9 is "No," you must go to Part II or Part III, whichever applies.

**Part II One-Time Exclusion of Gain for People Age 55 or Older**—By completing this part, you are electing to take the one-time exclusion (see page 2). If you are not electing to take the exclusion, go to Part III now.

10 Who was age 55 or older on the date of sale?  You  Your spouse  Both of you

11 Did the person who was 55 or older own and use the property as his or her main home for a total of at least 3 years of the 5-year period before the sale? See page 2 for exceptions. If "No," go to Part III now  Yes  No

12 At the time of sale, who owned the home?  You  Your spouse  Both of you

13 Social security number of spouse at the time of sale if you had a different spouse from the one above. If you were not married at the time of sale, enter "None" ▶ 13

14 Exclusion. Enter the smaller of line 8 or \$125,000 (\$62,500 if married filing separate return). Then, go to line 15 14 **125,000**

**Part III Adjusted Sales Price, Taxable Gain, and Adjusted Basis of New Home**

15	If line 14 is blank, enter the amount from line 8. Otherwise, subtract line 14 from line 8	15	6,000				
<ul style="list-style-type: none"> <li>• If line 15 is zero, stop and attach this form to your return.</li> <li>• If line 15 is more than zero and line 2 is "Yes," go to line 16 now.</li> <li>• If you are reporting this sale on the installment method, stop and see page 4.</li> <li>• All others, stop and enter the amount from line 15 on Schedule D, col. (g), line 4 or line 12.</li> </ul>							
16	Fixing-up expenses (see page 4 for time limits)	16	1,000				
17	If line 14 is blank, enter amount from line 16. Otherwise, add lines 14 and 16	17	126,000				
18	Adjusted sales price. Subtract line 17 from line 6	18	30,000				
19a	Date you moved into new home ▶ <b>5/5/96</b>	19b	91,300				
20	Subtract line 19b from line 18. If zero or less, enter -0-	20	-0-				
21	Taxable gain. Enter the smaller of line 15 or line 20	21	-0-				
<ul style="list-style-type: none"> <li>• If line 21 is zero, go to line 22 and attach this form to your return.</li> <li>• If you are reporting this sale on the installment method, see the line 15 instructions and go to line 22.</li> <li>• All others, enter the amount from line 21 on Schedule D, col. (g), line 4 or line 12, and go to line 22.</li> </ul>							
22	Postponed gain. Subtract line 21 from line 15	22	6,000				
23	Adjusted basis of new home. Subtract line 22 from line 19b	23	85,300				

**Sign Here Only if You Are Filing This Form by Itself and Not With Your Tax Return**

Under penalties of perjury, I declare that I have examined this form, including attachments, and to the best of my knowledge and belief, it is true, correct, and complete

Your signature \_\_\_\_\_ Date \_\_\_\_\_ Spouse's signature \_\_\_\_\_ Date \_\_\_\_\_

▶ If a joint return, both must sign. ▶

For Paperwork Reduction Act Notice, see separate instructions.

Cat No. 11710J

Form **2119** (1996)

Printed on recycled paper

**Filled-in Form 3903**

**If you need more information, turn to the page shown in the circle.**

Form **3903**

(154)

**Moving Expenses**

▶ Attach to Form 1040.

▶ See instructions on back.

OMB No. 1545-0062

**1996**

Attachment Sequence No. 62

Department of the Treasury  
Internal Revenue Service

Name(s) shown on Form 1040

**Frank R. and Evelyn D. Jones**

Your social security number

**516-001492**

**Caution:** If you are a member of the armed forces, see the instructions before completing this form.

1	Enter the number of miles from your old home to your new workplace . . . . .	96 miles
2	Enter the number of miles from your old home to your old workplace. . . . .	5 miles
3	Subtract line 2 from line 1. Enter the result but not less than zero . . . . .	91 miles

**Is line 3 at least 50 miles?**

**Yes ▶** Go to line 4. Also, see **Time Test** in the instructions.

**No ▶** You cannot deduct your moving expenses. Do not complete the rest of this form.

4 Transportation and storage of household goods and personal effects (see instructions) . . . . .

**4 530**

5 Travel and lodging expenses of moving from your old home to your new home. Do not include meals (see instructions). . . . .

**5 70**

6 Add lines 4 and 5 . . . . .

**6 600**

7 Enter the total amount your employer paid for your move (including the value of services furnished in kind) that is not included in the wages box (box 1) of your W-2 form. This amount should be identified with code P in box 13 of your W-2 form. . . . .

**7 -0-**

**Is line 6 more than line 7?**

**Yes ▶** Go to line 8.

**No ▶** You cannot deduct your moving expenses. If line 6 is less than line 7, subtract line 6 from line 7 and include the result in income on Form 1040, line 7.

8 Subtract line 7 from line 6. Enter the result here and on Form 1040, line 24. This is your moving expense deduction . . . . .

**8 600**

**For Paperwork Reduction Act Notice, see back of form.**

Cat. No. 12490K

Form **3903** (1996)

Form **4562**

**Depreciation and Amortization**  
(Including Information on Listed Property)

OMB No. 1545-0172

**1996**

Attachment  
Sequence No. 67

Department of the Treasury  
Internal Revenue Service

▶ See separate instructions. ▶ Attach this form to your return.

Names shown on return

**Frank R. and Evelyn D. Jones**

Business or activity to which this form relates

**Rental of store building**

Identifying number

**516-00-1492**

**Part I Election To Expense Certain Tangible Property (Section 179) (Note: If you have any "listed property," complete Part V before you complete Part I.)**

1	Maximum dollar limitation. If an enterprise zone business, see page 2 of the instructions . . . . .	1	\$17,500
2	Total cost of section 179 property placed in service. See page 2 of the instructions . . . . .	2	
3	Threshold cost of section 179 property before reduction in limitation . . . . .	3	\$200,000
4	Reduction in limitation. Subtract line 3 from line 2. If zero or less, enter -0- . . . . .	4	
5	Dollar limitation for tax year. Subtract line 4 from line 1. If zero or less, enter -0-. If married filing separately, see page 2 of the instructions . . . . .	5	
6	(a) Description of property	(b) Cost (business use only)	(c) Elected cost
7	Listed property. Enter amount from line 27. . . . .	7	
8	Total elected cost of section 179 property. Add amounts in column (c), lines 6 and 7 . . . . .	8	
9	Tentative deduction. Enter the smaller of line 5 or line 8 . . . . .	9	
10	Carryover of disallowed deduction from 1995. See page 2 of the instructions . . . . .	10	
11	Business income limitation. Enter the smaller of business income (not less than zero) or line 5 (see instructions)	11	
12	Section 179 expense deduction. Add lines 9 and 10, but do not enter more than line 11 . . . . .	12	
13	Carryover of disallowed deduction to 1997. Add lines 9 and 10, less line 12 ▶	13	

**Note:** Do not use Part II or Part III below for listed property (automobiles, certain other vehicles, cellular telephones, certain computers, or property used for entertainment, recreation, or amusement). Instead, use Part V for listed property.

**Part II MACRS Depreciation For Assets Placed in Service ONLY During Your 1996 Tax Year (Do Not include Listed Property.)**

**Section A—General Asset Account Election**

14 If you are making the election under section 168(f)(4) to group any assets placed in service during the tax year into one or more general asset accounts, check this box. See page 2 of the instructions . . . . .

**Section B—General Depreciation System (GDS) (See page 3 of the instructions.)**

(a) Classification of property	(b) Month and year placed in service	(c) Basis for depreciation (business/investment use only—see instructions)	(d) Recovery period	(e) Convention	(f) Method	(g) Depreciation deduction
15a 3-year property						
b 5-year property						
c 7-year property						
d 10-year property						
e 15-year property						
f 20-year property						
g 25-year property			25 yrs.		S/L	
h Residential rental property			27.5 yrs.	MM	S/L	
i Nonresidential real property			39 yrs.	MM	S/L	

**Section C—Alternative Depreciation System (ADS) (See page 4 of the instructions.)**

16a Class life					S/L	
b 12-year			12 yrs.		S/L	
c 40-year			40 yrs.	MM	S/L	

**Part III Other Depreciation (Do Not include Listed Property.) (See page 4 of the instructions.)**

17	GDS and ADS deductions for assets placed in service in tax years beginning before 1996 . . . . .	17	
18	Property subject to section 168(f)(1) election . . . . .	18	
19	ACRS and other depreciation . . . . .	19	

**Part IV Summary (See page 4 of the instructions.)**

20	Listed property. Enter amount from line 26. . . . .	20	
21	<b>Total.</b> Add deductions on line 12, lines 15 and 16 in column (g), and lines 17 through 20. Enter here and on the appropriate lines of your return. Partnerships and S corporations—see instructions . . . . .	21	
22	For assets shown above and placed in service during the current year, enter the portion of the basis attributable to section 263A costs . . . . .	22	

For Paperwork Reduction Act Notice, see page 1 of the separate instructions.

Cat. No. 12906N

Form **4562** (1996)

**Part V Listed Property—Automobiles, Certain Other Vehicles, Cellular Telephones, Certain Computers, and Property Used for Entertainment, Recreation, or Amusement**

281

Note: For any vehicle for which you are using the standard mileage rate or deducting lease expense, complete only 23a, 23b, columns (a) through (c) of Section A, all of Section B, and Section C if applicable.

**Section A—Depreciation and Other Information (Caution: See page 5 of the instructions for limitations for automobiles.)**

23a Do you have evidence to support the business/investment use claimed?  Yes  No 23b If "Yes," is the evidence written?  Yes  No

(a) Type of property (list vehicles first)	(b) Date placed in service	(c) Business/investment use percentage	(d) Cost or other basis	(e) Basis for depreciation (business/investment use only)	(f) Recovery period	(g) Method/Convention	(h) Depreciation deduction	(i) Elected section 179 cost	
24 Property used more than 50% in a qualified business use (See page 5 of the instructions.):									
		%							
		%							
		%							
25 Property used 50% or less in a qualified business use (See page 5 of the instructions.):									
USA sedan	9-3-93	3%				S/L -			
		%				S/L -			
		%				S/L -			
26 Add amounts in column (h). Enter the total here and on line 20, page 1.							26		
27 Add amounts in column (i). Enter the total here and on line 7, page 1.							27		

**Section B—Information on Use of Vehicles**

Complete this section for vehicles used by a sole proprietor, partner, or other "more than 5% owner," or related person. If you provided vehicles to your employees, first answer the questions in Section C to see if you meet an exception to completing this section for those vehicles.

	(a) Vehicle 1		(b) Vehicle 2		(c) Vehicle 3		(d) Vehicle 4		(e) Vehicle 5		(f) Vehicle 6	
	Yes	No										
28 Total business/investment miles driven during the year (DO NOT include commuting miles)	252											
29 Total commuting miles driven during the year	2,188											
30 Total other personal (noncommuting) miles driven	5,960											
31 Total miles driven during the year. Add lines 28 through 30.	8,400											
32 Was the vehicle available for personal use during off-duty hours?	✓											
33 Was the vehicle used primarily by a more than 5% owner or related person?	✓											
34 Is another vehicle available for personal use?	✓											

**Section C—Questions for Employers Who Provide Vehicles for Use by Their Employees**

Answer these questions to determine if you meet an exception to completing Section B for vehicles used by employees who are not more than 5% owners or related persons.

	Yes	No
35 Do you maintain a written policy statement that prohibits all personal use of vehicles, including commuting, by your employees?		
36 Do you maintain a written policy statement that prohibits personal use of vehicles, except commuting, by your employees? See page 6 of the instructions for vehicles used by corporate officers, directors, or 1% or more owners		
37 Do you treat all use of vehicles by employees as personal use?		
38 Do you provide more than five vehicles to your employees, obtain information from your employees about the use of the vehicles, and retain the information received?		
39 Do you meet the requirements concerning qualified automobile demonstration use? See page 6 of the instructions. Note: If your answer to 35, 36, 37, 38, or 39 is "Yes," you need not complete Section B for the covered vehicles.		

**Part VI Amortization**

(a) Description of costs	(b) Date amortization begins	(c) Amortizable amount	(d) Code section	(e) Amortization period or percentage	(f) Amortization for this year
40 Amortization of costs that begins during your 1996 tax year:					
41 Amortization of costs that began before 1996					41
42 Total. Enter here and on "Other Deductions" or "Other Expenses" line of your return					42

## Your Rights as a Taxpayer

The first part of this section explains some of your most important rights as a taxpayer.

The second part explains the examination, appeal, collection, and refund processes.

### I. Declaration of Taxpayer Rights

#### Protection of your rights —

IRS employees will explain and protect your rights as a taxpayer throughout your contact with us.

#### Privacy and confidentiality —

The IRS will not disclose to anyone the information you give us, except as authorized by law. You have the right to know why we are asking you for information, how we will use it, and what happens if you do not provide requested information.

#### Professional and courteous service —

If you believe that an IRS employee has not treated you in a professional manner, you should tell that employee's supervisor. If the supervisor's response is not satisfactory, you should write to your IRS District Director or Service Center Director.

#### Representation —

You may either represent yourself, or with proper written authorization, have someone else represent you in your place. You can have someone accompany you at an interview. You may make sound recordings of any meetings with our examination or collection personnel, provided you tell us in writing 10 days before the meeting.

#### Payment of only the correct amount of tax —

You are responsible for paying only the correct amount of tax due under the law — no more, no less.

#### Help from the Problem Resolution Office —

Problem Resolution Officers can help you with unresolved tax

problems and can offer you special help if you have a significant hardship as a result of a tax problem. For more information, write to the Problem Resolution Office at the District Office or Service Center where you have the problem, or call 1-800-829-1040 (1-800-829-4059 for TTY/TDD users).

#### Appeals and judicial review —

If you disagree with us about the amount of your tax liability or certain collection actions, you have the right to ask the IRS Appeals Office to review your case. You may also ask a court to review your case.

#### Relief from certain penalties —

The IRS will waive penalties when allowed by law if you can show you acted reasonably and in good faith or relied on the incorrect advice of an IRS employee.

### II. Examinations, Appeals, Collections, and Refunds

#### Examinations (Audits)

We accept most taxpayers' returns as filed. If we inquire about your return or select it for examination, it does not suggest that you are dishonest. The inquiry or examination may or may not result in more tax. We may close your case without change; or, you may receive a refund.

**By mail.** We handle many examinations and inquiries by mail. We will send you a letter with either a request for more information or a reason why we believe a change to your return may be needed. If you give us the requested information or provide an explanation, we may or may not agree with you, and we will explain the reasons for any changes. Please do not hesitate to write us about anything you do not understand. If you cannot resolve a question through the mail, you can request

a personal interview with an examiner.

**By interview.** If we notify you that we will conduct your examination through a personal interview, or you request such an interview, you have the right to ask that the examination take place at a reasonable time and place that is convenient for both you and the IRS. At the end of your examination, the examiner will give you a report if there are any proposed changes to your tax return. If you do not agree with the report, you may meet with the examiner's supervisor.

**Repeat examinations.** If we examined your tax return for the same items in either of the 2 previous years and proposed no change to your tax liability, please contact us as soon as possible so we can determine if we should discontinue the repeat examination. Publication 556, *Examination of Returns, Appeal Rights, and Claims for Refund*, will give you more information about the rules and procedures of an IRS examination.

#### Appeals

If you do not agree with the examiner's findings, you can appeal them to an Appeals Office. Most differences can be settled without expensive and time-consuming court trials. Your appeal rights are explained in detail in Publication 5, *Appeal Rights and Preparation of Protests for Unagreed Cases*. If you do not wish to use our Appeals Office or disagree with its findings, you can take your case to the U.S. Tax Court, U.S. Court of Federal Claims, or the U.S. District Court where you live. If the court agrees with you on most issues in your case, and finds that our position was largely unjustified, you may be able to recover some of your administrative and litigation costs. You will not be eligible to recover these costs unless you tried to resolve your case administratively, including going through our Appeals system, and you gave us all

the information necessary to resolve the case.

#### Collections

Publication 594, *Understanding The Collection Process*, explains your rights and responsibilities regarding payment of federal taxes. It is divided into several sections that explain the procedures in plain language. The sections include:

- 1) *When you have not paid enough tax.* This section describes tax bills and explains what to do if you think your bill is wrong.
- 2) *Making arrangements to pay your bill.* This covers making installment payments, delaying collection action, and submitting an offer in compromise.
- 3) *What happens when you take no action to pay.* This covers liens, releasing a lien, levies, releasing a levy, seizures and sales, and release of property. Publication 1660, *Collection Appeal Rights (for Liens, Levies and Seizures)*, explains your rights to appeal liens, levies and seizures and how to request these appeals.

#### Refunds

You may file a claim for refund if you think you paid too much tax. You must generally file the claim within 3 years from the date you filed your return or 2 years from the date you paid the tax, whichever is later. The law generally provides for interest on your refund if it is not paid within 45 days of the date you filed your return or claim for refund. Publication 556, *Examination of Returns, Appeals Rights, and Claims for Refund*, has more information on refunds.



1996 Tax Table—Continued

If line 6 (Form 1042), line 22 (Form 1040A), or line 37 (Form 1040) is—		And you are—				If line 6 (Form 1042), line 22 (Form 1040A), or line 37 (Form 1040) is—		And you are—				If line 6 (Form 1042), line 22 (Form 1040A), or line 37 (Form 1040) is—		And you are—			
At least	But less than	Single	Married filing jointly	Married filing separately	Head of a house- hold	At least	But less than	Single	Married filing jointly	Married filing separately	Head of a house- hold	At least	But less than	Single	Married filing jointly	Married filing separately	Head of a house- hold
		Your tax is—						Your tax is—						Your tax is—			
<b>5,000</b>						<b>8,000</b>						<b>11,000</b>					
5,000	5,050	754	754	754	754	8,000	8,050	1,204	1,204	1,204	1,204	11,000	11,050	1,854	1,854	1,854	1,854
5,050	5,100	761	761	761	761	8,050	8,100	1,211	1,211	1,211	1,211	11,050	11,100	1,861	1,861	1,861	1,861
5,100	5,150	769	769	769	769	8,100	8,150	1,219	1,219	1,219	1,219	11,100	11,150	1,869	1,869	1,869	1,869
5,150	5,200	776	776	776	776	8,150	8,200	1,226	1,226	1,226	1,226	11,150	11,200	1,876	1,876	1,876	1,876
5,200	5,250	784	784	784	784	8,200	8,250	1,234	1,234	1,234	1,234	11,200	11,250	1,884	1,884	1,884	1,884
5,250	5,300	791	791	791	791	8,250	8,300	1,241	1,241	1,241	1,241	11,250	11,300	1,891	1,891	1,891	1,891
5,300	5,350	799	799	799	799	8,300	8,350	1,249	1,249	1,249	1,249	11,300	11,350	1,899	1,899	1,899	1,899
5,350	5,400	806	806	806	806	8,350	8,400	1,256	1,256	1,256	1,256	11,350	11,400	1,906	1,906	1,906	1,906
5,400	5,450	814	814	814	814	8,400	8,450	1,264	1,264	1,264	1,264	11,400	11,450	1,714	1,714	1,714	1,714
5,450	5,500	821	821	821	821	8,450	8,500	1,271	1,271	1,271	1,271	11,450	11,500	1,721	1,721	1,721	1,721
5,500	5,550	829	829	829	829	8,500	8,550	1,279	1,279	1,279	1,279	11,500	11,550	1,729	1,729	1,729	1,729
5,550	5,600	836	836	836	836	8,550	8,600	1,286	1,286	1,286	1,286	11,550	11,600	1,736	1,736	1,736	1,736
5,600	5,650	844	844	844	844	8,600	8,650	1,294	1,294	1,294	1,294	11,600	11,650	1,744	1,744	1,744	1,744
5,650	5,700	851	851	851	851	8,650	8,700	1,301	1,301	1,301	1,301	11,650	11,700	1,751	1,751	1,751	1,751
5,700	5,750	859	859	859	859	8,700	8,750	1,309	1,309	1,309	1,309	11,700	11,750	1,759	1,759	1,759	1,759
5,750	5,800	866	866	866	866	8,750	8,800	1,316	1,316	1,316	1,316	11,750	11,800	1,766	1,766	1,766	1,766
5,800	5,850	874	874	874	874	8,800	8,850	1,324	1,324	1,324	1,324	11,800	11,850	1,774	1,774	1,774	1,774
5,850	5,900	881	881	881	881	8,850	8,900	1,331	1,331	1,331	1,331	11,850	11,900	1,781	1,781	1,781	1,781
5,900	5,950	889	889	889	889	8,900	8,950	1,339	1,339	1,339	1,339	11,900	11,950	1,789	1,789	1,789	1,789
5,950	6,000	896	896	896	896	8,950	9,000	1,346	1,346	1,346	1,346	11,950	12,000	1,796	1,796	1,796	1,796
<b>6,000</b>						<b>9,000</b>						<b>12,000</b>					
6,000	6,050	904	904	904	904	9,000	9,050	1,354	1,354	1,354	1,354	12,000	12,050	1,804	1,804	1,804	1,804
6,050	6,100	911	911	911	911	9,050	9,100	1,361	1,361	1,361	1,361	12,050	12,100	1,811	1,811	1,811	1,811
6,100	6,150	919	919	919	919	9,100	9,150	1,369	1,369	1,369	1,369	12,100	12,150	1,819	1,819	1,819	1,819
6,150	6,200	926	926	926	926	9,150	9,200	1,376	1,376	1,376	1,376	12,150	12,200	1,826	1,826	1,826	1,826
6,200	6,250	934	934	934	934	9,200	9,250	1,384	1,384	1,384	1,384	12,200	12,250	1,834	1,834	1,834	1,834
6,250	6,300	941	941	941	941	9,250	9,300	1,391	1,391	1,391	1,391	12,250	12,300	1,841	1,841	1,841	1,841
6,300	6,350	949	949	949	949	9,300	9,350	1,399	1,399	1,399	1,399	12,300	12,350	1,849	1,849	1,849	1,849
6,350	6,400	956	956	956	956	9,350	9,400	1,406	1,406	1,406	1,406	12,350	12,400	1,856	1,856	1,856	1,856
6,400	6,450	964	964	964	964	9,400	9,450	1,414	1,414	1,414	1,414	12,400	12,450	1,864	1,864	1,864	1,864
6,450	6,500	971	971	971	971	9,450	9,500	1,421	1,421	1,421	1,421	12,450	12,500	1,871	1,871	1,871	1,871
6,500	6,550	979	979	979	979	9,500	9,550	1,429	1,429	1,429	1,429	12,500	12,550	1,879	1,879	1,879	1,879
6,550	6,600	986	986	986	986	9,550	9,600	1,436	1,436	1,436	1,436	12,550	12,600	1,886	1,886	1,886	1,886
6,600	6,650	994	994	994	994	9,600	9,650	1,444	1,444	1,444	1,444	12,600	12,650	1,894	1,894	1,894	1,894
6,650	6,700	1,001	1,001	1,001	1,001	9,650	9,700	1,451	1,451	1,451	1,451	12,650	12,700	1,901	1,901	1,901	1,901
6,700	6,750	1,009	1,009	1,009	1,009	9,700	9,750	1,459	1,459	1,459	1,459	12,700	12,750	1,909	1,909	1,909	1,909
6,750	6,800	1,016	1,016	1,016	1,016	9,750	9,800	1,466	1,466	1,466	1,466	12,750	12,800	1,916	1,916	1,916	1,916
6,800	6,850	1,024	1,024	1,024	1,024	9,800	9,850	1,474	1,474	1,474	1,474	12,800	12,850	1,924	1,924	1,924	1,924
6,850	6,900	1,031	1,031	1,031	1,031	9,850	9,900	1,481	1,481	1,481	1,481	12,850	12,900	1,931	1,931	1,931	1,931
6,900	6,950	1,039	1,039	1,039	1,039	9,900	9,950	1,489	1,489	1,489	1,489	12,900	12,950	1,939	1,939	1,939	1,939
6,950	7,000	1,046	1,046	1,046	1,046	9,950	10,000	1,496	1,496	1,496	1,496	12,950	13,000	1,946	1,946	1,946	1,946
<b>7,000</b>						<b>10,000</b>						<b>13,000</b>					
7,000	7,050	1,054	1,054	1,054	1,054	10,000	10,050	1,504	1,504	1,504	1,504	13,000	13,050	1,954	1,954	1,954	1,954
7,050	7,100	1,061	1,061	1,061	1,061	10,050	10,100	1,511	1,511	1,511	1,511	13,050	13,100	1,961	1,961	1,961	1,961
7,100	7,150	1,069	1,069	1,069	1,069	10,100	10,150	1,519	1,519	1,519	1,519	13,100	13,150	1,969	1,969	1,969	1,969
7,150	7,200	1,076	1,076	1,076	1,076	10,150	10,200	1,526	1,526	1,526	1,526	13,150	13,200	1,976	1,976	1,976	1,976
7,200	7,250	1,084	1,084	1,084	1,084	10,200	10,250	1,534	1,534	1,534	1,534	13,200	13,250	1,984	1,984	1,984	1,984
7,250	7,300	1,091	1,091	1,091	1,091	10,250	10,300	1,541	1,541	1,541	1,541	13,250	13,300	1,991	1,991	1,991	1,991
7,300	7,350	1,099	1,099	1,099	1,099	10,300	10,350	1,549	1,549	1,549	1,549	13,300	13,350	1,999	1,999	1,999	1,999
7,350	7,400	1,106	1,106	1,106	1,106	10,350	10,400	1,556	1,556	1,556	1,556	13,350	13,400	2,006	2,006	2,006	2,006
7,400	7,450	1,114	1,114	1,114	1,114	10,400	10,450	1,564	1,564	1,564	1,564	13,400	13,450	2,014	2,014	2,014	2,014
7,450	7,500	1,121	1,121	1,121	1,121	10,450	10,500	1,571	1,571	1,571	1,571	13,450	13,500	2,021	2,021	2,021	2,021
7,500	7,550	1,129	1,129	1,129	1,129	10,500	10,550	1,579	1,579	1,579	1,579	13,500	13,550	2,029	2,029	2,029	2,029
7,550	7,600	1,136	1,136	1,136	1,136	10,550	10,600	1,586	1,586	1,586	1,586	13,550	13,600	2,036	2,036	2,036	2,036
7,600	7,650	1,144	1,144	1,144	1,144	10,600	10,650	1,594	1,594	1,594	1,594	13,600	13,650	2,044	2,044	2,044	2,044
7,650	7,700	1,151	1,151	1,151	1,151	10,650	10,700	1,601	1,601	1,601	1,601	13,650	13,700	2,051	2,051	2,051	2,051
7,700	7,750	1,159	1,159	1,159	1,159	10,700	10,750	1,609	1,609	1,609	1,609	13,700	13,750	2,059	2,059	2,059	2,059
7,750	7,800	1,166	1,166	1,166	1,166	10,750	10,800	1,616	1,616	1,616	1,616	13,750	13,800	2,066	2,066	2,066	2,066
7,800	7,850	1,174	1,174	1,174	1,174	10,800	10,850	1,624	1,624	1,624	1,624	13,800	13,850	2,074	2,074	2,074	2,074
7,850	7,900	1,181	1,181	1,181	1,181	10,850	10,900	1,631	1,631	1,631	1,631	13,850	13,900	2,081	2,081	2,081	2,081
7,900	7,950	1,189	1,189	1,189	1,189	10,900	10,950	1,639	1,639	1,639	1,639	13,900	13,950	2,089	2,089	2,089	2,089
7,950	8,000	1,196	1,196	1,196	1,196	10,950	11,000	1,646	1,646	1,646	1,646	13,950	14,000	2,096	2,096	2,096	2,096

\* This column must also be used by a qualifying widow(er).

Continued on next page

1996 Tax Table—Continued

If line 6 (Form 1040E), line 22 (Form 1040R), or line 37 (Form 1040) is—				And you are—				If line 6 (Form 1040E), line 22 (Form 1040R), or line 37 (Form 1040) is—				And you are—				If line 6 (Form 1040E), line 22 (Form 1040R), or line 37 (Form 1040) is—				And you are—															
At least	But less than	Single	Married filing jointly	Married filing separately	Head of a house- hold	At least	But less than	Single	Married filing jointly	Married filing separately	Head of a house- hold	At least	But less than	Single	Married filing jointly	Married filing separately	Head of a house- hold	At least	But less than	Single	Married filing jointly	Married filing separately	Head of a house- hold												
Your tax is—						Your tax is—						Your tax is—						Your tax is—																	
<b>14,000</b>						<b>17,000</b>						<b>20,000</b>						<b>15,000</b>						<b>18,000</b>						<b>21,000</b>					
14,000	14,050	2,104	2,104	2,104	2,104	17,000	17,050	2,554	2,554	2,554	2,554	20,000	20,050	3,004	3,004	3,004	3,004	15,000	15,050	2,254	2,254	2,254	2,254	18,000	18,050	2,704	2,704	2,704	2,704	21,000	21,050	3,154	3,154	3,154	3,154
14,050	14,100	2,111	2,111	2,111	2,111	17,050	17,100	2,561	2,561	2,561	2,561	20,050	20,100	3,011	3,011	3,011	3,011	15,050	15,100	2,261	2,261	2,261	2,261	18,050	18,100	2,711	2,711	2,711	2,711	21,050	21,100	3,161	3,161	3,161	3,161
14,100	14,150	2,119	2,119	2,119	2,119	17,100	17,150	2,569	2,569	2,569	2,569	20,100	20,150	3,019	3,019	3,019	3,019	15,100	15,150	2,269	2,269	2,269	2,269	18,100	18,150	2,719	2,719	2,719	2,719	21,100	21,150	3,169	3,169	3,169	3,169
14,150	14,200	2,126	2,126	2,126	2,126	17,150	17,200	2,576	2,576	2,576	2,576	20,150	20,200	3,026	3,026	3,026	3,026	15,150	15,200	2,276	2,276	2,276	2,276	18,150	18,200	2,726	2,726	2,726	2,726	21,150	21,200	3,176	3,176	3,176	3,176
14,200	14,250	2,134	2,134	2,134	2,134	17,200	17,250	2,584	2,584	2,584	2,584	20,200	20,250	3,034	3,034	3,034	3,034	15,200	15,250	2,284	2,284	2,284	2,284	18,200	18,250	2,734	2,734	2,734	2,734	21,200	21,250	3,184	3,184	3,184	3,184
14,250	14,300	2,141	2,141	2,141	2,141	17,250	17,300	2,591	2,591	2,591	2,591	20,250	20,300	3,041	3,041	3,041	3,041	15,250	15,300	2,291	2,291	2,291	2,291	18,250	18,300	2,741	2,741	2,741	2,741	21,250	21,300	3,191	3,191	3,191	3,191
14,300	14,350	2,149	2,149	2,149	2,149	17,300	17,350	2,599	2,599	2,599	2,599	20,300	20,350	3,049	3,049	3,049	3,049	15,300	15,350	2,299	2,299	2,299	2,299	18,300	18,350	2,749	2,749	2,749	2,749	21,300	21,350	3,199	3,199	3,199	3,199
14,350	14,400	2,156	2,156	2,156	2,156	17,350	17,400	2,606	2,606	2,606	2,606	20,350	20,400	3,056	3,056	3,056	3,056	15,350	15,400	2,306	2,306	2,306	2,306	18,350	18,400	2,756	2,756	2,756	2,756	21,350	21,400	3,206	3,206	3,206	3,206
14,400	14,450	2,164	2,164	2,164	2,164	17,400	17,450	2,614	2,614	2,614	2,614	20,400	20,450	3,064	3,064	3,113	3,064	15,400	15,450	2,314	2,314	2,314	2,314	18,400	18,450	2,764	2,764	2,764	2,764	21,400	21,450	3,214	3,214	3,214	3,214
14,450	14,500	2,171	2,171	2,171	2,171	17,450	17,500	2,621	2,621	2,621	2,621	20,450	20,500	3,071	3,071	3,127	3,071	15,450	15,500	2,321	2,321	2,321	2,321	18,450	18,500	2,771	2,771	2,771	2,771	21,450	21,500	3,221	3,221	3,407	3,221
14,500	14,550	2,179	2,179	2,179	2,179	17,500	17,550	2,629	2,629	2,629	2,629	20,500	20,550	3,079	3,079	3,141	3,079	15,500	15,550	2,329	2,329	2,329	2,329	18,500	18,550	2,779	2,779	2,779	2,779	21,500	21,550	3,229	3,229	3,421	3,229
14,550	14,600	2,186	2,186	2,186	2,186	17,550	17,600	2,636	2,636	2,636	2,636	20,550	20,600	3,086	3,086	3,155	3,086	15,550	15,600	2,336	2,336	2,336	2,336	18,550	18,600	2,786	2,786	2,786	2,786	21,550	21,600	3,236	3,236	3,435	3,236
14,600	14,650	2,194	2,194	2,194	2,194	17,600	17,650	2,644	2,644	2,644	2,644	20,600	20,650	3,094	3,094	3,168	3,094	15,600	15,650	2,344	2,344	2,344	2,344	18,600	18,650	2,794	2,794	2,794	2,794	21,600	21,650	3,244	3,244	3,449	3,244
14,650	14,700	2,201	2,201	2,201	2,201	17,650	17,700	2,651	2,651	2,651	2,651	20,650	20,700	3,101	3,101	3,183	3,101	15,650	15,700	2,351	2,351	2,351	2,351	18,650	18,700	2,801	2,801	2,801	2,801	21,650	21,700	3,251	3,251	3,463	3,251
14,700	14,750	2,209	2,209	2,209	2,209	17,700	17,750	2,659	2,659	2,659	2,659	20,700	20,750	3,109	3,109	3,197	3,109	15,700	15,750	2,359	2,359	2,359	2,359	18,700	18,750	2,809	2,809	2,809	2,809	21,700	21,750	3,259	3,259	3,477	3,259
14,750	14,800	2,216	2,216	2,216	2,216	17,750	17,800	2,666	2,666	2,666	2,666	20,750	20,800	3,116	3,116	3,211	3,116	15,750	15,800	2,366	2,366	2,366	2,366	18,750	18,800	2,816	2,816	2,816	2,816	21,750	21,800	3,266	3,266	3,491	3,266
14,800	14,850	2,224	2,224	2,224	2,224	17,800	17,850	2,674	2,674	2,674	2,674	20,800	20,850	3,124	3,124	3,225	3,124	15,800	15,850	2,374	2,374	2,374	2,374	18,800	18,850	2,824	2,824	2,824	2,824	21,800	21,850	3,274	3,274	3,505	3,274
14,850	14,900	2,231	2,231	2,231	2,231	17,850	17,900	2,681	2,681	2,681	2,681	20,850	20,900	3,131	3,131	3,239	3,131	15,850	15,900	2,381	2,381	2,381	2,381	18,850	18,900	2,831	2,831	2,831	2,831	21,850	21,900	3,281	3,281	3,519	3,281
14,900	14,950	2,239	2,239	2,239	2,239	17,900	17,950	2,689	2,689	2,689	2,689	20,900	20,950	3,139	3,139	3,253	3,139	15,900	15,950	2,389	2,389	2,389	2,389	18,900	18,950	2,839	2,839	2,839	2,839	21,900	21,950	3,289	3,289	3,533	3,289
14,950	15,000	2,248	2,248	2,248	2,248	17,950	18,000	2,696	2,696	2,696	2,696	20,950	21,000	3,146	3,146	3,257	3,146	15,950	16,000	2,396	2,396	2,396	2,396	18,950	19,000	2,846	2,846	2,846	2,846	21,950	22,000	3,296	3,296	3,547	3,296
<b>16,000</b>						<b>19,000</b>						<b>22,000</b>																							
16,000	16,050	2,404	2,404	2,404	2,404	19,000	19,050	2,854	2,854	2,854	2,854	22,000	22,050	3,304	3,304	3,561	3,304																		
16,050	16,100	2,411	2,411	2,411	2,411	19,050	19,100	2,861	2,861	2,861	2,861	22,050	22,100	3,311	3,311	3,575	3,311																		
16,100	16,150	2,419	2,419	2,419	2,419	19,100	19,150	2,869	2,869	2,869	2,869	22,100	22,150	3,319	3,319	3,589	3,319																		
16,150	16,200	2,426	2,426	2,426	2,426	19,150	19,200	2,876	2,876	2,876	2,876	22,150	22,200	3,326	3,326	3,603	3,326																		
16,200	16,250	2,434	2,434	2,434	2,434	19,200	19,250	2,884	2,884	2,884	2,884	22,200	22,250	3,334	3,334	3,617	3,334																		
16,250	16,300	2,441	2,441	2,441	2,441	19,250	19,300	2,891	2,891	2,891	2,891	22,250	22,300	3,341	3,341	3,631	3,341																		
16,300	16,350	2,449	2,449	2,449	2,449	19,300	19,350	2,899	2,899	2,899	2,899	22,300	22,350	3,349	3,349	3,645	3,349																		
16,350	16,400	2,456	2,456	2,456	2,456	19,350	19,400	2,906	2,906	2,906	2,906	22,350	22,400	3,356	3,356	3,659	3,356																		
16,400	16,450	2,464	2,464	2,464	2,464	19,400	19,450	2,914	2,914	2,914	2,914	22,400	22,450	3,364	3,364	3,673	3,364																		
16,450	16,500	2,471	2,471	2,471	2,471	19,450	19,500	2,921	2,921	2,921	2,921	22,450	22,500	3,371	3,371	3,687	3,371																		
16,500	16,550	2,479	2,479	2,479	2,479	19,500	19,550	2,929	2,929	2,929	2,929	22,500	22,550	3,379	3,379	3,701	3,379																		
16,550	16,600	2,486	2,486	2,486	2,486	19,550	19,600	2,936	2,936	2,936	2,936	22,550	22,600	3,386	3,386	3,715	3,386																		
16,600	16,650	2,494	2,494	2,494	2,494	19,600	19,650	2,944	2,944	2,944	2,944	22,600	22,650	3,394	3,394	3,729	3,394																		
16,650	16,700	2,501	2,501	2,501	2,501	19,650	19,700	2,951	2,951	2,951	2,951	22,650	22,700	3,401	3,401	3,743	3,401																		
16,700	16,750	2,509	2,509	2,509	2,509	19,700	19,750	2,959	2,959	2,959	2,959	22,700	22,750	3,409	3,409	3,757	3,409																		
16,750	16,800	2,516	2,516	2,516	2,516	19,750	19,800	2,966	2,966	2,966	2,966	22,750	22,800	3,416	3,416	3,771	3,416																		
16,800	16,850	2,524	2,524	2,524	2,524	19,800	19,850	2,974	2,974	2,974	2,974	22,800	22,850	3,424	3,424	3,785	3,424																		
16,850	16,900	2,531	2,531	2,531	2,531	19,850	19,900	2,981	2,981	2,981	2,981	22,850	22,900	3,431	3,431	3,799	3,431																		
16,900	16,950	2,539	2,539	2,539	2,539	19,900	19,950	2,989	2,989	2,989	2,																								

1996 Tax Table—Continued

File 9 (Form 1040E), File 22 (Form 1040A), or File 37 (Form 1040) is—					And you are—					File 9 (Form 1040E), File 22 (Form 1040A), or File 37 (Form 1040) is—					And you are—				
At least	But less than	Single	Married filing jointly	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly	Married filing separately	Head of a household		
Your tax is—					Your tax is—					Your tax is—									
<b>23,000</b>					<b>26,000</b>					<b>29,000</b>									
23,000	23,050	3,454	3,454	3,841	3,454	26,000	26,050	4,187	3,904	4,681	3,904	29,000	29,050	5,007	4,354	5,521	4,354		
23,050	23,100	3,461	3,461	3,856	3,461	26,050	26,100	4,181	3,911	4,686	3,911	29,050	29,100	5,021	4,361	5,535	4,361		
23,100	23,150	3,469	3,469	3,869	3,469	26,100	26,150	4,195	3,919	4,709	3,919	29,100	29,150	5,035	4,369	5,549	4,369		
23,150	23,200	3,476	3,476	3,883	3,476	26,150	26,200	4,209	3,926	4,723	3,926	29,150	29,200	5,049	4,376	5,563	4,376		
23,200	23,250	3,484	3,484	3,897	3,484	26,200	26,250	4,223	3,934	4,737	3,934	29,200	29,250	5,063	4,384	5,577	4,384		
23,250	23,300	3,491	3,491	3,911	3,491	26,250	26,300	4,237	3,941	4,751	3,941	29,250	29,300	5,077	4,391	5,591	4,391		
23,300	23,350	3,499	3,499	3,925	3,499	26,300	26,350	4,251	3,949	4,765	3,949	29,300	29,350	5,091	4,399	5,605	4,399		
23,350	23,400	3,506	3,506	3,939	3,506	26,350	26,400	4,265	3,956	4,779	3,956	29,350	29,400	5,105	4,406	5,619	4,406		
23,400	23,450	3,514	3,514	3,953	3,514	26,400	26,450	4,279	3,964	4,793	3,964	29,400	29,450	5,119	4,414	5,633	4,414		
23,450	23,500	3,521	3,521	3,967	3,521	26,450	26,500	4,293	3,971	4,807	3,971	29,450	29,500	5,133	4,421	5,647	4,421		
23,500	23,550	3,529	3,529	3,981	3,529	26,500	26,550	4,307	3,979	4,821	3,979	29,500	29,550	5,147	4,429	5,661	4,429		
23,550	23,600	3,536	3,536	3,995	3,536	26,550	26,600	4,321	3,986	4,835	3,986	29,550	29,600	5,161	4,436	5,675	4,436		
23,600	23,650	3,544	3,544	4,009	3,544	26,600	26,650	4,335	3,994	4,849	3,994	29,600	29,650	5,175	4,444	5,689	4,444		
23,650	23,700	3,551	3,551	4,023	3,551	26,650	26,700	4,349	4,001	4,863	4,001	29,650	29,700	5,189	4,451	5,703	4,451		
23,700	23,750	3,559	3,559	4,037	3,559	26,700	26,750	4,363	4,009	4,877	4,009	29,700	29,750	5,203	4,459	5,717	4,459		
23,750	23,800	3,566	3,566	4,051	3,566	26,750	26,800	4,377	4,016	4,891	4,016	29,750	29,800	5,217	4,466	5,731	4,466		
23,800	23,850	3,574	3,574	4,065	3,574	26,800	26,850	4,391	4,024	4,905	4,024	29,800	29,850	5,231	4,474	5,745	4,474		
23,850	23,900	3,581	3,581	4,079	3,581	26,850	26,900	4,405	4,031	4,919	4,031	29,850	29,900	5,245	4,481	5,759	4,481		
23,900	23,950	3,589	3,589	4,093	3,589	26,900	26,950	4,419	4,039	4,933	4,039	29,900	29,950	5,259	4,489	5,773	4,489		
23,950	24,000	3,596	3,596	4,107	3,596	26,950	27,000	4,433	4,046	4,947	4,046	29,950	30,000	5,273	4,496	5,787	4,496		
<b>24,000</b>					<b>27,000</b>					<b>30,000</b>									
24,000	24,050	3,607	3,604	4,121	3,604	27,000	27,050	4,447	4,054	4,961	4,054	30,000	30,050	5,287	4,504	5,801	4,504		
24,050	24,100	3,621	3,611	4,135	3,611	27,050	27,100	4,461	4,061	4,975	4,061	30,050	30,100	5,301	4,511	5,815	4,511		
24,100	24,150	3,635	3,619	4,149	3,619	27,100	27,150	4,475	4,069	4,989	4,069	30,100	30,150	5,315	4,519	5,829	4,519		
24,150	24,200	3,649	3,628	4,163	3,628	27,150	27,200	4,489	4,076	5,003	4,076	30,150	30,200	5,329	4,526	5,843	4,526		
24,200	24,250	3,663	3,634	4,177	3,634	27,200	27,250	4,503	4,084	5,017	4,084	30,200	30,250	5,343	4,534	5,857	4,534		
24,250	24,300	3,677	3,641	4,191	3,641	27,250	27,300	4,517	4,091	5,031	4,091	30,250	30,300	5,357	4,541	5,871	4,541		
24,300	24,350	3,691	3,649	4,205	3,649	27,300	27,350	4,531	4,099	5,045	4,099	30,300	30,350	5,371	4,548	5,885	4,548		
24,350	24,400	3,705	3,656	4,219	3,656	27,350	27,400	4,545	4,106	5,059	4,106	30,350	30,400	5,385	4,556	5,899	4,556		
24,400	24,450	3,719	3,664	4,233	3,664	27,400	27,450	4,559	4,114	5,073	4,114	30,400	30,450	5,399	4,564	5,913	4,564		
24,450	24,500	3,733	3,671	4,247	3,671	27,450	27,500	4,573	4,121	5,087	4,121	30,450	30,500	5,413	4,571	5,927	4,571		
24,500	24,550	3,747	3,679	4,261	3,679	27,500	27,550	4,587	4,129	5,101	4,129	30,500	30,550	5,427	4,579	5,941	4,579		
24,550	24,600	3,761	3,686	4,275	3,686	27,550	27,600	4,601	4,136	5,115	4,136	30,550	30,600	5,441	4,586	5,955	4,586		
24,600	24,650	3,775	3,694	4,289	3,694	27,600	27,650	4,615	4,144	5,129	4,144	30,600	30,650	5,455	4,594	5,969	4,594		
24,650	24,700	3,789	3,701	4,303	3,701	27,650	27,700	4,629	4,151	5,143	4,151	30,650	30,700	5,469	4,601	5,983	4,601		
24,700	24,750	3,803	3,709	4,317	3,709	27,700	27,750	4,643	4,159	5,157	4,159	30,700	30,750	5,483	4,609	5,997	4,609		
24,750	24,800	3,817	3,716	4,331	3,716	27,750	27,800	4,657	4,166	5,171	4,166	30,750	30,800	5,497	4,616	6,011	4,616		
24,800	24,850	3,831	3,724	4,345	3,724	27,800	27,850	4,671	4,174	5,185	4,174	30,800	30,850	5,511	4,624	6,025	4,624		
24,850	24,900	3,845	3,731	4,359	3,731	27,850	27,900	4,685	4,181	5,199	4,181	30,850	30,900	5,525	4,631	6,039	4,631		
24,900	24,950	3,859	3,739	4,373	3,739	27,900	27,950	4,699	4,189	5,213	4,189	30,900	30,950	5,539	4,639	6,053	4,639		
24,950	25,000	3,873	3,746	4,387	3,746	27,950	28,000	4,713	4,196	5,227	4,196	30,950	31,000	5,553	4,646	6,067	4,646		
<b>25,000</b>					<b>28,000</b>					<b>31,000</b>									
25,000	25,050	3,887	3,754	4,401	3,754	28,000	28,050	4,727	4,204	5,241	4,204	31,000	31,050	5,567	4,654	6,081	4,654		
25,050	25,100	3,901	3,761	4,415	3,761	28,050	28,100	4,741	4,211	5,255	4,211	31,050	31,100	5,581	4,661	6,095	4,661		
25,100	25,150	3,915	3,769	4,429	3,769	28,100	28,150	4,755	4,219	5,269	4,219	31,100	31,150	5,595	4,669	6,109	4,669		
25,150	25,200	3,929	3,776	4,443	3,776	28,150	28,200	4,769	4,226	5,283	4,226	31,150	31,200	5,609	4,676	6,123	4,676		
25,200	25,250	3,943	3,784	4,457	3,784	28,200	28,250	4,783	4,234	5,297	4,234	31,200	31,250	5,623	4,684	6,137	4,684		
25,250	25,300	3,957	3,791	4,471	3,791	28,250	28,300	4,797	4,241	5,311	4,241	31,250	31,300	5,637	4,691	6,151	4,691		
25,300	25,350	3,971	3,799	4,485	3,799	28,300	28,350	4,811	4,249	5,325	4,249	31,300	31,350	5,651	4,699	6,165	4,699		
25,350	25,400	3,985	3,806	4,499	3,806	28,350	28,400	4,825	4,256	5,339	4,256	31,350	31,400	5,665	4,706	6,179	4,706		
25,400	25,450	3,999	3,814	4,513	3,814	28,400	28,450	4,839	4,264	5,353	4,264	31,400	31,450	5,679	4,714	6,193	4,714		
25,450	25,500	4,013	3,821	4,527	3,821	28,450	28,500	4,853	4,271	5,367	4,271	31,450	31,500	5,693	4,721	6,207	4,721		
25,500	25,550	4,027	3,829	4,541	3,829	28,500	28,550	4,867	4,279	5,381	4,279	31,500	31,550	5,707	4,729	6,221	4,729		
25,550	25,600	4,041	3,836	4,555	3,836	28,550	28,600	4,881	4,286	5,395	4,286	31,550	31,600	5,721	4,736	6,235	4,736		
25,600	25,650	4,055	3,844	4,569	3,844	28,600	28,650	4,895	4,294	5,409	4,294	31,600	31,650	5,735	4,744	6,249	4,744		
25,650	25,700	4,069	3,851	4,583	3,851	28,650	28,700	4,909	4,301	5,423	4,301	31,650	31,700	5,749	4,751	6,263	4,751		
25,700	25,750	4,083	3,859	4,597	3,859	28,700	28,750	4,923	4,309	5,437	4,309	31,700	31,750	5,763	4,759	6,277	4,759		
25,750	25,800	4,097	3,866	4,611	3,866	28,750	28,800	4,937	4,316	5,451	4,316	31,750	31,800	5,777	4,766	6,291	4,766		
25,800	25,850	4,111	3,874	4,625	3,874	28,800	28,850	4,951	4,324	5,465	4,324	31,800	31,850	5,791	4,774	6,305	4,774		
25,850	25,900	4,125	3,881	4,639	3,881	28,850	28,900	4,965	4,331	5,479	4,331	31,850	31,900	5,805	4,781	6,319	4,781		
25,900	25,950	4,139	3,889	4,653	3,889	28,900	28,950	4,979	4,339	5,493	4,339	31,900	31,950	5,819	4,789	6,333	4,789		
25,950	26,000	4,153	3,896	4,667	3,896	28,950	29,000	4,993	4,346	5,507	4,346	31,950	32,000	5,833	4,796	6,347			

1996 Tax Table—Continued

If line 6 (Form 1040EZ), line 22 (Form 1040A), or line 37 (Form 1040) is—		And you are—				If line 6 (Form 1040EZ), line 22 (Form 1040A), or line 37 (Form 1040) is—		And you are—				If line 6 (Form 1040EZ), line 22 (Form 1040A), or line 37 (Form 1040) is—		And you are—			
At least	But less than	Single	Married filing jointly	Married filing separately	Head of a house- hold	At least	But less than	Single	Married filing jointly	Married filing separately	Head of a house- hold	At least	But less than	Single	Married filing jointly	Married filing separately	Head of a house- hold
		Your tax is—						Your tax is—						Your tax is—			
<b>32,000</b>						<b>35,000</b>						<b>38,000</b>					
32,000	32,050	5,847	4,804	6,381	4,804	35,000	35,050	6,887	5,254	7,201	5,828	38,000	38,050	7,527	5,704	8,041	6,468
32,050	32,100	5,851	4,811	6,375	4,811	35,050	35,100	6,701	5,281	7,215	5,842	38,050	38,100	7,541	5,711	8,055	6,482
32,100	32,150	5,875	4,819	6,389	4,819	35,100	35,150	6,715	5,269	7,229	5,856	38,100	38,150	7,555	5,719	8,069	6,496
32,150	32,200	5,859	4,826	6,403	4,830	35,150	35,200	6,729	5,278	7,243	5,870	38,150	38,200	7,569	5,728	8,083	6,510
32,200	32,250	5,903	4,834	6,417	4,844	35,200	35,250	6,743	5,284	7,257	5,884	38,200	38,250	7,583	5,734	8,097	6,524
32,250	32,300	5,917	4,841	6,431	4,858	35,250	35,300	6,757	5,291	7,271	5,898	38,250	38,300	7,597	5,741	8,111	6,538
32,300	32,350	5,931	4,849	6,445	4,872	35,300	35,350	6,771	5,299	7,285	5,912	38,300	38,350	7,611	5,749	8,125	6,552
32,350	32,400	5,945	4,856	6,459	4,886	35,350	35,400	6,785	5,306	7,299	5,926	38,350	38,400	7,625	5,756	8,139	6,566
32,400	32,450	5,959	4,864	6,473	4,900	35,400	35,450	6,799	5,314	7,313	5,940	38,400	38,450	7,639	5,764	8,153	6,580
32,450	32,500	5,973	4,871	6,487	4,914	35,450	35,500	6,813	5,321	7,327	5,954	38,450	38,500	7,653	5,771	8,167	6,594
32,500	32,550	5,987	4,879	6,501	4,928	35,500	35,550	6,827	5,329	7,341	5,968	38,500	38,550	7,667	5,779	8,181	6,608
32,550	32,600	6,001	4,886	6,515	4,942	35,550	35,600	6,841	5,336	7,355	5,982	38,550	38,600	7,681	5,786	8,195	6,622
32,600	32,650	6,015	4,894	6,529	4,956	35,600	35,650	6,855	5,344	7,369	5,996	38,600	38,650	7,695	5,794	8,209	6,636
32,650	32,700	6,029	4,901	6,543	4,970	35,650	35,700	6,869	5,351	7,383	6,010	38,650	38,700	7,709	5,801	8,223	6,650
32,700	32,750	6,043	4,909	6,557	4,984	35,700	35,750	6,883	5,359	7,397	6,024	38,700	38,750	7,723	5,809	8,237	6,664
32,750	32,800	6,057	4,916	6,571	4,998	35,750	35,800	6,897	5,366	7,411	6,038	38,750	38,800	7,737	5,816	8,251	6,678
32,800	32,850	6,071	4,924	6,585	5,012	35,800	35,850	6,911	5,374	7,425	6,052	38,800	38,850	7,751	5,824	8,265	6,692
32,850	32,900	6,085	4,931	6,599	5,026	35,850	35,900	6,925	5,381	7,439	6,066	38,850	38,900	7,765	5,831	8,279	6,706
32,900	32,950	6,099	4,939	6,613	5,040	35,900	35,950	6,939	5,389	7,453	6,080	38,900	38,950	7,779	5,839	8,293	6,720
32,950	33,000	6,113	4,946	6,627	5,054	35,950	36,000	6,953	5,396	7,467	6,094	38,950	39,000	7,793	5,846	8,307	6,734
<b>33,000</b>						<b>36,000</b>						<b>39,000</b>					
33,000	33,050	6,127	4,954	6,641	5,068	36,000	36,050	6,967	5,404	7,481	6,108	39,000	39,050	7,807	5,854	8,321	6,748
33,050	33,100	6,141	4,961	6,655	5,082	36,050	36,100	6,981	5,411	7,495	6,122	39,050	39,100	7,821	5,861	8,335	6,762
33,100	33,150	6,155	4,969	6,669	5,096	36,100	36,150	6,995	5,419	7,509	6,136	39,100	39,150	7,835	5,868	8,349	6,776
33,150	33,200	6,169	4,976	6,683	5,110	36,150	36,200	7,009	5,426	7,523	6,150	39,150	39,200	7,849	5,876	8,363	6,790
33,200	33,250	6,183	4,984	6,697	5,124	36,200	36,250	7,023	5,434	7,537	6,164	39,200	39,250	7,863	5,884	8,377	6,804
33,250	33,300	6,197	4,991	6,711	5,138	36,250	36,300	7,037	5,441	7,551	6,178	39,250	39,300	7,877	5,891	8,391	6,818
33,300	33,350	6,211	4,998	6,725	5,152	36,300	36,350	7,051	5,449	7,565	6,192	39,300	39,350	7,891	5,899	8,405	6,832
33,350	33,400	6,225	5,006	6,739	5,166	36,350	36,400	7,065	5,456	7,579	6,206	39,350	39,400	7,905	5,906	8,419	6,846
33,400	33,450	6,239	5,014	6,753	5,180	36,400	36,450	7,079	5,464	7,593	6,220	39,400	39,450	7,919	5,914	8,433	6,860
33,450	33,500	6,253	5,021	6,767	5,194	36,450	36,500	7,093	5,471	7,607	6,234	39,450	39,500	7,933	5,921	8,447	6,874
33,500	33,550	6,267	5,029	6,781	5,208	36,500	36,550	7,107	5,479	7,621	6,248	39,500	39,550	7,947	5,929	8,461	6,888
33,550	33,600	6,281	5,036	6,795	5,222	36,550	36,600	7,121	5,486	7,635	6,262	39,550	39,600	7,961	5,936	8,475	6,902
33,600	33,650	6,295	5,044	6,809	5,236	36,600	36,650	7,135	5,494	7,649	6,276	39,600	39,650	7,975	5,944	8,489	6,916
33,650	33,700	6,309	5,051	6,823	5,250	36,650	36,700	7,149	5,501	7,663	6,290	39,650	39,700	7,989	5,951	8,503	6,930
33,700	33,750	6,323	5,059	6,837	5,264	36,700	36,750	7,163	5,509	7,677	6,304	39,700	39,750	8,003	5,959	8,517	6,944
33,750	33,800	6,337	5,066	6,851	5,278	36,750	36,800	7,177	5,516	7,691	6,318	39,750	39,800	8,017	5,966	8,531	6,958
33,800	33,850	6,351	5,074	6,865	5,292	36,800	36,850	7,191	5,524	7,705	6,332	39,800	39,850	8,031	5,974	8,545	6,972
33,850	33,900	6,365	5,081	6,879	5,306	36,850	36,900	7,205	5,531	7,719	6,346	39,850	39,900	8,045	5,981	8,559	6,986
33,900	33,950	6,379	5,089	6,893	5,320	36,900	36,950	7,219	5,539	7,733	6,360	39,900	39,950	8,059	5,989	8,573	7,000
33,950	34,000	6,393	5,096	6,907	5,334	36,950	37,000	7,233	5,546	7,747	6,374	39,950	40,000	8,073	5,996	8,587	7,014
<b>34,000</b>						<b>37,000</b>						<b>40,000</b>					
34,000	34,050	6,407	5,104	6,921	5,348	37,000	37,050	7,247	5,554	7,761	6,388	40,000	40,050	8,087	6,004	8,601	7,028
34,050	34,100	6,421	5,111	6,935	5,362	37,050	37,100	7,261	5,561	7,775	6,402	40,050	40,100	8,101	6,011	8,615	7,042
34,100	34,150	6,435	5,119	6,949	5,376	37,100	37,150	7,275	5,569	7,789	6,416	40,100	40,150	8,115	6,022	8,629	7,056
34,150	34,200	6,449	5,126	6,963	5,390	37,150	37,200	7,289	5,576	7,803	6,430	40,150	40,200	8,129	6,038	8,643	7,070
34,200	34,250	6,463	5,134	6,977	5,404	37,200	37,250	7,303	5,584	7,817	6,444	40,200	40,250	8,143	6,050	8,657	7,084
34,250	34,300	6,477	5,141	6,991	5,418	37,250	37,300	7,317	5,591	7,831	6,458	40,250	40,300	8,157	6,064	8,671	7,098
34,300	34,350	6,491	5,149	7,005	5,432	37,300	37,350	7,331	5,599	7,845	6,472	40,300	40,350	8,171	6,078	8,685	7,112
34,350	34,400	6,505	5,156	7,019	5,446	37,350	37,400	7,345	5,606	7,859	6,486	40,350	40,400	8,185	6,092	8,699	7,126
34,400	34,450	6,519	5,164	7,033	5,460	37,400	37,450	7,359	5,614	7,873	6,500	40,400	40,450	8,199	6,106	8,713	7,140
34,450	34,500	6,533	5,171	7,047	5,474	37,450	37,500	7,373	5,621	7,887	6,514	40,450	40,500	8,213	6,120	8,727	7,154
34,500	34,550	6,547	5,179	7,061	5,488	37,500	37,550	7,387	5,629	7,901	6,528	40,500	40,550	8,227	6,134	8,741	7,168
34,550	34,600	6,561	5,186	7,075	5,502	37,550	37,600	7,401	5,636	7,915	6,542	40,550	40,600	8,241	6,148	8,755	7,182
34,600	34,650	6,575	5,194	7,089	5,516	37,600	37,650	7,415	5,644	7,929	6,556	40,600	40,650	8,255	6,162	8,769	7,196
34,650	34,700	6,589	5,201	7,103	5,530	37,650	37,700	7,429	5,651	7,943	6,570	40,650	40,700	8,269	6,176	8,783	7,210
34,700	34,750	6,603	5,209	7,117	5,544	37,700	37,750	7,443	5,659	7,957	6,584	40,700	40,750	8,283	6,190	8,797	7,224
34,750	34,800	6,617	5,216	7,131	5,558	37,750	37,800	7,457	5,666	7,971	6,598	40,750	40,800	8,297	6,204	8,811	7,238
34,800	34,850	6,631	5,224	7,145	5,572	37,800	37,850	7,471	5,674	7,985	6,612	40,800	40,850	8,311	6,218	8,825	7,252
34,850	34,900	6,645	5,231	7,159	5,586	37,850	37,900	7,485	5,681	7,999	6,626	40,850	40,900	8,325	6,232	8,839	7,266
34,900	34,950	6,659	5,239	7,173	5,600	37,900	37,950	7,499	5,689	8,013	6,640</						

1996 Tax Table—Continued

If line 8 (Form 1040EZ), line 22 (Form 1040A), or line 37 (Form 1040) is—		And you are—				If line 8 (Form 1040EZ), line 22 (Form 1040A), or line 37 (Form 1040) is—		And you are—				If line 8 (Form 1040EZ), line 22 (Form 1040A), or line 37 (Form 1040) is—		And you are—			
At least	But less than	Single	Married filing jointly	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly	Married filing separately	Head of a household
		Your tax is—						Your tax is—						Your tax is—			
<b>41,000</b>						<b>44,000</b>						<b>47,000</b>					
41,000	41,050	8,367	6,274	8,881	7,308	44,000	44,050	9,207	7,114	9,721	8,148	47,000	47,050	10,047	7,954	10,581	8,988
41,050	41,100	8,381	6,288	8,895	7,322	44,050	44,100	9,221	7,128	9,735	8,162	47,050	47,100	10,061	7,968	10,575	9,002
41,100	41,150	8,395	6,302	8,909	7,336	44,100	44,150	9,235	7,142	9,749	8,176	47,100	47,150	10,075	7,982	10,589	9,016
41,150	41,200	8,409	6,316	8,923	7,350	44,150	44,200	9,249	7,156	9,763	8,190	47,150	47,200	10,089	7,996	10,603	9,030
41,200	41,250	8,423	6,330	8,937	7,364	44,200	44,250	9,263	7,170	9,777	8,204	47,200	47,250	10,103	8,010	10,617	9,044
41,250	41,300	8,437	6,344	8,951	7,378	44,250	44,300	9,277	7,184	9,791	8,218	47,250	47,300	10,117	8,024	10,631	9,058
41,300	41,350	8,451	6,358	8,965	7,392	44,300	44,350	9,291	7,198	9,805	8,232	47,300	47,350	10,131	8,038	10,645	9,072
41,350	41,400	8,465	6,372	8,979	7,406	44,350	44,400	9,305	7,212	9,819	8,246	47,350	47,400	10,145	8,052	10,659	9,086
41,400	41,450	8,479	6,386	8,993	7,420	44,400	44,450	9,319	7,226	9,833	8,260	47,400	47,450	10,159	8,066	10,673	9,100
41,450	41,500	8,493	6,400	9,007	7,434	44,450	44,500	9,333	7,240	9,847	8,274	47,450	47,500	10,173	8,080	10,687	9,114
41,500	41,550	8,507	6,414	9,021	7,448	44,500	44,550	9,347	7,254	9,861	8,288	47,500	47,550	10,187	8,094	10,701	9,128
41,550	41,600	8,521	6,428	9,035	7,462	44,550	44,600	9,361	7,268	9,875	8,302	47,550	47,600	10,201	8,108	10,715	9,142
41,600	41,650	8,535	6,442	9,049	7,476	44,600	44,650	9,375	7,282	9,889	8,316	47,600	47,650	10,215	8,122	10,729	9,156
41,650	41,700	8,549	6,456	9,063	7,490	44,650	44,700	9,389	7,296	9,903	8,330	47,650	47,700	10,229	8,136	10,743	9,170
41,700	41,750	8,563	6,470	9,077	7,504	44,700	44,750	9,403	7,310	9,917	8,344	47,700	47,750	10,243	8,150	10,757	9,184
41,750	41,800	8,577	6,484	9,091	7,518	44,750	44,800	9,417	7,324	9,931	8,358	47,750	47,800	10,257	8,164	10,771	9,198
41,800	41,850	8,591	6,498	9,105	7,532	44,800	44,850	9,431	7,338	9,945	8,372	47,800	47,850	10,271	8,178	10,785	9,212
41,850	41,900	8,605	6,512	9,119	7,546	44,850	44,900	9,445	7,352	9,959	8,386	47,850	47,900	10,285	8,192	10,799	9,226
41,900	41,950	8,619	6,526	9,133	7,560	44,900	44,950	9,459	7,366	9,973	8,400	47,900	47,950	10,299	8,206	10,813	9,240
41,950	42,000	8,633	6,540	9,147	7,574	44,950	45,000	9,473	7,380	9,987	8,414	47,950	48,000	10,313	8,220	10,827	9,254
<b>42,000</b>						<b>45,000</b>						<b>48,000</b>					
42,000	42,050	8,647	6,554	9,161	7,588	45,000	45,050	9,487	7,394	10,001	8,428	48,000	48,050	10,327	8,234	10,841	9,268
42,050	42,100	8,661	6,568	9,175	7,602	45,050	45,100	9,501	7,408	10,015	8,442	48,050	48,100	10,341	8,248	10,855	9,282
42,100	42,150	8,675	6,582	9,189	7,616	45,100	45,150	9,515	7,422	10,029	8,456	48,100	48,150	10,355	8,262	10,869	9,296
42,150	42,200	8,689	6,596	9,203	7,630	45,150	45,200	9,529	7,436	10,043	8,470	48,150	48,200	10,369	8,276	10,883	9,310
42,200	42,250	8,703	6,610	9,217	7,644	45,200	45,250	9,543	7,450	10,057	8,484	48,200	48,250	10,383	8,290	10,897	9,324
42,250	42,300	8,717	6,624	9,231	7,658	45,250	45,300	9,557	7,464	10,071	8,498	48,250	48,300	10,397	8,304	10,911	9,338
42,300	42,350	8,731	6,638	9,245	7,672	45,300	45,350	9,571	7,478	10,085	8,512	48,300	48,350	10,411	8,318	10,925	9,352
42,350	42,400	8,745	6,652	9,259	7,686	45,350	45,400	9,585	7,492	10,099	8,526	48,350	48,400	10,425	8,332	10,939	9,366
42,400	42,450	8,759	6,666	9,273	7,700	45,400	45,450	9,599	7,506	10,113	8,540	48,400	48,450	10,439	8,346	10,953	9,380
42,450	42,500	8,773	6,680	9,287	7,714	45,450	45,500	9,613	7,520	10,127	8,554	48,450	48,500	10,453	8,360	10,967	9,394
42,500	42,550	8,787	6,694	9,301	7,728	45,500	45,550	9,627	7,534	10,141	8,568	48,500	48,550	10,467	8,374	10,981	9,408
42,550	42,600	8,801	6,708	9,315	7,742	45,550	45,600	9,641	7,548	10,155	8,582	48,550	48,600	10,481	8,388	10,995	9,422
42,600	42,650	8,815	6,722	9,329	7,756	45,600	45,650	9,655	7,562	10,169	8,596	48,600	48,650	10,495	8,402	11,014	9,436
42,650	42,700	8,829	6,736	9,343	7,770	45,650	45,700	9,669	7,576	10,183	8,610	48,650	48,700	10,509	8,416	11,029	9,450
42,700	42,750	8,843	6,750	9,357	7,784	45,700	45,750	9,683	7,590	10,197	8,624	48,700	48,750	10,523	8,430	11,045	9,464
42,750	42,800	8,857	6,764	9,371	7,798	45,750	45,800	9,697	7,604	10,211	8,638	48,750	48,800	10,537	8,444	11,060	9,478
42,800	42,850	8,871	6,778	9,385	7,812	45,800	45,850	9,711	7,618	10,225	8,652	48,800	48,850	10,551	8,458	11,076	9,492
42,850	42,900	8,885	6,792	9,399	7,826	45,850	45,900	9,725	7,632	10,239	8,666	48,850	48,900	10,565	8,472	11,091	9,506
42,900	42,950	8,899	6,806	9,413	7,840	45,900	45,950	9,739	7,646	10,253	8,680	48,900	48,950	10,579	8,486	11,107	9,520
42,950	43,000	8,913	6,820	9,427	7,854	45,950	46,000	9,753	7,660	10,267	8,694	48,950	49,000	10,593	8,500	11,122	9,534
<b>43,000</b>						<b>46,000</b>						<b>49,000</b>					
43,000	43,050	8,927	6,834	9,441	7,868	46,000	46,050	9,767	7,674	10,281	8,708	49,000	49,050	10,607	8,514	11,138	9,548
43,050	43,100	8,941	6,848	9,455	7,882	46,050	46,100	9,781	7,688	10,295	8,722	49,050	49,100	10,621	8,528	11,153	9,562
43,100	43,150	8,955	6,862	9,469	7,896	46,100	46,150	9,795	7,702	10,309	8,736	49,100	49,150	10,635	8,542	11,169	9,576
43,150	43,200	8,969	6,876	9,483	7,910	46,150	46,200	9,809	7,716	10,323	8,750	49,150	49,200	10,649	8,556	11,184	9,590
43,200	43,250	8,983	6,890	9,497	7,924	46,200	46,250	9,823	7,730	10,337	8,764	49,200	49,250	10,663	8,570	11,200	9,604
43,250	43,300	8,997	6,904	9,511	7,938	46,250	46,300	9,837	7,744	10,351	8,778	49,250	49,300	10,677	8,584	11,215	9,618
43,300	43,350	9,011	6,918	9,525	7,952	46,300	46,350	9,851	7,758	10,365	8,792	49,300	49,350	10,691	8,598	11,231	9,632
43,350	43,400	9,025	6,932	9,539	7,966	46,350	46,400	9,865	7,772	10,379	8,806	49,350	49,400	10,705	8,612	11,246	9,646
43,400	43,450	9,039	6,946	9,553	7,980	46,400	46,450	9,879	7,786	10,393	8,820	49,400	49,450	10,719	8,626	11,262	9,660
43,450	43,500	9,053	6,960	9,567	7,994	46,450	46,500	9,893	7,800	10,407	8,834	49,450	49,500	10,733	8,640	11,277	9,674
43,500	43,550	9,067	6,974	9,581	8,008	46,500	46,550	9,907	7,814	10,421	8,848	49,500	49,550	10,747	8,654	11,293	9,688
43,550	43,600	9,081	6,988	9,595	8,022	46,550	46,600	9,921	7,828	10,435	8,862	49,550	49,600	10,761	8,668	11,308	9,702
43,600	43,650	9,095	7,002	9,609	8,036	46,600	46,650	9,935	7,842	10,449	8,876	49,600	49,650	10,775	8,682	11,324	9,716
43,650	43,700	9,109	7,016	9,623	8,050	46,650	46,700	9,949	7,856	10,463	8,890	49,650	49,700	10,789	8,696	11,339	9,730
43,700	43,750	9,123	7,030	9,637	8,064	46,700	46,750	9,963	7,870	10,477	8,904	49,700	49,750	10,803	8,710	11,355	9,744
43,750	43,800	9,137	7,044	9,651	8,078	46,750	46,800	9,977	7,884	10,491	8,918	49,750	49,800	10,817	8,724	11,370	9,758
43,800	43,850	9,151	7,058	9,665	8,092	46,800	46,850	9,991	7,898	10,505	8,932	49,800	49,850	10,831	8,738	11,386	9,772
43,850	43,900	9,165	7,072	9,679	8,106	46,850	46,900	10,005	7,912	10,519	8,946	49,850	49,900	10,845	8,752	11,401	9,786
43,900	43,950	9,179	7,086	9,693	8,120	46,9											

1996 Tax Table—Continued

If line 37 (taxable income) is—		And you are—				If line 37 (taxable income) is—		And you are—				If line 37 (taxable income) is—		And you are—																																							
At least	But less than	Single	Married filing jointly	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly	Married filing separately	Head of a household																																				
		Your tax is—						Your tax is—						Your tax is—																																							
<b>50,000</b>																		<b>53,000</b>																		<b>56,000</b>																	
50,000	50,050	10,887	8,794	11,448	9,828	53,000	53,050	11,727	9,634	12,378	10,888	56,000	56,050	12,567	10,474	13,308	11,508																																				
50,050	50,100	10,901	8,808	11,463	9,842	53,050	53,100	11,741	9,648	12,393	10,892	56,050	56,100	12,581	10,488	13,323	11,522																																				
50,100	50,150	10,915	8,822	11,479	9,856	53,100	53,150	11,755	9,662	12,409	10,896	56,100	56,150	12,595	10,502	13,339	11,536																																				
50,150	50,200	10,929	8,836	11,494	9,870	53,150	53,200	11,769	9,676	12,424	10,910	56,150	56,200	12,609	10,516	13,354	11,550																																				
50,200	50,250	10,943	8,850	11,510	9,884	53,200	53,250	11,783	9,690	12,440	10,924	56,200	56,250	12,623	10,530	13,370	11,564																																				
50,250	50,300	10,957	8,864	11,525	9,898	53,250	53,300	11,797	9,704	12,455	10,938	56,250	56,300	12,637	10,544	13,385	11,578																																				
50,300	50,350	10,971	8,878	11,541	9,912	53,300	53,350	11,811	9,718	12,471	10,952	56,300	56,350	12,651	10,558	13,401	11,592																																				
50,350	50,400	10,985	8,892	11,556	9,926	53,350	53,400	11,825	9,732	12,486	10,966	56,350	56,400	12,665	10,572	13,416	11,606																																				
50,400	50,450	10,999	8,906	11,572	9,940	53,400	53,450	11,839	9,746	12,502	10,980	56,400	56,450	12,679	10,586	13,432	11,620																																				
50,450	50,500	11,013	8,920	11,587	9,954	53,450	53,500	11,853	9,760	12,517	10,994	56,450	56,500	12,693	10,600	13,447	11,634																																				
50,500	50,550	11,027	8,934	11,603	9,968	53,500	53,550	11,867	9,774	12,533	10,808	56,500	56,550	12,707	10,614	13,463	11,648																																				
50,550	50,600	11,041	8,948	11,618	9,982	53,550	53,600	11,881	9,788	12,548	10,822	56,550	56,600	12,721	10,628	13,478	11,662																																				
50,600	50,650	11,055	8,962	11,634	9,996	53,600	53,650	11,895	9,802	12,564	10,836	56,600	56,650	12,735	10,642	13,494	11,676																																				
50,650	50,700	11,069	8,976	11,649	10,010	53,650	53,700	11,909	9,816	12,579	10,850	56,650	56,700	12,749	10,656	13,509	11,690																																				
50,700	50,750	11,083	8,990	11,665	10,024	53,700	53,750	11,923	9,830	12,595	10,864	56,700	56,750	12,763	10,670	13,525	11,704																																				
50,750	50,800	11,097	9,004	11,680	10,038	53,750	53,800	11,937	9,844	12,610	10,878	56,750	56,800	12,777	10,684	13,540	11,718																																				
50,800	50,850	11,111	9,018	11,696	10,052	53,800	53,850	11,951	9,858	12,626	10,892	56,800	56,850	12,791	10,698	13,556	11,732																																				
50,850	50,900	11,125	9,032	11,711	10,066	53,850	53,900	11,965	9,872	12,641	10,906	56,850	56,900	12,805	10,712	13,571	11,746																																				
50,900	50,950	11,139	9,046	11,727	10,080	53,900	53,950	11,979	9,886	12,657	10,920	56,900	56,950	12,819	10,726	13,587	11,760																																				
50,950	51,000	11,153	9,060	11,742	10,094	53,950	54,000	11,993	9,900	12,672	10,934	56,950	57,000	12,833	10,740	13,602	11,774																																				
<b>51,000</b>																		<b>54,000</b>																		<b>57,000</b>																	
51,000	51,050	11,167	9,074	11,758	10,108	54,000	54,050	12,007	9,914	12,688	10,948	57,000	57,050	12,847	10,754	13,618	11,788																																				
51,050	51,100	11,181	9,088	11,773	10,122	54,050	54,100	12,021	9,928	12,703	10,962	57,050	57,100	12,861	10,768	13,633	11,802																																				
51,100	51,150	11,195	9,102	11,789	10,136	54,100	54,150	12,035	9,942	12,719	10,976	57,100	57,150	12,875	10,782	13,649	11,816																																				
51,150	51,200	11,209	9,116	11,804	10,150	54,150	54,200	12,049	9,956	12,734	10,990	57,150	57,200	12,889	10,796	13,664	11,830																																				
51,200	51,250	11,223	9,130	11,820	10,164	54,200	54,250	12,063	9,970	12,750	11,004	57,200	57,250	12,903	10,810	13,680	11,844																																				
51,250	51,300	11,237	9,144	11,835	10,178	54,250	54,300	12,077	9,984	12,765	11,018	57,250	57,300	12,917	10,824	13,695	11,858																																				
51,300	51,350	11,251	9,158	11,851	10,192	54,300	54,350	12,091	9,998	12,781	11,032	57,300	57,350	12,931	10,838	13,711	11,872																																				
51,350	51,400	11,265	9,172	11,866	10,206	54,350	54,400	12,105	10,012	12,796	11,046	57,350	57,400	12,945	10,852	13,726	11,886																																				
51,400	51,450	11,279	9,186	11,882	10,220	54,400	54,450	12,119	10,026	12,812	11,060	57,400	57,450	12,959	10,866	13,742	11,900																																				
51,450	51,500	11,293	9,200	11,897	10,234	54,450	54,500	12,133	10,040	12,827	11,074	57,450	57,500	12,973	10,880	13,757	11,914																																				
51,500	51,550	11,307	9,214	11,913	10,248	54,500	54,550	12,147	10,054	12,843	11,088	57,500	57,550	12,987	10,894	13,773	11,928																																				
51,550	51,600	11,321	9,228	11,928	10,262	54,550	54,600	12,161	10,068	12,858	11,102	57,550	57,600	13,001	10,908	13,788	11,942																																				
51,600	51,650	11,335	9,242	11,944	10,276	54,600	54,650	12,175	10,082	12,874	11,116	57,600	57,650	13,015	10,922	13,804	11,956																																				
51,650	51,700	11,349	9,256	11,959	10,290	54,650	54,700	12,189	10,096	12,889	11,130	57,650	57,700	13,029	10,936	13,819	11,970																																				
51,700	51,750	11,363	9,270	11,975	10,304	54,700	54,750	12,203	10,110	12,905	11,144	57,700	57,750	13,043	10,950	13,835	11,984																																				
51,750	51,800	11,377	9,284	11,990	10,318	54,750	54,800	12,217	10,124	12,920	11,158	57,750	57,800	13,057	10,964	13,850	11,998																																				
51,800	51,850	11,391	9,298	12,006	10,332	54,800	54,850	12,231	10,138	12,936	11,172	57,800	57,850	13,071	10,978	13,866	12,012																																				
51,850	51,900	11,405	9,312	12,021	10,346	54,850	54,900	12,245	10,152	12,951	11,186	57,850	57,900	13,085	10,992	13,881	12,026																																				
51,900	51,950	11,419	9,326	12,037	10,360	54,900	54,950	12,259	10,166	12,967	11,200	57,900	57,950	13,099	11,006	13,897	12,040																																				
51,950	52,000	11,433	9,340	12,052	10,374	54,950	55,000	12,273	10,180	12,982	11,214	57,950	58,000	13,113	11,020	13,912	12,054																																				
<b>52,000</b>																		<b>55,000</b>																		<b>58,000</b>																	
52,000	52,050	11,447	9,354	12,068	10,388	55,000	55,050	12,287	10,194	12,998	11,228	58,000	58,050	13,127	11,034	13,928	12,068																																				
52,050	52,100	11,461	9,368	12,083	10,402	55,050	55,100	12,301	10,208	13,013	11,242	58,050	58,100	13,141	11,048	13,943	12,082																																				
52,100	52,150	11,475	9,382	12,099	10,416	55,100	55,150	12,315	10,222	13,029	11,256	58,100	58,150	13,155	11,062	13,959	12,096																																				
52,150	52,200	11,489	9,396	12,114	10,430	55,150	55,200	12,329	10,236	13,044	11,270	58,150	58,200	13,170	11,076	13,974	12,110																																				
52,200	52,250	11,503	9,410	12,130	10,444	55,200	55,250	12,343	10,250	13,060	11,284	58,200	58,250	13,185	11,090	13,990	12,124																																				
52,250	52,300	11,517	9,424	12,145	10,458	55,250	55,300	12,357	10,264	13,075	11,298	58,250	58,300	13,201	11,104	14,005	12,138																																				
52,300	52,350	11,531	9,438	12,161	10,472	55,300	55,350	12,371	10,278	13,091	11,312	58,300	58,350	13,216	11,118	14,021	12,152																																				
52,350	52,400	11,545	9,452	12,176	10,486	55,350	55,400	12,385	10,292	13,106	11,326	58,350	58,400	13,232	11,132	14,036	12,166																																				
52,400	52,450	11,559	9,466	12,192	10,500	55,400	55,450	12,399	10,306	13,122	11,340	58,400	58,450	13,247	11,146	14,052	12,180																																				
52,450	52,500	11,573	9,480	12,207	10,514	55,450	55,500	12,413	10,320	13,137	11,354	58,450	58,500	13,263	11,160	14,067	12,194																																				
52,500	52,550	11,587	9,494	12,223	10,528	55,500	55,550	12,427	10,334	13,153	11,368	58,500	58,550	13,278	11,174	14,083	12,208																																				
52,550	52,600	11,601	9,508	12,238	10,542	55,550	55,600	12,441	10,348	13,168	11,382	58,550	58,600	13,294	11,188	14,098	12,222																																				
52,600	52,650	11,615	9,522	12,254	10,556	55,600	55,650	12,455	10,362	13,184	11,396	58,600	58,650	13,309	11,202	14,114	12,236																																				
52,650	52,700	11,629	9,536	12,269	10,570	55,650	55,700	12,469	10,376	13,199	11,410	58,650	58,700	13,325	11,216	14,129	12,250																																				
52,700	52,750	11,643	9,550	12,285	10,584	55,700	55,750	12,483	10,390	13,215	11,424	58,700	58,750	13,340	11,230	14,145	12,264																																				
52,750	52,800	11,657	9,564	12,300	10,598	55,750	55,800	12,497	10,404	13,230	11,438	58,750	58,800	13,356	11,244	14,160	12,278																																				
52,800	52,850	11,671	9,578	12,316	10,612	55,800	55,850	12,511	10,418	13,246	11,452	58,800	58,850	13,371	11,258	14,176																																					

1996 Tax Table—Continued

If line 37 (taxable income) is—		And you are—				If line 37 (taxable income) is—		And you are—				If line 37 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly	Married filing separately	Head of a household
		Your tax is—						Your tax is—						Your tax is—			
<b>59,000</b>						<b>62,000</b>						<b>65,000</b>					
59,000	59,050	13,433	11,314	14,238	12,348	62,000	62,050	14,363	12,154	15,168	13,188	65,000	65,050	15,293	12,994	16,098	14,028
59,050	59,100	13,449	11,328	14,253	12,362	62,050	62,100	14,379	12,168	15,183	13,202	65,050	65,100	15,309	13,008	16,113	14,042
59,100	59,150	13,464	11,342	14,269	12,376	62,100	62,150	14,394	12,182	15,199	13,216	65,100	65,150	15,324	13,022	16,129	14,056
59,150	59,200	13,480	11,356	14,284	12,390	62,150	62,200	14,410	12,196	15,214	13,230	65,150	65,200	15,340	13,036	16,144	14,070
59,200	59,250	13,495	11,370	14,300	12,404	62,200	62,250	14,425	12,210	15,230	13,244	65,200	65,250	15,355	13,050	16,160	14,084
59,250	59,300	13,511	11,384	14,315	12,418	62,250	62,300	14,441	12,224	15,245	13,258	65,250	65,300	15,371	13,064	16,175	14,098
59,300	59,350	13,526	11,398	14,331	12,432	62,300	62,350	14,456	12,238	15,261	13,272	65,300	65,350	15,386	13,078	16,191	14,112
59,350	59,400	13,542	11,412	14,346	12,446	62,350	62,400	14,472	12,252	15,276	13,286	65,350	65,400	15,402	13,092	16,206	14,126
59,400	59,450	13,557	11,426	14,362	12,460	62,400	62,450	14,487	12,266	15,292	13,300	65,400	65,450	15,417	13,106	16,222	14,140
59,450	59,500	13,573	11,440	14,377	12,474	62,450	62,500	14,503	12,280	15,307	13,314	65,450	65,500	15,433	13,120	16,237	14,154
59,500	59,550	13,588	11,454	14,393	12,488	62,500	62,550	14,518	12,294	15,323	13,328	65,500	65,550	15,448	13,134	16,253	14,168
59,550	59,600	13,604	11,468	14,408	12,502	62,550	62,600	14,534	12,308	15,338	13,342	65,550	65,600	15,464	13,148	16,268	14,182
59,600	59,650	13,618	11,482	14,424	12,516	62,600	62,650	14,549	12,322	15,354	13,356	65,600	65,650	15,479	13,162	16,284	14,196
59,650	59,700	13,635	11,496	14,439	12,530	62,650	62,700	14,565	12,336	15,369	13,370	65,650	65,700	15,495	13,176	16,299	14,210
59,700	59,750	13,651	11,510	14,455	12,544	62,700	62,750	14,580	12,350	15,385	13,384	65,700	65,750	15,510	13,190	16,315	14,224
59,750	59,800	13,666	11,524	14,470	12,558	62,750	62,800	14,596	12,364	15,400	13,398	65,750	65,800	15,526	13,204	16,330	14,238
59,800	59,850	13,681	11,538	14,486	12,572	62,800	62,850	14,611	12,378	15,416	13,412	65,800	65,850	15,541	13,218	16,346	14,252
59,850	59,900	13,697	11,552	14,501	12,586	62,850	62,900	14,627	12,392	15,431	13,426	65,850	65,900	15,557	13,232	16,361	14,266
59,900	59,950	13,712	11,566	14,517	12,600	62,900	62,950	14,642	12,406	15,447	13,440	65,900	65,950	15,572	13,246	16,377	14,280
59,950	60,000	13,728	11,580	14,532	12,614	62,950	63,000	14,658	12,420	15,462	13,454	65,950	66,000	15,588	13,260	16,392	14,294
<b>60,000</b>						<b>63,000</b>						<b>66,000</b>					
60,000	60,050	13,743	11,594	14,548	12,628	63,000	63,050	14,673	12,434	15,478	13,468	66,000	66,050	15,603	13,274	16,408	14,308
60,050	60,100	13,759	11,608	14,563	12,642	63,050	63,100	14,689	12,448	15,493	13,482	66,050	66,100	15,619	13,288	16,423	14,322
60,100	60,150	13,774	11,622	14,579	12,656	63,100	63,150	14,704	12,462	15,509	13,496	66,100	66,150	15,634	13,302	16,439	14,336
60,150	60,200	13,790	11,636	14,594	12,670	63,150	63,200	14,720	12,476	15,524	13,510	66,150	66,200	15,650	13,316	16,454	14,350
60,200	60,250	13,805	11,650	14,610	12,684	63,200	63,250	14,735	12,490	15,540	13,524	66,200	66,250	15,665	13,330	16,470	14,364
60,250	60,300	13,821	11,664	14,625	12,698	63,250	63,300	14,751	12,504	15,555	13,538	66,250	66,300	15,681	13,344	16,485	14,378
60,300	60,350	13,836	11,678	14,641	12,712	63,300	63,350	14,766	12,518	15,571	13,552	66,300	66,350	15,696	13,358	16,501	14,392
60,350	60,400	13,852	11,692	14,656	12,726	63,350	63,400	14,782	12,532	15,586	13,566	66,350	66,400	15,712	13,372	16,516	14,406
60,400	60,450	13,867	11,706	14,672	12,740	63,400	63,450	14,797	12,546	15,602	13,580	66,400	66,450	15,727	13,386	16,532	14,420
60,450	60,500	13,883	11,720	14,687	12,754	63,450	63,500	14,813	12,560	15,617	13,594	66,450	66,500	15,743	13,400	16,547	14,434
60,500	60,550	13,898	11,734	14,703	12,768	63,500	63,550	14,828	12,574	15,633	13,608	66,500	66,550	15,758	13,414	16,563	14,448
60,550	60,600	13,914	11,748	14,718	12,782	63,550	63,600	14,844	12,588	15,648	13,622	66,550	66,600	15,774	13,428	16,578	14,462
60,600	60,650	13,929	11,762	14,734	12,796	63,600	63,650	14,859	12,602	15,664	13,636	66,600	66,650	15,789	13,442	16,594	14,476
60,650	60,700	13,945	11,776	14,749	12,810	63,650	63,700	14,875	12,616	15,679	13,650	66,650	66,700	15,805	13,456	16,609	14,490
60,700	60,750	13,960	11,790	14,765	12,824	63,700	63,750	14,890	12,630	15,695	13,664	66,700	66,750	15,820	13,470	16,625	14,504
60,750	60,800	13,976	11,804	14,780	12,838	63,750	63,800	14,906	12,644	15,710	13,678	66,750	66,800	15,836	13,484	16,640	14,518
60,800	60,850	13,991	11,818	14,796	12,852	63,800	63,850	14,921	12,658	15,726	13,692	66,800	66,850	15,851	13,498	16,656	14,532
60,850	60,900	14,007	11,832	14,811	12,866	63,850	63,900	14,937	12,672	15,741	13,706	66,850	66,900	15,867	13,512	16,671	14,546
60,900	60,950	14,022	11,846	14,827	12,880	63,900	63,950	14,952	12,686	15,757	13,720	66,900	66,950	15,882	13,526	16,687	14,560
60,950	61,000	14,038	11,860	14,842	12,894	63,950	64,000	14,968	12,700	15,772	13,734	66,950	67,000	15,898	13,540	16,702	14,574
<b>61,000</b>						<b>64,000</b>						<b>67,000</b>					
61,000	61,050	14,053	11,874	14,858	12,908	64,000	64,050	14,983	12,714	15,788	13,748	67,000	67,050	15,913	13,554	16,718	14,588
61,050	61,100	14,069	11,888	14,873	12,922	64,050	64,100	14,999	12,728	15,803	13,762	67,050	67,100	15,929	13,568	16,733	14,602
61,100	61,150	14,084	11,902	14,889	12,936	64,100	64,150	15,014	12,742	15,819	13,776	67,100	67,150	15,944	13,582	16,749	14,616
61,150	61,200	14,100	11,916	14,904	12,950	64,150	64,200	15,030	12,756	15,834	13,790	67,150	67,200	15,960	13,596	16,764	14,630
61,200	61,250	14,115	11,930	14,920	12,964	64,200	64,250	15,045	12,770	15,850	13,804	67,200	67,250	15,975	13,610	16,780	14,644
61,250	61,300	14,131	11,944	14,935	12,978	64,250	64,300	15,061	12,784	15,865	13,818	67,250	67,300	15,991	13,624	16,795	14,658
61,300	61,350	14,146	11,958	14,951	12,992	64,300	64,350	15,076	12,798	15,881	13,832	67,300	67,350	16,006	13,638	16,811	14,672
61,350	61,400	14,162	11,972	14,966	13,006	64,350	64,400	15,092	12,812	15,896	13,846	67,350	67,400	16,022	13,652	16,826	14,686
61,400	61,450	14,177	11,986	14,982	13,020	64,400	64,450	15,107	12,826	15,912	13,860	67,400	67,450	16,037	13,666	16,842	14,700
61,450	61,500	14,193	12,000	14,997	13,034	64,450	64,500	15,123	12,840	15,927	13,874	67,450	67,500	16,053	13,680	16,857	14,714
61,500	61,550	14,208	12,014	15,013	13,048	64,500	64,550	15,138	12,854	15,943	13,888	67,500	67,550	16,068	13,694	16,873	14,728
61,550	61,600	14,224	12,028	15,028	13,062	64,550	64,600	15,154	12,868	15,958	13,902	67,550	67,600	16,084	13,708	16,888	14,742
61,600	61,650	14,239	12,042	15,044	13,076	64,600	64,650	15,169	12,882	15,974	13,916	67,600	67,650	16,099	13,722	16,904	14,756
61,650	61,700	14,255	12,056	15,059	13,090	64,650	64,700	15,186	12,896	15,989	13,930	67,650	67,700	16,115	13,736	16,919	14,770
61,700	61,750	14,270	12,070	15,075	13,104	64,700	64,750	15,202	12,910	16,005	13,944	67,700	67,750	16,130	13,750	16,935	14,784
61,750	61,800	14,286	12,084	15,090	13,118	64,750	64,800	15,218	12,924	16,020	13,958	67,750	67,800	16,146	13,764	16,950	14,798
61,800	61,850	14,301</															

1996 Tax Table—Continued

If line 37 (taxable income) is—		And you are—				If line 37 (taxable income) is—		And you are—				If line 37 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly	Married filing separately	Head of a household
		Your tax is—						Your tax is—						Your tax is—			
<b>68,000</b>						<b>71,000</b>						<b>74,000</b>					
68,000	68,050	16,223	13,834	17,028	14,888	71,000	71,050	17,153	14,674	17,958	15,708	74,000	74,050	18,063	15,514	18,897	16,548
68,050	68,100	16,239	13,848	17,043	14,892	71,050	71,100	17,169	14,688	17,973	15,722	74,050	74,100	18,099	15,528	18,915	16,562
68,100	68,150	16,254	13,862	17,059	14,896	71,100	71,150	17,184	14,702	17,989	15,736	74,100	74,150	18,114	15,542	18,933	16,576
68,150	68,200	16,270	13,876	17,074	14,910	71,150	71,200	17,200	14,716	18,004	15,750	74,150	74,200	18,130	15,556	18,951	16,590
68,200	68,250	16,285	13,890	17,090	14,924	71,200	71,250	17,215	14,730	18,020	15,764	74,200	74,250	18,145	15,570	18,969	16,604
68,250	68,300	16,301	13,904	17,105	14,938	71,250	71,300	17,231	14,744	18,035	15,778	74,250	74,300	18,161	15,584	18,987	16,618
68,300	68,350	16,316	13,918	17,121	14,952	71,300	71,350	17,246	14,758	18,051	15,792	74,300	74,350	18,178	15,598	19,005	16,632
68,350	68,400	16,332	13,932	17,136	14,966	71,350	71,400	17,262	14,772	18,066	15,806	74,350	74,400	18,192	15,612	19,023	16,646
68,400	68,450	16,347	13,946	17,152	14,980	71,400	71,450	17,277	14,786	18,082	15,820	74,400	74,450	18,207	15,626	19,041	16,660
68,450	68,500	16,363	13,960	17,167	14,994	71,450	71,500	17,293	14,800	18,097	15,834	74,450	74,500	18,223	15,640	19,059	16,674
68,500	68,550	16,378	13,974	17,183	15,008	71,500	71,550	17,308	14,814	18,113	15,848	74,500	74,550	18,238	15,654	19,077	16,688
68,550	68,600	16,394	13,988	17,198	15,022	71,550	71,600	17,324	14,828	18,128	15,862	74,550	74,600	18,254	15,668	19,095	16,702
68,600	68,650	16,409	14,002	17,214	15,036	71,600	71,650	17,339	14,842	18,144	15,876	74,600	74,650	18,269	15,682	19,113	16,716
68,650	68,700	16,425	14,016	17,229	15,050	71,650	71,700	17,355	14,856	18,159	15,890	74,650	74,700	18,285	15,696	19,131	16,730
68,700	68,750	16,440	14,030	17,245	15,064	71,700	71,750	17,370	14,870	18,175	15,904	74,700	74,750	18,300	15,710	19,149	16,744
68,750	68,800	16,456	14,044	17,260	15,078	71,750	71,800	17,386	14,884	18,190	15,918	74,750	74,800	18,316	15,724	19,167	16,758
68,800	68,850	16,471	14,058	17,276	15,092	71,800	71,850	17,401	14,898	18,208	15,932	74,800	74,850	18,331	15,738	19,185	16,772
68,850	68,900	16,487	14,072	17,291	15,106	71,850	71,900	17,417	14,912	18,221	15,946	74,850	74,900	18,347	15,752	19,203	16,786
68,900	68,950	16,502	14,086	17,307	15,120	71,900	71,950	17,432	14,926	18,237	15,960	74,900	74,950	18,362	15,766	19,221	16,800
68,950	69,000	16,518	14,100	17,322	15,134	71,950	72,000	17,448	14,940	18,252	15,974	74,950	75,000	18,378	15,780	19,239	16,814
<b>69,000</b>						<b>72,000</b>						<b>75,000</b>					
69,000	69,050	16,533	14,114	17,338	15,148	72,000	72,050	17,463	14,954	18,268	15,988	75,000	75,050	18,393	15,794	19,257	16,828
69,050	69,100	16,549	14,128	17,353	15,162	72,050	72,100	17,479	14,968	18,283	16,002	75,050	75,100	18,409	15,808	19,275	16,842
69,100	69,150	16,564	14,142	17,369	15,176	72,100	72,150	17,494	14,982	18,299	16,016	75,100	75,150	18,424	15,822	19,293	16,856
69,150	69,200	16,580	14,156	17,384	15,190	72,150	72,200	17,510	14,996	18,314	16,030	75,150	75,200	18,440	15,836	19,311	16,870
69,200	69,250	16,595	14,170	17,400	15,204	72,200	72,250	17,525	15,010	18,330	16,044	75,200	75,250	18,455	15,850	19,329	16,884
69,250	69,300	16,611	14,184	17,415	15,218	72,250	72,300	17,541	15,024	18,345	16,058	75,250	75,300	18,471	15,864	19,347	16,898
69,300	69,350	16,626	14,198	17,431	15,232	72,300	72,350	17,556	15,038	18,361	16,072	75,300	75,350	18,486	15,878	19,365	16,912
69,350	69,400	16,642	14,212	17,446	15,246	72,350	72,400	17,572	15,052	18,376	16,086	75,350	75,400	18,502	15,892	19,383	16,926
69,400	69,450	16,657	14,226	17,462	15,260	72,400	72,450	17,587	15,066	18,392	16,100	75,400	75,450	18,517	15,906	19,401	16,940
69,450	69,500	16,673	14,240	17,477	15,274	72,450	72,500	17,603	15,080	18,407	16,114	75,450	75,500	18,533	15,920	19,419	16,954
69,500	69,550	16,688	14,254	17,493	15,288	72,500	72,550	17,618	15,094	18,423	16,128	75,500	75,550	18,548	15,934	19,437	16,968
69,550	69,600	16,704	14,268	17,508	15,302	72,550	72,600	17,634	15,108	18,438	16,142	75,550	75,600	18,564	15,948	19,455	16,982
69,600	69,650	16,719	14,282	17,524	15,316	72,600	72,650	17,649	15,122	18,454	16,156	75,600	75,650	18,579	15,962	19,473	16,996
69,650	69,700	16,735	14,296	17,539	15,330	72,650	72,700	17,665	15,136	18,469	16,170	75,650	75,700	18,595	15,976	19,491	17,010
69,700	69,750	16,750	14,310	17,555	15,344	72,700	72,750	17,680	15,150	18,485	16,184	75,700	75,750	18,610	15,990	19,509	17,024
69,750	69,800	16,766	14,324	17,570	15,358	72,750	72,800	17,696	15,164	18,500	16,198	75,750	75,800	18,626	16,004	19,527	17,038
69,800	69,850	16,781	14,338	17,586	15,372	72,800	72,850	17,711	15,178	18,516	16,212	75,800	75,850	18,641	16,018	19,545	17,052
69,850	69,900	16,797	14,352	17,601	15,386	72,850	72,900	17,727	15,192	18,531	16,226	75,850	75,900	18,657	16,032	19,563	17,066
69,900	69,950	16,812	14,366	17,617	15,400	72,900	72,950	17,742	15,206	18,547	16,240	75,900	75,950	18,672	16,046	19,581	17,080
69,950	70,000	16,828	14,380	17,632	15,414	72,950	73,000	17,758	15,220	18,562	16,254	75,950	76,000	18,688	16,060	19,599	17,094
<b>70,000</b>						<b>73,000</b>						<b>76,000</b>					
70,000	70,050	16,843	14,394	17,648	15,428	73,000	73,050	17,773	15,234	18,578	16,268	76,000	76,050	18,703	16,074	19,617	17,108
70,050	70,100	16,859	14,408	17,663	15,442	73,050	73,100	17,789	15,248	18,593	16,282	76,050	76,100	18,719	16,088	19,635	17,122
70,100	70,150	16,874	14,422	17,679	15,456	73,100	73,150	17,804	15,262	18,609	16,296	76,100	76,150	18,734	16,102	19,653	17,136
70,150	70,200	16,890	14,436	17,694	15,470	73,150	73,200	17,820	15,276	18,624	16,310	76,150	76,200	18,750	16,116	19,671	17,150
70,200	70,250	16,905	14,450	17,710	15,484	73,200	73,250	17,835	15,290	18,640	16,324	76,200	76,250	18,765	16,130	19,689	17,164
70,250	70,300	16,921	14,464	17,725	15,498	73,250	73,300	17,851	15,304	18,655	16,338	76,250	76,300	18,781	16,144	19,707	17,178
70,300	70,350	16,936	14,478	17,741	15,512	73,300	73,350	17,866	15,318	18,671	16,352	76,300	76,350	18,796	16,158	19,725	17,192
70,350	70,400	16,952	14,492	17,756	15,526	73,350	73,400	17,882	15,332	18,686	16,366	76,350	76,400	18,812	16,172	19,743	17,206
70,400	70,450	16,967	14,506	17,772	15,540	73,400	73,450	17,897	15,346	18,702	16,380	76,400	76,450	18,827	16,186	19,761	17,220
70,450	70,500	16,983	14,520	17,787	15,554	73,450	73,500	17,913	15,360	18,717	16,394	76,450	76,500	18,843	16,200	19,779	17,234
70,500	70,550	16,998	14,534	17,803	15,568	73,500	73,550	17,928	15,374	18,733	16,408	76,500	76,550	18,858	16,214	19,797	17,248
70,550	70,600	17,014	14,548	17,818	15,582	73,550	73,600	17,944	15,388	18,748	16,422	76,550	76,600	18,874	16,228	19,815	17,262
70,600	70,650	17,029	14,562	17,834	15,596	73,600	73,650	17,959	15,402	18,764	16,436	76,600	76,650	18,889	16,242	19,833	17,276
70,650	70,700	17,045	14,576	17,849	15,610	73,650	73,700	17,975	15,416	18,779	16,450	76,650	76,700	18,905	16,256	19,851	17,290
70,700	70,750	17,060	14,590	17,865	15,624	73,700	73,750	17,990	15,430	18,795	16,464	76,700	76,750	18,920	16,270	19,869	17,304
70,750	70,800	17,076	14,604	17,880	15,638	73,750	73,800	18,006	15,444	18,810	16,478	76,750	76,800	18,936	16,284	19,887	17,318
70,800	70,850	17,09															

1996 Tax Table—Continued

If line 37 (taxable income) is—		And you are—				If line 37 (taxable income) is—		And you are—				If line 37 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly	Married filing separately	Head of a household
		Your tax is—						Your tax is—						Your tax is—			
<b>77,000</b>						<b>80,000</b>						<b>83,000</b>					
77,000	77,050	19,013	18,354	19,977	17,388	80,000	80,050	19,943	17,194	21,057	18,228	83,000	83,050	20,873	18,034	22,137	19,068
77,050	77,100	19,029	18,368	19,995	17,402	80,050	80,100	19,959	17,208	21,075	18,242	83,050	83,100	20,889	18,048	22,155	19,082
77,100	77,150	19,044	18,382	20,013	17,416	80,100	80,150	19,974	17,222	21,093	18,256	83,100	83,150	20,904	18,062	22,173	19,096
77,150	77,200	19,060	18,396	20,031	17,430	80,150	80,200	19,990	17,236	21,111	18,270	83,150	83,200	20,920	18,076	22,191	19,113
77,200	77,250	19,075	18,410	20,049	17,444	80,200	80,250	20,005	17,250	21,129	18,284	83,200	83,250	20,935	18,090	22,209	19,129
77,250	77,300	19,091	18,424	20,067	17,458	80,250	80,300	20,021	17,264	21,147	18,298	83,250	83,300	20,951	18,104	22,227	19,144
77,300	77,350	19,106	18,438	20,085	17,472	80,300	80,350	20,036	17,278	21,165	18,312	83,300	83,350	20,966	18,118	22,245	19,160
77,350	77,400	19,122	18,452	20,103	17,486	80,350	80,400	20,052	17,292	21,183	18,326	83,350	83,400	20,982	18,132	22,263	19,175
77,400	77,450	19,137	18,466	20,121	17,500	80,400	80,450	20,067	17,306	21,201	18,340	83,400	83,450	20,997	18,146	22,281	19,191
77,450	77,500	19,153	18,480	20,139	17,514	80,450	80,500	20,083	17,320	21,219	18,354	83,450	83,500	21,013	18,160	22,299	19,206
77,500	77,550	19,168	18,494	20,157	17,528	80,500	80,550	20,098	17,334	21,237	18,368	83,500	83,550	21,028	18,174	22,317	19,222
77,550	77,600	19,184	18,508	20,175	17,542	80,550	80,600	20,114	17,348	21,255	18,382	83,550	83,600	21,044	18,188	22,335	19,237
77,600	77,650	19,199	18,522	20,193	17,556	80,600	80,650	20,129	17,362	21,273	18,396	83,600	83,650	21,059	18,202	22,353	19,253
77,650	77,700	19,215	18,536	20,211	17,570	80,650	80,700	20,145	17,376	21,291	18,410	83,650	83,700	21,075	18,216	22,371	19,268
77,700	77,750	19,230	18,550	20,229	17,584	80,700	80,750	20,160	17,390	21,309	18,424	83,700	83,750	21,090	18,230	22,389	19,284
77,750	77,800	19,246	18,564	20,247	17,598	80,750	80,800	20,176	17,404	21,327	18,438	83,750	83,800	21,106	18,244	22,407	19,299
77,800	77,850	19,261	18,578	20,265	17,612	80,800	80,850	20,191	17,418	21,345	18,452	83,800	83,850	21,121	18,258	22,425	19,315
77,850	77,900	19,277	18,592	20,283	17,626	80,850	80,900	20,207	17,432	21,363	18,466	83,850	83,900	21,137	18,272	22,443	19,330
77,900	77,950	19,292	18,606	20,301	17,640	80,900	80,950	20,222	17,446	21,381	18,480	83,900	83,950	21,152	18,286	22,461	19,346
77,950	78,000	19,308	18,620	20,319	17,654	80,950	81,000	20,238	17,460	21,399	18,494	83,950	84,000	21,168	18,300	22,479	19,361
<b>78,000</b>						<b>81,000</b>						<b>84,000</b>					
78,000	78,050	19,323	18,634	20,337	17,668	81,000	81,050	20,253	17,474	21,417	18,508	84,000	84,050	21,183	18,314	22,497	19,377
78,050	78,100	19,339	18,648	20,355	17,682	81,050	81,100	20,269	17,488	21,435	18,522	84,050	84,100	21,199	18,328	22,515	19,392
78,100	78,150	19,354	18,662	20,373	17,696	81,100	81,150	20,284	17,502	21,453	18,536	84,100	84,150	21,214	18,342	22,533	19,408
78,150	78,200	19,370	18,676	20,391	17,710	81,150	81,200	20,300	17,516	21,471	18,550	84,150	84,200	21,230	18,356	22,551	19,423
78,200	78,250	19,385	18,690	20,409	17,724	81,200	81,250	20,315	17,530	21,489	18,564	84,200	84,250	21,245	18,370	22,569	19,439
78,250	78,300	19,401	18,704	20,427	17,738	81,250	81,300	20,331	17,544	21,507	18,578	84,250	84,300	21,261	18,384	22,587	19,454
78,300	78,350	19,416	18,718	20,445	17,752	81,300	81,350	20,346	17,558	21,525	18,592	84,300	84,350	21,276	18,398	22,605	19,470
78,350	78,400	19,432	18,732	20,463	17,766	81,350	81,400	20,362	17,572	21,543	18,606	84,350	84,400	21,292	18,412	22,623	19,485
78,400	78,450	19,447	18,746	20,481	17,780	81,400	81,450	20,377	17,586	21,561	18,620	84,400	84,450	21,307	18,426	22,641	19,501
78,450	78,500	19,463	18,760	20,499	17,794	81,450	81,500	20,393	17,600	21,579	18,634	84,450	84,500	21,323	18,440	22,659	19,516
78,500	78,550	19,478	18,774	20,517	17,808	81,500	81,550	20,408	17,614	21,597	18,648	84,500	84,550	21,338	18,454	22,677	19,532
78,550	78,600	19,494	18,788	20,535	17,822	81,550	81,600	20,424	17,628	21,615	18,662	84,550	84,600	21,354	18,468	22,695	19,547
78,600	78,650	19,509	18,802	20,553	17,836	81,600	81,650	20,439	17,642	21,633	18,676	84,600	84,650	21,369	18,482	22,713	19,563
78,650	78,700	19,525	18,816	20,571	17,850	81,650	81,700	20,455	17,656	21,651	18,690	84,650	84,700	21,385	18,496	22,731	19,578
78,700	78,750	19,540	18,830	20,589	17,864	81,700	81,750	20,470	17,670	21,669	18,704	84,700	84,750	21,400	18,510	22,749	19,594
78,750	78,800	19,556	18,844	20,607	17,878	81,750	81,800	20,486	17,684	21,687	18,718	84,750	84,800	21,416	18,524	22,767	19,609
78,800	78,850	19,571	18,858	20,625	17,892	81,800	81,850	20,501	17,698	21,705	18,732	84,800	84,850	21,431	18,538	22,785	19,625
78,850	78,900	19,587	18,872	20,643	17,906	81,850	81,900	20,517	17,712	21,723	18,746	84,850	84,900	21,447	18,552	22,803	19,640
78,900	78,950	19,602	18,886	20,661	17,920	81,900	81,950	20,532	17,726	21,741	18,760	84,900	84,950	21,462	18,566	22,821	19,656
78,950	79,000	19,618	18,900	20,679	17,934	81,950	82,000	20,548	17,740	21,759	18,774	84,950	85,000	21,478	18,580	22,839	19,671
<b>79,000</b>						<b>82,000</b>						<b>85,000</b>					
79,000	79,050	19,633	18,914	20,697	17,948	82,000	82,050	20,563	17,754	21,777	18,788	85,000	85,050	21,493	18,594	22,857	19,687
79,050	79,100	19,649	18,928	20,715	17,962	82,050	82,100	20,579	17,768	21,795	18,802	85,050	85,100	21,509	18,608	22,875	19,702
79,100	79,150	19,664	18,942	20,733	17,976	82,100	82,150	20,594	17,782	21,813	18,816	85,100	85,150	21,524	18,622	22,893	19,718
79,150	79,200	19,680	18,956	20,751	17,990	82,150	82,200	20,610	17,796	21,831	18,830	85,150	85,200	21,540	18,636	22,911	19,733
79,200	79,250	19,695	18,970	20,769	18,004	82,200	82,250	20,625	17,810	21,849	18,844	85,200	85,250	21,555	18,650	22,929	19,749
79,250	79,300	19,711	18,984	20,787	18,018	82,250	82,300	20,641	17,824	21,867	18,858	85,250	85,300	21,571	18,664	22,947	19,764
79,300	79,350	19,726	18,998	20,805	18,032	82,300	82,350	20,656	17,838	21,885	18,872	85,300	85,350	21,586	18,678	22,965	19,780
79,350	79,400	19,742	19,012	20,823	18,046	82,350	82,400	20,672	17,852	21,903	18,886	85,350	85,400	21,602	18,692	22,983	19,795
79,400	79,450	19,757	19,026	20,841	18,060	82,400	82,450	20,687	17,866	21,921	18,900	85,400	85,450	21,617	18,706	23,001	19,811
79,450	79,500	19,773	19,040	20,859	18,074	82,450	82,500	20,703	17,880	21,939	18,914	85,450	85,500	21,633	18,720	23,019	19,826
79,500	79,550	19,788	19,054	20,877	18,088	82,500	82,550	20,718	17,894	21,957	18,928	85,500	85,550	21,648	18,734	23,037	19,842
79,550	79,600	19,804	19,068	20,895	18,102	82,550	82,600	20,734	17,908	21,975	18,942	85,550	85,600	21,664	18,748	23,055	19,857
79,600	79,650	19,819	19,082	20,913	18,116	82,600	82,650	20,749	17,922	21,993	18,956	85,600	85,650	21,679	18,762	23,073	19,873
79,650	79,700	19,835	19,096	20,931	18,130	82,650	82,700	20,765	17,936	22,011	18,970	85,650	85,700	21,695	18,776	23,091	19,888
79,700	79,750	19,850	19,110	20,949	18,144	82,700	82,750	20,780	17,950	22,029	18,984	85,700	85,750	21,710	18,790	23,109	19,904
79,750	79,800	19,866	19,124	20,967	18,158	82,750	82,800	20,796	17,964	22,047	18,998	85,750	85,800	21,726	18,804	23,127	19,919
79,800	79,850	19,881</															

1996 Tax Table—Continued

If line 37 (taxable income) is—		And you are—				If line 37 (taxable income) is—		And you are—				If line 37 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly	Married filing separately	Head of a household
		Your tax is—						Your tax is—						Your tax is—			
<b>86,000</b>						<b>89,000</b>						<b>92,000</b>					
86,000	86,050	21,803	18,874	23,217	19,997	89,000	89,050	22,733	19,714	24,297	20,827	92,000	92,050	23,863	20,554	25,377	21,857
86,050	86,100	21,818	18,888	23,235	20,012	89,050	89,100	22,749	19,728	24,315	20,842	92,050	92,100	23,879	20,568	25,395	21,872
86,100	86,150	21,834	18,902	23,253	20,028	89,100	89,150	22,764	19,742	24,333	20,858	92,100	92,150	23,894	20,582	25,413	21,888
86,150	86,200	21,850	18,916	23,271	20,043	89,150	89,200	22,780	19,756	24,351	20,873	92,150	92,200	23,710	20,596	25,431	21,903
86,200	86,250	21,865	18,930	23,289	20,059	89,200	89,250	22,795	19,770	24,369	20,889	92,200	92,250	23,725	20,610	25,449	21,919
86,250	86,300	21,881	18,944	23,307	20,074	89,250	89,300	22,811	19,784	24,387	21,004	92,250	92,300	23,741	20,624	25,467	21,934
86,300	86,350	21,896	18,958	23,325	20,090	89,300	89,350	22,826	19,798	24,405	21,020	92,300	92,350	23,756	20,638	25,485	21,950
86,350	86,400	21,912	18,972	23,343	20,105	89,350	89,400	22,842	19,812	24,423	21,035	92,350	92,400	23,772	20,652	25,503	21,965
86,400	86,450	21,927	18,988	23,361	20,121	89,400	89,450	22,857	19,826	24,441	21,051	92,400	92,450	23,787	20,666	25,521	21,981
86,450	86,500	21,943	19,000	23,379	20,138	89,450	89,500	22,873	19,840	24,459	21,066	92,450	92,500	23,803	20,680	25,539	21,996
86,500	86,550	21,958	19,014	23,397	20,152	89,500	89,550	22,888	19,854	24,477	21,082	92,500	92,550	23,818	20,694	25,557	22,012
86,550	86,600	21,974	19,028	23,415	20,167	89,550	89,600	22,904	19,868	24,495	21,097	92,550	92,600	23,834	20,708	25,575	22,027
86,600	86,650	21,989	19,042	23,433	20,183	89,600	89,650	22,919	19,882	24,513	21,113	92,600	92,650	23,849	20,722	25,593	22,043
86,650	86,700	22,005	19,056	23,451	20,198	89,650	89,700	22,935	19,896	24,531	21,128	92,650	92,700	23,865	20,736	25,611	22,058
86,700	86,750	22,020	19,070	23,469	20,214	89,700	89,750	22,950	19,910	24,549	21,144	92,700	92,750	23,880	20,750	25,629	22,074
86,750	86,800	22,036	19,084	23,487	20,229	89,750	89,800	22,966	19,924	24,567	21,159	92,750	92,800	23,896	20,764	25,647	22,089
86,800	86,850	22,051	19,098	23,505	20,245	89,800	89,850	22,981	19,938	24,585	21,175	92,800	92,850	23,911	20,778	25,665	22,105
86,850	86,900	22,067	19,112	23,523	20,260	89,850	89,900	22,997	19,952	24,603	21,190	92,850	92,900	23,927	20,792	25,683	22,120
86,900	86,950	22,082	19,126	23,541	20,276	89,900	89,950	23,012	19,966	24,621	21,206	92,900	92,950	23,942	20,806	25,701	22,136
86,950	87,000	22,098	19,140	23,559	20,291	89,950	90,000	23,028	19,980	24,639	21,221	92,950	93,000	23,958	20,820	25,719	22,151
<b>87,000</b>						<b>90,000</b>						<b>93,000</b>					
87,000	87,050	22,113	19,154	23,577	20,307	90,000	90,050	23,043	19,994	24,657	21,237	93,000	93,050	23,973	20,834	25,737	22,167
87,050	87,100	22,129	19,168	23,595	20,322	90,050	90,100	23,059	20,008	24,675	21,252	93,050	93,100	23,989	20,848	25,755	22,182
87,100	87,150	22,144	19,182	23,613	20,338	90,100	90,150	23,074	20,022	24,693	21,268	93,100	93,150	24,004	20,862	25,773	22,198
87,150	87,200	22,160	19,196	23,631	20,353	90,150	90,200	23,090	20,036	24,711	21,283	93,150	93,200	24,020	20,876	25,791	22,213
87,200	87,250	22,175	19,210	23,649	20,369	90,200	90,250	23,105	20,050	24,729	21,299	93,200	93,250	24,035	20,890	25,809	22,229
87,250	87,300	22,191	19,224	23,667	20,384	90,250	90,300	23,121	20,064	24,747	21,314	93,250	93,300	24,051	20,904	25,827	22,244
87,300	87,350	22,206	19,238	23,685	20,400	90,300	90,350	23,136	20,078	24,765	21,330	93,300	93,350	24,066	20,918	25,845	22,260
87,350	87,400	22,222	19,252	23,703	20,415	90,350	90,400	23,152	20,092	24,783	21,345	93,350	93,400	24,082	20,932	25,863	22,275
87,400	87,450	22,237	19,266	23,721	20,431	90,400	90,450	23,167	20,106	24,801	21,361	93,400	93,450	24,097	20,946	25,881	22,291
87,450	87,500	22,253	19,280	23,739	20,446	90,450	90,500	23,183	20,120	24,819	21,376	93,450	93,500	24,113	20,960	25,899	22,306
87,500	87,550	22,268	19,294	23,757	20,462	90,500	90,550	23,198	20,134	24,837	21,392	93,500	93,550	24,128	20,974	25,917	22,322
87,550	87,600	22,284	19,308	23,775	20,477	90,550	90,600	23,214	20,148	24,855	21,407	93,550	93,600	24,144	20,988	25,935	22,337
87,600	87,650	22,299	19,322	23,793	20,493	90,600	90,650	23,229	20,162	24,873	21,423	93,600	93,650	24,159	21,002	25,953	22,353
87,650	87,700	22,315	19,336	23,811	20,508	90,650	90,700	23,245	20,176	24,891	21,438	93,650	93,700	24,175	21,016	25,971	22,368
87,700	87,750	22,330	19,350	23,829	20,524	90,700	90,750	23,260	20,190	24,909	21,454	93,700	93,750	24,190	21,030	25,989	22,384
87,750	87,800	22,346	19,364	23,847	20,539	90,750	90,800	23,276	20,204	24,927	21,469	93,750	93,800	24,206	21,044	26,007	22,399
87,800	87,850	22,361	19,378	23,865	20,555	90,800	90,850	23,291	20,218	24,945	21,485	93,800	93,850	24,221	21,058	26,025	22,415
87,850	87,900	22,377	19,392	23,883	20,570	90,850	90,900	23,307	20,232	24,963	21,500	93,850	93,900	24,237	21,072	26,043	22,430
87,900	87,950	22,392	19,406	23,901	20,586	90,900	90,950	23,322	20,246	24,981	21,516	93,900	93,950	24,252	21,086	26,061	22,446
87,950	88,000	22,408	19,420	23,919	20,601	90,950	91,000	23,338	20,260	24,999	21,531	93,950	94,000	24,268	21,100	26,079	22,461
<b>88,000</b>						<b>91,000</b>						<b>94,000</b>					
88,000	88,050	22,423	19,434	23,937	20,617	91,000	91,050	23,353	20,274	25,017	21,547	94,000	94,050	24,283	21,114	26,097	22,477
88,050	88,100	22,439	19,448	23,955	20,632	91,050	91,100	23,369	20,288	25,035	21,562	94,050	94,100	24,299	21,128	26,115	22,492
88,100	88,150	22,454	19,462	23,973	20,648	91,100	91,150	23,384	20,302	25,053	21,578	94,100	94,150	24,314	21,142	26,133	22,508
88,150	88,200	22,470	19,476	23,991	20,663	91,150	91,200	23,400	20,316	25,071	21,593	94,150	94,200	24,330	21,156	26,151	22,523
88,200	88,250	22,485	19,490	24,009	20,679	91,200	91,250	23,415	20,330	25,089	21,609	94,200	94,250	24,345	21,170	26,169	22,539
88,250	88,300	22,501	19,504	24,027	20,694	91,250	91,300	23,431	20,344	25,107	21,624	94,250	94,300	24,361	21,184	26,187	22,554
88,300	88,350	22,516	19,518	24,045	20,710	91,300	91,350	23,446	20,358	25,125	21,640	94,300	94,350	24,376	21,198	26,205	22,570
88,350	88,400	22,532	19,532	24,063	20,725	91,350	91,400	23,462	20,372	25,143	21,655	94,350	94,400	24,392	21,212	26,223	22,585
88,400	88,450	22,547	19,546	24,081	20,741	91,400	91,450	23,477	20,386	25,161	21,671	94,400	94,450	24,407	21,226	26,241	22,601
88,450	88,500	22,563	19,560	24,099	20,756	91,450	91,500	23,493	20,400	25,179	21,686	94,450	94,500	24,423	21,240	26,259	22,616
88,500	88,550	22,578	19,574	24,117	20,772	91,500	91,550	23,508	20,414	25,197	21,702	94,500	94,550	24,438	21,254	26,277	22,632
88,550	88,600	22,594	19,588	24,135	20,787	91,550	91,600	23,524	20,428	25,215	21,717	94,550	94,600	24,454	21,268	26,295	22,647
88,600	88,650	22,609	19,602	24,153	20,803	91,600	91,650	23,539	20,442	25,233	21,733	94,600	94,650	24,469	21,282	26,313	22,663
88,650	88,700	22,625	19,616	24,171	20,818	91,650	91,700	23,555	20,456	25,251	21,748	94,650	94,700	24,485	21,296	26,331	22,678
88,700	88,750	22,640	19,630	24,189	20,834	91,700	91,750	23,570	20,470	25,269	21,764	94,700	94,750	24,500	21,310	26,349	22,694
88,750	88,800	22,656	19,644	24,207	20,849	91,750	91,800	23,586	20,484	25,287	21,779	94,750	94,800	24,516	21,324	26,367	22,709
88,800	88,850	22,671</															

1996 Tax Table—Continued

If line 37 (taxable income) is—		And you are—				If line 37 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—						Your tax is—			
<b>95,000</b>						<b>98,000</b>					
95,000	95,050	24,593	21,394	26,457	22,787	98,000	98,050	25,523	22,268	27,537	23,717
95,050	95,100	24,609	21,408	26,475	22,802	98,050	98,100	25,539	22,283	27,555	23,732
95,100	95,150	24,624	21,422	26,493	22,818	98,100	98,150	25,554	22,299	27,573	23,748
95,150	95,200	24,640	21,436	26,511	22,833	98,150	98,200	25,570	22,314	27,591	23,763
95,200	95,250	24,655	21,450	26,529	22,849	98,200	98,250	25,585	22,330	27,609	23,779
95,250	95,300	24,671	21,464	26,547	22,864	98,250	98,300	25,601	22,345	27,627	23,794
95,300	95,350	24,688	21,478	26,565	22,880	98,300	98,350	25,616	22,361	27,645	23,810
95,350	95,400	24,702	21,492	26,583	22,895	98,350	98,400	25,632	22,376	27,663	23,825
95,400	95,450	24,717	21,506	26,601	22,911	98,400	98,450	25,647	22,392	27,681	23,841
95,450	95,500	24,733	21,520	26,619	22,926	98,450	98,500	25,663	22,407	27,699	23,856
95,500	95,550	24,748	21,534	26,637	22,942	98,500	98,550	25,678	22,423	27,717	23,872
95,550	95,600	24,764	21,548	26,655	22,957	98,550	98,600	25,694	22,438	27,735	23,887
95,600	95,650	24,779	21,562	26,673	22,973	98,600	98,650	25,709	22,454	27,753	23,903
95,650	95,700	24,795	21,576	26,691	22,988	98,650	98,700	25,725	22,469	27,771	23,918
95,700	95,750	24,810	21,590	26,709	23,004	98,700	98,750	25,740	22,485	27,789	23,934
95,750	95,800	24,826	21,604	26,727	23,019	98,750	98,800	25,756	22,500	27,807	23,949
95,800	95,850	24,841	21,618	26,745	23,035	98,800	98,850	25,771	22,516	27,825	23,965
95,850	95,900	24,857	21,632	26,763	23,050	98,850	98,900	25,787	22,531	27,843	23,980
95,900	95,950	24,872	21,646	26,781	23,066	98,900	98,950	25,802	22,547	27,861	23,996
95,950	96,000	24,888	21,660	26,799	23,081	98,950	99,000	25,818	22,562	27,879	24,011
<b>96,000</b>						<b>99,000</b>					
96,000	96,050	24,903	21,674	26,817	23,097	99,000	99,050	25,833	22,578	27,897	24,027
96,050	96,100	24,919	21,688	26,835	23,112	99,050	99,100	25,849	22,593	27,915	24,042
96,100	96,150	24,934	21,702	26,853	23,128	99,100	99,150	25,864	22,608	27,933	24,058
96,150	96,200	24,950	21,716	26,871	23,143	99,150	99,200	25,880	22,624	27,951	24,073
96,200	96,250	24,965	21,730	26,889	23,159	99,200	99,250	25,895	22,640	27,969	24,089
96,250	96,300	24,981	21,744	26,907	23,174	99,250	99,300	25,911	22,655	27,987	24,104
96,300	96,350	24,996	21,758	26,925	23,190	99,300	99,350	25,926	22,671	28,005	24,120
96,350	96,400	25,012	21,772	26,943	23,205	99,350	99,400	25,942	22,686	28,023	24,135
96,400	96,450	25,027	21,786	26,961	23,221	99,400	99,450	25,957	22,702	28,041	24,151
96,450	96,500	25,043	21,800	26,979	23,236	99,450	99,500	25,973	22,717	28,059	24,166
96,500	96,550	25,058	21,814	26,997	23,252	99,500	99,550	25,988	22,733	28,077	24,182
96,550	96,600	25,074	21,828	27,015	23,267	99,550	99,600	26,004	22,748	28,095	24,197
96,600	96,650	25,089	21,842	27,033	23,283	99,600	99,650	26,019	22,764	28,113	24,213
96,650	96,700	25,105	21,856	27,051	23,298	99,650	99,700	26,035	22,779	28,131	24,228
96,700	96,750	25,120	21,870	27,069	23,314	99,700	99,750	26,050	22,795	28,149	24,244
96,750	96,800	25,136	21,884	27,087	23,329	99,750	99,800	26,066	22,810	28,167	24,259
96,800	96,850	25,151	21,898	27,105	23,345	99,800	99,850	26,081	22,826	28,185	24,275
96,850	96,900	25,167	21,912	27,123	23,360	99,850	99,900	26,097	22,841	28,203	24,290
96,900	96,950	25,182	21,927	27,141	23,376	99,900	99,950	26,112	22,857	28,221	24,306
96,950	97,000	25,198	21,942	27,159	23,391	99,950	100,000	26,128	22,872	28,239	24,321
<b>97,000</b>						<div style="border: 1px solid black; border-radius: 50%; padding: 20px; width: fit-content; margin: auto;"> <p><b>\$100,000</b> or over — use the Tax Rate Schedules</p> </div>					
97,000	97,050	25,213	21,956	27,177	23,407						
97,050	97,100	25,229	21,973	27,195	23,422						
97,100	97,150	25,244	21,989	27,213	23,438						
97,150	97,200	25,260	22,004	27,231	23,453						
97,200	97,250	25,275	22,020	27,249	23,469						
97,250	97,300	25,291	22,035	27,267	23,484						
97,300	97,350	25,306	22,051	27,285	23,500						
97,350	97,400	25,322	22,066	27,303	23,515						
97,400	97,450	25,337	22,082	27,321	23,531						
97,450	97,500	25,353	22,097	27,339	23,546						
97,500	97,550	25,368	22,113	27,357	23,562						
97,550	97,600	25,384	22,128	27,375	23,577						
97,600	97,650	25,399	22,144	27,393	23,593						
97,650	97,700	25,415	22,159	27,411	23,608						
97,700	97,750	25,430	22,175	27,429	23,624						
97,750	97,800	25,446	22,190	27,447	23,639						
97,800	97,850	25,461	22,206	27,465	23,655						
97,850	97,900	25,477	22,221	27,483	23,670						
97,900	97,950	25,492	22,237	27,501	23,686						
97,950	98,000	25,508	22,252	27,519	23,701						

\* This column must also be used by a qualifying widow(er).

# 1996 Tax Rate Schedules

**Caution:** Use *only* if your taxable income (Form 1040, line 37) is \$100,000 or more. If less, use the Tax Table. Even though you cannot use the Tax Rate Schedules below if your taxable income is less than \$100,000, all levels of taxable income are shown so taxpayers can see the tax rate that applies to each level.

## Schedule X—Use if your filing status is Single

If the amount on Form 1040, line 37, is: Over—	But not over—	Enter on Form 1040, line 38	of the amount over—
\$0	\$24,000	..... 15%	\$0
24,000	58,150	\$3,600.00 + 28%	24,000
58,150	121,300	13,162.00 + 31%	58,150
121,300	263,750	32,738.50 + 36%	121,300
263,750	.....	84,020.50 + 39.6%	263,750

## Schedule Y-1—Use if your filing status is Married filing jointly or Qualifying widow(er)

If the amount on Form 1040, line 37, is: Over—	But not over—	Enter on Form 1040, line 38	of the amount over—
\$0	\$40,100	..... 15%	\$0
40,100	96,900	\$6,015.00 + 28%	40,100
96,900	147,700	21,919.00 + 31%	96,900
147,700	263,750	37,667.00 + 36%	147,700
263,750	.....	79,445.00 + 39.6%	263,750

## Schedule Y-2—Use if your filing status is Married filing separately

If the amount on Form 1040, line 37, is: Over—	But not over—	Enter on Form 1040, line 38	of the amount over—
\$0	\$20,050	..... 15%	\$0
20,050	48,450	\$3,007.50 + 28%	20,050
48,450	73,850	10,869.50 + 31%	48,450
73,850	131,875	18,833.50 + 36%	73,850
131,875	.....	39,722.50 + 39.6%	131,875

## Schedule Z—Use if your filing status is Head of household

If the amount on Form 1040, line 37, is: Over—	But not over—	Enter on Form 1040, line 38	of the amount over—
\$0	\$32,150	..... 15%	\$0
32,150	83,050	\$4,822.50 + 28%	32,150
83,050	134,500	19,074.50 + 31%	83,050
134,500	263,750	35,024.00 + 36%	134,500
263,750	.....	81,554.00 + 39.6%	263,750

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## Major Categories of Federal Income and Outlays for Fiscal Year 1995

On or before the first Monday in February of each year, the President is required to submit to the Congress a budget proposal for the fiscal year that begins the following October. The budget sets forth the President's proposed receipts, spending, and deficit or surplus for the Federal Government. The plan includes recommendations for new legislation as well as recommendations to change, eliminate, and add programs. After receiving the President's proposal, the Congress reviews it and makes changes. It first passes a budget resolution setting its own targets for receipts, outlays, and deficit or surplus. Individual spending and revenue bills are then enacted consistent with the goals of the budget resolution.

In fiscal year 1995 (which began on October 1, 1994, and ended on September 30, 1995), Federal income was \$1,355 billion and outlays were \$1,519 billion, leaving a deficit of \$164 billion.

### Federal Income

Income and social insurance taxes are, by far, the largest source of receipts. In 1995, individuals paid \$590 billion in income taxes and corporations paid \$157 billion. Social security and other insurance and retirement contributions were \$484 billion. Excise taxes were \$57 billion. The remaining \$66 billion of receipts were from Federal Reserve deposits, customs duties, estate and gift taxes, and other miscellaneous receipts.

### Federal Outlays

About 89% of total outlays were financed by tax receipts and the remaining 11% were financed by borrowing. Government receipts and borrowing finance a wide range of public services. The following is the breakdown of total outlays for fiscal year 1995\*:

**1. Social security, Medicare, and other retirement:** \$567 billion. These programs were about 36% of total outlays. They provide income support for the retired and disabled and medical care for the elderly.

**2. National defense, veterans, and foreign affairs:** \$326 billion. About 17% of total outlays were to equip, modernize, and pay our armed forces and to fund other national defense activities; about 2% went for veterans benefits and services; and about 1% went for international activities, including military and economic assistance to foreign countries and the maintenance of U.S. embassies abroad.

**3. Net interest:** \$232 billion. About 15% of total outlays were for net interest payments on the public debt.

**4. Physical, human, and community development:** \$128 billion. About 8% of total outlays were for agriculture; natural resources and environmental programs; transportation programs; aid for elementary and secondary education and direct assistance

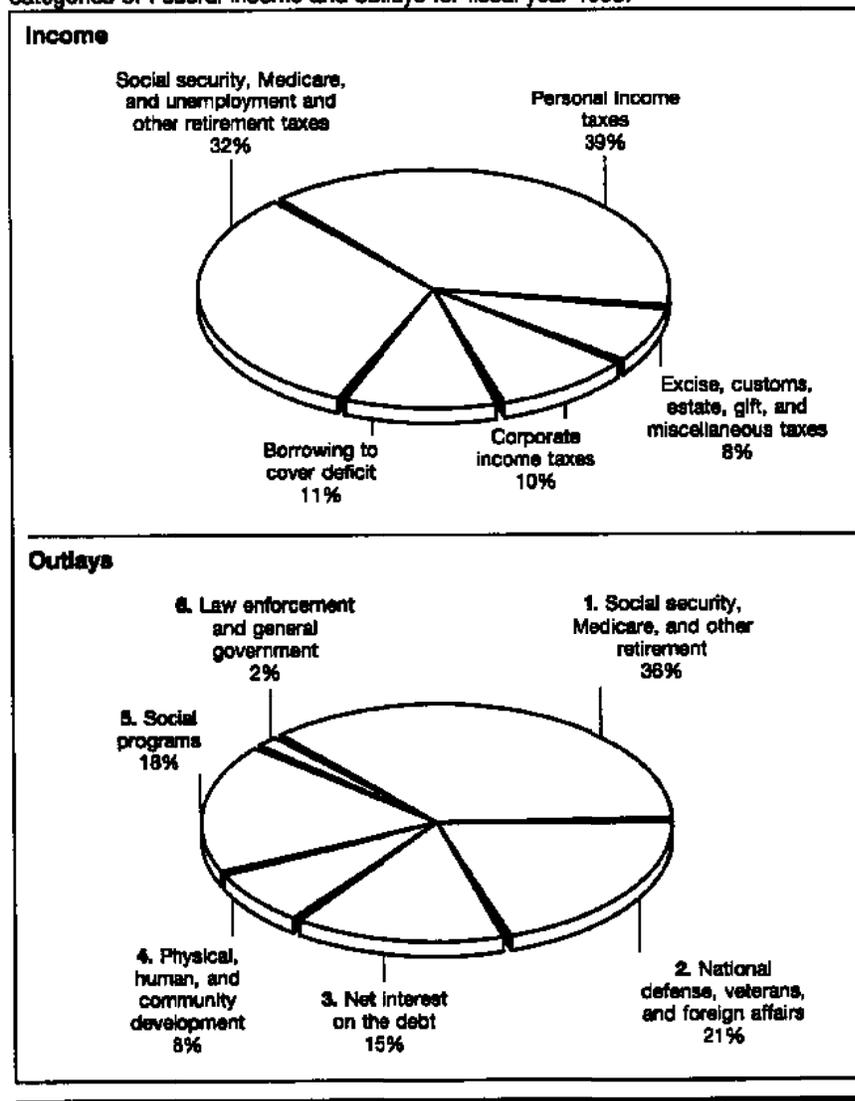
to college students; job training programs; deposit insurance, commerce and housing credit, and community development; and space, energy, and general science programs.

**5. Social programs:** \$280 billion. The Federal Government spent 12% of total outlays to fund Medicaid, food stamps, aid to families with dependent children, supplemental security income, and related programs. Over 6% was spent for health research and public health programs, unemployment compensation, assisted housing, and social services.

**6. Law enforcement and general government:** \$30 billion. About 2% of total outlays were for judicial activities, Federal law enforcement, and prisons; and to provide for the general costs of the Federal Government, including the collection of taxes and legislative activities.

*Note: Detail may not add to total due to rounding.*

**Income and Outlays**—These pie charts show the relative sizes of the major categories of Federal income and outlays for fiscal year 1995.



\* The percentages on this page exclude undistributed offsetting receipts, which were -\$44 billion in fiscal year 1995. In the budget, these receipts are offset against spending in figuring the outlay totals shown above. These receipts are primarily for the U.S. Government's share of its employee retirement programs, rents and royalties on the Outer Continental Shelf, and proceeds from the spectrum auction.

## Tax Publications for Individual Taxpayers

### General Guides

- 1 Your Rights as a Taxpayer
- 17 Your Federal Income Tax (For Individuals)
- 225 Farmer's Tax Guide
- 334 Tax Guide for Small Business
- 509 Tax Calendars for 1997
- 553 Highlights of 1996 Tax Changes
- 595 Tax Highlights for Commercial Fishermen
- 910 Guide to Free Tax Services

### Specialized Publications

- 3 Armed Forces' Tax Guide
- 378 Fuel Tax Credits and Refunds
- 463 Travel, Entertainment, Gift, and Car Expenses
- 501 Exemptions, Standard Deduction, and Filing Information
- 502 Medical and Dental Expenses
- 503 Child and Dependent Care Expenses
- 504 Divorced or Separated Individuals
- 505 Tax Withholding and Estimated Tax
- 508 Educational Expenses
- 514 Foreign Tax Credit for Individuals
- 516 U.S. Government Civilian Employees Stationed Abroad
- 517 Social Security and Other Information for Members of the Clergy and Religious Workers
- 519 U.S. Tax Guide for Aliens
- 520 Scholarships and Fellowships
- 521 Moving Expenses
- 523 Selling Your Home
- 524 Credit for the Elderly or the Disabled
- 525 Taxable and Nontaxable Income
- 526 Charitable Contributions
- 527 Residential Rental Property

- 529 Miscellaneous Deductions
- 530 Tax Information for First-Time Homeowners
- 531 Reporting Tip Income
- 533 Self-Employment Tax
- 534 Depreciating Property Placed in Service Before 1987
- 537 Installment Sales
- 541 Partnerships
- 544 Sales and Other Dispositions of Assets
- 547 Casualties, Disasters, and Thefts
- 550 Investment Income and Expenses
- 551 Basis of Assets
- 552 Recordkeeping for Individuals
- 554 Older Americans' Tax Guide
- 555 Federal Tax Information on Community Property
- 556 Examination of Returns, Appeal Rights, and Claims for Refund
- 559 Survivors, Executors, and Administrators
- 560 Retirement Plans for the Self-Employed
- 561 Determining the Value of Donated Property
- 564 Mutual Fund Distributions
- 570 Tax Guide for Individuals With Income From U.S. Possessions
- 575 Pension and Annuity Income (Including Simplified General Rule)
- 564 Nonbusiness Disaster, Casualty, and Theft Loss Workbook
- 567 Business Use of Your Home (Including Use by Day-Care Providers)
- 590 Individual Retirement Arrangements (IRAs)
- 593 Tax Highlights for U.S. Citizens and Residents Going Abroad

- 594 Understanding the Collection Process
- 596 Earned Income Credit
- 721 Tax Guide to U.S. Civil Service Retirement Benefits
- 901 U.S. Tax Treaties
- 907 Tax Highlights for Persons with Disabilities
- 908 Bankruptcy Tax Guide
- 911 Direct Sellers
- 916 Social Security and Equivalent Railroad Retirement Benefits
- 919 Is My Withholding Correct for 1997?
- 925 Passive Activity and At-Risk Rules
- 926 Household Employer's Tax Guide
- 929 Tax Rules for Children and Dependents
- 936 Home Mortgage Interest Deduction
- 946 How To Depreciate Property
- 947 Practice Before the IRS and Power of Attorney
- 950 Introduction to Estate and Gift Taxes
- 967 IRS Will Figure Your Tax
- 1542 Per Diem Rates
- 1544 Reporting Cash Payments of Over \$10,000
- 1546 How to use the Problem Resolution Program of the IRS

### Spanish Language Publications

- 1SP Derechos del Contribuyente
- 579SP Cómo Preparar la Declaración de Impuesto Federal
- 594SP Comprendiendo el Proceso de Cobro
- 596SP Crédito por Ingreso del Trabajo
- 850 English-Spanish Glossary of Words and Phrases Used in Publications Issued by the Internal Revenue Service

## Commonly Used Tax Forms

- 1040 U.S. Individual Income Tax Return
  - Sch A Itemized Deductions
  - Sch B Interest and Dividend Income
  - Sch C Profit or Loss From Business
  - Sch C-EZ Net Profit From Business
  - Sch D Capital Gains and Losses
  - Sch E Supplemental Income and Loss
  - Sch EIC Earned Income Credit
  - Sch F Profit or Loss From Farming
  - Sch H Household Employment Taxes
  - Sch R Credit for the Elderly or the Disabled
  - Sch SE Self-Employment Tax
- 1040EZ Income Tax Return for Single and Joint Filers With No Dependents
- 1040A U.S. Individual Income Tax Return
  - Sch 1 Interest and Dividend Income for Form 1040A Filers

- Sch 2 Child and Dependent Care Expenses for Form 1040A Filers
- Sch 3 Credit for the Elderly or the Disabled for Form 1040A Filers
- 1040-ES Estimated Tax for Individuals
- 1040X Amended U.S. Individual Income Tax Return
- 2106 Employee Business Expenses
- 2106-EZ Unreimbursed Employee Business Expenses
- 2119 Sale of Your Home
- 2210 Underpayment of Estimated Tax by Individuals, Estates, and Trusts
- 2441 Child and Dependent Care Expenses
- 2848 Power of Attorney and Declaration of Representative
- 3903 Moving Expenses
- 4562 Depreciation and Amortization

- 4668 Application for Automatic Extension of Time To File U.S. Individual Income Tax Return
- 4952 Investment Interest Expense Deduction
- 5329 Additional Taxes Attributable to Qualified Retirement Plans (Including IRAs), Annuities, and Modified Endowment Contracts
- 6251 Alternative Minimum Tax—Individuals
- 6283 Noncash Charitable Contributions
- 8582 Passive Activity Loss Limitations
- 8608 Nondeductible IRAs (Contributions, Distributions, and Basis)
- 8822 Change of Address
- 8829 Expenses for Business Use of Your Home

## How To Get Forms, Publications, and Other Information



You can get information from the IRS in several ways. Choose the method from the table below that is best for you.

Method	Type of Information	How To Get the Information								
• By phone	• Forms and publications	▶ Call 1-800-TAX-FORM (1-800-829-3676) during regular business hours. If you have access to TTY/TDD equipment, you can call 1-800-829-4059.								
	• Tele-Tax topics	▶ See your income tax package for the phone number and list of Tele-Tax topics.								
	• Personal assistance	▶ Call 1-800-829-1040 during regular business hours. If you have access to TTY/TDD equipment, you can call 1-800-829-4059.								
• By mail	• Forms and publications	▶ Write to the IRS Forms Distribution Center listed for your state. Print or type your name and address clearly and indicate the number of the form or publication, i.e., Form 1040 or Publication 483.  <table border="0"> <tr> <td><i>Address</i></td> <td><i>States (abbreviated)</i></td> </tr> <tr> <td>Western Area Distribution Center Rancho Cordova, CA 95743-0001</td> <td>AK, AZ, CA, CO, HI, ID, MT, NV, NM, OR, UT, WA, WY, Guam, Northern Marianas, American Samoa</td> </tr> <tr> <td>Central Area Distribution Center P.O. Box 8903 Bloomington, IL 61702-8903</td> <td>AL, AR, IL, IN, IA, KS, KY, LA, MI, MN, MS, MO, NE, ND, OH, OK, SD, TN, TX, WI</td> </tr> <tr> <td>Eastern Area Distribution Center P.O. Box 85074 Richmond, VA 23261-5074</td> <td>CT, DE, DC, FL, GA, ME, MD, MA, NH, NJ, NY, NC, PA, RI, SC, VT, VA, WV</td> </tr> </table> <p>If you live in any other location, see your income tax package for the address.</p>	<i>Address</i>	<i>States (abbreviated)</i>	Western Area Distribution Center Rancho Cordova, CA 95743-0001	AK, AZ, CA, CO, HI, ID, MT, NV, NM, OR, UT, WA, WY, Guam, Northern Marianas, American Samoa	Central Area Distribution Center P.O. Box 8903 Bloomington, IL 61702-8903	AL, AR, IL, IN, IA, KS, KY, LA, MI, MN, MS, MO, NE, ND, OH, OK, SD, TN, TX, WI	Eastern Area Distribution Center P.O. Box 85074 Richmond, VA 23261-5074	CT, DE, DC, FL, GA, ME, MD, MA, NH, NJ, NY, NC, PA, RI, SC, VT, VA, WV
	<i>Address</i>	<i>States (abbreviated)</i>								
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Eastern Area Distribution Center P.O. Box 85074 Richmond, VA 23261-5074	CT, DE, DC, FL, GA, ME, MD, MA, NH, NJ, NY, NC, PA, RI, SC, VT, VA, WV									
• Forms and publications	▶ The post office is a good source of the most common forms and schedules. The library stocks a wider variety of forms and some publications that you may photocopy. It may also have a CD-ROM from which you can view or print items. The CD contains forms from 1991 to the present and publications from 1994 to the present.									
• By visiting your local post office or library	• Forms and publications	▶ Use the Internet— <b>World Wide Web — <a href="http://www.irs.ustreas.gov">http://www.irs.ustreas.gov</a></b> <b>Telnet — <a href="http://irs.irs.ustreas.gov">irs.irs.ustreas.gov</a></b> <b>FTP — <a href="http://ftp.irs.ustreas.gov">ftp.irs.ustreas.gov</a></b> <i>TIP: If you subscribe to an on-line service, ask your provider how to best access IRS information.</i>								
	• Educational materials • IRS press releases and fact sheets • Tele-Tax topics • Answers to frequently asked questions	▶ Access the Internal Revenue Information Services bulletin board at 703-321-8020 (not toll-free).  <i>TIP: If you're a new user, you may want to read the on-line help first.</i>								
• With a computer and modem	• Forms and other information	▶ Dial 703-487-4160 (not toll-free) from your fax machine to reach IRS Tax Fax. You can request up to 3 items during each call. This fax program provides 100 of the most popular forms and instructions (not publications), as well as other information, 24 hours a day, seven days a week.								
	• Tele-Tax topics	▶ See your income tax package for a list of Tele-Tax topics.								
• By fax	• Forms and other information	▶ Dial 703-487-4160 (not toll-free) from your fax machine to reach IRS Tax Fax. You can request up to 3 items during each call. This fax program provides 100 of the most popular forms and instructions (not publications), as well as other information, 24 hours a day, seven days a week.								
	• Tele-Tax topics	▶ See your income tax package for a list of Tele-Tax topics.								

